

Treasury Committee inquiry into the inherited estates

Memorandum by Clare Spottiswoode CBE, Policyholder Advocate

A. Summary of the Key Issues underlying a Reattribution under current FSA rules

1. In a 'reattribution', an insurance company with an 'inherited estate' (a surplus built up from the under-distribution of profits derived from the investment of policyholders' premiums) offers a payment to its with-profits policyholders to buy out their interest in future distributions from that estate. My role is to negotiate with Norwich Union this "policyholder incentive payment" (PIP) on behalf of policyholders. I then produce a report to policyholders explaining whether the company's proposals are in their best interests. The FSA's rules about how companies are permitted to use their inherited estates affect policyholders' expectations about distributions they can expect from an inherited estate and therefore play a crucial role in determining the size of the PIP.
2. I was surprised to discover that insurance company managements enjoy an unusually large amount of discretion in determining what part of the return on a fund's investments should go to policyholders and what to shareholders. The FSA therefore has a particular responsibility to protect with-profits policyholders. Nevertheless, and despite the FSA's claim that the intention of its rules is that companies treat their with-profits policyholders fairly, in practice its rules, particularly about the permitted uses of inherited estates, seem to favour shareholders over policyholders. Under these rules, the size of the estate can be diminished before it is distributed and so the proportion which goes to policyholders is less than the 90 per cent which is supposed to be the norm.
3. I have requested guidance from the FSA on appropriate uses of the inherited estate. In December 2007 the FSA agreed to re-consult on whether mis-selling costs could be charged to the estate but it has not so far reconsidered some of its other rules that favour shareholders over policyholders. I believe that this is unfortunate and consider that the FSA should undertake a more wide-ranging review of its position. I would like to see a general principle adopted by the FSA that any amount not required to secure the guaranteed benefits to which policyholders are entitled should be distributed 90:10 in favour of policyholders.
4. The most important single issue is that existing FSA rules allow a degree of subsidisation of new business from an inherited estate. In response to my request for guidance, the FSA clarified its new business rules to the extent that it said that new business should not permanently erode the estate. However, a company can still hold back capital in a fund to support new business. This has the effect of delaying distributions from an inherited estate, thereby reducing distributions to current policyholders and "gifting" via "intergenerational transfers" a proportion of an estate to future policyholders.
5. As well as suppressing competition (because it gives an advantage over potential entrants to incumbents with inherited estates which can subsidise new business in this way) such action clearly disadvantages policyholders in a reattribution. The company only need offer them a payment to compensate for what they might have expected via future special distributions – which excludes the proportion of the estate "gifted" by current policyholders to future

policyholders under current FSA rules. In effect the shareholders would get the future policyholders' estate for free.

6. The company also has an incentive to forecast over-ambitious level of new business when formulating its PIP, making the question of future new business a contentious issue which complicates negotiations between the policyholder advocate and the company. The danger is that, without robust and clear guidance from the FSA to firms about the division of the estate between policyholders and shareholders in a reattribution, the reattribution offer will be unduly generous to shareholders.

B. Introduction

7. I am the appointed policyholder advocate in relation to Norwich Union's proposed reattribution of the inherited estates of its CGNU Life and CULAC with-profits funds.
8. This memorandum is submitted in advance of my appearance before the Committee on 22 April. I look forward to elaborating on it in oral evidence. The memorandum:
 - provides background information on my role as policyholder advocate in respect of Norwich Union policyholders;
 - summarises key issues that can affect the outcome of reattributions under current regulations;
 - provides answers to the Committee's questions; and
 - gives further details, in annexes from some of my advisers, on some important matters.

C. Background information

9. Under FSA rules put in place in 2005, the position of with-profits policyholders in a reattribution was strengthened by a provision that a policyholder advocate should be appointed by the company proposing the reattribution to represent the interests of policyholders. I was nominated to perform that role in respect of the proposed Norwich Union reattribution in spring 2006, following FSA approval, and formally appointed in November 2006. To assist in negotiations with the firm on behalf of policyholders, I appointed advisers on legal, economic, actuarial, tax, communications, and other issues related to the proposed reattribution, including a small group of eminent advisers (Prof. Sir Alan Budd, Sir Bryan Carsberg and Mr. Bill Knight).
10. In a reattribution, policyholders are offered a one-off payment by the insurance company (a policyholder incentive payment or PIP) in return for giving up their rights in the relevant inherited estate, in particular their right to participate in future distributions from the estate. My role, as outlined in the FSA's rules, includes negotiating with the company on behalf of policyholders the benefits to be offered to them in exchange for their rights in the inherited estate, and producing a report to policyholders telling them whether the company's proposals are in their interests. Negotiations with the company are currently in progress.

D. Key Issues

1. FSA permitted uses of the inherited estate

11. It became clear at an early stage of my negotiations with Norwich Union that the way in which firms are permitted by the FSA to use inherited estates could have a significant impact on the

level of any future distributions that policyholders could expect from an inherited estate. It would therefore potentially affect also the level of any incentive payment that the insurance company might offer to policyholders in return for their forfeiting their rights to such future distributions. I and my advisers (see, for example, Annexe 1 by Sir Alan Budd and Sir Bryan Carsberg) consider that the FSA has particular responsibilities with respect to the regulation of with-profits life assurance policies.

12. These policies are a prime example of a complex financial product which individuals purchase infrequently and about which they often lack the experience to protect their own interests. In the case of with-profits policies the degree of discretion about the management of funds is unusual in that the insurance company has been able (by exercising discretion whether and if so when to distribute surplus in the with profits fund) to decide what part of the return on investments should be attributable to the shareholders and what part to the policyholders. Such discretion involves a clear conflict of interest so that the regulator must, in our view, pay particular attention to how this discretion is exercised.
13. The FSA has said that the over-riding intention of its rules is to ensure that firms treat their with-profits policyholders fairly and that it recognises that the risks of unfair treatment are particularly acute when they arise from potential conflicts of interest within with-profits funds.
14. I and my advisers have therefore been surprised to find that the FSA rules, especially those that relate to the permitted uses of inherited estates, sometimes seem to further the interests of shareholders at the expense of policyholders, thereby effectively distributing the surplus in a fund in a ratio more favourable to shareholders than the normal 90:10 rule. That is because the size of the 90:10 distribution of surplus is first reduced by using the estate in ways that favour shareholders. For that reason, in August 2007 I requested guidance from the FSA.
15. I was disappointed that in its December 2007 response, whilst the FSA stated its intention to re-consult on whether mis-selling compensation costs should be charged to the inherited estate, it did not consider it necessary to reconsider some of its other rules and guidance which, in my view, clearly favour shareholders over policyholders.
16. One such rule which I believe the FSA should change relates to the permitted use of inherited estates to pay shareholders' tax (see Annexe 2 by my adviser, Chris O'Brien, University of Nottingham). I have asked the FSA to explain further its stance on this issue and I await its response.
17. More generally, I and my advisers consider the FSA should adopt a general principle that would require that an inherited estate is subject to the same discipline as the rest of the with-profits fund. That is, it would contribute to securing the guaranteed benefits to which the policyholders are entitled and any amount that was not required for this purpose would be distributed in the normal ratio of 90:10. Such a general principle would preclude the use of inherited estates in ways that favoured shareholders' interests over the interests of policyholders.

2. New with-profits business and FSA rules

18. In my view, one of the most controversial permitted uses of an inherited estate is the subsidisation of an insurance company's new with-profits business. Depending on the scale of the firm's forecast new business, it has the potential to reduce greatly the amount that current policyholders can expect to be distributed from an inherited estate. It is an issue which presents particular difficulties in a reattribution.

19. The FSA's December 2007 guidance letter says that an inherited estate should not be used to subsidise new business such that it permanently erodes the estate over time. However, the FSA does continue to permit the 'intergenerational transfer' of estate between policyholders by allowing a firm to hold back capital in a fund to support new business. This could otherwise be distributed in special bonus to current policyholders. In the absence of a reattribution this rule has the effect of transferring estate capital to future policyholders from current policyholders. It is also anti-competitive since it enables an incumbent with-profits firm with an inherited estate (invariably created by the under-distribution of profits built up from the investment of policyholders' premiums) to subsidise its new business in a way which other firms (without inherited estates) are unable to do.
20. However, in the context of a reattribution, the FSA's ruling on permitting capital to be held back to support new business can be particularly disadvantageous to policyholders. That is because the rule creates the peculiarity that the company, in order to make a policyholder incentive payment worthwhile to current policyholders, only needs to offer to compensate them for the value of the estate which they themselves might expect to receive by way of special future distributions. This means that in the absence of a reattribution the estate which would have been 'gifted' by current policyholders to new policyholders could potentially be transferred to shareholders for free unless the FSA intervenes to ensure a fair outcome.
21. The FSA's new business rules are particularly unfortunate because the firm has an incentive to forecast overly ambitious levels of new business when formulating its policyholder incentive offer. I have asked industry experts for advice on likely trends in the with-profits market in the future. I attach as Annexe 3 a summary report compiled by Cazalet Consulting. The analysis suggests that:
- with-profits policies will continue to appear unattractive to potential purchasers compared with other financial products
 - a continuing fall in with-profits sales seems more likely than a recovery
 - the AXA post-reattribution new business levels suggest it is unlikely a company will continue to write the same level of new business after a reattribution as it predicts before a reattribution.
22. However, it remains a fact that it is not possible to forecast new with-profits business with any degree of certainty. Reattribution negotiations have to consider a wide range of possible new business forecasts and without FSA intervention the outcome will be strongly influenced by these assumptions. As noted above, this could result in a reattribution offer that is unduly generous to shareholders, unless the FSA gives robust and clear guidance to firms as to how the proportion of the estate that in the normal course of events could be distributed to future policyholders should be divided between current policyholders and shareholders in the event of a reattribution.

3. The FSA's assessment of fairness review and transparency of process

23. Because of its significance, I asked the FSA to give specific guidance as to how the proportion of the inherited estate, which, under FSA new business rules, is projected to be passed without compensation to future policyholders, should be treated in a reattribution. In recent correspondence, the FSA chairman said that this tranche of capital has a value attached to it and so should be included in the negotiated payment made by the shareholder. The FSA Chief Executive similarly confirmed that, in negotiating with the firm, I should take into account the value shareholders will unlock from the *whole* of the inherited estate by its reattribution.

24. However, as Mr. Bill Knight points out in Annexe 4 to this evidence, whilst the policyholder advocate negotiates the PIP offer with the company and then makes her views known to policyholders, the formulation of the offer is a matter for the company. The policyholder advocate has no power to affect the terms of the offer, save that of persuasion. Moreover, the directors of the company which makes the offer have a duty to act in good faith in what they believe to be the interests of the company, which can also be described as a duty to act in the interest of the general body of shareholders. The FSA's own consideration of the fairness of a firm's reattribution offer, in the light of views expressed both by the firm and by the policyholder advocate, is therefore of particular importance.
25. The FSA usually makes its report on the fairness of a reattribution scheme available to the court which is required to give or withhold sanction for the scheme. Mr. Knight suggests that the FSA should either make, or commission, an assessment of any reattribution offer before it is made to policyholders and, if the company then decides to proceed, the assessment should be published and full reasons should be given.
26. As a matter of good practice, I will be publishing a detailed report which will be available to policyholders and other interested parties. I have therefore particularly welcomed the FSA's recent statement that it will "make public its conclusion on what fair treatment would require for consumers" in a reattribution and that the FSA expects to publish what it perceives as a "reasonable range" for any reattribution payment.

4. Policyholder communications

27. The normal process for a reattribution is that the company makes an incentive payment offer to policyholders to give up their rights to future special distributions from the inherited estate. A court then sanctions the arrangement under Part VII of the Financial Services and Markets Act 2000.
28. The policyholders decide whether or not to accept the company's offer. There is no policyholder meeting, but the FSA requires that policyholders be given the choice whether to accept the incentive payment or to reject it and maintain the status quo. The effect of the court sanction of the reattribution scheme is to prevent any policyholder who does not accept the PIP from subsequently challenging the scheme.
29. As policyholder advocate I have sought to communicate frequently with policyholders, including seeking their views in an open and constructive way (see Annexe 5, provided by my director of communications). This communication with policyholders has been particularly important since Norwich Union's proposed reattribution is the first since the FSA established the role of policyholder advocate.
30. It was clear from the outset that it would take time to obtain all the necessary information and to examine all the issues that can affect a fair outcome of a reattribution for policyholders. It was also almost inevitable that further clarification of the FSA's stance on the rules pertaining to a reattribution would be required, given that it is the first since the FSA's new with-profits rules were put in place in 2005. In order to communicate properly with policyholders and to be accountable to them, I have held open meetings, written twice to each policyholder, established call and correspondence centres to answer queries, and also communicated often via the internet.
31. It has been plain in my contact with policyholders that the complex nature of the with-profits product means that clear communication is essential with 'industry jargon' kept to a minimum. It

has also been clear that there is little understanding among policyholders about the uses to which the inherited estate can be put and that much greater openness from the industry is essential if Treating Customers Fairly is to be meaningful.

E. Answers to the Treasury Committee's questions

32. Following are brief answers to the questions on which the Treasury Committee has particularly requested written evidence. These answers complement the discussion of key issues in my Memorandum to the Committee.

The regulatory definition of the inherited estate in a with-profits fund.

33. The FSA defines the inherited estate as “an amount representing the fair market value of the with-profits assets less the realistic value of liabilities of a with-profits fund”. At the end of 2004 the FSA required companies with with-profits funds to calculate their “realistic balance sheet” for the first time as part of their annual solvency returns. The regulatory changes were designed to measure the true economic solvency of the fund. Under the regulations the realistic value of the fund’s assets are the market value of the all the investments held. The realistic liabilities include a retrospective assessment of the liabilities to policyholders based on the experience and management of the fund up to the valuation date and a prospective assessment based on the projected future experience and management of the fund. The excess capital in the fund (“the inherited estate”) is then the difference between the realistic assets and the realistic liabilities.
34. The term “realistic balance sheet” could create an artificial impression of the precision of the calculation, which in practice relies on sophisticated actuarial valuation techniques and are inevitably based on a series of assumptions. The policyholder advocate’s advisers consider that published realistic value of liabilities, calculated in accordance with FSA requirements, are a prudent valuation of the liabilities and that some adjustments are appropriate to establish an estate valuation which is more relevant as a starting point for a reattribution.

The extent to which life assurance companies should be permitted to diminish inherited estate in order to subsidise corporate activity, including financing new business, making strategic investments, paying shareholder tax and paying the costs of compensation for mis-selling.

35. If certain costs are not allowed by the FSA to be charged to policyholders’ asset shares, then they should not be able to be charged to inherited estates. An inappropriate charge to asset shares could be expected to have a detrimental effect on policyholders’ reversionary (annual) or terminal (final) bonuses. A charge to the inherited estate will have a similar outcome, in that it could reduce the value of policyholders’ special bonuses from distribution of the inherited estate. It is difficult to see how different uses of the inherited estates, as compared to the remainder of the with-profits funds, can be justified. If an insurance company seeks to use an inherited estate in ways that benefit shareholders over policyholders, and is not prevented from doing so by the FSA, this in effect circumvents the 90:10 Ministerial rule on distributions, since it artificially reduces – in ways that benefit shareholders – any ‘excess surplus’ that would have otherwise been available for 90:10 distributions.

Whether allowing life assurance companies to use inherited estate to subsidise corporate activity has any adverse effects on competition.

36. An important factor inhibiting new entry is that incumbent firms writing new with-profits business which have inherited estates have a cost advantage over other providers and would-be new entrants that is anti-competitive. This is because they are allowed by the FSA to use the

inherited estate to pay costs such as mis-selling compensation costs and shareholder tax, and also to provide capital to support new business. Inherited estates can therefore distort competition and lead to inefficient capital allocation. While it may ordinarily be that capital should not be a barrier for new entrants – who should be able to raise capital if the new business is profitable – this would mean putting shareholders' capital at risk in a way that does not apply to existing firms with inherited estates, where most of the risks can be borne by the inherited estate. There have been very few new entrants to the market in recent years. Only one firm writing with-profits business has been established since 1995: Pension Annuity Friendly Society. The top four with-profits companies, by market share, in 2006 were: Prudential (28.3%), Aviva (20.0%), Standard Life (9.3%), and Legal and General (6.2%). The Prudential's market share grew from 20.2 per cent in 2003 to 31.5 per cent in 2005. Aviva's market share has grown from 7.6 per cent in 2004 and 13.6 per cent in 2005. Aviva and Prudential have substantial inherited estates, while Legal and General also has a small inherited estate. (Source: Chris O'Brien, from FSA returns).

The principles that should guide the division of inherited estates in 90:10 funds between policyholders and shareholders upon reattribution of the estate.

37. The starting point for any reattribution proposal should be 90:10, according to the chief executive of the FSA, Hector Sants, in a letter to me dated 7 February 2008. I therefore consider that any reattribution offer must both exceed what current policyholders are giving up in terms of their expected future distributions and ensure that they also receive a fair proportion of the estate which, under FSA rules, would have been distributed to future policyholders. Otherwise the shareholders would be getting the future policyholders' proportion of the estate for free which would provide shareholders with an unfairly high rate of return from the reattribution, and would not represent fair treatment for policyholders. The FSA agrees that in a reattribution there is a value to be placed on the proportion of the estate which would have gone to future policyholders.

The appropriate sharing of inherited estate between current and future policyholders.

38. As noted above the FSA rules permit the estate to be used to provide capital subsidy for new business, thereby transferring a proportion of the inherited estate from one generation of policyholders to another. This means that under FSA rules the proportion of the inherited estate distributed to current policyholders rather than future policyholders depends on the level of new business which the firm is forecasting. In a reattribution, more significantly, this intergenerational transfer will no longer occur. This is because the company's PIP offer to policyholders is for the whole inherited estate. I asked the FSA how the tranche of inherited estate which would otherwise fall to future policyholders should be treated in a reattribution. In response a letter from Sir Callum McCarthy on 1 February 2008 confirmed that the future policyholders' tranche of capital has a value attached to it and so should be included in the negotiated payment. Mr. Sants similarly confirmed, in his letter of the 7 February 2008, that in negotiating with the firm a policyholder advocate should take into account the value shareholders will unlock from the *whole* of the inherited estate by its reattribution.

Whether policyholders' reasonable expectations of distributions from inherited estate should be zero or have a positive value.

39. On 22 January 2008 at an evidence session with the Treasury Select Committee the chief executive of the FSA confirmed that since FSA rules require firms to distribute excess capital in inherited estates as the excesses arise, then companies with inherited estates can no longer claim that policyholders' reasonable expectations of a special distribution are zero. This guidance

should ensure that any incentive payment offered by a company in a reattribution has proper regard to the quantifiable future surpluses that are likely to be generated by the fund and distributed as special bonuses to policyholders. This clarification therefore has a very positive benefit to policyholders in that it should prevent a company from offering them very little for giving up their rights in an inherited estate, on the basis that any offer should be regarded as a “windfall”.

Whether any distribution of benefits from the inherited estate should be made in a single payment or phased over several years.

40. The money should be fully distributed once it has been deemed as excess to the requirements of the fund. A staged distribution discriminates against policyholders who have been in the fund for longest and whose policies will naturally mature at some point during the phasing period. Staging the payments also could be seen as anti-competitive, and would appear to be in contravention of the FSA requirement that “Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim, or make a complaint”¹.

The role and responsibilities of the Policyholder Advocate.

41. The FSA rules which established the role of the policyholder advocate came into effect in 2005, and followed the AXA reattribution in 2000, the outcome of which was widely seen to be unfair to policyholders. The rules require a company to appoint a policyholder advocate if there is to be a reattribution. As noted in the FSA rules, the precise role of the policyholder advocate will depend on the type of firm concerned and the nature of the reattribution. However in general terms the policyholder advocate negotiates the aggregate value of the PIP offer with the company and other terms and conditions and then makes his or her views known to policyholders. It is important to note however that the policyholder advocate has no power to affect the terms of the offer except that of persuasion. It is the FSA which formally considers the fairness of the reattribution proposals, although it has said that it will have regard to the views of the policyholder advocate in this regard. The FSA would be expected to make a report to the court which considers whether it is appropriate to sanction the reattribution scheme, if it is made under Part VII of the Financial Services & Markets Act 2000, as is Norwich Union’s proposed reattribution.

The framework for negotiation between the Policyholder Advocate and the life assurance companies.

42. It is the company that makes the PIP offer in a reattribution, and the company that can withdraw an offer at any time during the process of negotiations with the policyholder advocate if it sees fit. In this sense the policyholder advocate has effectively no power to affect the terms of an offer, or to insist that an offer be put to policyholders. However the FSA has taken steps within its rules to ensure that the policyholder advocate is independent and well resourced and properly supported by advisers in his or her negotiations on policyholders’ behalf with the company. The policyholder advocate is therefore well equipped to analyse carefully a firm’s offer to consider whether any aggregate PIP offer is fair and whether it should be put to policyholders. The FSA made clear in its December 2007 guidance letter that the policyholder advocate can challenge any part of the operation of the with-profits fund in the course of negotiations with the firm. The FSA also made clear that if the policyholder advocate does not believe that the proposals are in the interests of policyholders, he or she should make that conclusion clear and communicate it to policyholders.

¹ The FSA has defined six outcomes for consumers which summarise what it wants “Treating Customers Fairly” to achieve, of which this is the sixth.

The role of the with-profits committees of life assurance companies.

43. I consider that a truly independent with-profits committee can in theory play a useful role in policing conflicts of interest and protecting policyholders' interests. Independence requires, in our view, that no member of a committee is an employee (or ex-employee) of the company and a very clear rule that the committee's role is to act in the interests of policyholders alone (and if for shareholders at all, then only to the extent of their pro rata interest in the relevant fund). However, we are sceptical as to their effectiveness as a practical matter. The asymmetry of information and resources (including time) as between committee members and the company is stark. I have witnessed at first hand the extent to which there is "devil in the detail" and how long it takes to gain an adequate understanding of models, and the implications of the results they produce. Even more important, however, is that the extent of the conflict of interest under the current rules regime is extreme, and the absence of clear principles by which to reach consistent judgments on what constitutes a fair resolution of those conflicts leaves far too much scope for subjectivity and inconsistency.

The approach of the Financial Services Authority to the issue of inherited estate.

44. The FSA began its with-profits review in 2001, the outcome of which established the role of the policyholder advocate and also, amongst other things, set out rules relating to the uses of the inherited estate. Since my appointment as the policyholder advocate in the Norwich Union proposed reattribution, the FSA has given further guidance on the uses of the inherited estate and some indication of its position as to what conditions need to be met in order for a reattribution offer to be considered fair to policyholders. However the FSA's rules still favour shareholders over with-profits policyholders in some instances. I and my advisers consider that the FSA should adopt a general principle that would require that an inherited estate is subject to the same discipline as the rest of the with-profits fund. Such a principle would preclude the use of an inherited estate in ways that favoured shareholders' interest over the interests of policyholders. If the FSA decides that the current rules should remain in place, then it is imperative that the FSA provides clear rules to ensure that in a reattribution shareholders offer a fair price to policyholders for the proportion of the inherited estate which, without a reattribution, would pass to future policyholders. If the FSA does not change its rules on the uses of the inherited estate or give robust guidance as to its position in a reattribution, then it is much less likely that a policyholder advocate will be able to negotiate a reattribution offer that is fair to policyholders and not overly generous to shareholders.

Annexe 1: Regulation and the role of the FSA

Note to Treasury Committee by Sir Alan Budd and Sir Bryan Carsberg

1. Introduction

45. We are members of a small group of advisers to the policyholder advocate who is acting on behalf of policyholders in relation to a proposed reattribution of life assurance funds by Norwich Union. This note sets out certain views that we have formed in the course of our advisory work on the regulatory framework for life assurance.

2. Competition and Regulation

46. There is a general principle that free competition between actual and potential suppliers is the best way of meeting consumers' preferences and providing goods and services efficiently. Regulation of markets may be needed when the markets concerned are not producing effective competition. However, regulation can inhibit competition if it imposes significant compliance costs on suppliers and raises barriers to entry. Therefore regulation should be proportional and limited to cases in which free markets are likely to fail. It should also focus first on promoting effective competition, by improving the information available to participants and in other ways, and resort to specific controls only where competition cannot be made effective.

47. Regulation can be justified in the case of sales of financial products in retail markets. The justification is that individuals who purchase financial assets often do so infrequently and lack the experience to protect their own interests in what can be complex transactions whose consequences are both uncertain and delayed. There is a considerable risk of "asymmetric information" – that is, the information available to the buyer about the consequences of a transaction is much smaller than the information available to the seller. In many cases, the uncertainty of the outcome is inevitable because of the nature of the associated investments. However, regulation should, as far as possible, ensure that purchasers are aware of the risks involved and it should also seek to remove or reduce certain types of risk associated with the liquidity or solvency of the supplier. The one-off nature of many transactions (even where they involve a commitment to a future stream of payments and receipts) adds to the problem that the products are themselves often highly complex.

48. The challenge to the Financial Services Authority in balancing the benefits of competition with the need to protect the consumer is recognized in the first two of the FSA's tasks that it sets out as conducive to meeting its objectives:

- (i) promoting efficient, orderly and fair markets; and
- (ii) helping retail consumers achieve a fair deal.

3. With-profits products

49. The FSA has particular responsibilities with regard to the regulation of with-profits life assurance policies. Here is a long-term savings product, which purchasers will, presumably, be purchasing to provide a lump sum when it is needed at some time in the future and perhaps to provide income at a time when income from employment will fall or cease. One might expect certainty and security to be prime considerations. However, purchasers are encouraged to undertake some risks in the expectation of higher returns. "With risks policies" might have been a better

label than “with profits policies” but investors should understand that the “profits” are earned because the premiums that they pay for their policies are partly being used to buy equity shares and other risky assets. At the same time there is some offer of certainty through the guaranteed payment to the policyholder at the end of the term of the policy or at earlier death. And the risks associated with returns above the guaranteed minimum can be reduced in two main ways: through the choice of assets purchased by the provider on behalf of the customer and by smoothing returns between cohorts of investors. The latter can only smooth out fluctuations around a trend; it cannot remove the risk that returns on investments fall permanently.

50. Life assurance companies need to build up a fund to meet their obligations under life policies. They need a fund to make reasonably sure that they can meet the guaranteed minimum payments on policies, including where the policyholder dies prematurely, even if the value of investments held by the fund has declined, and they need a fund to undertake the smoothing of returns. It is important for a regulatory authority to ensure that reasonable steps are taken to enable prospective policyholders to understand this and the terms on which distributions will be made to policyholders in the form of additions to the values of their policies. They should be informed about the extent of any discretion granted to the managers of the fund over distributions.
51. Discretion in the use of asset management usually means that funds can be managed, and assets bought and sold, without reference to pre-established rules and without reference to or permission from the person on whose behalf the funds are being managed. Policyholders may be familiar with that kind of discretion and will assume that such discretion is being exercised in their interest. In the case of with-profits policies, however, the degree of ‘discretion’ is unusual: the insurer has been able to exercise discretion in determining what part of the return on investments should be attributable to the shareholders and what part should be attributed to the policyholders. Such discretion involves a clear conflict of interest. Since competitive forces, which might have protected the policyholder, are weak in this part of the financial industry for the reasons we have described, the regulator must, in our view, pay particular attention to how this discretion is exercised.
52. The possibility of the use of discretion in this sense and the fact that life assurance is a complex product leads one to expect that the FSA will be particularly vigilant on behalf of the retail customers.

4. Economic principles of regulation

53. The framework for regulation outlined above leads to the conclusion that an important function of regulation is to deal with conflicts of interest between policyholders and suppliers, in a way that protects customers: uncontrolled conflicts of interest prevent the market from working with maximum efficiency.
54. As mentioned above, one potential conflict arises in relation to the level of distributions from a life fund. Distributions are divided between policyholders and shareholders in a fixed ratio that is communicated to policyholders. The normal ratio is 90:10 although this can be varied by agreement between the parties. If an insurer can accumulate funds out of interest, dividends and other earnings from investing premiums paid by policyholders, by limiting distributions, and, at some time, declare that it has a larger fund than is needed; and if it can then undertake a reattribution in relation to the surplus in the fund and distribute it in a ratio more favourable to shareholders than the 90:10 rule, then the insurer will have an incentive to limit regular distributions so as to have a large sum for reattribution. The FSA should set actuarial limits to the amount that can be accumulated in a with-profits fund, having regard to the guaranteed

minimum payments on policies, and require any remaining surplus to be distributed 90:10. An alternative would be to allow the firm to choose what practice it will follow, subject to the requirement that its practice must be clearly agreed with policyholders as part of their contracts. (This would apply to new policyholders - the regulator would still need to take action for existing policyholders who made no such agreement.) We understand that the FSA takes the view now that insurers should not be allowed to accumulate life funds that are surplus to actuarial requirements. To be effective, that view needs to incorporate actuarial rules for determining a surplus. Evidently such surpluses have not been prohibited in the past, otherwise the large surplus funds currently being considered for reattribution would not have arisen. The proportion in which reattributed funds should be divided should also be decided by the regulator. One cannot expect a fair outcome to be reached by negotiation when the insurer can simply retain the funds without any regulatory sanction.

55. An insurer will need to hold an amount in the life fund, over and above the amount required to ensure that guaranteed minimum payments on policies can be made, in order to meet its objectives for smoothing income. Here, too, there is a conflict. Here too the FSA should set a limit to the amount that can be retained for income smoothing or require that the procedure should be agreed as part of the initial contract for life assurance.
56. A second potential conflict arises in relation to charges against the life fund of expenses that should be borne by shareholders. Examples are fines and expenses that the insurer is required to bear in relation to mis-selling. It seems simply unacceptable that such expenses should be borne by the life fund and regulators should ensure that they are not.
57. A third potential conflict may arise in relation to new business. At one stage members of the industry used the with-profits life fund to *subsidise* new business. This was clearly unfair to existing policyholders. It may be acceptable for the life fund to be used to finance new business, where such business involves net cash outlays followed by net inflows, provided that the pricing of the business is set to achieve at least break-even over its lifetime. Financing new business would not be inconsistent with fairness to existing policyholders, as long as the cash needed is not deducted in determining the amounts available for distribution to existing policyholders.
58. An effectively competitive market would tend to ensure that the conflicts described above were resolved in ways that were not detrimental to policyholders. This would be brought about by the insurer's making explicit and clear promises in the contract agreed with policyholders. To the extent that competition in with-profits assurance is not fully effective in relation to the way firms use the inherited estate and distribute surplus funds, then effective economic regulation is needed to protect policyholders' interests.
59. In addition to specific rules to deal with the conflicts described above, a regulatory principle which prevented undue discrimination/preference as between groups of policyholders and between policyholders and shareholders could help to bring about the desired competitive outcome. Such a principle would require that an inherited estate was subject to the same discipline as the rest of the with-profits fund, that is it would be used to secure the guaranteed benefits to which the policyholders are entitled and would thereafter be distributed in the normal ratio of 90:10. If the regulatory regime was to establish clearly, by way of such a general principle, that shareholders were not able to benefit from inappropriate uses of an inherited estate (uses that had detrimental effects on policyholders) then a firm's incentives in relation to the making of distributions would also be more correctly aligned. This is because, in these circumstances, a firm would have less reason to under-estimate the potential of or postpone the possibility of distributions. In the absence of more profitable alternatives (that is, the use of the inherited estate to give undue preference to shareholders), it would be in shareholders' interests

to make calculations about possible distributions as accurately as possible. Such a principle would also better facilitate competition between with-profits insurers with or without inherited estates, since shareholders would no longer be able to use funds that would otherwise be distributed 90:10 to subsidise new with-profits business.

5. The FSA's guidance on reattribution.

60. In a letter dated 6 December, the FSA accepts that in a 90:10 with-profits fund, such as the Norwich Union funds, any surplus is to be distributed 90 per cent to policyholders and 10 per cent to shareholders. Given the particular features of with-profits policies, as described above, one looks for strong and convincing arguments for any departure from this principle. As the letter says, "It is for firms, and their senior management in particular, to manage their business effectively, including treating customers fairly, managing conflicts of interest and maintaining adequate systems and controls and financial and other resources."
61. The letter describes, in particular, FSA policy on four issues, of which two have especially exercised the advisers to the policyholder advocate, namely financing new business and paying mis-selling compensation costs (that is, the costs of compensating policyholders who are judged to have been misled when they purchased their products) from the inherited estate. As noted above, at one stage members of the industry used the inherited estate to *subsidise* new business. Fortunately the FSA letter appears to reject this practice. We do not believe that there are any arguments that could be used to justify such a use of the funds since it would clearly be contrary to the interests of the policyholders. However the letter does say that it is acceptable to use the inherited estate to meet the set-up costs of new with-profits business "provided the business is managed with a view to recovering those costs, and repaying them to the inherited estate, over a reasonable period". On the face of it, that may seem reasonable but it means that special steps have to be taken to ensure that policyholders whose policies mature before the set-up costs of new business have been recovered are not disadvantaged. In the negotiations on the Norwich Union reattribution, the company has presented estimates of the capital required for new business based on its own forecasts of new business and on the assumption that the capital concerned would be provided out of the inherited estate. Quite apart from the question of whether those estimates are reasonable, there is the far more important point that the effect is that the sum available for reattribution is at the discretion of Norwich Union. As will be clear from our earlier comments on discretion, we consider that is precisely the sort of discretion that should be avoided. It is difficult to believe that policyholders realized, at the time they invested in with-profits funds, that the insurer would be able, at its own discretion, to keep part of the fund to finance the start-up funds of new business. This goes far beyond any reasonable concept of smoothing.
62. In relation to mis-selling compensation costs, the FSA say that they decided, in 2003, to allow insurers to charge such costs to the inherited estate. However, in the light of the strength of views put to them more recently, they think that "it is appropriate to invite further consideration of the issue of charging mis-selling costs". We do not think that there is room for difference of opinion regarding what the outcome should be.

Annexe 2: Shareholders' tax

Note to Treasury Committee by Chris O'Brien, Director, Centre for Risk and Insurance Studies, Nottingham University Business School

63. The note considers the extent to which life assurance companies should be permitted to diminish the inherited estate by paying shareholder tax (being one of the subjects in the invitation to submit written evidence to the Committee).

64. This note concludes that the FSA should prohibit life assurance companies from using the inherited estate to pay shareholders' tax. We appreciate that any rule change will involve a consultation with interested parties.

65. The taxation of life assurance companies is complex, but the main points are:

- On pensions business:
 - the income and capital gains of companies are not subject to tax;
 - the part of the surplus attributable to shareholders (which is typically 10 per cent for with-profits business) is subject to tax at the usual corporation tax rate (28 per cent).*
- On life assurance business:
 - the income and capital gains of companies are subject to tax at a lower policyholder rate of 20 per cent;
 - and further tax is payable on the part of surplus attributable to shareholders, because the usual corporation tax rate applies to this, which exceeds the lower rate for policyholders. *
- (* The asterisked parts of the tax bill are known as "shareholders' tax".)

66. Who pays this shareholders' tax? It could be:

- deducted from the asset shares of policyholders, leading to lower distributed surpluses and bonuses than otherwise, meaning that the shareholders' tax is effectively borne 90 per cent by policyholders and 10 per cent shareholders;
- deducted from the amount of surplus transferred to shareholders, i.e. the shareholders pay the tax; or
- paid from the inherited estate.

67. We regard it as appropriate for shareholders' tax to be paid by shareholders, not policyholders, because:

- this tax is payable as a direct result of part of the surplus being attributable to shareholders (and is not payable by mutual life assurance companies).

- The tax rate applied is the usual rate of corporation tax payable by companies, not the rate applied to policyholders; and
 - certainly in the case of pensions, companies have generally marketed these policies as free of tax to policyholders.
68. We believe that the tax should not be paid from the inherited estate because this means it is being largely borne by policyholders:
- policyholders would have lower expectations of receiving future payments from the inherited estate (we add that FSA has accepted that policyholders have a non-zero interest in the inherited estate); and
 - by reducing the strength of the fund, it reduces policyholders' security and may lead to a more conservative investment strategy than would otherwise be the case, potentially to policyholders' detriment.
69. FSA reviewed this topic as part of its with-profits Review. They introduced a rule in 2004 which prohibited companies from charging this tax to asset shares, but allowed companies to charge the tax to the inherited estate provided this has been their past practice and is explained in their Principles and Practices of Financial Management (PPFM) document.
70. Many companies use this to justify charging shareholders' tax to the inherited estate, although some companies do charge shareholders' tax to shareholders.
71. We regard the rule as unsatisfactory. We expect shareholders to pay shareholders' tax, and this cannot be justified by companies having used the inherited estate to pay it in the past. We cannot expect policyholders to accept this as part of the contract just because a company has referred to it in its PPFM: many contracts began before PPFMs were first issued in 2004; and most policyholders have not read the PPFM (or would not understand the significance of this point if they had). Policyholders may have read the Consumer-friendly version of the company's PPFM, but this may make no reference to shareholders' tax.
72. FSA did not explain, in their consultation, why they adopted this stance. Recent FSA statements suggest some reasons:
- (1) Hector Sants, in his statement to the Treasury Select Committee on 22 January 2008, said, "as part of an open-ended process it is reasonable to charge those types of costs that you have alluded to, to do with new business and tax, because a vibrant and successful fund is to the advantage of policyholders in the long term."
 - However, charging shareholders' tax to the inherited estate for new business means that new business is being subsidised, which Hector Sants indicated to the Committee its rules did not permit;
 - the statement may suggest FSA would not allow shareholders' tax to be charged to the inherited estate in a closed fund, but its rules do not prohibit this.
 - (2) David Strachan, in his letter of 6 December 2007, said this rule was introduced "to avoid policyholders suffering any deductions from their benefits, while preserving a change in the tax law."

- However, we have been unable to establish what change in tax law this was and have asked FSA to clarify this.

73. Indeed, FSA has referred to the decision to allow companies to charge shareholders' tax to the inherited estate as a "concession" (as described in Consultation Paper 04/14, August 2004, Annexe 4, page 4). The consultation process about the new rules in 2003-05 was unsatisfactory, with no real explanation of why it adopted its position and no feedback on the objections.

74. We have therefore been urging FSA to review its position on shareholders' tax. While FSA has stated that it had previously consulted on the subject, we wish to see a new consultation, which takes into account the need to protect policyholders' interests, rather than simply make a concession to the industry and shareholders' interests.

Annexe 3: With-Profits: Commentary for the policyholder advocate



Note to Treasury Committee by Cazalet Consulting

1. Introduction

75. This paper is an abbreviated version of a more extensive paper produced for the policyholder advocate by Cazalet Consulting concerning the future of the with-profits business, in particular relating to the Norwich Union reattribution. It examines the future of with-profits business in the UK, by investigating whether there is a fundamental market for with-profits products, and whether with-profits is a unique investment format. Finally, it examines the writing of new business after a reattribution, via the AXA reattribution, concluding that:

- there is no fundamental market for with-profits;
- sales of products in with-profits format have been markedly unpredictable from time to time, and in recent years have generally been in sharp decline;
- while with-profits may be capable of providing investors with access to risk assets at the same time as providing downside protection and/or guarantees, nowadays this is not the only format that can provide such a combination. Increasingly providers are now actively developing and marketing “third-way” with-profits alternatives; and
- revisiting the AXA reattribution with the benefit of hindsight, it can be seen that projection of future with-profits new business levels from recent experience can be fraught with difficulty. In the case of AXA the actual post-reattribution with-profits new business levels achieved turned out to be very considerably below expectations at the time of the transaction, meaning that the capital requirements for such business were far in excess of what turned out to be needed.

2. No Fundamental Market

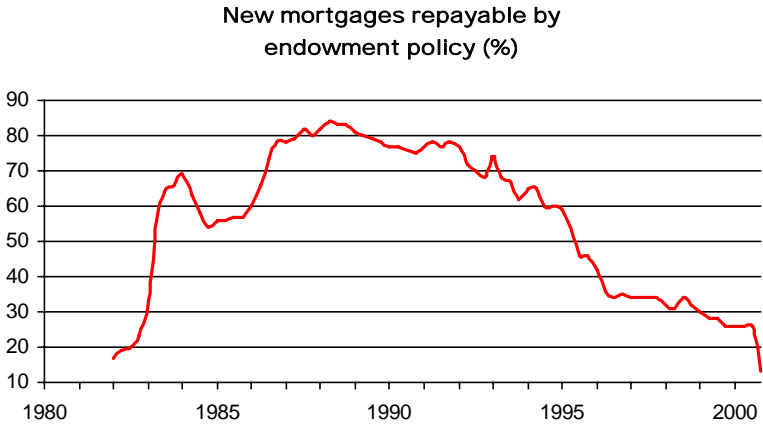
76. The vast bulk of the business that is written by or in-force within UK life assurance companies is savings or investment related. We think that it is demonstrably the case that, as a whole, life assurance companies have had no consistent product base and that, accordingly, making long term future extrapolations of new business volumes in most cases is a highly speculative activity.

77. We do not think that with-profits should be regarded as a “product type”, but rather as an investment format, and we do not think there is any fundamental market for with-profits, by which we mean that with-profits is not a financial necessity.

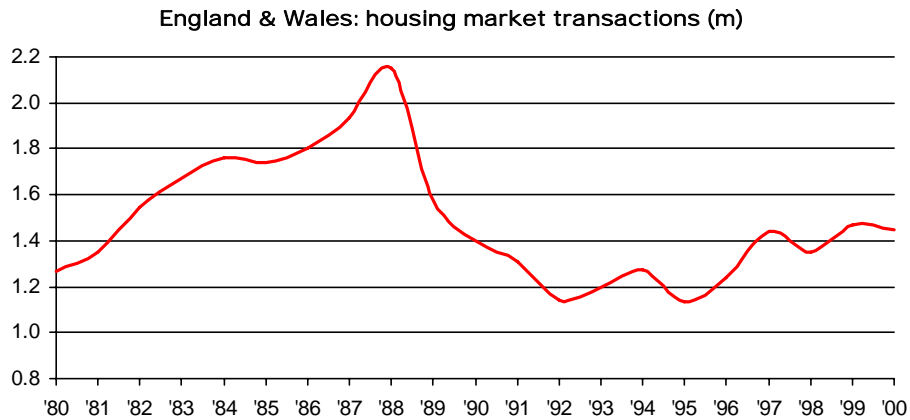
Example – endowment policies

78. For a period in the 1980s and 1990s, the main product line of the UK life industry was the mortgage endowment policy – a regular premium savings plan, most commonly in with-profits format. What appeared a core product line subsequently was almost totally wiped out during the space of a few short years as far as new business was concerned.

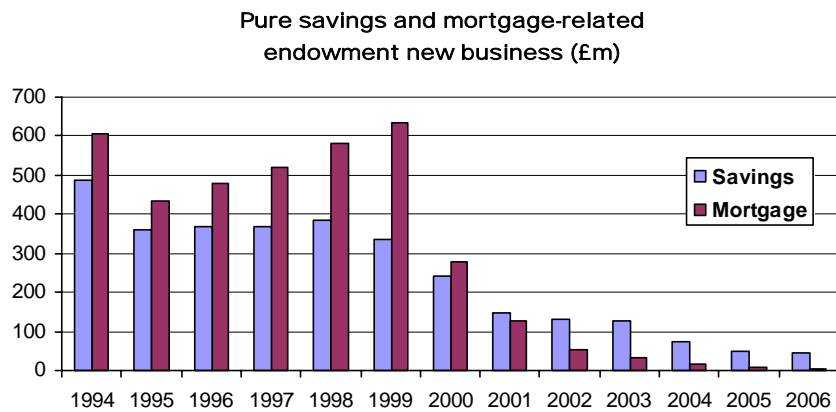
79. Back in the 1980s, the market for mortgage endowment policies expanded rapidly. The reasons for its sudden surge (in part related to a change to mortgage interest rate tax relief) could not reasonably have been foretold by anyone in 1980.
80. We suggest that the almost complete eradication of mortgage endowment new business that took place in the late 1990s/early 2000s (resulting initially from the emergence of evidence that the vast majority of such contracts were not capable of fulfilling their purpose – i.e. to pay off the associated home loan) was not recognised by any life offices in 1995.
81. We think that the tainting of mortgage endowments not only caused the drying up of sales of this product, but also helped contribute to the very substantial decline in sales of non mortgage-related endowments, which happened so quickly as to defy prediction by life office business planners.
82. The chart below tracks the proportion of new mortgages that were repayable by an endowment. The sudden and massive uptake of the mortgage endowment concept arose not only because of the optical attraction of the monthly outlay comparison and prospects of a lump sum at the end of the period, but was also heavily influenced by the actions of intermediaries (principal among them the building societies and banks), who quickly came to realise that there was much more money to be made from selling low cost endowments as opposed to mortgage term assurance. Depending on various factors, including interest rates, a £50,000 25 year mortgage on a repayment basis might have required an initial total monthly outlay of £360 (of which, say, £350 was interest and capital repayment and £10 was for the term assurance contract), whereas the same amount borrowed on an endowment basis might have required an initial total monthly outlay of £340 (of which, say £290 was interest and £50 for the low cost endowment). The difference in remuneration for the intermediary was quite striking, up-front commission paid for the £50 per month endowment would have been something like £400, compared to maybe only £70 for a £10 per month term policy.



83. Not only were the vast majority of new mortgages suddenly being set up on an endowment basis, the number of housing market transactions increased rapidly.



84. From the early 1990s, the mortgage endowment market suddenly fell from favour and all but disappeared from view, taking the non mortgage endowment with it.

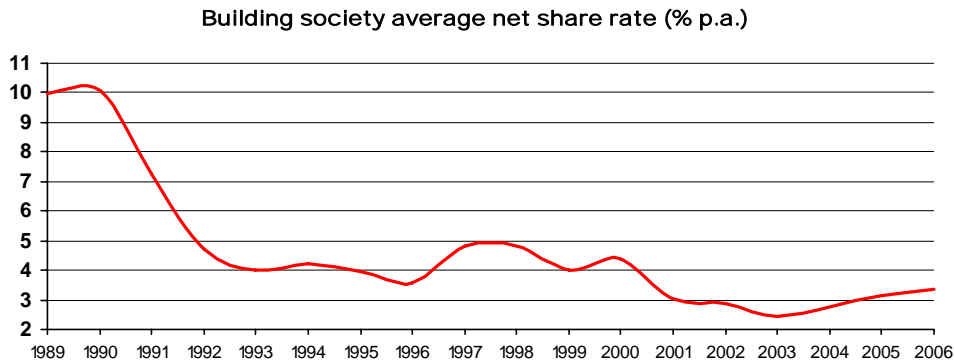


3. With-Profits Bonds

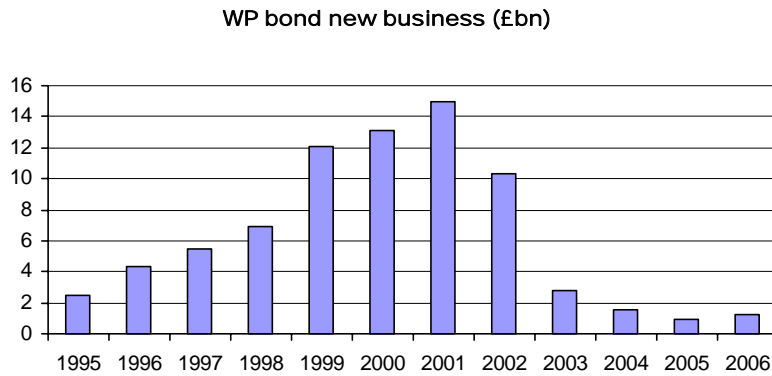
Not a core product

85. With-profit bonds were invented in the late 1980s, and new business volumes in the early years were rather modest and somewhat patchy.

86. Sales exploded in the second half of the 1990s and early 2000s as a result of two main factors: the UK's exit from the exchange rate mechanism and subsequent sharp declines in interest rates combined with a major marketing drive by companies.



87. The relatively low short-term interest rates of the late 1990s and early 2000s were a boon for writers of with-profits bonds as retail investors shifted assets from deposit accounts in pursuit of what they were led to believe would be higher returns.



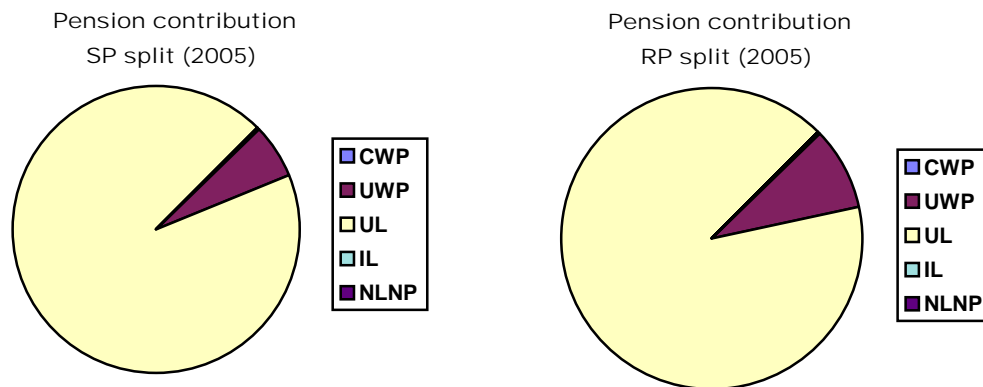
88. The with-profits bond surge and slump that straddled the turn of the decade was characterised by a product development race, as providers competed to offer the highest guarantees, highest bonus rates and highest commissions in order to gain market share and boost sales volumes.

89. Judging by the chart above, with-profits bonds could not be said to be a key financial services product. Rather, the market's heights were founded on a market optimism that helped cause considerable damage to the balance sheets of a number of providers, including one time market leaders such as Scottish Mutual and Royal & Sun Alliance.

4. Pensions Saving

Contribution split

90. The charts below describe the split according to investment format of pension accumulation (i.e. excluding pension annuities-in-payment) new business in 2005. The underlying data is derived from the Cazalet Consulting new business data set, which is based on detailed bottom-up analysis derived from FSA returns.



Legend	
CWP	Conventional with-profits
UWP	Unitised with-profits
UL	United linked
IL	Index-linked
NLNP	Non-linked non-profit
SP	Single premium
RP	Regular premium

91. It can be seen that, overwhelmingly, new pension business is in unit-linked format.
92. In 2005, there was £25bn of pension new single premium business written, of which only £1.6bn was in with-profits format (6.4 per cent of the overall new business written).
93. In 2005, there was £2.6bn of new pension regular premium written, of which only £0.2bn was in with-profits format (7.7 per cent of the overall new business written).
94. Further, much of the with-profits so-called “new” business recorded in 2005 was not “new” at all, but was in the form of incremental payments made to pre-existing pension plans.

Dwindling with-profits share of new business

95. The percentage of pensions saving new business attributable to with-profits has been shrinking.
96. In 1999, 19 per cent of new pensions saving single premiums were with-profits, compared to 6 per cent in 2005.
97. As for new pensions saving new regular premiums, 37 per cent of these were with-profits in 1999, compared to only 9 per cent in 2005.

5. “Third Way” Products

98. There are those that assert that there always will be consumer demand for with-profits (although given the trend in new business levels set out earlier on, such a view might be considered a little contentious) on the grounds that such offerings incorporate valuable guarantees and thereby are attractive to risk retail averse investors who seek exposure to risk assets (such as equities) while wishing to limit their risk.

99. Leaving aside the absolute and relative merits of individual with-profits based products currently available, what is clear is that with-profits is now not the only investment format under which retail investors can gain exposure to risk assets while limiting their risk and accessing valuable guarantees.

100. The last couple of years or so have seen the development of so-called “third way” products in the UK, many of them styled as “variable annuities”, importing techniques widely used and very popular among retail investors in the US and Japan, and which facilitate exposure to equities and other risk assets at the same time as incorporating investment guarantees to reduce the risk to the investor. Further, those providers offering or planning to offer variable annuity or similar “third way” contracts in the UK include a number of life assurance groups (such as AXA, Prudential, Royal London, Scottish Equitable and Standard Life) with a long with-profits heritage and substantial books of in-force with-profits business, but which are now focusing on “third way” approaches in developing new products for risk averse investors.

6. AXA Sun Life’s With-Profits New Business

Decline

101. In 1999, AXA Equity & Law Life Assurance Society plc (the with-profits business of which was the subject of the AXA reattribution, as a result of which it was transferred into AXA Sun Life plc) wrote £64m of new with-profits regular premiums and £699m of new with-profits single premiums.

102. In 2000, the year immediately prior to reattribution and transfer to AXA Sun Life, AXA Equity & Law’s with-profits new business fell to £46m of new with-profits regular premiums and £476m of new with-profits single premiums.

103. AXA Sun Life’s new with-profits business has been in decline post reattribution, to the point where, in 2006, new regular premiums totalled £7m and new single premiums were £45m.

104. Stripping out increments and pension rebate business, new regular premiums in 2006 would have been £4m and new single premiums would have been £22m, being absolutely and proportionately very small amounts.

AXA Sun Life plc with-profits new business (£m)				
Category/Premium type	2005		2006	
	RP	SP	RP	SP
UK life				
Endowment/bonds etc	4.4	1.5	1.7	0.7
Reinsured bonds	0.0	0.9	0.0	1.2
UK pensions				
Non-increments	1.2	17.6	1.7	16.8
Increments	12.2	36.2	3.4	20.3
Rebate business	3.8	18.8	0.0	1.3
WP drawdown	0.0	1.9	0.0	2.8
Overseas				
Miscellaneous	0.0	5.1	0.1	1.7

Assumptions prior to reattribution

105. In the run up to the making of reattribution proposals, investigations were made into the financial position of AXA Equity & Law as at 31 December 1998. It was confidently stated in the reattribution proposal policyholder circular that, based on the 31 December 1998 investigations, it would be “highly unlikely” that reviews of the company’s financial position as at end 2005 and every 5 years thereafter would show that it had more capital than it needed to support its new business development plans
106. In the AXA Equity & Law policyholder circular it was conceded, however, that the possibility existed that AXA Sun Life’s actual future experience might not to be in line with assumptions made when performing financial investigations based on the 31 December 1998 position. It was stated that analyses had been done to quantify the extent to which actual experience would be need to be different for there to be excess working capital at the end of 2005. For illustration, the circular set out various scenarios (being variations from the assumptions made based on the 31 December 1998 position) that would result in the fund having excess capital of £50m as at end 2005, including the following:
- An illustrative £50m excess capital position as at end 2005 was projected to arise if new with-profits business fell on average by 5.5 per cent per annum from the budgeted 2000 level. Interestingly, the text on page 56 of the policyholder circular states, “...new With Profits business would actually [our emphasis] need to fall...”, which indicates incredulity on the part of the writer that new with-profits business levels could ever fall!
 - A further illustration of how an excess capital of £50m as at end 2005 might be caused, was if actual new with-profits business was c30 per cent less than budgeted levels in 2000 and then increased in line with an assumed annual growth rate of 2 per cent above price inflation.
107. We do not know what the budgeted level of new business was for 2000. If we assume that the budgeted 2000 level was the same as the 1999 level (£64m of new regular premiums and £699m of new single premiums), then a 5.5 per cent per annum rate of decline (based on the first scenario above and being a rate of fall seemingly thought by AXA to be incredible) would have resulted in a 2005 new business result of £48m of new with-profits regular premiums (compared to an actual outturn of £22m) and new with-profits single premiums of £527m (compared to an actual outturn of £82m).
108. Taking the second scenario above, and assuming that the 2000 budgeted level of new with-profits business was the same as achieved in 1999, and factoring in inflation at a constant 2.5 per cent per annum for convenience, the resulting 2005 levels of new with-profits business being sufficient to result in the emergence of £50m of excess capital would have been something like £56m of new with-profits regular premiums (compared to an actual outturn of £22m) and £610m of new with-profits single premiums (compared to an actual outturn of £82m).

Annexe 4: Governance in a reattribution

Note to Treasury Committee by Mr. Bill Knight, former senior partner at Simmons and Simmons

109. I am one of the group advising the policyholder advocate in the reattribution of the Norwich Union inherited estate. This note is written for the Treasury Committee enquiring into the inherited estate held by life assurance companies' with-profits funds. It examines briefly the governance issues surrounding a reattribution and concludes that if a reattribution offer is to be made to policyholders it should first be independently assessed as fair.

1. The Process

110. In a reattribution policyholders give up their rights in the inherited estate, including the right to participate in future distributions from the inherited estate. The timing and amount of any future distribution is uncertain and this uncertainty is the greater because the interests of the policyholders are temporary – if a surplus is distributed after their policies have matured they will get no part of it. In return they receive a payment (the policyholder incentive payment or PIP) which is normally funded by the shareholders of the company in whose favour the estate is re-attributed.

111. A reattribution therefore involves a balancing of the interests of policyholders and shareholders. They do not negotiate directly between themselves but their interests are mediated by a process involving the directors of the insurance company, the policyholder advocate, an independent expert, the FSA and, usually, the court.

112. The normal process is that the company makes an offer to policyholders to surrender their rights to future distributions from the inherited estate in return for the PIP. The court then sanctions the arrangement under Part VII of the Financial Services and Markets Act 2000.

113. The roles of the parties are as follows:

114. *The company* makes the offer. The directors are responsible for it, and their duty is to act in good faith in what they believe to be the interests of the company. While the company is solvent this can also be described as a duty to act in the interest of the general body of shareholders. Recent statutory codification of directors' duties has not affected this basic principle.

115. *The policyholder advocate* represents the policyholders. The policyholder advocate exists because FSA rules require the company to appoint one if there is to be a reattribution. The policyholder advocate negotiates the offer with the company and then makes his or her views known to policyholders. The formulation of the offer is a matter for the company. The policyholder advocate has no power to affect the terms of the offer save that of persuasion. Although called an advocate, the policyholder advocate has no tribunal before which to appear.

116. *The independent expert*, normally an actuary, reviews the proposals, his primary concern being to ensure that the proposals will not damage the security of the policyholders' normal benefits. His report is made available to the FSA, the policyholder advocate and the court and a summary is provided to policyholders.

117. *The FSA* considers the fairness of the scheme and usually makes a report to the court. The full extent of the FSA's role in this respect is not completely clear to those advising the

policyholder advocate, but it seems that the FSA will publish its “reasonable range” assessment, of any reattribution offer, although timing is unknown at present.

118. *The policyholders* decide whether or not to accept the offer. There is no policyholder meeting or vote in the case of a Part VII transfer, but the FSA requires that policyholders be given the choice whether to accept the PIP or, as regards their policy, maintain the status quo
119. *The court* considers whether it is appropriate to sanction the reattribution scheme, if it is made pursuant to a Part VII transfer. The effect of the court sanction is to prevent any policyholder who does not accept the PIP from subsequently challenging the scheme.

2. The company’s duties to the policyholders.

120. The policyholders have rights and it must follow that the company owes them corresponding duties. The policies themselves are generally brief or even silent on the extent and nature of the policyholders’ rights but policyholders have such rights (for example guaranteed rates of return) as the express terms of the policies do confer. Collectively they have the right to receive a defined amount (generally 90 per cent) of any distribution of the funds or sub-fund in which they participate. This right arises from the constitutional documents of the company or from the policies. FSA rules restrict the uses to which the fund can be put and the policyholders would be entitled to compensation if these restrictions were broken.
121. But the policyholders’ rights which are set out in the policies or in FSA rules do not amount to a comprehensive scheme for the management of the fund and leave crucial areas to the discretion of the company and therefore to the directors. So for example the risk appetite of the fund and consequent decisions as to how much can safely be distributed are essentially matters for the directors. The directors are allowed to tie up fund capital by writing new business and the amount of new business and the projections of that amount (which can significantly affect the amount of the fund available for distribution) are matters for the directors.
122. How should the directors exercise these discretions? Companies have for many years been advised that the directors’ duty is to the company or, as explained above, to the general body of shareholders. Of course this may not be to the policyholders’ detriment. Competitive considerations require that the policyholders receive a reasonable rate of return, so that it is in the interests of the company to maintain its competitive position by seeing that they do. And it is in the interest of the company that the directors should pay strict regard to the policyholders’ rights and the regulatory rules. However, the existence of the inherited estate raises problems all of its own where it far surpasses any amount which might be thought necessary to provide guarantees or otherwise maintain policyholders’ returns at a competitive level.
123. The inherited estate is an asset of the company and in these circumstances any board should use it for the benefit of the company to the extent that they are advised that they can. The estate has come to be used for funding the start up of new business, for the payment of taxes on shareholder transfers, for the payment of penalties for mis-selling for which the company is liable and to make strategic investments. These uses of the estate have been permitted by the FSA, although it is now re-considering its position on mis-selling and has prohibited the writing of new business on terms that are likely to erode the estate.
124. Until now the policyholders have not had a voice in this, but the creation of the Office of Policyholder Advocate has allowed their position to be re-evaluated and the policyholder advocate in the Norwich Union reattribution, Clare Spottiswoode, has received advice from leading counsel that although the inherited estate is an asset of the company it is a necessary

implied term of the policies that in dealing with the fund, including the inherited estate, the company should have regard to the objectives of the fund as a vehicle for the provision of financial services to policyholders. The legal analysis usually adopted by those advising insurers is very much at odds with this.

125. Both sides cannot be right. Until we have a decision, or a series of decisions, of the court we will not know the rights and wrongs of it. However vehemently each side advances its position, the extent of the policyholders' rights and the basis for the directors' decisions are matters which are in dispute, and they are matters which critically affect the negotiation of the amount of a PIP in a reattribution.
126. However some things can be said.
127. First, in a reattribution companies are not willing to proceed on the basis that policyholders have no rights over the inherited estate. They seek policyholders' consent, they pay them a PIP and they usually seek the sanction of the court. If the policyholders had no rights over the inherited estate the company could simply appropriate the estate out of the fund so long as the FSA agreed – nobody is seriously suggesting this.
128. Second, to the extent that policyholders have rights the company owes them a duty. But unless and until the policyholders' rights in the inherited estate are agreed or defined by a court this is territory which is disputed between the policyholders and the company – each side seeking a greater share. In this dispute the company has the initiative.
129. Third, if the extent of the interests of the policyholders was agreed this conflict would be much easier to deal with. It is generally in the interests of a company to observe policyholders' rights and if that involves a conflict between the duties of the directors to the company and the duty of the company to the policyholders no doubt means would be found to manage it. The difficulty comes before those rights are agreed.
130. Fourth, a reattribution will solve the problem so far as the reattributed assets are concerned, not by defining policyholders' rights in those assets but by terminating them.
131. In deciding whether or not to accept a reattribution offer, policyholders will naturally compare it with the value of the distributions from the estate that they might receive if they do not accept. Given the directors' power to take decisions which directly affect the likelihood that policyholders will receive such distributions, and given that they perceive their duty as being to act in the interests of the company in exercising these discretions, is it right that they should also set the terms of a reattribution offer without a mechanism to deliver a fair result?

3. Conclusion

132. In defence of the status quo it can be said that an offer is only an offer. The policyholder will have the benefit of the policyholder advocate's views and can accept it or reject it according to his circumstances. But consider the position of a policyholder who receives an offer of a cash sum in return for rights which he never knew he had. If he rejects it, how will he assess his chances of his receiving any equivalent sum during the lifetime of the policy, given the discretion of the directors over the sums he will receive and the fact that, as they would say, they are bound to exercise those discretions in the interests of the company? In many cases, the company will have made him an offer he cannot refuse.
133. It might be thought that the court would provide an appropriate safeguard. It is not suggested that a court would sanction a scheme which it thought to be unfair. But the courts

have recognised that it is not for them to set the terms of the scheme – the role of the court is to give or withhold sanction. Moreover the court will act on the evidence before it. By the time the scheme comes to court it will have been accepted by policyholders and the policyholder advocate may be constrained from arguing against the scheme and thereby seeking to deny a PIP to policyholders who have accepted it. In particular, the policyholder advocate may conclude that the offer is in the interests of a significant percentage of policyholders, but overall at a level which is unfairly beneficial to the company. In those circumstances it would be difficult for the policyholder advocate to oppose the scheme

134. If it were a condition of the making of the offer that an independent and suitably qualified third party, taking account of the arguments of the company and the policyholder advocate, must have pronounced it fair in amount as well as in process terms then the result, given the uncertainties, would likely be rough justice. But at least justice, however rough, would be seen to be done. If in the future the courts do hold that policyholders have substantial rights over the disposition of the inherited estate, then accepting policyholders will have lost those rights forever through the reattribution to the advantage of the company. Without an effective independent assessment of the offer the customer will not have been treated fairly. If such an assessment is to be persuasive it will have to deal with the legal position as well as the regulatory position, analysing the directors' duties, explaining how different approaches may affect the outcome, and reaching a conclusion on the right approach to take.
135. It would be unreasonable to force a company to make a reattribution offer at a level higher than it is prepared to pay, so the introduction of such a requirement may result in the company deciding not to make an offer at all, but in this developing situation continuing uncertainty may be better than an offer which would terminate policyholders' rights without fully recognising them.
136. For these reasons I believe that the FSA should either make, or commission, an assessment of any reattribution offer before it is made. If the company then decides to proceed the assessment should be published and full reasons should be given.

Annexe 5: Role and responsibilities of the policyholder advocate – policyholder communications

Note to Treasury Committee by Jonathan Haslam, CBE, MCIPR director of communications, the Office of the Policyholder Advocate

137. This note sets out:

- the Norwich Union policyholder advocate's approach to policyholder communication
- some of the practical considerations important in trying to communicate with a large body of policyholders, including the difficulties posed by industry jargon

138. It concludes that:

- policyholders have not been well served by the information available to them prior to making their investment;
- that more effort is being made to explain the circumstances and issues in a reattribution; and
- that the work must continue and intensify to meet the standards of Treating Customers Fairly.

The policyholder advocate's general approach to policyholder communication

139. In determining how best to be accountable to those she represents the policyholder advocate in the Norwich Union reattribution has sought to make herself as available as possible to policyholders, setting in place a range of communication mechanisms which have included:

- visiting various cities in the UK and the Republic of Ireland and holding open meetings;
- writing to each potentially eligible policyholder on appointment and subsequently;
- establishing a call centre in India;
- establishing a correspondence centre in Norwich;
- publishing a website and encouraging users to register for email updates and to post comments to the policyholder advocate about the reattribution
- being willing to enter into a dialogue with the media in respect of general issues while seeking to respect the necessary confidentiality of the process of reattribution negotiation

140. One element of the open meetings was to 'consult' with policyholders, as required by the then Conduct of Business Rules from the Financial Services Authority.

141. Even more time will need to be spent explaining the result of a negotiation, whether positive or negative, using all the media described in this paper.

Practical considerations²

Open meetings

142. The policyholder advocate's office had no means by which to judge the likely level of interest in open meeting and made assumptions. In the event the number of acceptances was far greater than those ultimately attending. There has been a small number of complaints from policyholders that more events should have been undertaken. It is accepted that an open meeting in the North West of England at least, should have been included. In part that omission was met by providing a DVD recording of an event to those who complained.

143. The meeting demonstrated that policyholders in general were not well informed about the nature of with-profits, that they were entirely unfamiliar with the concept of a reattribution and that they saw the meeting as an opportunity to vent their frustration at the performance of their policies.

Internet consultation

144. Recognising that policyholders might wish to express a view but not attend an open meeting, an internet-based questionnaire was developed. The questionnaire sought to make real the FSA injunction to consult to inform the policyholder advocate in the subsequent negotiations.

145. The information gained was of interest and was a way of trying to involve policyholders in a process from which otherwise they were likely to feel remote. Nonetheless, it was an imperfect mechanism and policyholders' expectations needed to be managed so that its importance was not overstated.

Industry jargon and openness

146. Both policyholder mailings sent from by the policyholder advocate have been done jointly with Norwich Union and have been market tested. The quality of communication has been considerably improved as a result of this testing.

147. It is instructive, however, to look at the jargon of the industry and the extent to which ordinary policyholder literature fully sets out key issues. Sir Howard Davies made the point, while chairman of the FSA, that industry jargon was unhelpful. He cited the term 'inherited estate' and questioned why it was not simply called 'accumulated assets'. There is misunderstanding about 'reattribution'. Policyholders find the use of 'surplus assets' unhelpful, and more so when there is 'excess surplus' which is made the subject of a 'special bonus', which is differentiated from the 'reversionary' bonus (annual) or 'terminal' bonus ('final'). The industry is trying to address some of these issues but it has further to go.

148. Aside from the language there are issues about openness. The Principles and Practices of Financial Management and other papers refer to uses of the estate and 'tax obligations'. It is unfortunate that openness does not dictate the acknowledgment that the estate bears the cost of tax on shareholder transfers under a distribution. Similarly, explanation in everyday language of the way the estate is used in respect of new business in the written material that policyholders are most likely to read would be an improvement. The consumer-friendly versions of these materials have not gone far enough.

² The Office of the Policyholder Advocate would like to acknowledge the assistance of Norwich Union employees in organising events, running the correspondence and call centre operations and facilitating policyholder mailings. Some issues with mailings are explained in the body of the text.

149. Admittedly, the concepts in a reattribution are particularly difficult to explain to a lay audience with a limited appetite for written material. However, that puts an onus on all concerned to produce the clearest possible documents.

The mailings

150. Policyholders should be informed by the company on the appointment of the policyholder advocate and at intervals (supposed to be no more than six months) throughout the process.

151. In general the mailings have been harmoniously organised in conjunction with the company. This make good sense in that different aspects of the process can be presented to achieve balance and costs (which are considerable) can be contained. However, the tensions inherent between negotiating parties and the different views about what to tell policyholders about a continuing process have resulted in at least one, and arguably two, company mailings being issued without a balancing piece from the policyholder advocate. This is unfortunate

Correspondence and call centres

152. Both of these facilities have been essential to meeting the needs of policyholders. This office has been fortunate in having seconded to it a Norwich Union expert on customer experience to manage these processes and for the dedication of seconded staff working in the correspondence and call centres.

Conclusion:

153. There needs to be greater openness from the industry to explain the nature of with-profits and sues of the inherited estate.

- Industry jargon is a barrier to understanding and needs to be phased out wherever possible;
- commendable efforts by Norwich Union to introduce more market testing of written materials is welcome and needs to be encouraged;
- policyholder advocates need the ability to communicate more readily with policyholders, even though the result might be greater cost;
- commitment to explain the result of reattribution negotiation directly and indirectly to policyholders is an essential component of accountability.