

The Treasury Select Committee  
Inquiry into Inherited Estates  
Memorandum from the Financial Services Authority

Introduction

1. This Memorandum is submitted by the Financial Services Authority in the context of the Committee's inquiry into inherited estates. We look forward to elaborating on it in oral evidence on 22 April. The Memorandum draws on material already published by the FSA, including guidance to firms and advice to consumers on the FSA website and correspondence with the Aviva Policyholder Advocate.
2. The Memorandum covers:
  - A. Introduction to with-profits;
  - B. Overview of inherited estates, distribution and reattribution;
  - C. The regulatory framework for a reattribution;
  - D. The FSA's role in a reattribution;
  - E. The role of the Policyholder Advocate;
  - F. The specific questions the Committee has asked the FSA; and
  - G. The general questions in the Committee's call for evidence (to the extent not covered elsewhere).
3. In the light of the current debate on reattribution proposals by insurance companies and the ongoing public debate on the fairness of such reattributions, we would like to make one point at the outset. In the case of a firm wishing to reattribute the inherited estate from its with-profits fund, it is entirely a matter for the firm itself whether to undertake a reattribution. However, if a firm does choose to, then the reattribution needs to be conducted within the regulatory framework described in this Memorandum, including ensuring that policyholders are treated fairly. If there is no reattribution, or if reattribution negotiations do not proceed to conclusion, policyholders will not be worse off than they would have been if the negotiations had not begun.

A. Introduction to with-profits

4. With-profits products are sold as long-term investments, and have certain features which traditionally have included:
  - Policyholder premiums are held in a pooled fund that is invested in a range of assets, a significant proportion of which are usually in equities and property;
  - Certain guarantees, which usually increase over the lifetime of the policy - for example, the payment of a guaranteed amount at maturity or on retirement, or on death. The guaranteed amount may build through the duration of the contract by the addition of regular bonuses. A final bonus, which does not form part of this guaranteed amount, may be added at the end of the contract;
  - 'Smoothing' of returns to policyholders, to cushion policyholders from the extremes of fluctuations in the property and equity markets; and

- Sharing in the profits or losses of the other business in the pooled fund, including, for example, those arising from mortality risks and expense risks.

Among other considerations, these characteristics give rise to capital requirements if the fund is to be able to deliver to policyholders the features they offer to provide.

5. The with-profits sector attracted particular scrutiny in the early part of the decade, prompted by concerns about: the high degree of discretion given to the insurance company's management over how the with-profits fund is operated; the complexity and opacity of the products; poor early surrender values; and a lack of consumer understanding of the nature of the risks. More recently there has been publicity about inherited estates and fund closures. A significant number of with-profits funds are now closed to new business (amounting to around £100bn out of £420bn in terms of with-profit liabilities).
6. In response to these concerns, in 2005 the FSA implemented a much improved regulatory regime for the with-profits sector (and insurance more generally). The overall objective has been greater policyholder protection. After extensive consultation, the new rules have delivered:
  - Rules and guidance to firms on the management of with-profits funds;
  - Clarity and disclosure on how management exercise discretion;
  - Express limits to that discretion in key areas; and
  - Improved assessments of the true extent of firm liabilities (to include guarantees) and of the resulting capital requirement.
7. Specifically, the main elements of this enhanced regulatory regime are:
  - Requirements for governance of firms' with-profits business in recognition of the conflicts that can arise between shareholders and policyholders; these include a requirement for independent input (possibly through a With-Profits Committee) and appointment of a With-Profits Actuary;
  - A requirement on firms to publish a document called 'Principles and Practices of Financial Management' (PPFM) and a consumer-friendly PPFM describing how they manage their funds;
  - New rules to help firms determine what it means to treat customers fairly, that cover the decisions on payouts, surrender values and charges to the fund;
  - Requirements for a firm to appoint a Policyholder Advocate (PA) to represent policyholders in negotiations with the firm in the event of a reattribution; and
  - Rules about firms' obligations should a fund close to new business.

## B. Overview of Inherited Estates, Distribution and Reattribution

8. An inherited estate is part of the with-profits fund. The inherited estate is the part of the with-profits fund over and above what is required to meet the fund's liabilities that the insurer retains as working capital. It will also include any excess surplus in the fund. It may in future be distributable to with-profits policyholders (see below). Legally the whole fund (including the inherited estate) is an asset of the insurer. In most with-profits firms the inherited estate has built up over many years, from premiums from past generations of policyholders and the investment returns on them,

and/or past injections of capital from shareholders or reinvestment of shareholders' dividends. Our rules constrain the firm so that it cannot use the assets in the inherited estate in ways that are detrimental to with-profits policyholders.

9. The working capital required by the with-profits fund is of two kinds - the capital the FSA requires the fund to hold to ensure it can meet its liabilities in changing future circumstances; and the capital the firm chooses to hold to support the business. The FSA requires a fund to hold capital at a confidence level of 99.5% over one year, which is equivalent to a BBB credit rating, and is the minimum level of regulatory capital. However if a firm's risk appetite is in excess of the regulatory minimum, FSA's rules require it to hold capital commensurate with that risk appetite. And, for any given risk appetite, a fund will need to hold more capital if it chooses to hold riskier, more volatile assets. The working capital may be held inside the fund as a part of the inherited estate, or outside of the fund. In either case the capital is required until such time as policyholders' interests can be sufficiently protected without it – for example, if the risks in the fund decrease in some way.

#### *Distribution*

10. Our rules require firms with with-profits funds to consider at least once a year whether the fund(s) contain an 'excess surplus' (which is a surplus over and above the value of the assets required to match the fund's liabilities and the amount required as working capital). If they do, firms must consider whether retaining it would be in breach of Principle 6 of our Principles of Business – "A firm must pay due regard to the interests of its customers and treat them fairly". We expect firms to be able to justify why it would not be unfair to keep the surplus assets, which are assets which are not required for the purposes of the fund's business. If the firm cannot properly justify retention of the assets then we would expect it to be distributed on a 90/10 (policyholder to shareholder) basis in line with the 1995 Ministerial Statement (see para 20 below), or other basis applicable to the particular fund.

#### *Reattribution*

11. In a reattribution, the firm chooses to negotiate to *reattribute* the inherited estate held within the with-profits fund so that it moves outside the fund. In order to do this, the firm effectively buys out the right policyholders have to a share of any future distributions from the inherited estate. Policyholders normally receive a one-off cash payment. This payment reflects the rights they are giving up and the value shareholders are gaining from the transaction. After paying policyholders, the firm gains control over the funds from the inherited estate. These funds will need to be kept for the foreseeable future to continue to provide the working capital as support for the with-profits fund and for this reason are not immediately payable to the shareholder.
12. As noted above, capital held as part of the inherited estate is needed as working capital (both to protect policyholders against adverse market conditions and to allow the fund to stay open to new business). It may therefore not be available for distribution to policyholders (and shareholders) in the foreseeable future and, indeed, may never be distributed during the lives of many current policies. Furthermore, during the time the capital is employed as working capital it can go up or down in

value, and hence any future distributions, if made, would be of an uncertain amount. Therefore, in a reattribution, policyholders are being compensated for giving up their rights and interests to receive an uncertain amount at an uncertain time.

### C. The Regulatory Framework for Reattribution

13. Firms who wish to carry out a reattribution must follow a process set out in FSA rules and guidance. The process is designed to ensure that:

- policyholders are treated fairly during the reattribution process, including by ensuring that there is someone completely independent of the firm (the policyholder advocate) representing policyholders' interests during the process;
- taking account of the circumstances in which the firm finds itself, the reattribution is within the range of reasonable outcomes available to the firm and takes due account of policyholders' interests and treats policyholders fairly; and
- the process itself is as open and transparent as possible.

14. Specifically, when undertaking a reattribution, we require firms to:

- identify and appoint a policyholder advocate (PHA) to negotiate (on behalf of eligible with-profits policyholders) the benefits to be offered to them in exchange for the rights and interests they are being asked to give up. The PHA must be approved by the FSA.
- notify us of the PHA's terms of appointment;
- depending on the legal process used, appoint an expert (called an independent expert or a reattribution expert) to assess objectively the reattribution proposals and prepare a report for the benefit of a Court and the FSA;
- send appropriate and timely information to every policyholder that might be affected by the proposed reattribution; and
- give eligible policyholders the option individually to accept or reject the proposals or, if the legal process being followed allows the majority of policyholders to bind the minority, to vote on whether the proposals should go ahead.

15. We require any firm that does propose a reattribution to comply with our Principles for Business. For example, the firm must act with integrity, have due regard to their policyholders' interests, must ensure that their policyholders have adequate information and must avoid or manage conflicts of interest. Policyholders must be treated fairly during the reattribution process and as a result of the reattribution.

16. We recognise that firms have different circumstances and may adopt different legal procedures to achieve a reattribution. For example, some firms may give effect to a reattribution using the transfer of business procedures in Part VII of FSMA. Other firms may use the procedures in Part 26 of the Companies Act 2006. In each case the Court will have a role in deciding whether it is appropriate for the reattribution to go ahead. Our rules will accommodate these different legal processes.

D. The Role of the FSA in a Reattribution

17. Our role in a proposed reattribution is to scrutinise the fairness of the proposals.
18. In relation to the negotiation between the firm and the PA, the FSA also has a duty to oversee the process and to assist in the process where appropriate, but we are not a party to the negotiation between the PA and the firm. In carrying out this role, we look at whether it appears that the PA and the firm are able to conduct a full and fair negotiation.
19. Once the PA and the firm have completed their negotiations, we form a view on whether the overall proposals are fair to policyholders. In doing so, we take into account the interests of all policyholders, including the relevant with-profits policyholders, and the implications of the proposals for the financial position of the firm. We consider carefully the detailed information provided to us by the firm and other relevant stakeholders. The information provided by the firm will include the views expressed by the firm's with-profits actuary. We take into account the report prepared by the independent expert or reattribution expert (who is required to undertake an objective assessment of the proposals and to report on this) and the report prepared and the opinions expressed by the PA. We ask the firm to demonstrate to us that the proposals are fair and that they are consistent with all other relevant FSA requirements.
20. In a reattribution of a 90:10 fund, our assessment of fairness starts with the principle set out in the Ministerial Statement of February 1995 – namely, that the basis of *distributions* to policyholders and shareholders will be in the proportions of 90% and 10% respectively. If the *reattribution* proposal is to divide value between policyholders and shareholders on a basis that is different from this 90:10 starting point, we look at the basis for that proposed division and decide whether it is fair, compared with policyholders awaiting a potential future 90:10 distribution. (There is no guarantee that circumstances will arise in which the inherited estate will become available for distribution. Therefore what is at stake for the current policyholders is the certainty of receiving a payment now from the reattribution against the possibility of an uncertain amount at an uncertain time in the future – see also paragraph 10.)
21. We will also focus on the fairness of the offer being made to policyholders vis-à-vis the overall benefit to the shareholder. One of the ways we approach this is to review the return to the shareholder.
22. Where the firm and PHA agree that a reattribution deal should be put to policyholders, our assessment of fairness will form part of our submission to the Court (and so will be made public). Our assessment of fairness will include the range of outcomes that we assess to be fair. Making our assessment of fairness public at this stage is consistent with our commitment to act transparently. Should the two parties agree that a deal can be put to policyholders and that it would facilitate the process to know our preliminary view on fairness (including the range of outcomes), we would privately inform the parties at that point.

23. We will make our assessment of fairness before the reattribution proposals are put to policyholders by the firm. If we conclude that the proposals are unfair to policyholders, we will take steps to prevent the firm from putting the deal to policyholders.

E. The Policyholder Advocate's role

24. The precise role of the Policyholder Advocate (PHA) will depend on the type of firm concerned and the nature of the reattribution proposals. We developed the PA role so that with-profits policyholders have an informed and independent person, properly supported by advisers, who can negotiate on their behalf with the firm; this is particularly important, given the complex nature of with-profits business. The negotiation centres on the value of the benefits which will be offered to policyholders in exchange for the rights or interests they will be asked to give up. The PA can challenge any part of the operation of the with-profits fund in the course of negotiations with the firm.
25. A key responsibility of the PHA is to explain to policyholders whether, in the PHA's view, the firm's proposals are in their interests. In particular, the PA compares the firm's proposals for a reattribution with the position as it would be if the reattribution did not go ahead. The PHA takes into account the probability that there may be *distribution* of surpluses in the future and other factors such as the value that should be attached to capital retained to finance new business. If the PHA does not believe that the proposals are in the interests of policyholders, he or she should communicate that conclusion to policyholders.

F. Specific questions addressed by the Committee to the FSA

*Has the FSA raised the potential competition implications of the rule which allows companies to use the inherited estate to finance new business with the Office of Fair Trading?*

26. We have been in contact with the Office of Fair Trading on this issue and understand that they will be making their own position clear.

*What is the view of the FSA on Norwich Union's proposal to stagger distribution payouts over 3 years (so that people whose policies mature before 1 January 2010 do not receive the full amount), and does this comply with FSA rules and the FSA's requirement to Treat Customers Fairly?*

27. We review the nature and scale of the proposed distribution against our Principles for Business, in particular against the need for a firm to maintain adequate financial resources, to treat its customers fairly, and to communicate in a manner which is clear, fair and not misleading.
28. As noted above, firms should distribute excess surplus to policyholders if they do not have a proper justification for retaining it. However, the phasing of such distributions

can have advantages for policyholders. Receipt of a single lump sum could create an incentive for some policyholders to cash in their policies. In determining how large a payment is appropriate and how to phase payments, the firm needs to guard against the risk of a significant increase in surrenders of policies and so protect the strength and security of the continuing fund for remaining policyholders. Phasing payments may help to mitigate this risk. Whilst this will mean that those policies which mature during the three years will be eligible for only part of the distribution, it serves to protect the continuing interests of those policyholders who remain in the fund. A firm needs to consider the interests of all groups of policyholders in ensuring that the actions it takes are fair.

*Will the FSA be encouraging other life assurance companies (for example, the Prudential) to follow Norwich Union's decision to distribute its excess surplus?*

29. As noted above, our rules require firms with with-profits funds to consider at least once a year whether the fund(s) contain an 'excess surplus' (over and above the working capital of the fund). If they do, we would expect it to be distributed on a 90/10 basis, or other basis applicable to that particular fund, in line with the 1995 Ministerial Statement.
30. It is for the senior management of firms, advised by their Actuarial Function Holder, and with input from their With-Profits Committee or equivalent, to decide whether an excess surplus exists and what they should do with it. No two companies are alike and each, in light of the risk appetite determined by the Board, will need to consider the level of regulatory and working capital they will need taking account factors, such as:
  - The degree of (in particular) investment risk that policyholders have been accustomed to taking in the with-profits fund;
  - Level of guarantees given to policyholders;
  - Investment policy of the fund;
  - Management actions that a company is permitted to apply (in accordance with its PPFM) to protect its financial position;
  - Projected new business volumes.
31. As part of our supervisory work we challenge firms on the decisions they make on how much of any surplus they should retain, for example, to support new business, strategic investments and the firm's risk appetite, and how much might be available for distribution.
32. If a firm looks to retain, rather than distribute, an excess surplus without being able to justify why they are not being unfair in doing so, then we will take appropriate regulatory action.

*According to the FSA's Conduct of Business Rules, a firm must assess whether there is an excess surplus in the inherited estate every year, and make a distribution or carry out a reattribution if having this surplus is a breach of Treating Customers Fairly. Given that the Prudential's inherited estate is estimated at £8.6 billion, has the FSA made an assessment of whether the Prudential was in breach of these rules?*

33. A firm will normally carry out an assessment of whether it has an excess surplus in its with-profits fund by reference to, amongst other things, a Financial Condition Report (FCR) prepared by the firm's Actuarial Function Holder. The FCR is ratified by the Board of the firm before submitting it to the FSA. We then challenge the firm on the basis on which this decision has been reached in order to satisfy ourselves as to the adequacy of this decision within the requirements of our rules. Recent discussions with Prudential have centred on the FCR submitted for the year end 2006 and are ongoing.

G. Questions asked by the Committee as part of its Call for Evidence

*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.*

34. Our rules require firms to ensure that they do not use the inherited estate in ways which would adversely affect existing policyholders. We set out below some of our expectations of firms in managing and using the inherited estate, including in managing the conflicts of interest between policyholders and shareholders in the inherited estate.

*Financing new business*

35. In principle, we agree that the inherited estate can be used to provide capital to back new business in the with-profits fund where this does not have a material adverse effect on the interests of existing policyholders. Writing new business utilises capital that is subsequently released back over the life of the policies. This is because regulatory requirements and accounting conventions prevent the full expected economic value of the new business from being immediately brought onto the firm's balance sheet. The writing of new business, even where that business is expected to be profitable, will usually be associated with relatively heavy administrative, commission and set-up costs in the initial period. We consider that it is acceptable to use the assets in the inherited estate to meet those initial costs, provided the business is managed with a view to recovering those costs over a reasonable period.
36. The volume and pricing of the new business is key, and our rules do not permit, for example, the marketing of loss leaders or a firm to persist in marketing products where actual volumes experienced are insufficient to justify costs. We monitor this as part of our ongoing supervision.

37. One of the results of writing new business into the fund is that the fund, or the inherited estate, is then effectively supporting the new policies as well as existing policies. This transfers the benefit of the inherited estate between the generations of policyholders and is an intrinsic feature of with-profits business where a fund is open to new business.
38. While relevant during the normal course of supervision, at the time of a reattribution process, we take particular interest in reviewing the firm's assumptions for its new business flows post-reattribution. We will consider the significance of the assumptions about the volume and nature of new business which the firm expects to undertake, and whether the firm's assumptions are reasonable in the context of the reattribution scheme.

#### *Paying tax on transfers to shareholders*

39. With-profits funds are not taxpayers and do not have their own separate official tax assessments. The firm is the taxpayer. Its corporation tax assessment takes into account factors including some arising from its with-profits business. The firm makes a charge to its with-profits fund as a contribution towards its overall corporation tax liability.
40. Our rules provide that the maximum amount of this charge is the notional corporation tax for which the with-profits fund would be liable if it were, itself, a taxpayer subject to its own separate tax assessment. We expect firms to carry out the exercise of doing this computation each year. Two elements of this corporation tax are:
41. Firstly, the tax on the investment returns from assets that back policyholder benefits. We consider this element of corporation tax to be an appropriate charge to the fund because the investment returns help to increase the policy benefits to policyholders.
42. Secondly, part of the tax liability arising within a with-profits fund comes about when there is a transfer of money from the with-profits fund to shareholders. Firms are not permitted to charge any of this part of the with-profits funds' tax liability which is identified with a distribution to shareholders to the with-profits fund unless it has been their established practice to do so and that established practice is disclosed in its PPFM (which will include disclosure in the consumer friendly PPFM where tax is material). We concluded at the time, and continue to believe, that this is reasonable in the context of the wide-ranging review we undertook and the overall framework of policyholder protection which was introduced.

#### *Financing strategic investments*

43. Our rules also allow firms to make 'strategic investments' - investments in businesses in which the firm, or an affiliate of the firm, has an interest - using assets in the inherited estate.
44. Firms can undertake such investments and continue to hold those investments as long as they do not prejudice the interests of existing policyholders. When reviewing such investments, we expect firms to consider whether the purchase or retention of such an investment is fair to its with-profits policyholders. We expect firms to consider the

likely returns from the investment compared with other activities which the firm might undertake and the risks associated with the investment. We also expect firms to review such investments on an on-going basis to ensure that they continue to be suitable. We monitor this as part of our ongoing supervision work.

45. While relevant during the normal course of supervision, at the time of a reattribution process, we take particular interest in considering any strategic investments held in the with-profits fund and whether their continued retention, or the making of the initial investment, appears fair. If we have reason to doubt that the investments were made or retained in line with our rules and guidance, we will consider appropriate regulatory action.

*Paying mis-selling compensation costs*

46. Our rules currently allow firms to charge mis-selling compensation costs to the inherited estate on the basis that with-profits policyholders share in both the gains and losses arising from the business in the long-term fund. In the light of representations received on this and the above three uses of inherited estates, we have recently reviewed all aspects of our rules in this area. In the light of the strength of views now put to us, we have decided to invite views on the issue of charging mis-selling costs, and on whether, given the nature of those costs, they should be borne solely by the shareholder. We will consult during the first half of 2008 on whether we should change our approach to require shareholders to meet mis-selling costs.

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

47. We do not accept that life insurance companies are allowed to use assets in their with-profits funds to subsidise corporate activities. In fact, there are fewer regulatory constraints on the use of surplus assets in long-term funds that do not contain any with-profits business. Moreover, we have seen no evidence that the uses of assets of with-profits funds that we permit give rise to any adverse competition issues. The two life assurance firms that have written the largest amounts of business in recent years have no with-profits business and therefore no inherited estates. In 2006, the last year for which we have data, only 5% of all new life and pensions business was with-profits business and approximately 80 firms wrote only other than with-profits business (most of whom had no inherited estate). We understand that the OFT will be making their own report on this matter.

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

48. Policyholders have a right to a share of a distribution from an inherited estate if one is made. There is no guarantee that a distribution will be made during the lifetime of their policy and policyholders have no right to a distribution during the life of their policy. In line with the Ministerial Statement of 1995, the right to a share in any distribution gives policyholders as a class an interest in any surplus retained in the inherited estate. That interest has no absolute value unless and until a distribution is made, and it is not an interest of any individual policyholder. In the context of a reattribution, however, its value can be negotiated and we expect a value to be placed

on it and paid to current policyholders in a reattribution. As we confirmed in our oral evidence to the Committee in January 2008, we take the view therefore that policyholders' interests are not zero.

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

49. As part of the enhanced regulatory regime for with-profits introduced in 2005 we introduced guidance requiring firms to have in place governance arrangements which: are 'appropriate to the scale and complexity of their with-profits business'; which 'involve some independent judgement in the assessment of compliance with the PPFM; and explain 'how any competing or conflicting rights and interests of policyholders and, if applicable, shareholders have been addressed.' The independent judgement can be provided in different ways including, but not confined to, establishing a With-Profits Committee which includes some non-executive directors and external non-directors, or using an independent person with appropriate skills to perform the role.
50. We require a firm's governance arrangements to support the overall outcomes we are seeking – that firms should treat their policyholders fairly and manage their conflicts of interest effectively. We expect senior management of firms to ensure that they consult their with-profits governance arrangements on all significant issues affecting with-profits policyholders' interest (e.g. changes to investment strategy, charges and bonuses). These governance arrangements should also be able to provide an independent challenge in the firm's overall assessment of how any conflicts of interest between policyholders and, if applicable, shareholders have been addressed.

14 April 2008