

September 2, 2008

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Dear Peter

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.

This memorandum:

- provides background information on my role as policyholder advocate in respect of Norwich Union policyholders;
- responds to the two questions asked in FSA Consultation Paper 08/11 dated June 2008 , entitled 'With-profits funds – compensation and redress'

A. Introduction

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).

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 have been concluded recently and the outcome was announced on 30 July 2008.

Key Issues

B. FSA permitted uses of the inherited estate

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. I and my advisers consider that the FSA has particular responsibilities with respect to the regulation of with-profits life assurance policies.

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.

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.

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.

I was disappointed that in its December 2007 response, whilst the FSA stated its intention to reconult 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.

One such rule which I believe the FSA should change relates to the permitted use of inherited estates to pay shareholders' tax. I have asked the FSA to explain further its stance on this issue and I await its response.

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, an inherited estate 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, particularly in the use of the estate to subsidise the capital cost of writing of new business, and in paying shareholders' tax as noted above. I set out these matters in more detail in a memorandum to the Treasury Committee¹.

C. Response to the consultation paper 'With-profits funds – compensation and redress'

The paper notes² that allowing proprietary companies running with-profits funds to charge payments for compensation and redress in relation to their past and present policies to their inherited estates may not lead to the intended outcome of COBS 20.2, which is that firms treat with-profits policyholders fairly. The current rules do not permit proprietary companies to pay financial penalties (fines) from a long-term insurance fund, and the FSA proposes to leave this position unchanged.

The FSA states that it believes that the rules as they stand provide insufficient incentive for proprietary firms to address failure of systems and controls and, as a result, with-profits policyholders may not be treated fairly. It further notes that shareholders alone should bear the risk of such management failures as is already the case in relation to non-profit business such as unit-linked business that is not written in a with-profits fund.

FSA Consultation Question 1

Do you agree with our proposal to prevent the use of inherited estates to pay compensation and redress?

Response

¹ The memorandum was published in full in HSC 496, 19 June 2008, Twelfth Report of Session 2007-8, Treasury Committee.

² Overview, page 3, 1.4

The current regulatory regime in respect of mis-selling presents with-profits life insurance companies with a moral hazard by permitting the use of the inherited estate to pay compensation and redress. Open funds benefit from the selling of new policies and introducing new policyholders to with-profits funds. There is every incentive on the companies to sell profitable new policies. Sales force personnel as well as the shareholder will benefit from commissions, where payable, and profit-generating new business. As noted above, with-profits policies are complex financial products which the potential owner may lack the experience to judge adequately in terms of whether they are suitable to meet the investment or savings needs of the individual concerned. In such instances, the individual may rely on the sales person to give appropriate advice and guidance about the suitability of the product for their needs. The nature of that advice could be influenced by the extent to which the adviser believes that any inappropriate advice could result in financial compensation being borne by the shareholder as opposed to an inherited estate, which could be regarded as a contingency reserve for such matters. In the latter case it is more likely that less care would be given to advice to potential policyholders than in the former.

The cost of widespread or systematic failures of advice resulting in mis-selling, if borne by the inherited estate, can be very significant both in total financial terms and in respect of the impact not just on the policyholders who have been mis-sold, but on the other policyholders in the fund. The possibility that those policyholders have of benefiting from special bonus distributions from any excess surplus in the inherited estate is diminished by the permanent erosion that results from paying the costs of mis-selling compensation and redress. This is clearly unfair and the FSA is right to propose to prevent the use of inherited estates to pay compensation and redress in instances of mis-selling.

FSA Consultation Question 2

Do you agree with our detailed proposals?

The proposals include that the rule change will take effect for payments after 1 November 2008 and, where arrangements to the contrary are governed by existing court approved schemes, such schemes will take precedence. These proposals are uncontroversial.

A further detailed proposal is that the rule will apply to all types of compensation on the basis that distinguishing between 'systematic' mis-selling and other events that might give rise to payments of compensation and redress will be difficult to frame and open to abuse.

In giving oral evidence to the Treasury Committee (see page 3, footnote 1) I suggested that there could be a slightly more nuanced approach to that suggested by the FSA's detailed proposal above. It should be possible to differentiate between systematic and widespread mis-selling and mis-selling which results from human failing or inadvertent miscalculation. A provision to facilitate such a differentiation could be met by an opportunity to apply to the FSA to charge to asset shares the costs of compensation or redress in isolated incidents of mis-selling. The prospect of any such additional charge should be made clear to policyholders. Applications could be made with a time delay to allow other instances to come to light or be recoverable in circumstances where it appeared in hindsight that there was a systematic problem. However, consideration would need to be given to the fact that the administrative costs of such a rule may well outweigh its advantages, in which case I would support the FSA's proposal.

The final detail proposed by the FSA is that 'guarantee' schemes, which typically promise mortgage endowment maturities will cover the home loan they were taken out to pay off if investment growth achieves a set level, should continue to be met from the inherited estate.

This approach contrasts starkly with the otherwise clear proposal to prevent compensation and redress payments being made from the inherited estate. To the extent that the costs of such guarantees result from systematic failure, there is no reason to permit policyholders to be charged to meet such costs. The argument adduced above, in respect of the impact on policyholders' reasonable expectations of special bonus distributions for excess surplus in the inherited estate, have equal force in the case of guarantees as they do in the case of other compensation and redress payments from the inherited estate. As such, there is no reason to exclude guarantee schemes from the general prohibition proposed on allowing the inherited estate to be used to meet the cost of compensation and redress payments.

Yours sincerely,

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Policyholder Advocate