Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

Telephone: 020 7066 9346
Email: enquiries@fs-cp.org.uk

Matthew Field
Conduct Business Unit Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

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Dear Matthew,

This is the Financial Services Consumer Panel's response to the Financial Services Authority's consultation CP12/38: Mutuality and with-profits funds: a way forward.

The Panel understands the rationale behind the proposals to intervene in the mutual with–profits sector, by removing the current barriers that prevent mutuals with a single common fund from identifying and ring-fencing the with-profits element of their business. The FSA hopes that this process of identifying and separating the 'mutual capital' will facilitate a well-managed run-off of the business, and where appropriate, allow the business to continue to be a viable provider of non-with-profits products.

We are broadly supportive of the principle behind the CP, in so far as it aims to ensure that there are no undue restrictions precluding viable businesses from continuing to innovate and avoid closure, particularly when this also serves the interests of a group of consumers, the non-with profits members of mutuals.

However, the change you propose is a departure from a fundamental principle of the mutual, which is predicated on the assumption that policyholders are, in effect, the 'owners' of the firm. Your central proposal requires a change in the Conduct of Business Sourcebook (COBS) Chapter 20, which in effect, will remove the right of with-profits policyholders to vote on the significant issue of identifying and ring-fencing 'mutual capital'.

We appreciate that the mutual sector is under significant stress and we agree that something must be done to ensure that the sector can continue in a viable manner that delivers good results for all members. We also recognise the difficulties caused by the marked decline in new with-profits business and the associated negative cash flows, which mean that for most firms the with-profits element of the business is in an accelerated phase of run-off.

However, any intervention must be proportionate and give careful consideration to the interests of long-term policyholders. This is particularly important when considering with-profits policyholders, the cohort of vulnerable consumers likely to be especially affected by this rule change.

As a result of exit penalties or potential loss of valuable guarantees, with-profits policyholders are often locked into what were typically long-term, opaquely written contracts. Some will have mortgage endowments and pensions which are due to mature and pay out over the next few years; fund values will be much lower in many cases than the policyholders were led to expect. In some cases consumers will not be able to pay off their mortgage and in the current climate, re-mortgaging will be difficult, particularly if the timing coincides with their retirement, as is often the case. This makes any changes to the structure of mutuals a potentially high-profile issue.

The crux of our concern is that the proposals will give firms permission to make a significant change to their business model without seeking the approval of with-profits policyholders, as currently required under COBS 20.2.60 G(2). In our view, this voting right is fundamental. We understand your objection that the voting exercise is expensive to run[1] but note with surprise that the CP offers no quantification of voting costs to support the strong assertion that disenfranchisement might be in with-profit policyholders' interests.

In view of the cost objection, we gave some consideration to an option of granting only small mutuals the right to apply for a modification as you propose. But this option would offend the notion of equality of rights and may expose with-profits policyholders of small mutuals to considerable harm, especially if governance is not of the highest standard.

Based on the evidence presented in CP12/38, our first and preferred option is for the retention of the with-profits policyholders' voting right, one that should apply to all firms, irrespective of their size.

However, should the FSA decide to press ahead with its proposals, we would recommend a considerable strengthening of the requirement for firms to submit an 'independent report' in support of their intention to identify "mutual capital".

We are concerned that the "independent expert" central to your proposals may not prove truly independent of the management of the mutual that must pay the commissioned expert's fee; the weaknesses of the with-profits actuaries regime revealed by the FSA's previous investigations are an indication of the potential difficulties.[2] The effect of bias in favour of management would be aggravated were management's self-interests not wholly aligned with those of policyholders. It has been put to us that the governance of mutuals is not always satisfactory.

To strengthen the proposal, clear and robust terms of reference for the independent expert would be required in the Panel's view. We note that the proposed amendment to COBS guidance refers to the need for the terms of reference to be agreed with the FCA. Missing from this guidance is an emphatic statement that the expert should be independent of management, act solely in the interests of all members, and be especially mindful of the most vulnerable.

[1] CP12/38, paragraph 2.33
[2] "With-profits regime review report", FSA, June 2010, paragraphs 3.26n

To help achieve these ends, we propose that the role of the independent expert be recast as that of a Member Advocate. The Advocate would be charged with assessing the soundness of the proposal in the same way as an independent expert, as outlined in your document, but crucially would be required to put the interests of all members at the heart of his/her considerations. A key task would be to advise on whether or not (depending on the circumstances) with-profits policyholders should be given their right to vote, or for it to be waived.

We do not believe that the requirement for a Member Advocate would cost more than the requirement to obtain an 'independent report'. However, our proposal would ensure that the needs of the consumers who are potentially most vulnerable, because they cannot easily exit from a with profits policy without incurring penalties or losing valuable guarantees, are put at the centre of any considerations.

It is clear from recent Mergers and Acquisition activity that the mutual market is contracting and it is likely that the implementation of the recommendations of your consultation paper will accelerate this trend. Therefore, we urge the FSA to consider the longer-term consequences (intended and unintended) and the precedents which would be set by this proposed COBS rule change. Our concerns cannot be expressed readily in the question format you present and therefore we would welcome the opportunity to meet to discuss these points with you in advance of a final decision.

Set out below are our responses to 3 of the general questions raised in your CP.

1. **Do you agree with this analysis and do you think its conclusions are fair to with-profits policyholders and sustainable for mutual organisations**

- The Consumer Panel does not agree with the central proposal to disenfranchise with-profits policyholders by removing their right to vote on a matter which fundamentally affects the business and their investments. Moreover, the proposal lacks the necessary checks, balances and oversight that might redress the balance which currently appears to be tilted towards managers of mutuals. The proposed independent expert report might focus on other concerns to the detriment of with-profits policyholder protection.

- We are not convinced by your argument that the cost of a with-profits policyholder vote is a robust rationale for eliminating this process. Indeed we were very surprised that, having made this assertion, you did not provide any clear analysis on what these costs might be. The absence of any quantification of benefits in the CBA[3] is also disappointing; the proffered rationale sits incongruously with your willingness to estimate costs based on an assumption about the proportion of mutual firms applying for a waiver.[4] We believe these are serious omissions which we urge you to address in order to facilitate a meaningful consideration of the issue.

[3] Annex 1, paragraph 15
[4] Annex 1, paragraph 14.

2. Do you agree with our approach to a proposed process for recognising mutual members' funds?

- We agree that firms should be required to apply to the FSA/FCA/PRA for a modification before any separation of mutual funds can be effected. However, we do not agree with the proposal to remove the existing guidance for mutuals in COBS 20.2.60 G(2).

- We are further concerned that this proposal, should it be implemented, will set a precedent that would de facto remove the with-profits policyholders' vote permanently and which might easily be extended to non-with profits policyholder members of mutuals.

3. Do you agree with the support element we are proposing for the process and the principles outlined

- As noted above, we do not believe that the support element is sufficiently robust. We are concerned that the 'independent report' might be biased in favour of the firm's management, and might not fully consider the position of with-profits policyholders, who are generally very long-term investors in mortgage and pension plans and who are, in effect, 'trapped' by exit penalties or the loss of potentially valuable guarantees. We recommend that instead of an 'independent' report, firms should be required to provide a report from a Member Advocate. The Member Advocate would be required to consider and uphold the interests of all members, with special regard to the most vulnerable, and, in so far they differed, to disregard the self-interests of management. The Advocate would also advise whether or not the mutual should seek the approval of with-profits policyholders.

Yours sincerely

Adam Phillips
Chair
Financial Services Consumer Panel