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

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

Peter Morris
Products Team, Investment Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

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Dear Peter

CP11/5* Protecting with-profits policyholders**

This is the Financial Services Consumer Panel's response to CP11/5*** Protecting with-profits policyholders.

Overview

Overall we support the measures set out in this Consultation Paper and the action the FSA is taking to protect the interests of with-profits policyholders. There are some proposals where we would like the FSA to go further, such as ensuring greater transparency about the operation of with-profits committees and the decisions they take; and more prescriptive rules on significant reductions in levels of new business. There are also areas where we believe further work is required.

Governance

We have particular concerns about the proposal to require only funds in excess of £500mn to have a with-profits committee, with so-called "small funds" falling below the threshold being required to ensure the involvement of "independent judgement" in key areas. Our view is that policyholders in all with-profits funds, including small funds, are entitled to the same levels of independent representation. We support a mandatory with-profits committee across the board, but with a sliding scale approach to the composition of the committee depending on the size of the fund.

If the FSA Board pursues some form of cut-off point for the establishment of a with-profits committee, we would wish to see comprehensive evidence to support both the decision and the chosen amount. The figure of £500mn identified in the Paper is described as being familiar to firms and having the benefit of simplicity, but is otherwise arbitrary and does not seem to take account of the interests of policyholders, whose interests are of paramount concern.

We would like to see prescriptive rules published on appropriate Terms of Reference for with-profits committees and greater policyholder access to the work of with-profits committees through key information on firms' websites and in annual reports.

Charges to with-profits funds

We have concerns about any pension fund deficit being met with with-profits policyholder funds. We would like to see more evidence to support the validity and fairness of these charges as a whole and if they are to continue to be met in this way, we believe that this is an area that the with-profits committee should scrutinise closely.

Advice

Although not within the scope of the current consultation, the long-standing issue of accessible and affordable advice for policyholders is a key concern and is yet to be addressed. Decisions around whether to retain or sell/surrender a with-profits policy can be complicated and it can be almost impossible for many policyholders to take such decisions without the benefit of financial advice. But the availability of such advice is low and consequently the cost of it can often be prohibitive either in cash terms or in relation to the likely value of a particular policy.

The most obvious question to be answered therefore is who should pay for this advice and there is no equally obvious answer. As advice around the retention or disposal of a regulated investment constitutes regulated advice, it would not be possible for an unauthorised organisation such as The Money Advice Service to fill the gap, although we do nevertheless see a role for The Money Advice Service in providing information and guidance on with-profits issues in general. Requiring firms operating with-profits funds to pay a small levy towards the cost of advice could be appropriate. We would like the FSA to stimulate public debate in this area by publishing a discussion paper or occasional paper on the subject, or perhaps by hosting a roundtable-type event to air the issues. The Panel will be happy to participate.

Review

We would like the regulator to undertake a post-implementation review of the new arrangements after a reasonable period and taking into account the changes that will result from Solvency II. We suggest that 2015 would be an appropriate point at which to begin the review.

Detailed questions

Q1: Do you agree with the proposal to include guidance setting out our view of some of the interests of policyholders in with-profits funds?

We agree with this proposal. We would like to see the FSA taking the opportunity presented by the introduction of the guidance to publicise it widely, for the benefit of consumers as well as firms and advisers.

Conflicts of interest

Q2: Do you agree with our proposal to convert elements of COBS 20.2.1G into mandatory requirements in a rule and to clarify the types of conflicts that may arise?

Yes. We believe that this strengthening and clarification of the requirements relating to managing conflicts of interest should help firms to revise their policies and procedures to meet the necessary standards demanded by the regulator and by policyholders in this particular area, without in any sense undermining the need for compliance with Principle 6 (Treating Customers Fairly).

As is made clear in the Paper, there is a complex relationship between stakeholders such as with-profits policyholders and other policyholders, and current and future policyholders. The FSA's proposals should help firms to understand the need to consider the interaction between the interests of various groups of individuals and to comply with both principles and rules. As well as technical compliance however there will often be a significant element of judgement in deciding what is "fair" in particular circumstances. In all cases we would expect firms to be in a position to explain to the regulator and, if appropriate, to policyholders the basis on which such a decision was made.

Fair treatment of with-profits policyholders with particular regard to mutually-owned long-term insurance funds

Q3: Do you agree with our proposed approach to the use of COBS 20.2.17R and to the clarifying amendments to the definition of 'required percentage' that we propose to make? Do you consider the guidance that we propose to make in this area to be adequate and clear?

This is an important area and it is evident that greater clarity is required around this particular issue. We support the FSA's view that in relation to distributions, with-profits policyholders with a mutual should not be treated in a materially different and less favourable way than policyholders with a shareholder owned firm. All policyholders are entitled to fair treatment.

We have no objection to the proposed amendments to the definition of "required percentage" and no comments on the proposed guidance. We do however think it will be important for firms to demonstrate unequivocally what their practice is and for this to be communicated to policyholders. In cases of doubt it may be appropriate to seek policyholders' views.

New business

Q4: Do you agree with our proposal to strengthen our rule and guidance on the terms of new business written into a with-profits fund?

We support this proposal which changes the emphasis of the new business 'test' to the far more appropriate question of whether there is likely to be any adverse effect on with-profits policyholders' interests as a result of the new business. We note that firms will be required to carry out all appropriate analysis and to provide it to the with-profits committee or alternative arrangement. This will again be an area where a significant degree of individual judgement will be required and we would like the relevant rule/guidance to ensure that the governing body makes clear to the with-profits committee the rationale behind the proposal to (continue to) write new business, as well as the financial analysis.

Material reductions in new business

Q5: Do you agree with our proposal that a firm should discuss with us what actions may be required to ensure the fair treatment of with-profits policyholders if it experiences sustained and significant falls in the volume of new business?

Yes, we support this proposal. It is entirely appropriate that there should be early and meaningful dialogue between the firm and the regulator in these circumstances. It is not entirely clear to us, however, how this would work in practice. For example, would firms already writing few new contracts into a fund be required to discuss the position with the regulator, or would they only be required to comply with the new rules if levels of business fell still further? We would like to see existing 'low level' funds covered so that existing policyholders will enjoy the additional protection provided by the new requirements.

There is also a need for clarity around the meaning of "significant" in this context. We recommend the use of a sliding scale in the form of a percentage or ratio range as a mechanism for alerting management to the need for a possible reference to the regulator, with a mandatory trigger point at which referral should be made.

Q6: Do you agree with our proposal to require firms to have fair distribution plans appropriate to their reasonable/sustainable new business projections?

Yes. We would have expected firms to have produced such plans for their own use, so this new requirement should not place any additional burden on the business.

Q7: Do you agree with our proposal that firms prepare, maintain and update a management plan containing contingency arrangements in the event they experience sustained and significant falls in new business volumes?

We agree with this proposal and, again, would expect firms to have this information already.

Q8: Do you agree that the with-profits funds that closed to new business before the current rules came into effect in 2005 should have run-off plans?

We agree with this proposal. Firms with funds that were already closed to new business by 2005 should have run-off plans, or the information necessary to produce them. We agree that the plans should be submitted within three months of the new rule coming into force.

Market value reductions

Q9: Do you agree with our proposal to change the rule so that an MVR can be applied only where there could otherwise be a payment in excess of the value of the assets underlying the policy?

and

Q10: Do you agree with our proposal to clarify our rule relating to MVRs and distribution ratios?

We support both proposals, which we understand reflect existing policy. MVRs are a mechanism for protecting remaining policyholders and should be a proportionate rather than a penal charge. They should be applied transparently and only where appropriate and communicated in a timely and effective manner. Firms should also proactively inform policyholders of exit periods when an MVA will not be applied.

Strategic investments

Q11: Do you agree with our proposal that the existing guidance on strategic investments should be strengthened into a rule and that the guidance formerly in COB 6.12.86G (amended to take account of the new rule) should be restored?

We were shocked to see from the Paper that it continues to be fairly common practice for firms to use with-profits funds to invest in assets such as own premises and substantial connected investments. This is an area which is extremely important for policyholders and for firms in view of the conflicts of interest which can arise and the illiquid nature of some of the investments. As the Paper notes, issues around retention and disposal of strategic investments become even more significant where funds are either closed or accepting little new business.

It may well be that in strengthening the current guidance into a rule and re-introducing earlier guidance as proposed, a move which we support, the FSA is going as far as it thinks reasonable to require firms to take account of their with-profits policyholders' interests fully when considering retention, purchase or sale of significant investments of this nature. We understand that a firm's investment strategy is a complex area based on expert advice and experience. However, that is little consolation to with-profits policyholders who find their funds invested in assets that might not be readily realisable and/or the value of which is dependent on the profitability and viability of the business as a whole. It is not possible to 'turn the clock back' and prohibit firms from using with-profits funds in this way, but we would like the regulator to ensure that it has the resources to analyse plans to retain or invest with-profits policyholders' funds in these classes of asset, including taking full account of the views of the with-profits committee, and to respond effectively and robustly.

Charges made to with-profits funds

Q12: Do you agree with our proposal to amend COBS 20.2.23R to prevent value being extracted from a with-profits fund by other group companies making charges in excess of their costs?

We support this proposal. As is indicated in the paper, there is no sensible rationale for making a profit from in-house services provided to with-profits funds.

We note the comments made in the Paper about meeting pension scheme deficits from a with-profits fund and we are surprised that this is considered appropriate. We would expect such deficits to be the responsibility of shareholders, not policyholders, in proprietary companies. We would like to see more evidence about approaches to managing pension fund deficits in other industries to ensure this part of the financial

services industry is not placing the burden for its pension scheme deficit unduly on policyholders.

In the meantime, we are not persuaded that the FSA's approach of implicitly permitting a fair and reasonable proportion of any deficit to be included in the staff costs that are charged to the with-profits fund, is sufficiently robust. We see this as a specific area of costs that the with-profits committee should scrutinise closely to ensure that there is no disproportionate levy on the fund. These costs should also be clearly communicated to existing and new policy holders to ensure transparency.

Excess surplus

Q13: Do you agree with our proposal to remove the ability of firms to reattribute excess surplus?

We support this change which reflects the Aviva judgement and will provide much needed clarity.

Reattributions

Q14: Do you agree that a firm that proposes a reattribution should, prior to that proposal, be required to pay particular attention to identifying and distributing excess surplus?

Yes, we agree. That is the only approach which is consistent with the relevant rules and guidance, including treating customers fairly.

Q15: Do you agree that the policyholder advocate should have control over the content of communications provided by the policyholder advocate for policyholders?

Yes, we strongly support this approach. Policyholders are entitled to receive information from their representative that has not been subjected to any form of 'censorship' by the firm.

Doubts have been expressed anecdotally about the effectiveness of communications with policyholders in a reattribution. Policyholders often have difficult decisions to make in these circumstances and face systemic behavioural biases, such as hyperbolic discounting (favouring short-term gains much more than long-term ones) which the FSA notes as a risk in the Retail Conduct Risk Outlook 2011. It is important that customers fully understand what the reattribution means and how it will affect them. We hope that placing control of policyholder advocate communications with policyholders in the hands of the policyholder advocate him/herself would go some way towards ensuring that the complex issues and considerations are expressed clearly.

Q16: Do you agree that it would be unfair for a firm proposing a reattribution to seek to bind the minority, against their wishes, by means of the reattribution scheme?

Yes, we agree. Binding the minority in this way would not be consistent with the rights of individual policyholders to make informed choices in a reattribution. Policyholders should have the option of retaining their interest in the estate.

Corporate governance

Q17: Do you agree that a with-profits committee should be required for all with-profits funds except small funds, and that the threshold suggested is the right one?

Our view is that policyholders in all with-profits funds, including small funds where the risk to individual policyholders could be said to be higher than in a large fund, are entitled to the same levels of independent representation. This includes a with-profits committee. We think it unlikely that many potential policyholders would know, or realise that they needed to take account of, the size of a particular fund before deciding to invest. Placing responsibility for providing "independent judgement" on one individual is in our view unrealistic. Whatever the skills and expertise of that individual, he or she will always face a possibly insurmountable hurdle in making sure the interests of with-profits policyholders are taken into account by a board or governing body.

We are mindful of course that the cost of setting up and running a with-profits committee would in all likelihood be passed on to policyholders and we can see that there is a balance to be struck between structured, formal independent representation and disproportionate cost. However, without further detailed evidence of the cost of setting up and running with-profits committees it is difficult to know the cost burden we are describing and whether the benefits may outweigh those costs. On this point we recommend the FSA investigate and provide further information.

We are opposed to the polarised approach set out in the Paper, with a single cut-off point for the establishment of a with-profits committee of £500mn. We recommend instead a with-profits committee for all funds but with a 'sliding scale' approach to the size and composition of the committee which is directly related to the size of the fund. The committee for even the smallest funds should comprise more than one individual. This should go some way towards ensuring appropriate representation for all with-profits policyholders while bearing in mind potential burdensome costs.

If the FSA Board pursues some form of cut-off point for the establishment of a with-profits committee, we would wish to see comprehensive evidence to support both the decision and the chosen amount. We do not think that the figure of £500mn identified in the Paper would be the right one. The Paper describes this as being familiar to firms and having the benefit of simplicity, but does not seem to take account of the interests of policyholders and we believe that this is the most important consideration. In absolute terms £500mn is a large sum and if an arbitrary limit has to applied, we would have thought a much smaller sum, no more than £100mn, would have been more appropriate given the market profile.

If there are to continue to be funds without a with-profits committee, the fiduciary obligations of the person providing "independent judgement" should be strengthened to provide greater protection for with-profits policyholders. The areas in which firms

are required to take account of the views of the independent person should be the same as those for the with-profits committee. The Paper makes it clear that whatever is decided at this stage, Solvency II could have an impact, so the requirements put in place as a result of the current consultation are likely to be temporary. We agree that action is required in this area during this interim period, but only after more work has been undertaken to establish whether there should be a small fund 'dispensation' and, if so, what the cut-off point should be.

I reiterate that in the Panel's view all with-profits funds should have an appropriate with-profits committee.

The paper refers to a requirement on firms with one or more funds with a with-profits committee to appoint the same with-profits committee, thereby ensuring that all with-profits policyholders in any fund within the firm, regardless of size, are represented by a with-profits committee. We support this approach provided that it is mandatory and agree that it should ensure consistency, although it remains to be seen how this would work in practice.

We are aware of concerns that there may not be enough appropriately skilled people to take up the responsibilities on with-profits committees. We would therefore recommend that the FSA work with the industry, trade bodies and accrediting institutions to establish training provision in this area. One might also envisage a forum to share learning and offer peer support, which could also serve to highlight issues that should be addressed by the regulator.

Q18: Do you agree that the members of a with-profits committee should be independent and completely external to the firm whose with-profits fund(s) they are considering?

and

Q19: Alternatively, should we continue to allow directors and non-executive members of the governing body to sit on the with-profits committee, subject to its having an independent majority?

We believe the with-profits committee should be completely independent to the firm and that its members should be external. It would be inconsistent with the principle of independence for any of the firm's non-executive directors to be on the committee. If such a move was permitted, the committee could be vulnerable to actual or perceived influence by the firm and it would create additional 'hurdles' for the committee to overcome in demonstrating its independence to policyholders.

In the medium and longer term consideration should be given to investing resources in training and developing individuals to take on the committee role if such individuals are difficult to recruit.

Q20: Do you agree with defining independence using the same criteria for independence as the Financial Reporting Council's current Code?

Yes, we agree that the criteria are appropriate.

Q21: Do you agree with the proposal to have terms of reference published on the firm's website?

Yes. There is a need for much greater transparency around the operation of with-profits committees and publication of the terms of reference is a part of that. Policyholders with access to the internet will be able to find this information, but other arrangements would have to be put in place to ensure that all policyholders were made aware of the terms of reference. This could be achieved by the inclusion of a suitably clear leaflet in other written communications to policyholders.

We would like to see the FSA prescribing rules on drawing up reasonable and appropriate Terms of Reference, including the powers and responsibility of the with-profits committee to challenge the PPFM. We would also like firms to set up a webpage on their sites, accessible from the home page, providing important information about the committee, including key committee documents and decisions and the basis on which decisions were taken. A summary of this information, written by the with-profits committee, should also be included in firms' annual reports. This small package of measures should improve policyholder access to information about the with-profits committee and raise the profile of the committee more widely.

Q22: Do you agree that the conclusions of the with-profits committee and the governing body's decisions to accept or to reject those conclusions must be clearly recorded?

Yes. This is part of basic good governance practice.

Q23: Do you agree that with-profits committees should have the right to make a reasonable request to obtain external advice and in shareholder-owned firms request that this is at the shareholders expense?

We agree with this proposal. In order to fulfil their obligations, with-profits committees need access to the right information at the right time and this could occasionally include external advice. The committee support function should be empowered to take such steps as are necessary to help the committee to do its job properly. We agree that the cost of support and external advice should be met by the shareholders where the firm is a proprietary company and we would like to see FSA guidance on appropriate provisioning/funding by firms.

Q24: Are these the right areas for a with-profits committee to consider and on which to provide advice?

The areas shown in paragraph 3.23 of the Paper are all ones in which the with-profits committee should take an interest and provide advice, although the list should not be considered exhaustive. In addition to considering the firm's compliance with its PPFM, however, we would like the with-profits committee to have a greater input to the document itself with particular regard to its fair treatment of policyholders. We would also expect the with-profits committee to consider the level of charges to policyholders alongside the costs of running a with-profits fund and to challenge firms to justify any increases.

As we have said in our response to question 12, if it is decided to continue to permit with-profits funds to be used to meet a proportion of any pension fund deficit we would expect the with-profits committee to scrutinise the level of charges closely.

Q25: Do you agree that the with-profits committee should be able to raise issues proactively that it thinks the governing body needs to consider?

Yes, this will be an intrinsic part of the work of the independent with-profits committee. The committee's effectiveness and ability to represent with-profits policyholders' interests would be compromised if its operation was restricted to reacting to approaches from the governing body.

Q26: Can with-profits committees or other independent persons as described operate effectively alongside the with-profits actuary?

We believe that it is essential for the with profits committee to have access to its own independent actuarial advice. This would be the most effective way of ensuring conflicts of interest do not arise. If implemented, it will be important for the regulator to review how their proposal works in practice and be ready to respond to any issues around independence and effectiveness.

Q27: Is it right to introduce a notification mechanism for alerting the regulator to significant issues where there has been disagreement?

Yes. Instances of the governing body departing from the with-profits committee's advice are likely to be significant and have implications for with-profits policyholders' interests, so it is entirely appropriate that the regulator should be alerted and take appropriate action. We think it would be appropriate for the committee to deal directly with the regulator in cases of significant potential policyholder detriment, or where there is great urgency.

Q28: Do the proposed changes for the with-profits actuary provide sufficient support for his independence and how practical is the arrangement for setting his remuneration?

We remain sceptical about the extent to which the with-profits actuary can be truly independent. In the absence of a completely independent with-profits actuary, the proposals in the paper might go some way towards strengthening the with-profits actuary's role. The practicality and effectiveness of the arrangements can best be assessed as part of a post-implementation review, but we hope that in the meantime the FSA will be actively monitoring this approach against the desired outcomes and intervening earlier if necessary

Q29: Are there any other matters that you think are relevant to this consultation?

We recommend that the regulator undertakes a comprehensive post-implementation review to assess the effectiveness of the new arrangements for policyholders. We are mindful of the fact that the industry will be undergoing a period of change arising from Solvency II, as well as from the new regime proposed in the Paper. We would not wish to see an extended transitional or 'lead in' period however, given the

number of with-profits policyholders at risk and the scale of actual and potential detriment. A target date of 2015 would seem to be appropriate.

Although not directly relevant to this consultation, we have already referred to the issue of accessible and affordable advice for policyholders. This is an area which needs to be addressed soon and, as we have indicated, we would like the FSA to stimulate public debate in this area.

Yours sincerely

Adam Phillips
Chair
Financial Services Consumer Panel