

Financial Services Consumer Panel  
Submission to Treasury Committee  
Inquiry into the Inherited estate

April 2008

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## Executive summary

The Financial Services Consumer Panel is pleased to have this opportunity to inform the Treasury Committee about issues of concern we have in relation to the inherited estates held by with-profits funds. While we are aware that there are numerous challenges in this area, we have focused this submission on our principal concerns.

The Panel has questioned<sup>1</sup> in the past the permitted uses of the fund, particularly where it seems some companies appear to treat the inherited estate as a free asset. While we recognise that the inherited estate belongs to the firm, as does the with-profits fund, there does not seem to be sufficient recognition that policyholders have contributed to the building of the inherited estate and as a result have a justified interest in how that estate is used and distributed. We welcome the introduction of the role of policyholder advocate and acknowledge the FSA's role in scrutinising the fairness of reattribution proposals.

The Panel's aim is to ensure policyholders are treated fairly in any distribution of inherited estate. In particular, we would like to see

- Greater independence in with profits committees and increased transparency about the reasons for their decisions
- Better, more helpful communication with policyholders during the reattribution process
- Timely, effective and fair distribution of benefits once decisions have been made
- A review of the role, responsibilities and effectiveness of the Policyholder Advocate following the Norwich Union reattribution process to determine whether it is necessary to strengthen the role
- A wider debate about the permitted uses of a fund than currently proposed by the FSA
- A review of the current rules relating to the governance of with profits funds.

Adam Phillips

Vice Chairman

Financial Services Consumer Panel

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<sup>1</sup> Financial Services Consumer Panel Press Release: FSA must do more to ensure Treating Customers Fairly for reattribution of inherited estates, December 2007

## Principal Concerns

**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**

1. The Panel has expressed concern<sup>2</sup> in the past about the permitted uses of the inherited estate. The inherited estate can be a substantial asset for proprietary companies and assists with the running of the business. While we are aware that the inherited estate belongs to the firm, as does the with-profits fund, there does not seem to be sufficient recognition that policyholders have contributed to the building of the inherited estate and as a result have a justified interest in how that estate is used and distributed. In addition, there does not seem to be sufficient appreciation of the benefits that shareholders have received through the permitted uses of the inherited estate or appropriate recompense to policyholders for this.
2. The potential for conflicts of interest between shareholders and policyholders in the use of the inherited estate is clear. We believe that the key issue is how to ensure that these conflicts are managed, so that the company's use of the inherited estate reflects the principle of Treating Customers Fairly<sup>3</sup> ('TCF'), as well as taking shareholder interests into account, where appropriate.
3. Following the with-profits review undertaken by the FSA in 2001 it decided to require insurers to produce a document called the Principles and Practices of Financial Management (PPFM) explaining how firms ran their with-profits business. The PPFM contains information such as how policy payouts are determined, the operation of smoothing, bonuses and market value reductions. Firms are required to produce a consumer friendly version which summarises the key aspects in a clear and understandable way.
4. Last year the Panel commissioned research<sup>4</sup> into the question of whether customers in closed funds were being treated fairly. This found that there was a strong view amongst consumer representatives and some providers that conflicts of interest between shareholders and policyholders

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<sup>2</sup> Financial Services Consumer Panel Press Release: FSA must do more to ensure Treating Customers Fairly for reattribution of inherited estates, December 2007

<sup>3</sup> Principle 6 of the FSA's 11 Principles for Businesses: A firm must pay due regard to the interests of its customers and treat them fairly.

<sup>4</sup> Are Customers in closed funds being treated fairly? Raising the bar for advice, administration, communications and governance. Research for the Financial Services Consumer Panel by the Pensions Institute, Cass Business School and IFF Research Ltd, pg 29, para 4.4:Governance

can, in effect be 'written into' the PPFM to the benefit of shareholders. These include the management's right to use policyholder capital to fund new business operations and costs (including comparatively high levels of initial commission), to buy closed funds, to pay shareholder tax and to pay mis-selling claims. We do not suggest that such uses of policyholder capital represent breaches of regulatory rules, nor do we suggest that the conduct of business rules encourage such use, but we are concerned that the present governance arrangements for funds are not sufficiently robust or transparent.

5. We are pleased that the FSA intends to consult<sup>5</sup> during the first half of 2008 on whether it should change its approach and require shareholders to meet mis-selling costs. However, given the concerns we encountered in our research, in the interests of policyholders we suggest that firms' use of policyholder capital is reviewed more widely in an open debate.

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

6. The key principle that should guide any reattribution is to treat policyholders fairly. This is much more complex than it sounds, given that policyholders have been in the fund for different lengths of time and that no one can be certain what the future will hold. The Policyholder Advocate has been examining this problem in detail, but it seems reasonable that money should be paid out as soon as possible and that it should go to all policyholders who were in the fund when a Policyholder Advocate is appointed.
7. An important problem facing those involved in considering the size of the fund available for redistribution is that a decision to stop seeking new business has a considerable impact on the way the fund has to be managed and the risk appetite of the fund. New policyholders joining the fund enable it to take on more investment risk and therefore should lead to higher returns. It is therefore assumed that it is in policyholders' as well as shareholders' interests for a fund to continue to invest in developing new business where this is likely to be profitable. However, a decision to close a fund or seek new business less aggressively can create a situation where the risks of the fund are reduced and excess surplus is created. If the strategy changes after a reattribution all the excess surplus goes to the shareholders. If such a change in policy could have been anticipated before the reattribution, it would be extremely unfair to policyholders who would have based their decision on misleading information. It is therefore important that the Policyholder Advocate and the Company agree that the new business strategy for the fund is reasonable and that after a reattribution the FSA checks that the company follows its stated strategy

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<sup>5</sup> [http://www.fsa.gov.uk/pubs/other/reattribution\\_letter.pdf](http://www.fsa.gov.uk/pubs/other/reattribution_letter.pdf)

under its requirement to ensure that a firm manages conflicts of interest, fairly<sup>6</sup>.

8. We have expressed our concern to the FSA that a firm could set a high risk appetite requiring capital to be set aside to cover this and then after the reattribution adopt a low risk appetite and pass the excess capital to shareholders, circumventing the reattribution. In response to our concern, which is also shared by Clare Spottiswoode, the Policyholder Advocate for the potential reattribution of the CGNU Life and Commercial Union Life Assurance Company Funds, the FSA has said that it expects firms to limit post reattribution distribution.<sup>7</sup> We look forward to an explanation of how this can be achieved.

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

9. The Panel believes that policyholders have a reasonable expectation that a distribution from the inherited estate has a positive value. The inherited estate is built up by with-profits funds over many years and is above the amount expected to be needed to meet current and future policyholder commitments and other liabilities. As such it has a real tangible value; to argue that the inherited estate has a zero value seems to be counter intuitive.

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

10. The Panel suggests that the views of the Policyholder Advocate should be taken into account when the firm decides how the distribution of benefits should take place. We do believe that it is fairer to make a single payment rather than phasing payment over several years. In addition, we believe that it is essential that the views of with-profits committees on this issue should be made public. This would enable policyholders to be aware of the opinions of the body established to represent their interests and their reasons for believing that a particular course of action was appropriate. We can see no reason why these views should not be disclosed.

**The role and responsibilities of the Policyholder Advocate**

11. Following the AXA reattribution in 2000, the role of the Policyholder Advocate was introduced to enable policyholders to have an independent representative in the process. The Panel welcomed the creation of this role as it is important that policyholders have a strong and appropriately qualified voice in this arena. The appointment of Clare Spottiswoode by

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<sup>6</sup> The FSA's Principles for Business: Principle 8: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

<sup>7</sup> [http://www.fsa.gov.uk/pubs/other/reattribution\\_letter.pdf](http://www.fsa.gov.uk/pubs/other/reattribution_letter.pdf)

Norwich Union in November 2006 is the first time that this new role has been tested.

12. There is no doubt that the creation of the role of Policyholder Advocate has enabled a more effective debate about the reattribution to be conducted. We look forward to a comprehensive review of the role, responsibilities and effectiveness of the Policyholder Advocate on conclusion of the process.
13. We believe that Ms Spottiswoode and her team have done a good job of engaging with the complex issue of with-profits funds and as a result have exposed some potential conflicts of interest that need to be addressed.

### **The role of with-profits committees of life assurance companies**

14. Since 2004, the FSA has required firms to have an independent voice to represent policyholders, such as a with-profits committee ('WPC'). The Panel's research found that while some companies have moved towards a genuinely independent model, 60% of funds had a WPC that was not independent. In some cases the WPC was a sub-committee of the main board, while in others WPC members consisted of current directors, former directors and non-executive directors. In about 10% of cases the firm did not provide information about the composition of the with-profits committee in the PPFM.
15. While 40% of WPC's had a degree of independence, the level of independence varied considerably. Within this group the research found fewer than five cases where the independent members had the majority vote. In the other examples, there was usually only one independent member.
16. The Panel believes that the independence of the WPC should be strengthened and that it should provide a public and regulatory 'window' on the firm's use of policyholder capital. The primary purpose of WPCs should be to ensure that the financial management of the fund, which includes the inherited estate, is in the best interests of policyholders. To achieve this clear objective the WPC should be independent of the firm's board. This would require a majority of independent members (or the power for independent members to cast a majority vote) and an independent chair. An independent WPC would be more effective in negotiations on management decisions in relation to the distribution of the inherited estate and ensuring that the TCF principle is taken into account in the management of the fund.
17. The Panel believes that the WPC's remit should include TCF. TCF is aimed at directors and senior managers, who must ensure that the principle of TCF is embedded in the corporate culture. At present the management's approach to running the with-profits fund is set out in the

PPFM document. Experts consulted in the Panel's research were divided on the value of the PPFM in relation to TCF but there was agreement that the PPFM remains the reference point for the WPC's assessment of fair treatment to policyholders.

18. One way to achieve a better balance between the needs of shareholders and policyholders would be for the WPC to assess the management's adherence to the principle of TCF as well as to the PPFM. For example, the WPC could report on the company's use of capital in relation to its opinion of TCF and the PPFM, setting out any discrepancies between the two. While it is acknowledged that this may establish conflicts between the WPC and the board of the firm, this is not necessarily a negative development, but merely brings into the open conflicts that already exist and which may otherwise be overlooked. The FSA could consider the model used by the Pensions Regulator in the regulation of occupational pension schemes to resolve disputes between the WPC and the board of the firm.
19. The FSA could strengthen the WPC by establishing a 'knowledge and guidance centre' for committee members, similar to that provided by the Pensions Regulator for trustees of occupational pension schemes.<sup>8</sup> This could set out the key aspects of regulation that WPC members need to read and understand, for example conduct of business rules and TCF requirements. It could include any requirements to review fund surplus on an annual basis and to review any changes to the PPFM that are material in relation to the fair treatment of policyholders. It could set out considerations for TCF in relation to the management's use of capital, including the inherited estate. To raise the visibility of the with-profits committee as a mechanism for TCF and reassure policyholders that their interests are being represented and protected, it would be desirable for the with-profits committee to have its own website with a clear link from the firm's site.
20. The FSA could further strengthen the TCF regime through the requirement that management produces a simplified annual financial statement that sets out how it has used policyholder capital, including the inherited estate, over the past year and why it expects this use will provide a good return to the fund for the policyholders' benefit. Although in theory this information can be gleaned from the PPFM, with-profits experts interviewed for the research said, of PPFMs, that the management could 'tick all the right boxes' but may still not provide a clear picture of how capital has been used. The simplified statement could set out how the fund is invested, including its asset allocation and information about the asset management team. In addition it could include all other uses of capital, for example for new business purposes, to buy closed funds, to pay shareholder tax, to pay mis-selling claims, and to pay comparatively

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<sup>8</sup> <http://www.thepensionsregulator.gov.uk/trustees/index.aspx>



high levels of commission (relative to similar products) to advisers for the sale of new products.

### **The approach of the Financial Services Authority to the issue of inherited estates**

- 21 The FSA has an independent role to scrutinise the fairness of reattribution proposals. It has an obligation to consider proposals in the light of its regulatory objectives. We are pleased that the FSA has clearly set out its views on its role in the reattribution process in a letter to Clare Spottiswoode and Norwich Union<sup>9</sup>. We are particularly pleased that the FSA has stated that in conducting its role it will examine whether it appears that the Policyholder Advocate and the firm are able to conduct a full and fair negotiation.
- 22 It is important that the Policyholder Advocate is properly resourced to enable the proper fulfilment of this important role designed to represent the interests of policyholders. We believe this is a critical role and support the FSA in its aims. We are particularly keen to ensure that policyholders are treated fairly in any distribution agreement. We believe that TCF must be a key feature of any future debate on the permitted uses of the inherited estate.
- 23 On the wider issue of with profits, the Panel has, in its last annual report, rated the FSA as weak in this area. While we acknowledge that the FSA has taken steps to address some of the issues facing policyholders, we continue to believe that the FSA could do more to help consumers get access to helpful advice and to understand the decisions they need to take on their with profits policies.

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<sup>9</sup> [http://www.fsa.gov.uk/pubs/other/reattribution\\_letter.pdf](http://www.fsa.gov.uk/pubs/other/reattribution_letter.pdf)

## Role of the Consumer Panel

The main purpose of the Panel is to provide advice to the FSA. Consequently the emphasis of the Panel's work is on activities that are regulated by the FSA. The Panel is also responsible for assessing and commenting on the FSA's effectiveness. The Panel also looks at the impact on consumers of activities outside but related to the FSA's remit. Examples include European issues and policy proposals by H M Treasury and others. The Panel has regard to the interests of all groups of consumers, including those who are particularly disadvantaged in the context of financial services. The Panel can also advise the Government on the scope of financial services regulation; and consider other matters that assist it in carrying out its primary functions.

### How the Panel operates

The full Panel meets about 10 times per year. In addition, smaller 'working groups' meet monthly to deal with specific issues in more detail and to consider the Panel's formal responses to FSA and other consultations. FSA staff and other third parties are invited to these meetings and participate in discussions. The Panel also holds meetings outside the FSA's offices with members of the financial services industry, as well as with consumer representatives. The Panel also commissions research to obtain a better understanding of consumers' views and to identify areas of concern. A monthly report of the Panel's work and concerns is provided for the FSA Board.

### Accountability

The Panel publishes an annual report on its activities. Annual Reports, responses to consultations, research reports and other information is available on the Panel's website at [www.fs-cp.org.uk](http://www.fs-cp.org.uk). The website contains the Panel's e-mail address, but makes it clear that the Panel is not in a position to pursue individual or specific complaints from the public about financial services. The Panel does however consider carefully the wider implications of any complaints or other information provided by consumers and others who contact the Panel.

### Membership

Panel members are appointed by the FSA Board following an open recruitment process based on the Nolan principles; the appointment of the Chairman must have the formal approval of the Treasury. Currently the selection process for a new Chairman is taking place following the resignation of John Howard, the Chairman from 1 October 2005 until 31 March 2008. Adam Phillips, who joined the Panel in March 2004, was appointed Vice Chairman with effect from 1 November 2005 and is currently Acting Chairman.

Members of the Panel have a wide range of relevant experience such as consumer advice and advocacy, front-line advice, legal expertise, market research, consumer policy and the media.