Financial Services Authority

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To the Chief Executives of all UK Mutual Insurers

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Our Ref:

Your Ref:

Dear Chief Executive

MUTUAL INSURERS OPERATING WITH-PROFITS FUNDS

I am writing to you to address some of the points that emerged from our consideration of firms' responses to my letter of 13 October 2009 to all chief executive officers (CEOs) of mutual insurers that provide with-profits business.

Background

The aim of the October 2009 letter was to explain the conclusions that we had reached on several questions put to us by mutual firms and by what is now called the Association of Financial Mutuals.

Firms were asked to consider the implications of that letter for them and to communicate their conclusions to us by the end of December 2009. Since then, we have been carefully considering firms' responses and, in some cases, have been in touch with firms to request further information and to clarify some of the issues they raised.

Diversity within the Mutual Sector

One of the features of the mutual insurance sector is its diversity. This was emphasised in a number of specific areas by firms' responses:

- the differences in mutual insurers' form and size and how their origins and development have had an impact on their fund structures;

- the wide variety of purposes for which mutual insurers were formed and the different ways in which membership has been acquired; and

- the split between types of business historically and currently written by mutual insurers and their different approaches to the provision of discretionary benefits.

Legal Advice

In my letter of 13 October 2009, I explained that some of the questions put to us by firms had raised issues as to the legal position underpinning some of our rules and summarised the legal advice we received about the interests of with-profits policyholders in a mutual's fund. That advice was that, in general, with-profits policyholders in their capacities as policyholders and members of a mutual will ultimately be entitled to all or almost all the assets in a mutual's long-term fund after the mutual's contractual obligations in respect of policies written into that fund have been satisfied.

Some firms accepted that position; others suggested that, after discharging the contractual entitlements of policyholders and the reasonable expectations of with-profits policyholders to receive smoothed asset shares in the form of bonuses, the mutual's long-term fund belongs to the mutual itself and thus ultimately to its members. In the context of a mutual that is no longer writing with-profits business, the consequence of the second approach would be that, after payment of ordinary policy benefits, with-profits policyholders would receive no further distribution of any surplus in the long-term fund unless they were also members and, even then, they would only be eligible to share in that surplus if the mutual itself were to be dissolved or wound up.

A number of firms evidently received legal advice to the effect that, in their own particular circumstances, the interests in their long-term funds were quite different from the general position described in my previous letter. We recognise that analysing legal interests in the long-term fund of a mutual raises some difficult issues. We also recognise that the extent of with-profits policyholders' interests as a class in that fund and the interaction of these interests with the concept of membership will depend to some extent on factors that vary from mutual to mutual. Nevertheless, the with-profits policyholders of any firm, be it a mutual or a proprietary company, clearly have entitlements and expectations in relation to the fund in which their policies have been written. Our concern is to ensure that they are treated fairly in relation to those entitlements and expectations and, in considering whether or not this is the case, we see no reason why the fair treatment of mutual with-profits policyholders should differ to their detriment from that of their counterparts in proprietary companies.

Principle 6 and Reasonable Expectations

The concept of "policyholders' reasonable expectations" was an important element of insurance companies' legislation for many years and formed the basis of the February 1995 Ministerial Statement on Orphan Estates[1]. Policyholders' reasonable expectations now form

[1] See Ministerial Statement on 'Orphan Estates' issued on 24 February 1995 by Corporate Affairs Minister Jonathan Evans, in which it was made clear that the common practice by proprietary insurers of making distributions to policyholders and

part of our wider consideration of whether firms have had due regard to the interests of their customers and treated them fairly, as required by Principle 6 of our Handbook. However, a number of firms referred to these expectations in their responses and we have considered them in this context.

The 1995 Ministerial Statement addressed the reasonable expectations of with–profits policyholders of a proprietary company in relation to distributions of surplus from the long-term fund. It established an expected distribution ratio as between policyholders and shareholders and considered the factors that might demonstrate that a different proportion was appropriate, such as a firm's history and past practice, any statements it has made as to bonus philosophy or entitlement to share in profits (including in its constitution or policyholder literature) and general practice within the life industry. This approach is now embodied in aspects of our COBS 20 regime, notably COBS 20.2.17R(2)[2].

We are of the view that:

- it would be, at the very least, surprising if the reasonable expectations of with-profits policyholders in a mutual firm were as fundamentally less extensive than those of similar policyholders in a proprietary company as some firms have effectively argued and in the normal course we would expect our requirement for firms to treat their customers fairly to produce at least as favourable an outcome for mutual with-profits policyholders as for those in proprietary companies;

- the factors that could conceivably operate to justify a different outcome are the same in relation to the with-profits policyholders of a mutual as they are for those of a proprietary company;

- diversity within the mutual sector means that the existence and effect of these factors varies to some extent from firm to firm but, based on our review of firms' responses, it appears to us that the fair treatment of mutual with-profits policyholders makes it likely that they should, if anything, share more extensively, not less, in any surplus in the long-term fund than those in proprietary companies; and

- if a firm suggests that its own particular circumstances warrant a different outcome, it must be able to point to clear and unambiguous factors to justify this.

We expect mutual insurers to reflect these points in the context of applying Principle 6 and COBS 20 to their dealings with their with-profits policyholders and in considering, in particular, the fair treatment of those policyholders in relation to any surplus in the long-term fund.

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shareholders in the proportion 90-10 would be used to assess the reasonable expectations of those policyholders and to set the basis of attribution of surplus between policyholders and shareholders unless there was clear evidence that a different proportion was appropriate.

[2] See also in this context the Glossary definition of "required percentage".

Past Practice in relation to Surplus

Some firms have suggested that surplus in their long-term fund has in the past been distributed or allocated in some other way to a wider group than just with-profits policyholders and argued that this justifies a similar approach to any future distributions or allocations of that surplus. We accept that a firm's past practice and any statements made to its policyholders as to entitlement to share in profits are factors that are relevant in defining policyholders' expectations in relation to surplus and thus to any consideration of what constitutes fair treatment of those policyholders.

However, if a firm indicates that it has distributed or allocated (or is proposing to do so) part of any surplus to anyone other than its with-profits policyholders, then we will consider whether, for example, this has been clearly and unambiguously communicated to its with-profits policyholders in a timely fashion, with an explanation of the justification for this, in assessing its effect on what is fair. We would also expect the firm to make explicit disclosure of the amount involved and of the cumulative total of such amounts in the past. We will be considering whether to amend our annual reporting requirements to incorporate this disclosure.

Closed Long Term Funds of Mutuals

We recognise that the members of a mutual as a class have certain rights conferred on them by the mutual's constitution. These generally include a right to share (on various bases) in any surplus after all other liabilities have been discharged and the mutual is wound up or dissolved. In the ordinary course of a mutual's business, the entirely contingent nature of this right means that it will be of negligible value or effect. However, we accept that this right becomes potentially less contingent when all with-profits business has been written from the mutual's single long-term fund and it closes to new with-profits business. In that event, the winding-up or dissolution of the mutual may become more likely and the significance of members' rights in relation to that surplus may increase.

Even in these circumstances, however, we would still find it difficult to understand why the fair treatment of with-profits policyholders would generally warrant their receiving less on any distribution of surplus from the long-term fund than similar policyholders in a proprietary company. Indeed, for the reasons noted above, we believe the reasonable expectations of mutual with-profits policyholders will in many cases to be more extensive and firms must be able to point to clear justifications for adopting a different approach.

When a mutual insurer finds itself in this situation, we would expect it to take this point into account when applying Principle 6 in the context of formulating its run-off plan, so as to ensure a fair distribution from the fund to its with-profits policyholders, as required by COBS 20.2.56R.

Next Steps

On 29 June 2010, we announced our intention to conduct further policy work around aspects of our existing regime for with-profits business to see whether it could be further strengthened to provide better protection for with-profits policyholders. As part of this, we

will consider whether our rules should develop our current approach, set out in this letter, to the treatment of with-profits funds of mutuals in order to provide greater clarity and consistency for mutuals and their with-profits policyholders. We will do this with the aim of including any proposals in the Consultation Paper planned for the end of this year.

In the meantime, the FSA Relationship Manager for your firm or, for SF&CD firms, the Smaller Insurers Team, will continue to follow-up with you, as necessary, on your response to the October 2009 Dear CEO in a manner consistent with the points made in this letter.

Yours sincerely

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