Policy Statement

# PS12/4

Financial Services Authority

# Protecting with-profits policyholders

## Feedback on CP11/5 and final rules

FSA®

Financial Services Authority

March 2012

# Contents

| | | |
|---|---|---|
| | Abbreviations used in this paper | 3 |
| 1 | Overview | 5 |
| 2 | Summary of responses to CP11/5 | 7 |
| 3 | Corporate governance | 31 |

**Annex 1:** List of non-confidential respondents

**Appendix 1:** Made rules (legal instrument)

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This Policy Statement reports on the main issues arising from Consultation Paper 11/5: *Protecting with-profits policyholders* and publishes final rules.

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# Abbreviations used in this paper

| | |
|---|---|
| CEO | Chief Executive Officer |
| CA 2006 | Companies Act 2006 |
| CBA | Cost benefit analysis |
| COBS | Conduct of Business sourcebook |
| CP | Consultation Paper |
| EBR | Equity Backing Ratio |
| EU | European Union |
| FRC | Financial Reporting Council |
| FSA | Financial Services Authority |
| FSCP | Financial Services Consumer Panel |
| MVR | Market Value Reduction |
| ORSA | Own Risk and Solvency Assessment |
| PS | Policy Statement |
| PPFM | Principles and Practices of Financial Management |
| RPI | Retail Prices Index |
| Solvency II | Directive 2009/138/EC |
| SUP | Supervision manual |
| SYSC | Senior Management Arrangements, Systems and Controls |
| WPRR | With-Profits Regime Review |

# 1 Overview

## Purpose

1.1 In Consultation Paper (CP)11/5: *Protecting with-profits policyholders*[1], we set out our proposals for a range of changes to our rules and guidance concerning the operation of with-profits funds, primarily in the Conduct of Business sourcebook (COBS) Chapter 20. This fulfilled a commitment made to the Treasury Committee in relation to the With-Profits Regime Review (WPRR)[2], published in June 2010, and to delivering on our *Business Plan 2010/11*.[3]

## Background

1.2 COBS 20 contains most of the rules on the operation of with-profits funds. The proposed changes arose partly from issues raised by the WPRR and day-to-day supervisory work, and partly from the discussions we were involved in with mutual life offices and friendly societies under Project Chrysalis. The focus of those discussions with mutuals has been to address the consequences for those firms of material reductions in, or cessation of, with-profits business and the implications that arise for the future of the mutual and friendly society organisations that provide those policies.

1.3 We consulted on changes in several areas of with-profits business. These were:

- the fair treatment of with-profits policyholders generally and in mutually-owned long-term insurance funds specifically;
- conflicts of interest;
- the terms on which firms should write new business;
- the effect of material reductions in new business;

1 CP11/5: *Protecting with-profits policyholders* (February 2011)
2 www.fsa.gov.uk/pubs/other/withprofits_report.pdf
3 Business Plan 2010/11

- Market Value Reductions (MVRs);
- strategic investments;
- charges;
- excess surplus;
- reattributions; and
- the role of independent judgment including With-Profits Committees and other aspects of corporate governance.

## Who should read this paper?

1.4 This Policy Statement (PS) will be of interest to all firms writing new with-profits business or with existing books of with-profits business. It may also be of interest to consumers who may be affected by the subject, whether as with-profits policyholders, as shareholders in a life insurance company or as members of a mutual life insurer or friendly society.

## Responses

1.5 The consultation period closed on 24 May 2011 and we received 68 responses. Forty-four of these were from firms and industry representatives, 15 from individuals, either policyholders or employees of insurers writing in a personal capacity, six from consultancy firms working in the life industry and three from consumer groups.

1.6 This PS summarises the comments we received from the consultation to our proposals and sets out our response to them. We include final amended Handbook text in the Appendix to this PS.

# 2 Summary of responses to CP11/5

**2.1** In this chapter, we report on the responses that we received to the questions posed in CP11/5, our views on those responses and our policy decisions on how to proceed.

**2.2** Before replying to the consultation questions, some respondents had overall comments on the underlying principles we set out and the cumulative effect of the changes we proposed. Several respondents stated that, in their view, the proposals would have more significant and fundamental effects than the commentary in CP11/5 suggested. The basic point of disagreement with our proposals highlighted by firms and industry representatives was over the extent of with-profits policyholders' interests in a with-profits fund. Several firms stressed the importance of the legal and beneficial ownership of a with-profits fund by the insurer and viewed the interests of with-profits policyholders in the broader with-profits fund to be limited to the parts of the fund that will provide the amounts required to meet expected payouts under their contracts. We were told that it was incorrect and misleading to suggest that with-profits policyholders have an interest in all parts of the with-profits fund.

**2.3** Several respondents also discussed the potential practical impacts of our proposals, particularly on mutual with-profits funds. One respondent said that they considered that our proposals carried the risk that the draft rules would elevate the rights of the with-profits policyholders in such a way as to be unfair and inconsistent with the principles of mutuality. While a number of respondents acknowledged that with-profits policyholders have certain legitimate expectations, it was suggested to us that their interests should not override those of other policyholders and members within a with-profits fund, which in their view was the result of our proposals. Others predicted that the proposals as a whole could result in a significant reduction in the number of firms within the mutual life insurance sector in particular, either through demutualisation or winding-up.

**2.4** Some proprietary companies had similar concerns, questioning whether with-profits products would remain viable if the proposals were introduced, rejecting our characterisation of the interests that with-profits policyholders have in the fund and relying instead on a view that those interests are limited to that part of the fund that will be needed to pay out smoothed 'asset share'.

**2.5** We also received other views. Some firms were supportive of the policy intentions. There was still concern that there could be unintended consequences from what some firms regarded as overly prescriptive draft rules. Such firms thought that the remedy lay in increasing the focus on firms' risk appetites and effective governance. Some consumer representatives agreed in principle that we should clarify policyholders' interests in with-profits funds, but said that the guidance we proposed would not in itself address the weaknesses that have led to what they regarded as substantial policyholder detriment, particularly in shareholder-owned funds.

**2.6** Our approach in this PS is based on our considered view that the interests of with-profits policyholders are more extensive than the narrow interpretation put forward by some regulated firms. Indeed we believe that fair treatment of with-profits policyholders requires us to take a much broader view of the relationship between those policyholders and firms than can be encapsulated by a legal analysis of the ownership of the firm's assets. However, we are also conscious that protecting policyholders need not be achieved at the cost of the continued existence of with-profits funds and the firms that offer them. A proper balance between the different interests in a with-profits fund is required, whether between with-profits policyholders and other members as may be the case in a mutual, between with-profits policyholders and shareholders in a proprietary firm, or even between different types of policyholder. We believe that much can be achieved by more effective governance arrangements, although this is not sufficient in itself. In several places we have modified our proposals in response to consultation in order to assist firms to implement changes in practice, or we have decided not to proceed for now with new rules where we believe that further consultation may be necessary.

**2.7** In particular we intend to conduct further work on the mutual with-profits sector. We will re-examine the arguments that have been put to us both before and during the course of this consultation process and we will review our proposals on possible ways forward. We have also listened to feedback expressing concern about the volume and intensity of regulatory change for life insurers, not least from Solvency II and other European Union (EU) initiatives as well as our own work on with-profits, the Retail Distribution Review and the new regulatory structures in the UK. In terms of with-profits business, we will therefore prioritise our work on mutuals and on preparing for Solvency II over revisiting any unresolved issues arising from CP11/5 and our planned work on customer communications. However, we do recognise the importance of these issues and we will continue to develop policy in these areas.

### Responses to individual questions from CP11/5

**2.8** We proposed to introduce guidance at the start of COBS 20 to set out our high-level view of with-profits policyholders' interests in a with-profits fund. The proposed guidance reflected our previously expressed views and reflected the wording used in our last with-profits consultation in CP09/9.[4]

> **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?*

**2.9** The responses did not focus on whether or not we should publish guidance, since many respondents were in favour in principle, but instead disagreed with what the proposed guidance actually said. The industry, and particularly the mutual with-profits sector, was strongly of the view that we had mischaracterised the nature of the interest with-profits policyholders have in a with-profits fund, with mutual firms alleging that we were effectively prioritising the interests of current with-profits policyholders above those of other members of a mutual. Proprietary firms said that we were ignoring the legal and beneficial ownership of the fund and its assets by the firm.

**2.10** We were also told that such guidance could not encompass all the variation within the with-profits industry, taking into account the history of individual funds and the established practices within each. Some policyholders and their representatives put forward the view that the proposed guidance was too weak and that in a proprietary firm all a fund's assets belong to policyholders and to shareholders in their profit share proportions of 90:10 and that they should not be disbursed differently without very clear arguments permitting this.

#### Our response

Our proposed guidance was intended to restate at a high level the FSA's existing view as to the interests of with-profits policyholders in a with-profits fund. It set out our previously expressed and published views and reflected the position we have consistently taken with individual firms in the context of our day-to-day supervision when applying our Handbook rules, particularly COBS 20, to with-profits funds. Questions were asked about whether in practice the guidance has the effect of inappropriately elevating the rights of with-profits policyholders above those of other stakeholders, for example, members in a mutual. This largely depends on how the guidance affects particular rules and how those rules are applied by firms to their individual circumstances; these are dealt with in more detail later in this PS.

4 CP09/9: *With-profit funds – compensation and redress: Further consultation, feedback on CP08/11 and draft Handbook text* (February 2009)

We recognise the concern of policyholder groups that, in a proprietary fund with a 90:10 distribution ratio, reinforcing the 90:10 split could be desirable, but we do not take (and never have taken) the view that the with-profits fund is beneficially owned by policyholders to the extent of all potential distributions. In any event we consider that there are other ways to protect policyholders and we also need to take into account the nature of with-profits business with its changing population of policyholders and the interaction between the rights of future policyholders and current policyholders. We do, however, believe that the high-level guidance we write should in principle also apply to proprietary 100:0 funds as well as to mutual life insurers and many friendly societies.

The guidance we proposed was not premised on a legal analysis of the ownership of a fund, which we acknowledge is generally legally and beneficially with the insurer. We consider the guidance on the interests of with-profits policyholders in a with-profits fund to be an important statement of the FSA's approach to the scope and application of COBS 20 rules and to how it expects firms to behave towards with-profits policyholders. Accordingly, we will retain the guidance we proposed and will seek to address some of the issues arising from how it is interpreted in the detailed rules below.

**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?*

**2.11** There was support for this proposal from some elements of the industry, although other firms said that it compounded what they regard as the mistaken view that with-profits policyholders' interests in a fund are more extensive than they believe is the case. There was also some concern that the emphasis on fairness to with-profits policyholders could be delivered at the expense of fairness to other groups, particularly non-profit members in mutual insurers. As far as this is an issue for mutuals, respondents said that the problem stems from the definition of a with-profits fund, which for mutuals includes both the explicit interests of with-profits members and the mutual capital, in which all the members, however defined, have an interest.

**2.12** We were also told that directors of firms need to have regard to, and comply with, their common law and statutory duties, which may not always mean preferring the interests of with-profits policyholders over others. In particular, directors of firms subject to the Companies Act 2006 (CA 2006) are required to act in the way that 'would be most likely to promote the success of the company for the benefit of its members as a whole' (section 172(1) CA 2006). It was argued that, when presented with a choice between favouring with-profits and non-profit policyholder members, COBS 20.2 as amended could require the interests of the with-profits policyholders to be preferred, even though this may put the

directors in breach of their CA 2006 obligations (or equivalent common law rules for those mutuals not subject to the CA 2006).

**2.13** Other firms made a similar point that the interests of members in a mutual fund should be governed by the rules of that fund, rather than FSA requirements. From the shareholder side, there was particular concern that the drafting of the rule suggested that an undisclosed benefit was necessarily an unfair one, a suggestion with which firms disagreed. Respondents also said that the draft rule did not appear to require consideration of whether the benefit that arose was material or not. Nor did it appear to be limited to consideration of expected benefits; indeed it might also catch benefits arising after a conflict of interest has been resolved, in circumstances that were not at the time expected to arise.

**2.14** The point was also made by several respondents that the effect of these rules and guidance on non-directive friendly societies should be clarified since such funds may need to be exempt from the governance requirements in COBS 20.5, as they are currently exempt from the governance requirements in COBS 20.3.

### Our response

We recognise the concern expressed by mutuals in particular about the practical difficulties involved in balancing their directors' duties to their members and the FSA rules on with-profits policyholders and this is a point that has been raised before. However, we do not believe that complying with FSA rules will bring a director into conflict with CA 2006 requirements, nor do we accept that a firm has to be unfair to its with-profits policyholders in order to fulfil its responsibilities to its wider membership. In any event a firm will need to ensure that any decisions it takes comply with Principle 6 which requires firms to treat their policyholders fairly, so this rule simply makes sure that a firm ensures that its operating practices incorporate these principles of fairness.

Regarding the disclosure of benefits to shareholders and others, our view is that policyholders are more likely to feel that they have been fairly treated if they can see how they have been treated. We note the point made by some respondents that a benefit that is fair but which has not been disclosed does not become unfair simply through that lack of transparency. However, undisclosed benefits, even when capable of being fair if disclosed, may not be consistent with the principle of communicating with customers in a way that is clear, fair and not misleading. This is likely to be more pertinent in a 90:10 fund, but can also apply when there are non-profit members also sharing in surplus. We do not feel that it is necessary to attach a materiality threshold to every rule, nor to specify that it applies only to expected (rather than unexpected) benefits, since firms must in any case expect to exercise a degree of judgment. We will, therefore, retain the proposed wording within the rule, although we will amend the opening of the rule to read: 'A firm must take reasonable care to ensure…'

It is not our intention to create additional compliance burdens on non-directive friendly societies, although we note that there will be fewer such societies under the more inclusive requirements of Solvency II than under the current rules. The new guidance on which we consulted at COBS 20.2.1C G will, therefore, apply only to those firms to which COBS 20.5 also applies. This revision aims to clarify the original policy intention, and therefore has no impact on the CBA in the CP.

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**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?*

**2.15** The practical effect of this rule and guidance was to clarify how the 90:10 distribution rule applied to those mutuals that were unable to demonstrate that their particular practice for distributions had been clearly and unambiguously communicated to their with-profits policyholders. For example, that an amount of 'mutual capital' is relevant in the particular circumstances of a firm and is not in practice distributable in circumstances short of a winding up.

**2.16** In responses, both mutual and proprietary firms were concerned that the proposal effectively sought to apply current standards of disclosure to policies that were sold many years ago in a way that firms would not be able to comply with. It was argued that established and consistent practice over a significant period may not be capable of being taken into account simply because it was the established norm and, therefore, at the time was not seen as being necessary to be communicated to with-profits policyholders or to other stakeholders. However, that would not necessarily mean that the practice was unfair.

**2.17** Several mutual firms said that the question of what constitutes a 'distribution' would also need to be addressed. The 90:10 distribution ratio in proprietary with-profits funds helps to provide fairness in distributions between policyholders and shareholders. The situation is more complicated in a mutual's common fund where non-profit policyholders may also be members and may also benefit from different applications of surplus, such as offering lower premiums or receiving alternative benefits of membership. As some respondents pointed out, it is also the case that the 90:10 ratio normally applies only to distributions of surplus after setting aside whatever funds are necessary to support the continuing operation of the business, so the rule does not address whether or not it is fair to retain that part of the surplus that is not distributed.

**2.18** Some mutuals have pointed out that their history began by providing non-profit policies, to which with-profits policies were later added as a means of distributing surpluses that they were accumulating by writing their non-profit business profitably. Proposals to enable firms to begin now to accumulate mutual capital for the future are resisted by many firms

in favour of their being allowed to recognise existing mutual capital within the fund. If that were to be accepted, it would reduce the amounts distributable to existing and future with-profits policyholders but would increase the likelihood of the mutual continuing in business and attracting new members to join. This would in turn necessitate that mutual funds are able to find new ways of distributing surplus fairly, either through a more innovative approach to new with-profits policies, or through an alternative mechanism outside with-profits. No clear universal solution that has found favour with all parties has yet been found, balancing fairness to existing with-profits policyholders with preserving the future of the mutual life sector for future non-profit and with-profits members.

## Our response

In CP11/5 we produced an analysis of how our current rules operate in practice with regard to the fair treatment of with-profits policyholders and with particular focus on the mutual with-profits sector. This is an area of considerable complexity and many firms consider it to be at the heart of the debate about the future of the mutual life sector in a financial environment in which a declining volume of with-profits business is being written.

Following feedback from respondents we have decided that it would not be appropriate for us to seek to make Handbook provisions on these issues at this time. We will not proceed with the proposed guidance in CP11/5 at COBS 20.2.17A G now. As a result, the corresponding CBA on this proposal in the CP will not apply.

We will continue to discuss the issues raised with mutual firms, as we have been doing for some time including since the consultation period ended, as well as engaging with consumer representatives. We need to look again at these issues which, as set out in our 'Dear CEO' letters, are not limited to the interests of with-profits policyholders, but also involve members of mutuals who hold non-profit policies. We are also minded to consider further the broader consumer interest in having a diverse market in financial services providers in which mutuality has a future alongside proprietary companies. We will aim to broaden the debate and return to this, potentially in a Discussion Paper in 2012/13.

We will implement our proposed clarification of the definition of 'required percentage', which emphasises the primacy of a firm's established practice, as adequately demonstrated by the firm in its policyholder communications, in deciding what the required percentage should be. This is particularly applicable to with-profits funds in shareholder-owned firms, although it is also capable of being applied to a mutual with-profits fund. We also retain the reference to fair treatment in this regard at COBS 20.2.1G (3) since this applies whatever a particular firm's required percentage may be.

**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?*

**2.19** The objective of this proposal was to tighten the existing rule to guard against situations in which new business is either loss-leading in itself or where not enough of it is being sold to cover the cost of acquiring it.

**2.20** There were two main views on this issue, depending on whether the respondent took a broad or a narrow view of policyholders' interests in the fund. For those few firms that took the narrow view, the use of the estate in a proprietary with-profits fund is a matter for the shareholder, as the policyholder has no reasonable expectation of participating in a future distribution from the estate. On this view it is irrelevant to consider the impact of writing new business on a policyholder's expectations. Others said that where it was established practice to use the estate as the working capital of the fund to support the writing of new business, then this should be allowed to continue as it is a legitimate and established basis for writing such business, involving appropriate risk sharing in line with policyholder expectations.

**2.21** Those who accept the broader view of the interests of with-profits policyholders agreed that in principle new business should not be written that erodes the value of the estate to the detriment of the prospects for with-profits policyholders. Some firms welcomed the proposal wholeheartedly while others felt that the existing rule, if properly applied, was already sufficient.

**2.22** However, if the proposed change were to go ahead, several respondents felt that there were also points of detail that they felt could cause unintended consequences if not addressed. Some argued that business which had a small detrimental effect, such as deferring the emergence of surplus, or a marginal reduction in the Equity Backing Ratio (EBR), should be allowed if that was consistent with the requirements of the fund's Principles and Practices of Financial Management (PPFM). Others said that the requirement should be applied to new business in aggregate, rather than to each individual policy since otherwise the with-profits committee or other advisory arrangement would effectively have a veto on new business if even a single policyholder potentially faced non-material detriment. It should also be made explicit that the rule did not apply to increments to existing policies or new policies resulting from options exercised on existing business.

**2.23** Others queried the definition of 'profit' and whether it was assuming an average cost basis or a marginal cost basis that would avoid possible distortions from the allocations of overheads. Several respondents said that the requirement to produce 'all' appropriate analysis was an impossible task likely to lead to paralysis by analysis as boards and with-profits committees tried to demonstrate the depth of their work. Some referred to the need to take into account the interests of future with-profits policyholders as well as existing ones

explicitly, since capital deployed now to back new business might not deliver a return for some years, but could be in the interests of future with-profits policyholders.

## Our response

This change was intended as a modest tightening of an existing rule in response to concerns about the possibility of inappropriate depletion of the estate causing detriment to the prospects for distributions to existing and future with-profits policyholders. This could be through either new business being deliberately priced on loss-making terms or new business generating insufficient volume to cover all the costs associated with it.

We recognise that there are two views of the appropriateness of regulation in this area, affecting as it does not only the outcomes for policyholders but also the uses of the estate, which is particularly sensitive territory for some proprietary firms. Nevertheless, in order further to secure the protection of consumers, we will proceed with this change to our rules and guidance, but we have also taken into account some of the detailed comments from providers. These reflect:

- comments received about the scope of the analysis that has to take place to demonstrate that new business is likely not to cause detriment to policyholder interests. We have decided that firms will need to carry out or obtain only appropriate advice rather than *all* appropriate advice, and firms can take a proportionate approach in determining what is appropriate having regard to relevant factors;
- that consideration of the impact of new business should be by reference to each new business line when viewed as a whole, having regard to expected volumes and duration. This means that the terms of each particular new product line, including e.g. pricing, should be considered;
- that the impact of new business should be assessed by reference to the with-profits policyholders in the relevant fund when considered together rather than to each individual policy at any single point in time. As such short-term deferrals of the emergence or distribution of surplus or a marginal reduction in the EBR do not necessarily mean that there is an adverse impact so long as the new business is financially self-supporting and adds sufficient value so that policyholders continue to be treated fairly; and
- our view that the rule is not aimed in general at increments and new business arising out of the exercise of options in place on existing business.

These revisions aim to clarify our policy intention and therefore have no impact on the CBA discussion on 'material reduction in new business' as included in the CP. We have taken what we believe to be a pragmatic approach to incorporating these points of detail into the Handbook text. We believe that this will provide a sound basis on which new business can continue to be written, bringing new policyholders into a fund, subject to adequate safeguards being in place to ensure appropriate protection of existing and future policyholders.

We have also made a transitional rule with the effect that new business based on compliant decisions taken by a firm's governing body prior to 1 April 2012 will be deemed to be compliant with the new rule until 1 July 2012.

**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?*

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

**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?*

**2.24** Most respondents, including product providers, acknowledged that moving away from the binary open/closed approach to with-profits funds was a positive development and felt that it was entirely appropriate for firms to discuss with the FSA at an early stage their plans for treating their various stakeholders fairly where they experience a sustained and significant fall in the volume of new business. Several were also keen to make the point that this should not necessarily imply that closing to new business was the only available next step. Two firms were opposed, suggesting in essence that this would create a presumption of a windfall distribution.

**2.25** Some respondents who accepted the principle said that the proposed rules and guidance required further clarification. In particular, no definition is currently given for either a 'sustained' or 'substantial' fall nor, we were told, was there any defined reference period or starting point for the measurement of whether any fall in the volume of new business is sustained or substantial. Others asked whether firms currently writing low levels of new business would be able in practice to identify a falling off that is sustained or substantial.

**2.26** Several firms noted that COBS 20.2.41A R as consulted on would require a firm to initiate discussions with the FSA if there was a sustained and substantial fall in the amount of non-profit business being written in the fund even if there continued to be a substantial amount of with-profits business being written. Firms noted that 20.2.41B G (2) suggested that a firm might be considered closed to new business if it is not effecting a material volume of non-profit contracts regardless of the volume of with-profits business being written.

**2.27** Proposals for fair distribution plans and management plans produced a range of responses. Many thought the proposals were reasonable in conception, but questioned the practical implications, the cost effectiveness for smaller providers and the interaction with and potential for duplication around existing UK capital adequacy reporting and future Solvency II reporting. There was some support for the view that funds writing very low levels of new with-profits business may not be dissimilar to closed funds and should have better plans for distribution than they do at the moment.

**2.28** Some respondents suggested that the fair distribution and management plans should be aligned with and part of the forthcoming Own Risk and Solvency Assessment (ORSA) and other Solvency II requirements. Another suggestion was to bring three documents together into a single amalgamation, combining features of the existing run-off plans, together with fair distribution plans and management plans. Others thought that the issues raised could be covered by a mixture of improved governance, as recommended elsewhere in CP11/5, through the FSA's risk assessment processes and through its regular meetings with larger firms, without the expense of additional reporting processes.

### Our response

We remain of the view that a fund facing a sustained or substantial fall-off in the volume of new business should discuss the adequacy of its planning with the regulator. We do not propose to introduce a definition of these terms as firms should in any event read the requirements in light of their purpose and with regard to the existing Principle 11 of the Handbook, which requires firms to disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice. However, we also recognise the points that have been made about the parallels between what is proposed in CP11/5, what is already required by the Individual Capital Assessment process for larger firms and what is expected shortly to be required by the ORSA process under Solvency II. We also recognise that there are additional costs involved that could be particularly onerous for smaller funds and those below the threshold for compliance with the EU insurance directives.

For these reasons we will not proceed with requiring firms to draw up separate fair distribution and management plans at this time. We will consider whether to

revisit these proposals in due course, once we have greater clarity on the contents and level of detail available from the ORSA and other Solvency II reporting. As a result, the costs estimated for producing such plans in the CP will not apply.

We have removed the references at COBS 20.2.54R and COBS 20.2.41B G(2) to material volumes of non-profit business being relevant to whether or not a with-profits fund should be regarded as having ceased to effect new contracts of insurance. We have, however, retained this reference in COBS 20.2.41A R. The impact of this is to retain the reference where the rule is intended to initiate a discussion about fairness, but to remove it where the rule is intended to bring about the closure of a fund. We recognise that a fund that stops writing new non-profit business may wish to continue to write with-profits business provided that doing so is fair to its with-profits policyholders.

**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?*

**2.29** Most respondents agreed with this proposal, although some firms commented that we should be proportionate in its implementation and give firms, which hadn't previously had to draw up a run-off plan, sufficient time to gather and present the information, suggesting a twelve month delay in implementation. Others said that firms had a considerable regulatory task in front of them already in preparing for Solvency II and that much of the wording in the detailed rules in SUP App 2.15 is drafted to apply at the point of closure and so some of the information requested would not be relevant to firms that closed many years ago.

## Our response

Firms that have funds that were closed prior to 2005 should already have the information necessary to produce a run-off plan that is proportionate to the issues faced by the fund. We agree that not all the requirements in SUP App 2.15 will be relevant, particularly those rules aimed at actions immediately post-closure. We will, therefore, require firms to produce only information that is relevant to the efficient and effective run-off of the fund while delivering fairness to policyholders. In terms of timescale, while we don't expect firms to have to perform a great deal of new work, we agree that a requirement of three months may be challenging, especially for those firms with a number of closed funds, so we will instead require these plans to be submitted by 31 December 2012.

These revisions clarify the original policy intention (e.g. requiring firms to produce only relevant information) and reflect feedback that a requirement to submit the

plan within three months could be challenging for some firms. Hence they should not impact materially on the cost benefit analysis in relation to requiring run-off plans for with-profits funds that closed to business prior to 2005.

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**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?*

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

**2.30** MVRs are not well understood by consumers or by some of their advisers and are naturally disliked by those to whose policies they are applied. Those who remain invested in the fund and have their interests protected by the MVR do not necessarily appreciate the benefit they receive. However, we accept them as a reasonable means of maintaining fairness between different groups of policyholders when applied properly. They essentially reduce or suspend 'upwards smoothing' of payouts when the fund cannot afford to continue making payments of more than the policy's fair share of the underlying assets. The proposal to remove the ability of firms to impose an MVR on the basis of liquidity risks alone was welcomed by consumer organisations and there was little dissent from firms.

**2.31** Some firms queried whether they would still be able to apply normal smoothing within the target ranges for payouts which might mean paying less than 100% of asset share. One suggestion that we received was that the rule should be modified so that the reference point for the minimum payout when an MVR applies is the asset share adjusted for smoothing, rather than the unadjusted asset share. Others asked whether the rule would apply to each policy individually or to groups of policies in aggregate. Others asked whether they would have to review the level of MVRs on a daily basis in order to reflect price movements in underlying assets, which they considered to be impractical.

**2.32** On the issue of ensuring that firms that impose an MVR make a proportionate change to the amounts distributed to shareholders as well, most firms accepted this. Some mutual with-profits firms were concerned that the wording of the rule and guidance also potentially applied to them. Others were in no doubt that it applied only to proprietary firms.

**2.33** Consumer groups accepted both proposals. One commented that, as a protection mechanism for consumers, when they have to be imposed MVRs should be proportionate rather than penal in their application.

### Our response

We were pleased that firms generally accepted that the scope for imposing an MVR should be reduced.

We recognise that there needs to be an element of pragmatism in how the rule on MVRs is applied to reflect the intention to deliver asset share payouts in aggregate over time, not necessarily on each individual maturing policy at all times. This is consistent with the nature of smoothing and avoids the cost and administrative complexity of daily recalculation and adjustment. Similarly, we would not regard normal smoothing, which takes an asset share payout below 100%, as inconsistent with the rule. As such we have amended the proposed rule so that firms will only need to comply to the extent that it is reasonably practicable to do so.

In a mutual or a proprietary 100:0 fund, no adjustment is necessary to the 0% to account for an MVR since there is no other provider of capital also sharing in the total payout. The new rule in COBS 20.2.17A R specifically refers to shareholders, so we see no need to revise the wording, which is intended to apply to proprietary firms. However, we note that if mutuals and friendly societies were able to go through the appropriate process, for example policyholder and/or court approval, to recognise the treatment of mutual capital in their particular circumstances, such that the required percentage for these funds may become less than 100% (as the surplus is then potentially shared with the mutual capital), it may be necessary to revisit this. The effect of recognising ring-fenced funds as part of Solvency II will also have to be considered.

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

**2.34** There was a variety of feedback on this issue, with significant differences in approach from consumer groups, proprietary firms and mutuals. One consumer group was shocked that it continues to be fairly common practice for firms to use with-profits funds to invest in assets such as their own premises and substantial connected investments. While they acknowledged that it may not be possible to remove all strategic investments, we were urged to ensure that the regulator has the resources to analyse plans to retain or invest with-profits policyholders' funds in these assets, including taking full account of the views of the with-profits committee, and to respond effectively and robustly.

**2.35** Those few proprietary firms that take a narrow view of policyholders' interests said that policyholders have no reasonable expectation in relation to strategic investments purchased by the estate that can continue to be held within with-profits funds if the firm regards them

as appropriate. On this view if such investments are held within the estate, rather than being allocated or hypothecated to asset shares, then policyholders should have no interest in their retention or disposal. Other proprietary funds that take a broader view of policyholders' interests accepted the principle that strategic investments should have no adverse effect on the interests of with-profits policyholders. We were also told that the proposed definition of strategic investments was too wide and should be restricted to those investments that are genuinely strategic in nature, i.e. an investment with a connected party for a strategic purpose. The intention was to avoid an investment that was not strategic falling within the scope of the rule as drafted. An example is an investment in a public stock in which trading is suspended so that it becomes illiquid and difficult to sell or dispose of and so potentially falls within the definition.

**2.36** Some of the mutual firms argue that converting the existing guidance on strategic assets into a rule may be appropriate for a proprietary insurer that has a choice between holding strategic investments on behalf of policyholders or in a shareholder fund. This could lead to a conflict of interest in the absence of clear and transparent principles. However, they argue that the situation is different for a mutual insurer that does not have the option to hold strategic investments as an asset of its shareholder fund, and normally has no choice but to hold strategic investments as an investment of the single common fund which also contains with-profits business. They add that holding such investments could be in the interests of the members of the society as a whole, which may extend more broadly than with-profits policyholders. However, another mutual said that they had disposed of their previous head office building precisely because of the sort of concerns we had raised.

**2.37** Others said that the current guidance in COBS 20.2.36G recognised the distinction between proprietary firms and mutuals by applying the rule on the purchase of strategic investments only to proprietary firms, in recognition that a mutual firm can purchase strategic investments only through its common fund (which is equated with the with-profits fund). However, by removing this distinction in the proposed new COBS 20.2.36R it imposes harsher treatment on mutuals, making it more difficult for them to compete. We were told that the proposed rule might prevent mutuals from writing non-profit business altogether. We were also told that the proposed definition of a strategic investment (e.g. significant but potentially illiquid, hard to sell or dispose of, or hard to value) could apply to a normal investment into, say, private equity or even certain types of corporate bonds and should be revised.

**2.38** Some respondents raised a legal point, similar to that referred to for the rules on conflicts of interest above. If the board of a mutual believes that a strategic investment by the with-profits fund would benefit the members of the mutual as a whole, it may nonetheless be constrained by the proposed rule change from making or retaining that investment, potentially putting the directors in breach of their duties under the Companies Acts to act in the interests of the fund as a whole.

**2.39** Several respondents asserted that the proposed consideration in COBS 20.2.36A G (1)(f) using a test based around a 'knowledgeable existing with-profits policyholder' could not

be reliably determined and could potentially undermine the independence and role of the with-profits actuary in COBS 20.2.36A G (1)(e).

## Our response

There are a number of aspects to this proposal, but the fundamental point remains that whether an individual is a with-profits policyholder in a fund owned by a mutual or a proprietary firm, the decision to buy, or to retain, strategic investments within the fund should be made with due regard to the effect on with-profits policyholders and whether this is fair to them.

The existing guidance in COBS 20.2.36 G refers specifically to purchasing or retaining 'another business, directly or by or through a connected person'. The issue of strategic investments is broader than this, as we have tried to draw out, but we accept that the proposed definition could benefit from being more tightly focused and we have reflected this in revised text which now refers to it being made for 'a strategic purpose' and for 'a duration consistent with that purpose'. In order for such a definition to be effective we are also including a provision requiring the firm to have adequately documented the strategic purpose in its records. We have also included guidance giving the main examples of investments that we consider fall in this category. The intention remains that investment in, for example, a group subsidiary or a large and illiquid asset such as a firm's head office should fall within the definition of a strategic investment and should have no adverse effect on the interests of with-profits policyholders when considered together if such an investment is to be made or retained. For consistency with our changes to the new business rule above we have also clarified that, when determining whether with-profits policyholders interests are adversely affected, firms may consider the interests of with-profits policyholders in the relevant fund when taken together.

We recognise the concerns of some mutual firms that their discretion could be constrained by this rule given their common fund structure, but we believe that the reference to a proprietary firm in the guidance at COBS 20.2.36 G (1)(f), as renumbered, reflects to an appropriate extent the distinction between mutual and proprietary firms. We also believe that the revised and tightened definition should avoid this rule and its associated guidance being applied to types of assets not intended to fall within scope, such as private equity investments held for legitimate diversification of risk purposes, fixed income investments and assets used to support the writing of non-profit business generally, none of which is intended to be caught.

We note that the boards of mutual firms with members who are not with-profits policyholders, like the boards of proprietary firms, may have to take into account broader considerations than if they were solely involved with investments on

behalf of with-profits policyholders. Many have substantial non-profit businesses and some may be responsible for more than one with-profits fund. There are proposals elsewhere in this PS that deal with managing conflicts of interest and the need to record decision-making efficiently. Firms that have effective governance should be able to manage their different responsibilities under legislative and regulatory requirements appropriately.

Again, these revisions clarify our original policy intention and have no material impact on the cost benefit analysis of requirements in relation to strategic investments.

In the light of feedback we are content not to proceed with the proposed guidance on a 'knowledgeable existing with-profits policyholder'. We recognise that such a viewpoint is not easy to determine and there may be conflicts of interest between different with-profits policyholders within the same fund depending on their attitude to risk and the expected duration of their policies. We have also made a transitional rule with the effect that retaining a strategic investment based on compliant decisions taken by a firm's governing body prior to 1 April 2012 will be deemed to be compliant with the new rule until 1 October 2012.

**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?*

**2.40** Firms and trade bodies agreed with the proposition that firms should not be allowed to set charges so as to make disproportionate profits for shareholders at the expense of policyholders. However, they did not believe that the proposed rule should apply to established arrangements where a service company offers a service for agreed fees and takes on operational risks which they see as a legitimate part of the shareholder/policyholder arrangement. They viewed it as appropriate for the service company to retain a cost margin as compensation for incurring risks that are retained by the service company (and sometimes because of the need to hold capital). We were told that our proposals did not recognise that the practice among some funds of charging fixed fees (or at least linked to price or earnings indices) over extended periods to with-profits funds effectively removed the risk of expense overruns for the fund and transferred it to the service company to the overall benefit of policyholders.

**2.41** We had argued that proprietary firms running 90:10 funds should ensure intra-group service providers charge at cost because the group's return is from the 10% share of any distribution. Several firms said that if the new rule resulted in higher fees being paid to an external (i.e. non-group) company, the shareholder would only lose one-ninth of the reduced with-profits fund surplus. The possibility of retaining this one-ninth may well not be enough for the shareholder to want to retain the risks associated with providing services when it cannot charge any risk margin over costs for taking on those risks.

**2.42** In terms of the level of fees charged by intra-group asset managers, we were told that these were usually determined on an arms-length basis and on commercial terms. It is not uncommon for charges for investment services to a with-profits fund in a group to be lower than charges applied to external clients because the volume of business provided by intra-group funds provides the asset management division with economies of scale. We were also told that the draft rule took no account of whether the in-house service provider would deliver the best value for money and outcomes for policyholders in terms of service and performance, relative to alternatives available in the market.

**2.43** Respondents said that when a transfer of business between two firms is being considered, the most common structure is for any with-profits fund involved to be transferred to the new owner as a 'ring-fenced' fund or separate sub-fund within the new structure. Schemes of Transfer normally set out the expense charging basis for the new sub-fund. We were therefore asked to clarify that any new rules would not seek to overturn existing Court-approved expense charging structures relating to with-profits funds.

**2.44** Representatives of mutual life insurers told us that charging a reasonable profit margin in addition to the cost of services put a group company in an equivalent position to an external service provider and in their view should not be considered as 'extracting value'. They also asserted that, since a fund manager in a group headed by a mutual is also of necessity part of the common fund, any charges would remain in the fund in a different form, reducing any potential detriment. They were also concerned that the rule as drafted would deter 'white knight' bids for mutuals in difficulty because, following the proposed rule change, it would be more difficult for an acquiring mutual with-profits fund to make a sufficient return on capital from a take-over or rescue in order for it to treat its own with-profits policyholders fairly.

**2.45** One respondent noted that with many with-profits funds in decline, if a service company is unable to make a profit, it will be unwilling to take on the risks associated with providing the service, such as run-off risk. Hence there is a danger that with-profits funds within groups will find that they are unable to lay off some of their risks within the group and the policyholders will be left to bear the full burden of the run-off without any capital (other than their own) being invested to improve matters. An unintended consequence could be to reduce the prospects for with-profits policyholders rather than to protect them.

**2.46** While concern about the proposal was widespread, there was also some support from several respondents, including firms, for action in this area. One consumer organisation contrasted the direct benefits to shareholders from increased in-house costs with the indirect and less certain return from their 10% share of any distributions, suggesting that, given the option, firms would always favour the former. They were also concerned about the charging formulas used by some firms that allow for annual uprating of charges using a formula linked to the Retail Prices Index (RPI). Many respondents believed that some current practices appeared to be unfair and that it was right for the FSA to make these proposals. Alternative suggestions put forward included a benchmarking approach to ensure that charges were not excessive, while others preferred to rely on new governance

processes as set out elsewhere in this PS, including the explicit scrutiny of the with-profits committee and greater disclosure to policyholders about how the costs of running the fund are met.

## Our response

We acknowledge many of the concerns raised, particularly by mutual firms around fixed cost charging in funds in run-off and the potential effect on merger and acquisition activity in the mutual sector. The argument around proprietary funds is more finely balanced, where in-house asset management and service company charging creates the scope for the detriment we identified and which some respondents highlighted, but where the proposed policy change may have unintended and negative consequences for with-profits policyholders.

Accordingly, we do not intend to proceed with this change as proposed in the immediate future. Accordingly the cost benefit analysis, including the estimation of transfers as consulted on in the CP, will not apply. In recognition of consumer concerns, in particular, we will consider alternative approaches, perhaps allowing for charges to include an element to represent the realistic impact of risk transfers from the fund to the service provider and allowing firms to compare costs with charges over an extended period of say five years. There could also be better disclosure of costs. This would be sufficiently different from the proposal on which we consulted to require fresh consultation.

Firms should note in this context that our existing proposals on governance include a focus on the fairness of charges to with-profits policyholders, so this is an area that will continue to receive scrutiny both within a firm's internal governance and by the regulator. This is a topic that we would also expect firms to consider in connection with their compliance with the new rule in COBS 20.2.1AR on unfair benefits.

Both the Financial Services Consumer Panel (FSCP) and Which? have also urged us to look again at the extent to which pension scheme deficits are charged to with-profits funds in proprietary firms to ensure that there is no disproportionate levy on the fund. We have not – to date – seen any specific proposals on what limits it would be reasonable to place on operating costs that can be charged to a with-profits fund beyond that imposed by the existing rule at COBS 20.2.23R.

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

**2.47** Many respondents mistakenly believed that we had proposed to abolish reattributions altogether. Others correctly observed the distinction between reattribution of working capital

and distribution of excess surplus, which was what lay behind our proposal. Proprietary firms that take a narrow view of policyholder interests suggested that the proposal was not consistent with current law as it appeared to assert that with-profits policyholders have an interest in, or expectation to participate in, distributions from excess surplus. We were told that policyholders have no reasonable expectation to any distribution in excess of their smoothed asset share and that fairness could not require an insurer to distribute excess surplus in which, we were told, policyholders had no legal or beneficial interest, to which they had no contractual entitlement, and to which they had not contributed.

**2.48** One respondent agreed with our basic point that reattributions and distributions are fundamentally different processes and should not be regarded as alternatives to each other. However, we were told that while distribution is an option for the use of excess surplus, a reattribution is an option for the distribution of the whole of the estate, including any excess surplus, and should remain.

**2.49** Another respondent said that if mutual funds were able to go through the appropriate formal process, for example court approval and/or a policyholder vote, to recognise mutual capital as separate from their with-profits fund, then the proposed provisions on reattributions may have unintended consequences on a restructuring conducted by a mutual insurer to split its long-term fund into a with-profits fund and a mutual fund. A further comment received was that reattribution of excess surplus should still be possible where a mutual can demonstrate that it can reasonably be used for other purposes, which are in line with the aims of the organisation, e.g. to give security to continuing non-profit business.

## Our response

Our proposal is intended to make the difference between a reattribution and a distribution clearer, not to prevent reattributions. When a reattribution takes place in a proprietary fund, excess surplus is typically distributed first and the remaining working capital, which the fund needs to retain, is then subject to the reattribution. The working capital that is reattributed can include that element of surplus which remains after the excess surplus has been identified.

The process was designed for firms with shareholders and with-profits policyholders, not for mutuals. Firms that seek policyholder and/or court approval for schemes to separate out with-profits capital from a mutual's common fund should not, in our view, be required to follow the full reattribution process currently envisaged by the Handbook. We will need to consider with such mutuals what alternative process may be appropriate for their circumstances and the mechanism for achieving that. There might be some similarities in terms of process, including the possibility of employing an independent expert, but since most with-profits policyholders are also members of the mutual they have invested in, they would in part be negotiating with themselves in their different capacities, which is a very different situation from

the one currently envisaged in a reattribution by the Handbook. For example, to the extent that there is a class of 'member' as distinct from a class of 'with-profits policyholder', this is largely an issue of resolving conflicts between differing, but often overlapping, interests. In these circumstances a policyholder advocate would not be appropriate. We do not, therefore, believe that this proposal will affect mutual life funds.

Neither do we share the view of some proprietary firms that with-profits policyholders have no interest in excess surplus. This is covered in more detail elsewhere in this PS.

It should also be noted that this is an evidential provision and that the rule to which it relates remains in force and unamended. We see this as a tidying up of the rules, not a significant substantive change, and we will therefore proceed with the proposal as consulted on.

**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?*

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

**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?*

**2.50** Some firms said that existing safeguards should be sufficient to ensure that policyholders are fairly treated in a reattribution, so introducing a new rule on excess surplus was unnecessary. Others said that while firms should be required to pay particular attention to identifying excess surplus, there should not be an automatic distribution of excess surplus prior to each reattribution. An even stronger view put forward by some was that excess surplus is the property of the firm, and the firm must be allowed full discretion as to its management and disposal, with respondents suggesting that our proposal is not within our legal powers to make.

**2.51** One respondent said that a significant amount of time and cost would be involved in developing the systems and analysis required to meet the requirements of the proposed COBS 20.2.42R(1). They felt that a distinction needed to be drawn between the existing requirement that firms assess whether an excess surplus exists on an annual basis and the prospective modelling that would be necessary to determine in what circumstances it might

have excess surplus in the future. There was also a risk that subsequent appointment of a policyholder advocate might lead to a need to revisit the assumptions and calculations of the model.

2.52 Consumer groups said that our proposal was the only approach that would be consistent with the relevant rules and guidance, including treating customers fairly.

2.53 On policyholder communications, some firms said that they did not believe that it was appropriate for a third party, such as the policyholder advocate, to control communications with a firm's customers. Others said that, while the principle was fair, the insurer should be given an opportunity to object to and prevent such communications with its own customers, where there are reasonable grounds for objection. Another suggestion was that the policyholder advocate should generally look to agree communications with the insurer first and if agreement can't be reached then the matter should be referred to the FSA.

2.54 Policyholder groups tended to support the proposal as increasing the likelihood of transparent communication of difficult matters, possibly with the firm sending out a parallel communication at the same time rather than having to respond subsequently, if they took a different view. Others noted that it would be unfortunate for a situation to develop where conflicting messages were issued by the firm and the policyholder advocate, leading to policyholder confusion.

2.55 One contributor to the consultation pointed out that the policyholder advocate will have access to confidential information about a firm and its operations and that constraints apply to the information that listed firms can disclose. The policyholder advocate is also negotiating with the firm and may seek to strengthen his or her position by casting the firm's past practice in a poorer light than might be appropriate or indicating to policyholders that they have a greater entitlement to the inherited estate than may be the case. While a firm would be likely to seek to correct potentially misleading statements, such statements may nevertheless damage the firm's reputation. The respondent concluded that it would be reasonable for a firm to retain the right to review, and challenge on reasoned grounds, the content of policyholder communications proposed by the policyholder advocate.

2.56 Our proposal to prevent a firm from seeking to bind the minority in a reattribution was unwelcome to most firms. One respondent suggested that if a binding scheme was prepared and taken to the courts, it would remain open to the FSA to contest such a proposition in court. Minorities can be bound in other processes such as schemes of arrangement and Part VII transfers under the Financial Services and Markets Act 2000, so to single out reattributions seemed disproportionate. In addition, leaving a small minority in a fund can be disproportionately costly to administer and therefore might in fact operate against policyholders' best interests.

## Our response

We recognise that preventing all reattributions that seek to bind the minority can be seen as inflexible and that the regulator will have the opportunity to object in court if appropriate. The courts can take their own view of the fairness of any scheme. The draft Handbook text provided an element of discretion on this point, but on balance we are persuaded that we can achieve the policy intention of appropriate policyholder protection without proceeding with this proposal. In the CBA, as consulted on in the CP, we note that our investigation did not reveal a case where the minority of policyholders were bound to a reattribution they rejected. The court process provides an additional safeguard.

Policyholder communications is a perennial and knotty problem, with policyholders in a reattribution having to make an important personal decision on what will often be a less than perfect understanding of the technical issues involved. We are not persuaded that making either the regulator or the independent expert into an adjudicator, in the event of disputes between the firm and the policyholder advocate over the content of communications, would improve the process as this could impair either body's existing responsibilities in a reattribution by drawing them into the negotiating process.

We also recognise firms' concerns about reputational risk and disclosure of inappropriate information. We have decided to proceed with an amended version of this proposal, under which the policyholder advocate will be required to consult the firm about policyholder communications and to agree messages where possible, but with the residual right to communicate independently if agreement is not reached in a reasonable time. It was not part of the original policy intention to expose firms to inappropriate reputational risk or disclosure. Therefore this amendment is to clarify the original policy intention, and should have no material impact on the cost and benefit analysis of requirements in relation to 'communicating with policyholders'.

The requirement that a firm which seeks to make a reattribution must first discuss certain matters with the regulator, including projections for new business and the capital required to support those projections, is in our view clearly part of the FSA's responsibility to deliver appropriate protection to policyholders. We acknowledge that this reflects our existing view that the interests of with-profits policyholders in proprietary funds are more extensive than the narrow interpretation placed on them by some few firms.

Changes in this area do not necessarily imply criticism of previous reattributions, since those concluded to date have been approved by the courts as being fair. Our intention is to improve the process and, as part of this, we believe that the more work firms can do earlier in the process, particularly in terms of identifying what is to be distributed and what is to be subject to reattribution,

the shorter the process will be once a policyholder advocate is appointed. It is likely to be preferable for policyholders to have to deal with the uncertainty that accompanies a reattribution for the shortest possible time consistent with achieving a fair and equitable outcome. We will therefore proceed with this element of the proposals on the basis on which we consulted.

# 3 Corporate governance

**3.1** Responses to our proposals on corporate governance were characterised by a lack of consensus, with many firms taking the view that their current arrangements happened to be the most appropriate. Some respondents said that all with-profits funds should have a committee; others thought that our threshold requirement was set too low and would catch too many. Some were firm supporters of the independent person as an alternative to a committee; others thought that we were asking too much of such a person, particularly in a large fund.

**3.2** Many were concerned about the additional costs of recruiting and supporting additional members of a with-profits committee.

> **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?*

**3.3** Trade bodies told us that this was a reasonable proposal with relation to proprietary firms but that it was less clear how it should apply to mutual life firms. They also acknowledged that many mutuals have in practice established with-profits committees, and benefit from the insight this provides to running their with-profits funds. Mutuals told us that they have invested a significant amount of effort since Lord Myners' report on the governance of mutual life offices, producing an annotated version of the UK Corporate Governance Code, compliance with which is a requirement of membership of the Association of Financial Mutuals.

**3.4** There was also some concern about where the threshold for a mandatory with-profits committee should lie, since under current EU directives it is possible for a friendly society to be both non-directive and to have assets of over £500m. We were therefore urged to re-consider the definition in light of the forthcoming requirements of Solvency II. Another respondent said that the need for a committee should be related to the likely conflicts and not to the amount of with-profits business.

**3.5** From a consumer perspective we were told 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, should be entitled to the same levels of independent representation, including a with-profits committee, so the proposed threshold requirement was in their view set too high. Policyholders would be unlikely to know the size of a particular fund, or to realise that they might need to take account of it, before deciding to invest. Placing responsibility for providing an element of independent judgement on a single individual would be unrealistic. However, it was also acknowledged that there is a cost to such a committee that would be borne by policyholders, so more work should be done on the relative costs and benefits. One suggestion was that a committee should always comprise more than one person, with larger or more complex funds requiring greater representation. We were also told of concerns that firms would not appoint genuinely independent people to these positions.

**3.6** Some firms took the view that larger firms are more likely to have sophisticated checks and balances in place in their overall governance structures than smaller firms, making with-profits committees less necessary. They questioned where the evidence was that an independent person was less effective and asserted that the likely costs were considerably greater than we had estimated. Others said that there may not be an adequate supply of potential members of such committees with the requisite experience, without which there may be detriment to the interests of policyholders. This was advanced as an argument for having a higher threshold condition. However, one respondent expressed the view that to demand specialised expertise for this role would perpetuate the unhelpful notion that understanding of the issues involved in with-profits business was beyond the capabilities of the intelligent lay person.

**3.7** Another suggestion was that all firms should be required to have a with-profits committee unless a waiver was granted, allowing the regulator to take a risk-based view on an individual fund-by-fund basis. Others said that closed funds should be exempt from the requirement to have a committee, particularly where those funds have an established run-off plan.

**3.8** Some smaller mutuals, including some to whom the proposal would apply, were concerned that the cost of a with-profits committee could be as great as that of their board and that the additional costs would fall on policyholders without necessarily delivering material benefits. Several respondents noted that the current governance arrangements are set out in COBS 20.3 and that non-directive friendly societies are currently exempt from the requirements of that chapter of the Handbook. The CP did not include a corresponding exemption in the draft text from the requirements in COBS 20.5. We were asked to reinstate this exemption, particularly by Holloway sickness societies.

**3.9** Another point raised in responses was the proposal that firms with more than one with-profits fund should appoint the same with-profits committee. Respondents said that there may be circumstances where the potential conflicts of interest between funds would make this inappropriate. In addition, some funds are subject to court Schemes which mandate a body to monitor policyholders' interests that might duplicate the functions of a with-profits committee.

## Our response

In our view the with-profits committee's role (and that of the independent person) is to provide focused advice and challenge to management on the running of the with-profits fund, including the conflicts of interest arising, with specific reference to with-profits policyholders. This is of particular importance in shareholder-owned firms, but with-profits mutuals with substantial non-profit business or other potential conflicts of interest could also benefit from this focus. We also acknowledge the point made by some respondents that a large fund is not necessarily complex and that particular issues can arise in smaller funds, something that our proposal did not fully deal with.

One possible way forward would be to reverse the logic and, instead of saying that all funds above a certain size must have a with-profits committee, to propose that all funds must have a with-profits committee unless the firm can demonstrate that it is either too small for it to be proportionate or too simple in operation for it to be necessary. Within that we should also make it clear that it was not our intention to extend this area of regulation to non-directive firms or to societies for their Holloway sickness business.

Given the variety of views expressed, we are not sufficiently persuaded to go ahead with our proposal in the form in which we put it forward. We will retain existing provisions that mean that firms need to consider whether a with-profits committee is appropriate for the particular fund or funds they manage, including with regard to the size, nature and complexity of the fund in question. Firms should note that, in our view, having seen all the various arrangements in action, we continue to believe that it is best practice to have a with-profits committee, at least for complex funds. We think that there is considerable merit in the suggestion that we make a with-profits committee the general rule except for those firms whose low level of complexity makes one unnecessary and which would retain the existing ability to use an independent person in those circumstances to fulfil the role. We recognise that firms may need further pointers as to what factors may be regarded as relevant to deciding that a fund is non-complex. In our view such a change would be sufficiently different from our proposal to require re-consultation.

We will not proceed with this change at this time, but we will give further thought to the various options with the intention of consulting on revised proposals in due course. This change from the CP means that the number of firms that would need to have a with-profits committee could be fewer than the 23 estimated.

We have, however, decided to retain an amended definition of a 'with-profits advisory arrangement' in the Handbook Glossary to allow firms to decide whether to appoint an independent person or one or more non-executive directors, if appropriate, having regard to the size, nature and complexity of the fund in question. The larger or more complex a fund is, the more likely it will be that it

would be appropriate to appoint an independent person (see COBS 20.5.2G(2)). We have also deleted the text on with-profits governance that we had proposed to introduce in SYSC 3.2.9A G since, on reflection, we believe that setting out our rules and guidance in COBS 20.5 makes this cross-reference in SYSC unnecessary.

**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?*

**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?*

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

**3.10** Policyholder groups have said previously that, in their view, all members of the with-profits committee should be fully independent of the firm. Some expressed concern that management may be unlikely to be properly challenged because members of these committees acquire their expertise either as former staff of the funds involved, or by having had a career in a similar business elsewhere within the industry. We were told that it would be inconsistent with the principle of independence for any of a firm's non-executive directors to be on the committee and that a policyholders' representative should also be a member of the with-profits committee.

**3.11** Firms and trade bodies took a different view. Several noted that a similar proposal was considered and rejected at the time of our original review of with-profits governance in paragraphs 4.6 and 4.9 of PS167.[5] We were told that the case had not been made for a reversion to the model considered at that time. One respondent said that their preference would always be to include individuals on a committee who have knowledge and experience of the business concerned. As well as having an independent element, the committee benefits from having some members with an in-depth understanding and in-house experience of the fund. Others said that that an independent majority with an independent chair should be adequate and that key knowledge of a firm's previous with-profits practices may be lost if a completely independent format is proposed.

**3.12** In the context of smaller mutuals, we were told that existing board directors, whether non-executive or executive, can act in an independent way. The situation was said to be analogous with the situation in which similar individuals act as pension trustees working in the interests of the members of the pension fund.

5 *With-profits governance and the role of actuaries in life insurers* – Feedback on CP167, made and near-final text (June 2003)

**3.13** For smaller firms without a with-profits committee we were told that there was a risk that the independent individual responsible for taking on the duties of the with-profits committee would not have the checks and balances inherent in any committee structure, and would therefore increase unpredictability and difficulty in managing the fund. Many firms would be reluctant to have their strategy dependent on a single individual, so that a number of smaller firms would feel forced to appoint a with-profits committee with the attendant costs.

**3.14** Most mutual firms agreed with the proposal on independence using the same definition of independence as the Financial Reporting Council's (FRC's) current code as this is also adopted in the annotated version of the code used by mutual insurers. Some proprietary firms said that we should go further and add an additional requirement that would exclude candidates who have held the position of actuarial function holder or with-profits actuary from consideration as an independent member, although they could serve as a company-nominated member.

**3.15** Others said that a committee member who might not be objectively independent because of past employment or current or past relationships may be deemed by the rest of the committee to be independent notwithstanding those issues, if they believe that the individual nonetheless demonstrates independence. In such circumstances, the committee should state publicly why they believe that the individual is capable of acting independently. Another respondent said that this was similar to the 'comply or explain' basis of the code and could see no reason why mutual insurers should not be able to explain why a person should be classified as independent even though they do not meet the strict code definition of independent.

### Our response

As a regulator, we have the benefit today of having seen for ourselves how with-profits committees function in practice and perform a valuable advisory and challenge function within the corporate governance of many firms, although we acknowledge that much of what they do has not been visible to policyholders. We are not persuaded that removing people who have personal knowledge of the management of the fund and its history from the committee, or asking individual policyholders to represent not their own interests, but the often conflicting interests of different generations of other policyholders, would deliver benefits commensurate with the costs involved. Distance from the business would be likely to make such committees less effective and in some firms could result in duplication with governing bodies.

Accordingly we will not go down the fully independent route for with-profits committees. We believe that if committees have an independent majority, possibly with a senior independent non-executive or external person chairing the

committee, then they can reasonably include internal appointments to link them more effectively to the business. While it might be difficult for a former actuarial function holder or with-profits actuary to demonstrate their independence from management, we will not act on the suggestion that we referred to above, but will leave it to boards to assess the independence or otherwise of their appointments.

In the CP, we estimated the total costs for firms under the 'majority independent' requirement to be around £2.3m a year for the 23 firms estimated to need a with-profits committee. We have decided now not to impose the £500m threshold and rather to retain the existing provisions (i.e. firms need to take a view on whether a with-profits committee is appropriate for the particular fund or funds they manage having regard to the size, nature and complexity of the fund in question). So the number of firms directly affected could be fewer than 23.

In addition, one firm asserted in its feedback that the cost of an independent person was in the region of £100,000 to £150,000 a year as opposed to our estimate of £60,000 a year. We recognise that the cost of an independent person can vary, depending on the size, nature and complexity of the fund, and the independent person's experience.

Based on a revised estimate of eight firms setting up a 'majority independent' with-profits committee and 15 firms replacing one with-profits committee member with an independent person, we estimate revised total costs to be around £3.3m.[6]

The FSA has existing powers to review all appointments to with-profits committees through the Approved Persons regime and we already place reliance on non-executive directors as part of the lines of defence against consumer detriment. In defining independence, firms should have regard to the guidance we have issued which is in line with the FRC's guidelines, including the annotated version used by mutual insurers. This is in line with the FRC's 'comply or explain' rubric.

Similar criteria should apply to other means of delivering the independent judgment required by the Handbook so that, for example, a senior non-executive in a mutual insurer would also need to be independent (as set out by the annotated code) to fulfil this function. We have also made a transitional rule such that firms' existing governance arrangements are deemed to comply with the provisions in COBS 20.5 until 1 July 2012.

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

6 Eight firms without WPC now will need to spend 8*3*£100,000 = £2.4m to set up WPC; 15 firms that currently have WPC will need to on average replace one existing WPC member £60,000 (assuming that is the difference in cost between an independent person vs. a current WPC member) 15*1*£60,000 = £0.9m; £2.4m+£0.9m = £3.3m.

**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?*

**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?*

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

**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?*

**3.16** The FSCP commented on the need for much greater transparency around the operation of with-profits committees and felt that publication of the terms of reference on a website would help policyholders with access to the internet, but that other arrangements would have to be put in place to ensure that all policyholders were made aware of them. They suggested that we should prescribe rules on drawing up reasonable and appropriate terms of reference, including the powers and responsibility of the with-profits committee to challenge the PPFM. They would also like firms to set up a webpage on their sites, accessible from the home page, that provides important information about the committee, including key committee documents and decisions and the basis on which decisions are taken. A summary of this information, written by the with-profits committee, should also be included in firms' annual reports.

**3.17** Most firms supported the proposal on publishing the terms of reference, although some mutuals noted that terms of reference applicable to proprietary firms would not necessarily work for mutual insurers and that very small providers with no website should be exempt.

**3.18** Several firms noted that the role of the with-profits committee had shifted from consideration of whether the PPFM had been complied with to the provision of advice and recommendations to the board. Others expressed concern about the extensive requirements for the terms of reference in COBS 20.5.3R, which were considered disproportionate for the operation of smaller with-profits funds. We were told that the wide-ranging list of issues on which with-profits committees are to be consulted will lead to a significant slowing down in management processes, and could lead to the final say in strategy being with the with-profits committee rather than the management and the board.

**3.19** Many respondents found the proper recording of the committee and the board to be part of basic good governance practice. Others wished to be reassured that these records would remain confidential. To do otherwise we were told would be likely to undermine the functioning of the board.

**3.20** On reasonable requests for external support, mutual insurers were more supportive than proprietary firms, who questioned why the shareholder should have to meet the bill for costs incurred on behalf of the with-profits fund. One proprietary firm suggested that if the proposal under consideration is in the interest of shareholders (e.g. an insurance business transfer), firms would accept that it is reasonable that the cost of any related advice is met by the shareholders. On the other hand, if the actions that give rise to the need for the advice are for the benefit of the fund or relate to the normal running of the fund's business, it is considered reasonable and fair that a fair proportion of these costs is borne by the fund, as at present. An example given was advice on a conflict of interest between different classes of policyholders. It was also suggested to us that the wording of the proposed COBS 20.5.6G (1) might make clear that sharing of advice costs between the with-profits fund and the shareholder would also be a potentially acceptable outcome.

**3.21** There was general agreement that the list of issues for with-profits committees to cover was thorough and included the right areas for the committee to consider. Some firms provided lists of possible additional items. There was some concern that it could involve the with-profits committee in inappropriately detailed work for an advisory committee, e.g. the company should be reviewing complaints management and the with-profits committee should be reviewing high-level complaints data. A clear distinction of responsibility is needed between the day-to-day management of the fund and oversight. The terms of reference of the committee would clearly need to reflect this.

**3.22** Other firms said that until the extent of the rights of policyholders are clarified, i.e. whether they are limited to contractual rights or have a more extensive contingent interest over the whole of the fund, expanding the role of these committees is premature.

**3.23** One consultancy commented that the leading with-profits providers have been steadily improving their investment governance processes in recent years. However, there are still marked differences in approach, leading to questions as to how robust the investment governance of smaller providers might prove to be on closer inspection. Greater monitoring of the investment governance process could be a key role for the with-profits committee and we were told that an outline of this process should be made available to policyholders.

**3.24** It was generally accepted that the committee should be able to raise issues proactively. One respondent qualified this by saying that, while the increased governance was welcomed, it may lead to a number of detailed recommendations to the governing body that could result in inefficient management of the fund and increased resourcing internally to support the committee. They were also concerned that management might want to use the fund to support new business while the committee might want to try to encourage distribution of surplus to policyholders. This could create tension within the firm between the future needs

of the fund and the needs of current with-profits policyholders, as seen by management and the committee.

## Our response

We will go ahead with our proposal to require firms with a website to publish terms of reference for with-profits committees on their website. For firms without a website, in particular small mutual firms, we will include a requirement to make the terms available on request. We will consider looking further at the FSCP's suggestions on transparency when we review with-profits customer communications more generally.

Our vision for the with-profits committee is that it should be providing advice and challenge to the board and, where appropriate, recommendations. Decisions rest with the board or governing body, as does the responsibility for those decisions. The governing body will in many cases have responsibilities that are not synonymous with the with-profits policyholders only, i.e. it has responsibilities possibly to shareholders, to other members, or to other policyholders. Hence, it may take a different view of what fairness requires in a particular situation and will not always follow in all material respects the advice of the with-profits committee. Where this happens, it needs to ensure that it makes a full and appropriate record of the reasons and gives the with-profits committee a reasonable period to consider them and respond, and then considers any further representations from the with-profits committee and provides further reasons following that if appropriate. Our intention is to improve the quality of decisions taken in order to protect with-profits policyholders better, not to impose the with-profits committee's view on the firm's governing body.

Access to external advice is something that a with-profits committee can request, and the different circumstances outlined by firms suggest that it may be reasonable to decline the request if the matter is exclusive to the fund and its policyholders. Since the guidance we proposed was that committees could request external support, not that it had to be provided in all cases regardless of cost or materiality, we believe on balance that this should remain. We have, however, amended the guidance at COBS 20.5.6G (1) to reflect that costs are not necessarily the exclusive responsibility of either the fund or the firm and may be shared, according to whether the issue under consideration is wholly or partly to the benefit of the firm rather than policyholders.

Again, these revisions aim to clarify our original policy intention, and have little impact on the cost benefit analysis of the related proposals.

We do not propose to expand the list of issues for a with-profits committee or

advisory arrangement to consider now. But we ask firms to note that the list is, and was intended to be, non-exhaustive. Also, not all issues on it will be relevant to the same extent to all funds. We note and agree that committees should not get distracted by reviewing detailed business processes, but nor is it for us to specify the appropriate level of detail for each issue – committees and firms will need to come to their own views in light of the terms of reference and the need to treat policyholders fairly.

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

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

**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?*

**3.25** Firms commented that the with-profits committee was both capable of operating effectively alongside the with-profits actuary and that it was difficult to see how effective with-profits governance could be achieved without the close co-operation of the with-profits committee and the with-profits actuary. Many felt that our proposal to include close working in the with-profits committee's terms of reference was in line with current practice. However, others said that while this was the case, the committee should not feel constrained from acting independently of the with-profits actuary if it considers it necessary.

**3.26** One firm suggested that the new rule should ensure that the committee will see any advice that the with-profits actuary provides to the company as well as any additional advice that they would like to have. The FSA was asked to recognise that the with-profits committee may take a different stance from the with-profits actuary and the company could hold different views to one or both of these; this would be a consequence of each taking a view independent of the others and is not necessarily a failure of governance.

**3.27** The proposed notification mechanism was accepted by many firms, but a number commented that it should only be necessary to alert the regulator in very exceptional circumstances, where the board is embarking on actions that will lead to severe and tangible detriment to policyholders. Others felt that our proposal added little to the existing Handbook requirement under Principle 11 to disclose to the FSA anything relating to the firm of which the FSA would reasonably expect notice; to the ability of the with-profits

committee to report to policyholders; and, to the existing responsibilities for with-profits committee members under the Approved Persons rules.

**3.28** There was opposition from some to the proposal that the with-profits committee should have a formal role in assessing the performance of the with-profits actuary or in assessing the suitability of candidates for the position. We were told that, since the with-profits actuary is appointed by the firm, giving the with-profits committee a say in choosing the with-profits actuary would compromise the independence of the with-profits committee by involving it in the management of the firm.

**3.29** There was also concern about the practicality of the remuneration arrangements for the with-profits actuary. It was suggested that in practice any potential conflicts will need to be managed rather than eliminated entirely and that this should be recognised in the drafting of the rules. The FSCP was sceptical about the extent to which the with-profits actuary could ever be truly independent. One firm that agreed with this view commented that, since the with-profits actuary will need to report to someone and that their line of reporting will ultimately reach the CEO, then no reporting line could be said to be completely free of potential conflict.

**3.30** One respondent put forward an alternative to the effect that the emphasis should be placed on the appropriateness of the individual, as assessed on appointment to the role of with-profits actuary and subsequently, and on the culture of the organisation, as opposed to focusing on reporting lines and remuneration structure. Under this view the with-profits actuary can operate effectively as part of the business, including reporting to the actuarial function holder or the finance director. Provided the with-profits actuary has access to the board, the with-profits committee and the chief risk officer, this should provide sufficient means for expressing any concerns he has about a conflict of interest that has arisen as a result of the with-profits actuary's reporting line.

**3.31** Some mutuals were concerned that the proposal would not work for smaller funds in particular where the posts of actuarial function holder and with-profits actuary may be held by the same person. In their view, the with-profits actuary should be able to manage conflicts in the same way as any other employee or director. We were told that the proposals seemed restrictive rather than supportive and would make it difficult to identify a suitable person within the firm with sufficient seniority and influence to act as with-profits actuary.

## Our response

We accept the concerns that some firms have raised about reporting and remuneration arrangements. With-profits actuary roles often tend to be part-time or combined with other roles and can be difficult for the individuals concerned to operate in effectively while still managing their future career prospects. The existing requirements of SUP 4.3 (appointment of actuaries) and the actuarial profession's Guidance Note 39 emphasise the need for individuals of high quality and require firms to provide sufficient resources. We will therefore revise the rule on which we consulted in order to be less prescriptive and to require that where a conflict of interest arises, it should be identified and managed effectively.

In terms of requiring the with-profits committee to work closely with the with-profits actuary, we have moved this from a rule into guidance. This gives the committee greater discretion over how it conducts its work and maintains the separation between the with-profits actuary and the committee within a firm's internal governance structures.

We will add guidance to the Handbook text to make it clear that we expect that the proposed notification mechanism to alert the regulator to significant disagreements between the board and the with-profits committee will only to be used in exceptional circumstances. It supplements existing notification provisions by providing a specific focus and also gives the with-profits committee, rather than the firm, the initiating role in the firm's notification. We will monitor whether it is being used and, if so, whether it is being used appropriately, through supervisors and periodic feedback from firms.

Again, these revisions aim to clarify our original intention, and have little impact on the cost benefit analysis of the related proposals.

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

**3.32** A number of mutual insurers reported their fundamental disagreement with the approach taken by us to the regulation of mutual insurers with both with-profits and non-profit business. They also questioned whether our general rule-making power, which is qualified by the words 'as appear to [the FSA] to be necessary or expedient for the purpose of protecting the interests of consumers' enabled us to make the rules we proposed. We were told that the proposals in CP11/5 enhanced, rather than protected, the rights of the current generation of with-profits policyholders to the detriment of future with-profits policyholders, current and new non-profit policyholders and members, and were therefore beyond the FSA's statutory powers.

**3.33** One of the mutual insurers noted that Section 2.20 of CP11/5 acknowledged the ability of a mutual to create so-called 'mutual capital' by splitting the long-term fund, with the agreement of its with-profits policyholders, into a with-profits fund and a mutual fund. However, the CP did not go into further detail about how such a split could take place or about specifically what type of consent and from whom would be required.

**3.34** The firm suggested that if this mutual capital structure was to be a realistic option for mutuals, then certain things would be needed:

a) a clearly understood mechanism for splitting funds in a mutual, supported by the regulator, including an agreed approach to any policyholder notification requirements and, where applicable, any policyholder or member consent requirements; and

b) an acknowledgement from the regulator that requirements for policyholder/member consent to any splitting of funds in a mutual will take into account the circumstances of the relevant mutual including the terms of relevant policies, policyholder literature and the mutual's constitution. Specific consent from with-profits policyholders should only be required if the relevant splitting of the fund involves a material adverse change to the existing rights and expectations of the relevant with-profits policyholders, taking into account the terms of their policies, relevant policyholder literature and the mutual's constitution. In other circumstances, i.e. where there is no material adverse change to their existing rights and expectations but rather a clarification for the benefit of all parties, specific consent of with-profits policyholders should not be required.

**3.35** In practice, we were told, the consent of the majority of members of the relevant mutual as a whole to the splitting of the fund is likely to be required, because the splitting is likely to require a change to the constitution or other rules of the relevant mutual. We were urged to engage proactively with the industry on the whole matter of mutual insurance firms and with-profits business.

**3.36** In its submission, the actuarial profession urged us to give greater encouragement to innovative forms of with-profits contracts such as annuities, unit-linked business and term assurances, where the surplus arises from mortality and expense experience rather than predominantly from investment performance. We were told that mutual insurers should be allowed to retain capital within the business to support wide varieties of participation, and the fact that a firm ceases to write substantial volumes of 'conventional' with-profits business should not be an automatic signal that the firm should be deemed to be closed to new business.

**3.37** One policyholder in a mutual insurer asked us to be explicit that the with-profits assets are owned by policyholders and that the management are the stewards of the assets on their behalf. Another said that there was no mention of any proposal to establish any forum for

policyholders to exchange views with insurers, proprietary or mutual. CP11/5 is focused on policyholder protection but nowhere, we were told, is there any attempt to solicit the opinions of policyholders. A further policyholder comment concerned the particular needs of with-profits annuitants and the information provided to them by firms, given that there is generally no means of surrendering or transferring a with-profits annuity to another provider.

**3.38** The FSCP recommended that the regulator should undertake a further comprehensive post-implementation review to assess the effectiveness of the new arrangements for policyholders, subject to the necessity to implement Solvency II as well, but taking place around 2015.

## Our response

We recognise that we need to look again at the issues facing with-profits mutuals and the impacts on their with-profits policyholders and other members as soon as possible. We also take note of the actuarial profession's view that more innovation in with-profits products may be desirable. The existing suggestions for ways forward for these mutuals have not found favour with many firms, but at the same time the amount of with-profits business in a mutual's common fund continues to fall, leading to considerable existential angst within the mutual sector. We will return to this as soon as is practical, given current EU imperatives and domestic regulatory changes.

We do not share the gloomiest predictions from some firms within the mutual with-profits sector about the impact of protecting policyholders' interests on the future of the sector. Having said that, we note the trend of demutualisation and of consolidation within the mutual sector that has taken place over the past decade and we see little sign that this is set to change in the near future. Those trends are unlikely to be seriously affected by the changes we have proposed, which are in any event incremental.

We expect that there will be continuing demand for long-term savings products for pensions and other purposes which the life industry has traditionally been a major player in providing. With-profits business not only gives savers and investors the opportunity to benefit from the business experience of the firm in addition to investment returns with some additional smoothing, it also provides useful asset diversification for small investors. The underlying issue is more one of confidence and here it is for firms to communicate the benefits of long-term life assurance saving to consumers, rather than to focus on the impact of domestic with-profits regulation.

Relatively few individual policyholders responded to the consultation, but those that did showed the gap between their perception of the assets in the with-profits fund as being owned by the policyholders and managed by the

firms, as opposed to many firms' views that they own the assets and that their responsibility to policyholders is limited to ensuring expected contractual payouts. There is then a further issue, firms say, around the extent of those contractual rights and related expectations and how they can be quantified. Our planned work on policyholder communications may be the right place to address this and to identify ways to deal with information asymmetry and to give firms the opportunity to explain themselves more effectively to the policyholders on whose behalf they manage these investments.

**Q30:** *Do you think that the CBA has identified the relevant costs and benefits and that the costs have been appropriately estimated?*

**3.39** The CBA was not accepted by all respondents. Many from the mutual sector said that the proposals, if implemented, could lead to the rapid disappearance of the mutual with-profits sector, an outcome that was not costed in the CBA. A proprietary firm told us that the CBA was invalid as it resulted from a suite of proposals that were inequitable, misdirected, in places irrational, and founded on a legally flawed position.

**3.40** Beyond these high level concerns there were two more detailed issues in particular that were referred to in responses. The first relates to the cost of producing and maintaining distribution plans and management plans. We had estimated that the maximum incremental cost for the population of 53 open funds of setting up these plans would be around £2.4m, an implied average cost of £45,000 per fund. In responses, at least one firm put the estimated cost at nearer to £250,000 per fund, assuming an increase in dedicated resource.

**3.41** The second and perhaps even more significant issue for those funds affected was the cost of setting up a with-profits committee to replace an independent person or other arrangement. One firm said that the cost of review by an independent person was in the region of £100,000 to £150,000 a year while having at least three independent people to sit on a with-profits committee, plus the additional resourcing required to support the committee, plus overheads would be expected to total in the region of £500,000 a year. This is an additional cost of £350,000 to £400,000 according to the firm, compared to our estimate of additional costs of around £180,000. Another firm said that the possible need to advise policyholders of a change to 'practices' as detailed as those within a PPFM could, even if achieved by an addition to annual statements, cost in excess of £1m given the complex history of many firms involving legacy products and systems.

**3.42** Other firms suggested that reliance on the enhanced governance proposals and more effective supervision could deliver our objectives to protect policyholders' interests without needing all the detailed rule changes also proposed. Others noted that costs are absolute figures, while their impact on smaller firms are relative and the smaller the firm the greater the impact.

## Our response

In terms of the impact on the mutual life sector, this is an area of considerable complexity, particularly in a financial environment in which the volume of new with-profits business has been declining. We intend to conduct further work on the mutual with-profits sector. For the time being, we have decided not to make the Handbook provisions on which we consulted at COBS 20.2.17A G.

In terms of producing and maintaining distribution plans and management plans, we appreciate that the costs can vary, but we used an estimated average cost of £45,000 per fund based on our experience and knowledge. In any case, we have decided not to proceed with requiring firms to draw up separate fair distribution and management plans at this time. We will consider whether to revisit these proposals in due course.

In terms of the cost of an additional independent person in governance structures, we recognise that the cost can again vary, depending on the size, nature and complexity of the fund, and the independent person's experience. We have revised the total costs in our response to Q18 to Q20, taking into account both the feedback on the costs involved, as well as the policy decision to go down the 'majority independent' route for with-profits committees.

## Annex 1

# List of non-confidential respondents

**Companies and organisations**

The Actuarial Profession

Association of British Insurers

Association of Financial Mutuals

Aviva UK

B&CE Benefit Schemes

British Friendly

The Children's Mutual

Cirencester Friendly Society

Cornish Mutual

DG Mutual

Engage Mutual

Equitable Life

Family Investments

Financial Services Consumer Panel

Healthy Investment

Herbert Smith LLP

Holloway Friendly

Investment & Life Assurance Group

LV=

Mercer Limited

Metropolitan Police Friendly Society

MGM Advantage

Milliman Limited

NFU Mutual

Norwich Union Policyholders' Action Group

OAC Consultants

The Oddfellows

Old Mutual Wealth Management

Phoenix Group

Police Mutual

Prudential Assurance Company

Red Rose Assurance

Royal London

Scottish Friendly

Sheffield Mutual

Standard Life

Steve Dixon Associates

Towers Watson

Wesleyan Assurance Society

Which?

Wiltshire Friendly

Zurich Assurance

### Individuals

Jessie Adams

Peter Baker

Peter Bloxham

John Bolland

Roy England

Stephen Gore

Michael Graham

Bob Houlston

Peter McMahon

Dr Michael Nassim

Chris O'Brien, Nottingham University

RW Wright

Anonymous (1)

Thirteen confidential responses were also received and some of the respondents above provided an additional confidential response.

## Appendix 1

# Made rules (legal instrument)

# CONDUCT OF BUSINESS SOURCEBOOK (WITH-PROFITS BUSINESS) INSTRUMENT 2012

## Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 139(4) (Miscellaneous ancillary matters);
(3) section 149 (Evidential provisions);
(4) section 156 (General supplementary powers); and
(5) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

## Commencement

C. This instrument comes into force on 1 April 2012.

## Amendments to the Handbook

D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

| (1) | (2) |
|---|---|
| Glossary of definitions | Annex A |
| Conduct of Business sourcebook (COBS) | Annex B |
| Supervision manual (SUP) | Annex C |

## Citation

E. This instrument may be cited as the Conduct of Business Sourcebook (With-Profits Business) Instrument 2012.

By order of the Board
23 February 2012

## Annex A

## Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

| | |
|---|---|
| *strategic investment* | an investment which:<br><br>(a) is made for a strategic purpose;<br><br>(b) is made for an expected duration consistent with that purpose and is, or has the potential to be, illiquid or hard to value; and<br><br>(c) is significant in value in proportion to the size of the *with-profits fund*. |
| *terms of reference* | the terms of reference of a *firm's with-profits committee*, or the terms of appointment of the person or persons acting as the *with-profits advisory arrangement*, satisfying the requirements set out in *COBS* 20.5.3R. |
| *with-profits advisory arrangement* | (a) an independent person; or<br><br>(b) if appropriate, one or more *non-executive directors* appointed to provide independent judgment to the *governing body* of a *firm*;<br><br>which satisfies the requirements of its *terms of reference*. |

Amend the following as shown.

| | |
|---|---|
| *required percentage* | the *required percentage* referred to in *COBS* 20.2.17R is, for each *with-profits fund*:<br><br>(a) the percentage (if any) required in respect of that fund by:<br><br>(i) the *firm's* articles of association, registered rules or other equivalent instrument; or<br><br>(ii) a relevant order made by a court of competent jurisdiction;<br><br>(b) if (a) does not apply, the percentage ~~specified in the *firm's PPFM*, if that percentage~~ <u>that</u> reflects the *firm's* established practice<u>, if it has one</u>;<br><br>(c) if (a) and (b) do not apply, not less than 90 per cent. |

*with-profits committee*

a committee: ~~of the *governing body*, including non-executive members, of the *governing body* and possibly some external non-directors with appropriate skills and experience~~

(a) the majority of the members of which are independent of the *firm*, or, where there is an equal number of independent and non-independent members, which is chaired by a *person* who is one of the independent members; and

(b) which satisfies the requirements of its *terms of reference*.

## Annex B

## Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

**20.1.4 R** The following do not apply to a *non-directive friendly society*:

(1) *COBS* 20.3 (Principles and Practices of Financial Management); ~~and~~

(2) *COBS* 20.4 (Communications with with-profits policyholders); and

(3) *COBS* 20.5 (With-profits governance).

…

**20.2.1 G** (1) *With-profits business*, by virtue of its nature and the extent of discretion applied by *firms* in its operation, involves numerous potential conflicts of interest that might give rise to the unfair treatment of *policyholders*. Potential conflicts of interest may arise between shareholders and *with-profits policyholders*, between *with-profits policyholders* and non-profit *policyholders* within the same fund, between *with-profits policyholders* and the members of mutually-owned *firms*, between *with-profits policyholders* and management, and between different classes of *with-profits policyholders*, for example those with and without guarantees. The *rules* in this section address specific situations where the risk may be particularly acute. ~~However, a *firm* should give careful consideration to any aspect of its operating practice that has a bearing on the interests of its *with-profits policyholders* to ensure that it does not lead to an undisclosed, or unfair, benefit to *shareholders*.~~

(2) *With-profits policyholders* have an interest in the whole and in every part of the *with-profits fund* into which their *policies* are written and from which the amounts payable in connection with their *policies* are to be paid. Those amounts include those required to satisfy their contractual rights and such other amounts as the *firm* is required to pay in order to treat them fairly (including but not limited to the amounts required to satisfy their reasonable expectations).

(3) The fair treatment of *with-profits policyholders* requires the *firm's* pay-outs on individual *with-profits policies* to be fair (see *COBS* 20.2.3R et seq.) and, if the *firm* makes a distribution from the *with-profits fund* into which their *policies* are written, the receipt by the *with-profits policyholders* of at least the *required*

*percentage* (see *COBS* 20.2.17R).

20.2.1A R A *firm* must take reasonable care to ensure that all aspects of its operating practice are fair to the interests of its *with-profits policyholders* and do not lead to an undisclosed, or otherwise unfair, benefit to shareholders or to other *persons* with an interest in the *with-profits fund*.

20.2.1B G (1) Notwithstanding that there may not be a *rule* in the remainder of this section addressing a particular aspect of a *firm's* operating practices, *firms* will need to ensure that they take reasonable care to ensure that all aspects of their operating practice comply with *COBS* 20.2.1AR.

(2) For the avoidance of doubt *COBS* 20.2.1AR does not exhaust or restrict the scope of *Principle* 6. *Firms* will in any event need to ensure that their operating practices are consistent with *Principle* 6.

20.2.1C G When considering the provisions in this chapter a *firm* will need to ensure that, if applicable, it complies with the with-profits governance requirements in *COBS* 20.5.

20.2.1D G For the purposes of COBS 20.2.1AR the *FSA* expects a *firm* to be able to demonstrate that it has taken reasonable care to ensure its operating practices are fair, including being able to produce appropriate evidence to show that it has followed relevant governance procedures.

…

20.2.16 R A *firm* must not, in so far as is reasonably practicable, make a market value reduction to the face value of the units of an accumulating *with-profits policy* unless:

(1) the *market value* of the *with-profits assets* in the relevant *with-profits fund* is, or is expected to be, ~~significantly~~ less than the assumed value of the assets on which the face value of the units of the *policy* has been based; ~~or~~ and

(2) ~~there has been, or there is expected to be, a high volume of surrenders, relative to the liquidity of the relevant *with profits fund*; and~~ the market value reduction is no greater than is necessary to reflect the impact of the difference in value referred to in (1) ~~or (2)~~ on the relevant ~~surrender~~ payment out to the *policyholder*.

20.2.16A G If a *firm* is able to satisfy *COBS* 20.2.16R(1), then the volume of surrenders, transfers, or other exits from the *with-profits fund* that there has been, or is expected to be, is a factor that a *firm* may take into account when it is considering whether to make a market value reduction, and if so, its amount, subject to the limit in *COBS* 20.2.16R(2).

Conditions relevant to distributions

20.2.17 R A *firm* must:

(1) not make a distribution from a *with-profits fund*, unless the whole of the cost of that distribution can be met without eliminating the regulatory surplus in that *with-profits fund*; and

(2) ensure that the amount distributed to *policyholders* from a *with-profits fund*, taking into account any adjustments required by *COBS* 20.2.17AR, is not less than the *required percentage* of the total amount distributed.~~; and~~

~~(3) if it adjusts the amounts distributed to *policyholders*, apply a proportionate adjustment to amounts distributed to shareholders, so that the distribution to policyholders will not be less than the *required percentage*.~~

20.2.17A R (1) Where a *firm* adjusts the amounts distributed to *policyholders*, either by market value reduction or otherwise, in a way that would result in a distribution to *policyholders* of less than the *required percentage*, taking both the relevant distributions and the adjustment into account, then the *firm* must apply a proportionate adjustment to amounts distributed to shareholders so that the distribution to *policyholders* will not be less than the *required percentage*.

(2) The adjustments referred to in (1) include but are not limited to a situation where such an adjustment has the effect of retrospectively reducing past *policyholder* distributions.

20.2.17B G An example of the application of *COBS* 20.2.17AR, without limitation to its scope generally, is where a *firm* reduces, for any reason, the amounts of a bonus or of bonus units added to *policies* in force. The *firm* should treat this as effectively a 'negative distribution', calculated by making the same assumptions regarding discount rates and other relevant factors as would be used for positive bonus additions. The amount so calculated should then be taken into account in ensuring that the amount distributed to *policyholders* from a *with-profits fund* is not less than the *required percentage* for the purposes of *COBS* 20.2.17R.

…

20.2.21 R At least once a year (or, in the case of a *non-directive friendly society*, at least once in every three years) and whenever a *firm* is seeking to make a *reattribution* of its *inherited estate*, a *firm's governing body* must determine whether the *firm's with-profits fund*, or any of the *firm's with-profits fund*, has an *excess surplus*.

20.2.22 E (1) If a *with-profits fund* has an *excess surplus*, and to retain that surplus would be a breach of *Principle* 6 (Customers' interests) the *firm* should~~:~~

~~(a)~~ make a distribution from that *with-profits fund*~~; or~~

~~(b)~~ ~~carry out a *reattribution*~~.

…

…

New business

20.2.28 R ~~If a~~ A *firm* ~~proposes to~~ must not effect new *contracts of insurance* in an existing *with-profits fund*~~, it must only do so~~ unless:

(1) ~~on terms that are, in the reasonable opinion of~~ the *firm's governing body*~~,~~ is satisfied, so far as it reasonably can be, and can demonstrate, having regard to the analysis in (2), ~~unlikely to have a material~~ that the terms on which each type of contract is to be effected are likely to have no adverse effect on the interests of ~~its existing~~ the *with-profits policyholders* whose *policies* are written into that fund; and

(2) the *firm* has:

(a) carried out or obtained appropriate analysis, based on relevant evidence and proportionate to the risks involved, as to the likely impact on *with-profits policyholders*, having regard to relevant factors including:

(i) the volumes of each type of contract that the *firm* expects to be effected; and

(ii) the periods over which the contracts are expected to remain in force; and

(b) provided the analysis referred to in (a) to its *with-profits committee* or, if applicable, its *with-profits advisory arrangement* and to its *governing body* for the purposes of (1).

20.2.28A G (1) Writing new *insurance business* into a *with-profits fund* is not, of itself, automatically adverse to the interests of *with-profits policyholders*. For example, new *insurance business* which defers the emergence or distribution of surplus to a limited extent for a number of *policyholders*, or which leads to a marginal change in the equity backing ratio, may, subject to satisfying the guidance in *COBS* 20.2.60G and *COBS* 20.2.29G, reasonably be considered not to have an adverse effect on the *with-profits policyholders* in a *with-profits fund*, if the *firm's governing body* is satisfied (and can demonstrate based on appropriate analysis) that each new line of *insurance business* is likely to be financially self-supporting over the periods during which the contracts are expected to remain in

force and is likely to add sufficient value to the *with-profits fund*.

(2) Conversely, if the particular line of new *insurance business* is priced on loss-making terms or the terms are such that the new *insurance business* is not likely to generate sufficient value after covering all the costs associated with it (in either case when considered in aggregate over the periods over which the contracts are expected to remain in force), then in the *FSA's* view, the terms of that *insurance business* are likely to have an adverse impact on *with-profits policyholders* interests in the relevant fund.

(3) *Firms* will need to ensure that they comply with *COBS* 20.2.28R at all times, but in practice *firms* will be expected to pay particular attention when they are designing and pricing or re-pricing products, when they are preparing their financial plans that take into account their expected costs and levels of new business, and, in particular, when reviewing their financial performance, if that reveals that costs or levels of new business have varied significantly from those expected previously.

(4) New business for the purposes of *COBS* 20.2.28R will not, in general, include increments on existing *policies* or business written as a result of the exercise of options by an existing *policyholder*.

20.2.29 G In some circumstances, it may be difficult or impossible for a *firm* to mitigate the risk of ~~a material~~ an adverse effect on its existing, or new, *with-profits* policyholders ….

20.2.30 G (1) When a *firm* prices the new *insurance business* that it proposes to effect in an existing *with-profits fund* it should estimate the volume of new *insurance business* that it is likely to effect and then build in adequate margins that will allow it to recover any acquisition costs to be charged to the *with-profits fund*.

(2) *COBS* 20.2.28R requires *firms* to obtain appropriate analysis and evidence and this should include at least a profitability analysis on a marginal cost basis.

…

Other rules and guidance on the conduct of with-profits business

…

20.2.36 ~~G~~ R ~~If a proprietary *firm* is considering using~~ A *firm* must not:

(1) use *with-profits assets* to finance the purchase of ~~another business~~ a *strategic investment*, directly or by or through a *connected person*~~,~~; or

(2) ~~if a *firm* is considering whether it should~~ retain ~~such~~ an investment referred to in (1);

~~it should consider whether~~ unless its *governing body* is satisfied, so far as it reasonably can be, and can demonstrate, that the purchase or retention ~~would be, or will remain, fair to~~ is likely to have no adverse effect on the interests of its *with-profits policyholders* whose *policies* are written into the relevant fund. ~~When a *firm* makes that assessment it should consider whether it would be more appropriate for the investment to be made using assets other than those in a *with-profits fund*.~~

20.2.36A R A *firm* must keep adequate records setting out the strategic purpose for which a *strategic investment* has been purchased or retained.

20.2.36B G (1) In order for a *firm* to comply with *COBS* 20.2.36R, a *firm's governing body* should consider:

(a) the size of the investment in relation to the *with-profits fund*;

(b) the expected rate of return on the investment;

(c) the risks associated with the investment, including, but not limited to, liquidity risk, the capital needs of the acquired business or investment and the difficulty of establishing fair value (if any);

(d) any costs that would result from divestment;

(e) whether the *with-profits actuary* would regard the investment as having no adverse effect on the interests of *with-profits policyholders* as a class;

(f) in the case of a proprietary *firm*, whether it would be more appropriate for the investment to be made using assets other than those in the *with-profits fund*; and

(g) any other relevant material factors.

(2) A *firm* should also consider whether making or retaining the investment should be disclosed to *with-profits policyholders*.

(3) Examples of *strategic investments* include, but are not limited to, a significant investment in another business or significant real estate assets used within the business of the *firm*.

…

~~Major~~ Significant changes in with-profits funds

…

20.2.41A R A *firm* must contact the *FSA* as soon as is reasonably practicable to make arrangements to discuss what actions may be required to ensure the fair treatment of *with-profits policyholders* if, in relation to any *with-profits fund* it operates:

(1) the *firm* reasonably expects, or if earlier, there has been, a sustained and substantial fall in either the volume of new *non-profit insurance contracts*, or in the volume of new *with-profits policies* (effected other than by *reinsurance*), or in both, effected into the *with-profits fund*; or

(2) the *firm* cedes by way of *reinsurance* most or all of the new *with-profits policies* which it continues to effect.

20.2.41B G (1) The aim of the discussions in *COBS* 20.2.41AR is to:

(a) allow the *FSA* to comment on the adequacy of the *firm's* planning; and

(b) seek agreement with the *firm* on any other appropriate actions to ensure *with-profits policyholders* are treated fairly.

(2) If the *firm* is no longer effecting a material volume of new *with-profits policies* (other than by *reinsurance*) into a *with-profits fund*; or if it is ceding by way of *reinsurance* most or all of the new *with-profits policies* which it continues to effect, then it may also be appropriate to consider whether, in the particular circumstances of the *firm*, it should be regarded as ceasing to effect new *contracts of insurance* for the purposes of *COBS* 20.2.54R(3).

(3) In the discussions the *FSA* will have with regard to *COBS* 20.2.28R (New business), if the volumes of new business are expected to be profitable and, in relation to *non-profit insurance business*, it is demonstrated that a fair distribution to *with-profits policyholders* out of the fund can be achieved and the economic value of any expected future profits is likely to be available for distribution during the lifetime of the *with-profits business* for the purposes of *COBS* 20.2.60G, then, in the *FSA's* view, it is likely to be reasonable for a *firm* to be satisfied that there will be no adverse effect for *with-profits policyholders*, and accordingly that such business may continue to be written.

…

20.2.42 R A *firm* that is seeking to make a *reattribution* of its *inherited estate* must:

(1) ~~identify at the earliest appropriate point a policyholder advocate, who is free from any conflicts of interest that may be, or may appear to be, detrimental to the interests of~~

~~*policyholders*, to negotiate with the *firm* on behalf of relevant *with-profits policyholders*~~ first discuss with the *FSA* (as part of its determination under *COBS* 20.2 .21R):

(a) its projections for capital required to support existing business, which must include an assessment of:

(i) the *firm's* future risk appetite for the *with-profits fund* and other relevant business; and

(ii) how much of the margin for prudence can be identified as excessive and removed from the projected capital requirements; and

(b) its projections for capital required to support future new business, which must include an assessment of:

(i) new business volumes;

(ii) product terms; and

(iii) pricing margins;

(2) following the discussions referred to in (1), identify at the earliest appropriate point a *policyholder advocate*, who is free from any conflicts of interest that may be, or may appear to be, detrimental to the interests of *policyholders*, to negotiate with the *firm* on behalf of relevant *with-profits policyholders* and seek the approval of the *FSA* for the appointment of the *policyholder advocate* as soon as he is identified, or appoint a *policyholder advocate* nominated by the *FSA* if its approval is not granted; and

…

…

20.2.44 G The precise role of the *policyholder advocate* in any particular case will depend on the nature of the *firm* and the *reattribution* proposed. A *firm* will need to discuss, with a view to agreeing, with the *FSA* the precise role …

…

20.2.45 R A *firm* must:

(1) notify the *FSA* of the terms on which it proposes to appoint a *policyholder advocate* (whether or not the candidate was nominated by the *FSA*);

(2) ensure that the terms of appointment for the *policyholder advocate*:

(a) include a description of the role of the *policyholder advocate* as agreed with the *FSA* under *COBS* 20.2.44G;

(aa) stress the independent nature of the *policyholder advocate's* appointment and function, and are consistent with it;

…

(e) specify when and how the *policyholder advocate's* appointment may be terminated; ~~and~~

(f) allow the *policyholder advocate* to communicate freely and in confidence with the *FSA*;

(g) require the *policyholder advocate* to communicate with *policyholders*:

(i) as soon as is practicable after his appointment, having regard to (h)(i) and (iii); and

(ii) thereafter no less frequently than every six *months* for the duration of the *policyholder advocate's* appointment; and

(h) require the *policyholder advocate*:

(i) to make reasonable endeavours to agree with the *firm* the contents of any proposed *policyholder* communications;

(ii) to allow sufficient time for the process in (i) in order to meet any timescales in (g); and

(iii) to provide copies of the final draft of the intended *policyholder* communications, whether or not agreement has been reached in accordance with (i) above, both to the *firm* and to the *FSA* at least seven *days* in advance of the date on which the *policyholder advocate* intends to make the communications.

…

20.2.54 R A *firm* will be taken to have ceased to effect new *contracts of insurance* in a *with-profits fund*:

(1) when any decision by the *governing body* to cease to effect new *contracts of insurance* takes effect; or

(2) where no such decision is made, when the *firm* is no longer:

(a) actively seeking to effect new *contracts of insurance* in that fund; or

(b) effecting new *contracts of insurance* in that fund, except by increment; or

(3) if the *firm*:

(a) (i) is no longer effecting a material volume of *with-profits policies* (other than by *reinsurance*), into the *with-profits fund*; or

(ii) is ceding by way of *reinsurance* most or all of the new *with-profits policies* which it continues to effect; and

(b) cannot demonstrate that it will treat *with-profits policyholders* fairly if it does not cease to effect new *contracts of insurance*.

20.2.55 R A *firm* must contact the *FSA* to discuss whether it has, or should be taken to have, ceased to effect new *contracts of insurance* if:

(1) it is no longer effecting a material volume of new *with-profits policies* in a particular *with-profits fund*, other than by *reinsurance*; or

(2) it cedes by way of *reinsurance* most of the new *with-profits policies* which it continues to effect.

G For the purposes of *COBS* 20.2.54R(3) the *FSA* will have regard to, amongst other things, the factors set out in *COBS* 20.2.41BG(3).

20.2.56 R The run-off plan required by this section *COBS* 20.2.53R must:

(1) demonstrate include an up-to-date plan to demonstrate how the *firm* will ensure a fair distribution of the closed *with-profits fund*, and its *inherited estate* (if any); and

(2) be approved by the *firm's governing body*.

20.2.57 G (1) A *firm* should also include the information described in Appendix 2.15 (Run-off plans for closed with-profits funds) of the Supervision manual in its run-off plan.

(2) A *firm* should periodically review and update its run-off plan and submit updated versions to the *FSA* when requested to do so.

…

20.2.60 G (1) If *non-profit insurance business* is written in a *with-profits fund*, a *firm* should take reasonable steps to ensure that the

economic value of any future profits expected to emerge on the *non-profit insurance business* is available for distribution during the lifetime of the *with-profits business*.

(1A) Where a *with-profits fund* contains assets which may not be readily realisable, the *firm* should take reasonable steps to ensure that the economic value of those assets is made available as part of a fair distribution to *with-profits policyholders*.

(2) Where it is agreed by its *with-profits policyholders*, and subject to meeting the requirements for effecting new *contracts of insurance* in an existing *with-profits fund* (*COBS* 20.2.28R), a *mutual* may make alternative arrangements for continuing to carry on *non-profit insurance business*, and a *non-directive friendly society* may make alternative arrangements for continuing to carry on non-insurance related business.

…

~~Governance arrangements for with-profits business~~

20.3.2 G ~~In complying with the *rule* on systems and controls in relation to compliance, financial crime and money laundering (*SYSC* 3.2.6R or *SYSC* 6.1.1R), a *firm* should maintain governance arrangements designed to ensure that it complies with, maintains and records any applicable *PPFM*. These arrangements should:~~

~~(1) be appropriate to the scale nature and complexity of the *firm's with profits business*;~~

~~(2) include the approval of the *firm's PPFM* by its *governing body*; and~~

~~(3) involve some independent judgment in assessing compliance with its *PPFM* and addressing conflicting rights and interests of *policyholders* and, if applicable, shareholders, which may include but is not confined to:~~

~~(a) establishing a *with-profits committee*;~~

~~(b) asking an independent person with appropriate skills and experience to report on these matters to the *governing body* or to any *with-profits committee*; or~~

~~(c) for small *firms*, asking one or more non-executive members of the *governing body* to report to the *governing body* on these matters.~~ [deleted]

20.3.3 G ~~If a *person* or committee who provides independent judgement wishes to make a statement or report to *with profits policyholders*, in addition to any annual report made by a *firm* to those *policy holders*, a *firm* should~~

~~facilitate this.~~ [deleted]

After COBS 20.4 insert the following new section. The text is not underlined.

## 20.5 With-profits governance

Requirement to appoint a with-profits committee or advisory arrangement

20.5.1 R A *firm* must, in relation to each *with-profits fund* it operates:

(1) appoint:

(a) a *with-profits committee*; or

(b) a *with-profits advisory arrangement* (referred to in this section as an 'advisory arrangement'), but only if appropriate, in the opinion of the *firm's governing body*, having regard to the size, nature and complexity of the fund in question;

(2) ensure that the *with-profits committee* or advisory arrangement operates in accordance with its *terms of reference*; and

(3) make available a copy of any *terms of reference* on the *firm's* website, or if the *firm* does not have a website, at the request of *policyholders*.

20.5.2 G (1) Ultimate responsibility for managing a *with-profits fund* rests with the *firm* through its *governing body*. The role of the *with-profits committee* or advisory arrangement is, in part, to act in an advisory capacity to inform the decision-making of a *firm's governing body*. The *with-profits committee* or advisory arrangement also acts as a means by which the interests of *with-profits policyholders* are appropriately considered within a *firm's* governance structures. The *with-profits committee* or advisory arrangement should address issues affecting *policyholders* as a whole or as separately identifiable groups of *policyholders* generally rather than dealing with individual *policyholder* complaints or taking management decisions with respect to a *with-profits fund*.

(2) If a *firm* considers that it is appropriate to appoint an advisory arrangement, a *firm's governing body* will need to decide whether it is appropriate to appoint an independent person or one or more *non-executive directors* to carry out the role. The *FSA* expects *firms* to make this determination according to the nature, size and complexity of the fund in question. So the larger or more complex the fund is, the more likely it would be that it would be appropriate to appoint an independent person.

(3) Where a *firm* has appointed a *with-profits committee* to one of its *with-profits funds* it may also decide to appoint that *with-profits committee* to some or all of its other *with-profits funds*, even if the *firm* would not

have determined it appropriate to appoint a *with-profits committee* to those other funds when considered individually having regard to their size, nature or complexity.

Terms of reference of with-profits committee or advisory arrangement

20.5.3 R A *firm* must ensure that the *terms of reference* contain, as a minimum, terms having the following effect:

(1) the role of the *with-profits committee* or advisory arrangement is, as relevant, to assess, report on, and provide clear advice and, where appropriate, recommendations to the *firm's governing body* on:

(a) the way in which each *with-profits fund* is managed by the *firm* and, if a *PPFM* is required, whether this is properly reflected in the *PPFM*;

(b) if applicable, whether the *firm* is complying with the principles and practices set out in the *PPFM*;

(c) whether the *firm* has addressed effectively the conflicting rights and interests of *with-profits policyholders* and other *policyholders* or stakeholders including, if applicable, shareholders, in a way that is consistent with *Principle* 6 (treating customers fairly); and

(d) any other issues with which the *firm's governing body*, *with-profits committee* or advisory arrangement considers *with-profits policyholders* might reasonably expect the *with-profits committee* or advisory arrangement*s* to be involved;

(2) that the *with-profits committee* or advisory arrangement must:

(a) decide on the specific matters it will consider in order to enable it to carry out its role described in (1)(a) to (d) as appropriate to the particular circumstances of the *with-profits fund(s)*; and

(b) in any event give appropriate consideration to the following non-exhaustive list of specific matters:

(i) the identification of surplus and *excess surplus*, the merits of its distribution or retention and the proposed distribution policy;

(ii) how bonus rates, smoothing and, if relevant, market value reductions have been calculated and applied;

(iii) if relevant, the relative interests of *policyholders* with and without valuable guarantees;

(iv) the *firm's* with-profits customer communications such as annual policyholder statements and product literature and

whether the *with-profits committee* or advisory arrangement wishes to make a statement or report to *with-profits policyholders* in addition to the annual report made by a *firm*;

(v) any significant changes to the risk or investment profile of the *with-profits fund* including the management of material illiquid investments and the *firm's* obligations in relation to *strategic investments*;

(vi) the *firm's* strategy for future sales supported by the assets of the *with-profits fund* and its impact on surplus;

(vii) the impact of any management actions planned or implemented;

(viii) relevant management information such as customer complaints data (but not necessarily information relating to individual customer complaints);

(ix) the drafting, review, updating of and compliance with run-off plans, court schemes and similar matters; and

(x) the costs incurred in operating the *with-profits fund*;

(3) that any person appointed as a member of the *with- profits committee* or as a person carrying out the advisory arrangement must have the appropriate skills, knowledge and experience to perform, or contribute to, as appropriate, the role set out in (1) and (2);

(4) if the *firm* appoints a *with-profits committee*:

(a) that there must be three or more members;

(b) that the quorum for any meeting (or decision by written procedure) must be at least half of the number of, and no less than two, members; and

(5) that the *with-profits committee* or advisory arrangement must:

(a) advise the *governing body* on the suitability of candidates proposed for appointment as the *with-profits actuary*; and

(b) assess the performance of the *with-profits actuary* at least annually, and report its view to the *governing body* of the *firm*.

20.5.4 G (1) The *FSA* expects that a *with-profits committee* will meet at least quarterly and ad hoc if required.

(2) The *FSA* expects that, in general, a *with-profits committee* or advisory arrangement will work closely with the *with-profits actuary*, and obtain his opinion and input as appropriate.

Role of with-profits committee or advisory arrangement in the *firm's* governance

20.5.5 R A *firm* must:

(1) ensure that its *governing body*, in the context of its consideration of issues referred to in *COBS* 20.5.3R(1)(a) to (d) and (2)(b)(i) to (x):

(a) obtains, as relevant, assessments, reports, advice and/or recommendations of the *with-profits committee* or advisory arrangement, if the *governing body*, the *with-profits committee* or advisory arrangement considers that significant issues concerning the interests of *with-profits policyholders* need to be considered by the *firm*;

(b) allows the *with-profits committee or* advisory arrangement sufficient time to enable it to provide fully considered input on the issues to be considered;

(c) considers fully and gives due regard to the input of the *with-profits committee* or advisory arrangement when determining issues concerning the management of the *with-profits funds* and the interests of *with-profits policyholders*;

(d) if the *governing body* decides to depart in any material way from the advice or recommendations of the *with-profits committee* or advisory arrangement, sets out fully its reasons and allows the *with-profits committee* or advisory arrangement a reasonable period to consider them and respond; and

(e) considers any further representations from the *with-profits committee* or advisory arrangement and, if appropriate, sets out fully any additional reasons if it continues to depart from the *with-profits committee* or advisory arrangement's advice or recommendation;

(2) provide a *with-profits committee* or advisory arrangement with sufficient resources as it may reasonably require to enable it to perform its role effectively;

(3) notify the *FSA* of the decision of the *governing body* to depart from the advice or recommendation of the *with-profits committee* or advisory arrangement if the *with-profits committee* or advisory arrangement considers that the issue is sufficiently significant and requests of the *governing body* that the *FSA* be informed; and

(4) consult the *with-profits actuary* on the appointment of a new member of the *with-profits committee* or of the person or persons carrying out the advisory arrangement.

20.5.6 G (1) *COBS* 20.5.5R(2) requires that a *firm* provides a *with-profits committee* or advisory arrangement with sufficient resources. A *with-profits*

*committee* or advisory arrangement should be able to obtain external professional, including actuarial, advice, at the expense of the *firm*, if the *with-profits committee* or advisory arrangement considers the advice to be necessary to perform its role effectively. In a proprietary firm the *with-profits committee* or advisory arrangement should be able to request that the cost of the external professional advice either is not chargeable to the *with-profits fund* in question, or is shared with the *with-profits fund*, according to whether the issue under consideration is wholly or partly to the benefit of the *firm* rather than *policyholders*. A *with-profits committee* or advisory arrangement should also be adequately supported by the *firm's* own internal resources and support functions. This may include the *firm* ensuring that relevant employees, including the *with-profits actuary*, are made sufficiently available, and provide relevant information and input, to assist the *with-profits committee* in its role, as required.

(2) If the *with-profits committee* or advisory arrangement wishes to make a statement or report to *with-profits policyholders* in addition to the annual report made by a *firm*, the effect of *COBS* 20.5.5R(2) is that a *firm* will need to facilitate this.

(3) In order to comply with *SYSC* 3.2.20R the *FSA* expects *firms* to keep full records of all requests of, and material produced by, the *with-profits committee* or advisory arrangement, and of all decisions and reasons of the *governing body* as described in *COBS* 20.5.5R(1)(d) and (e).

(4) For the purposes of *COBS* 20.5.5R(3), the *FSA* expects that it will only be in exceptional circumstances that a *with-profits committee* or alternative arrangement will consider a departure from a recommendation or advice to be sufficiently significant to warrant its making a request of the *governing body* that the *FSA* be informed.

Assessment of independence by governing body

20.5.7 G (1) The *FSA* expects the *governing body* of the *firm* to decide whether a member of the *with-profits committee* or a person (other than a *non-executive director*) carrying out the advisory arrangement is independent. The *FSA* expects a *firm's governing body* to adopt the following approach and have regard to the following factors when making this assessment:

(a) the *governing body* should determine whether the person is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the person's judgment; and

(b) the *governing body* should state its reasons if it determines that a person is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the person:

(i) has been an employee of the *firm* or group within the last five years; or

(ii) has, or has had within the last three years, a material business relationship with the *firm* either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the *firm*; or

(iii) has received or receives additional remuneration from the *firm*, participates in the *firm's* share option or a performance-related pay scheme, or is a member of the *firm's* pension scheme; or

(iv) has close family ties with any of the *firm's* advisers, directors or senior employees; or

(v) has significant links with the *firm's* directors through involvement in other companies or bodies; or

(vi) represents a significant shareholder; or

(vii) has served on the *governing body* for more than nine years from the date of their first election.

(2) If a *firm* appoints one or more *non-executive directors* to carry out the advisory arrangement, the *FSA* expects the *governing body* of the *firm* to be satisfied that that person or persons is or are adequately able to provide independent judgment.

Governance arrangements in relation to the PPFM

20.5.8 G In complying with the *rule* on systems and controls in relation to compliance, financial crime and money laundering (*SYSC* 3.2.6R), a *firm* should maintain governance arrangements designed to ensure that it complies with, maintains and records, any applicable *PPFM*. These arrangements should:

(1) be appropriate to the scale, nature and complexity of the *firm's with-profits business*; and

(2) include the approval of the *firm's PPFM* by its *governing body*.

Amend the following as shown.

**TP 2 Other Transitional Provisions**

| (1) | (2) | (3) | (4) | (5) | (6) |
|---|---|---|---|---|---|
| | Material to which the transitional provision applies | | Transitional provision | Transitional provision: dates in force | Handbook provisions: coming into force |

| | | | | | |
|---|---|---|---|---|---|
| … | | | | | |
| 2.9 | *COBS* 20.2.1G to *COBS* 20.2.23R, *COBS* 20.2.26R to *COBS* 20.2.41G~~, *COBS* 20.2.53R to *COBS* 20.20.2.60G (Treating with profits policy holders fairly)~~ | R | The provisions listed in column (2) do not apply to a *firm* if, and to the extent that, they are inconsistent with an arrangement that was formally approved by the *FSA*, a *previous regulator* or a court of competent jurisdiction, on or before 20 January 2005. | … | … |
| … | | | | | |
| 2.11 | *COBS* TP 2.9 | G | The *rules* and *guidance* on treating with-profits policyholders fairly (*COBS* 20.2.1G - *COBS* 20.2.41G; ~~*COBS* 20.2.53R – *COBS* 20.2.60G~~) may be contrary to, or inconsistent with, some arrangements that were formally approved by the *FSA*, a *previous regulator* or a court… | … | … |
| … | | | | | |
| 2.18 | *COBS* 20.2.53R to *COBS* 20.2.60G, *SUP* App 2.15G | R | (1) Unless (2) applies, and subject to (3), a *firm* that has ceased to effect new *contracts of insurance* in a *with-profits fund* must submit to the *FSA* a run-off plan of the type described in *COBS* 20.2.53R(2); *COBS* 20.2.56R, and *COBS* 20.2.57G, if it has not done so already, by 31 December 2012, regardless of when it closed to new business.<br><br>(2) Paragraph (1) does not apply to a *firm* if, and to the extent that, to comply would be contrary to or inconsistent with an arrangement that was formally approved by a court of competent | From 1 April 2012 indefinitely | 1 November 2007 and 1 April 2012 |

| | | | | | |
|---|---|---|---|---|---|
| | | | jurisdiction, on or before 1 April 2012.<br><br>(3) A *firm* required by (1) above to produce a run-off plan:<br><br>(a) should consider the guidance in *SUP* App 2.15.6G, 2.15.7G(11), 2.15.13G, 2.15.14G and 2.15.15G to continue to apply to it, as appropriate;<br><br>(b) may demonstrate compliance with the guidance in *SUP* App 2.15.2G, 2.15.3G, 2.15.4G and 2.15.5G by reference to existing documents created by or for the *firm*, provided that it submits copies of relevant extracts to the *FSA*;<br><br>(c) may disregard the remaining provisions in *SUP* App 2.15G if to do so would be consistent with meeting the requirements of *COBS* 20.2.56R(1); and<br><br>(d) may otherwise tailor the run-off plan to reflect the fact that the fund in question has already been closed. | | |
| 2.19 | *COBS* 20.2.53R to *COBS* 20.2.60G | G | The effect of *COBS* TP 2.18 is that *firms* which were not required to submit a run-off plan to the *FSA* because they ceased to effect new *contracts of insurance* before 1 November 2007 or because of previous transitional provisions in *COBS*, will need to submit a version of a run-off plan to the *FSA*, taking into account the fact that the fund has already closed, by 31 December 2012. However, this will not apply to the extent that | From 1 April 2012 indefinitely | 1 November 2007 and 1 April 2012 |

| | | | | | |
|---|---|---|---|---|---|
| | | | it would be inconsistent with a formally approved court scheme. | | |
| 2.20 | *COBS* 20.2.28R | R | *Firms* which continue to effect new *contracts of insurance* in reliance on decisions made by the *firm's governing body* complying with *COBS* 20.2.28R prior to 1 April 2012 are deemed to be compliant with *COBS* 20.2.28R until 1 July 2012. | From 1 April 2012 to 1 July 2012 | 1 April 2012 |
| 2.21 | *COBS* 20.2.36R to *COBS* 20.2.36AR | R | *Firms* which retain *strategic investments* in reliance on decisions made by the *firm's governing body* appropriately taking into account *COBS* 20.2.36G prior to 1 April 2012 are deemed to be compliant with *COBS* 20.2.36R and 20.2.36AR until 1 October 2012. | From 1 April 2012 to 1 October 2012 | 1 April 2012 |
| 2.22 | *COBS* 20.5.1R to 20.5.5R | R | *Firms'* existing governance arrangements are deemed to comply with the provisions in *COBS* 20.5.1R to 20.5.5R until 1 July 2012. | From 1 April 2012 to 1 July 2012 | 1 April 2012 |

…

## Schedule 1 Record keeping requirements

…

| Handbook reference | Subject of record | Contents of record | When record must be made | Retention period |
|---|---|---|---|---|
| … | | | | |
| *COBS* 19.2.3R | Promotion of personal pension scheme | … | … | … |
| *COBS* 20.2.36AR | *strategic investments* | A description of the strategic purpose for which a *strategic investment* has been purchased or retained | Before making a *strategic investment* or when reviewing whether to retain a *strategic investment* | Until the *firm* ceases to hold the *strategic investment* in question |

| … | | | | |
|---|---|---|---|---|

## Schedule 2 Notification requirements

| Handbook reference | Matters to be notified | Contents of notification | Trigger Event | Time allowed |
|---|---|---|---|---|
| … | | | | |
| *COBS* 21.2.8R | … | | | |
| *COBS* 20.5.5R(3) | The decision of a *firm's governing body* to depart from the advice or recommendation of the *with-profits committee* or advisory arrangement. | A description of:<br><br>(1) the decision of, and reasons given by, the *firm's governing body*;<br><br>(2) the recommendation and advice of the *with-profits committee* or advisory arrangement;<br><br>together with a copy of the *firm's* records of the decision, reasons, advice and recommendations. | The *with-profits committee* or advisory arrangement considers that the issue is sufficiently significant and requests of the *governing body* that the *FSA* be informed. | As soon as reasonably practicable |

## Annex C

### Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text and striking through indicates deleted text.

4.3.17 R A *firm* must require and allow any *actuary* appointed to perform the *with-profits actuary* function to perform his duties and must:

…

(4) …..; ~~and~~

(5) pay due regard to his advice…(the committee of management); and

(6) ensure that where a conflict of interest may arise in relation to the role of the *with-profits actuary* and the advice he gives, for example due to the *firm's* reporting lines or remuneration process, that potential conflict is identified and managed in order to minimise the possible effect of the potential conflict on the advice given.

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