CLIFFORD CHANCE

Client briefing
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Protecting With-Profits Policyholders – FSA Consultation Paper CP11/5

INTRODUCTION

On 24 February 2011 the FSA published Consultation Paper 11/5, "Protecting With-Profits Policyholders" ("**CP 11/5**"). It covers a variety of issues, including the terms on which new business is written, material reductions in new business, profit margins for services provided to with-profits funds by in-house service companies, market value reductions and governance. It also addresses the specific position of mutuals. This briefing summarises the main areas of change which would take place if the FSA's proposals in CP11/5 were to be implemented as proposed, and considers the issues arising from these changes and their potential implications for the UK insurance industry.

The FSA has asked for comments by 24 May 2011. It will then finalise the draft rules and guidance and publish a Policy Statement giving feedback in the third quarter of 2011.

The FSA will publish a further Consultation Paper concerning with-profits business later in 2011, which will relate to (i) communications to with-profits policyholders and (ii) changes to the FSA Conduct of Business Sourcebook (COBS) arising from the implementation of Solvency II. For more information on Solvency II, please see our latest Update by clicking on this link.

BACKGROUND

The current FSA requirements regarding with-profits funds, in COBS 20 in the FSA Handbook, have been in place since 2005. Principle 6 of the FSA's Principles of Business, which requires a firm to pay due regard to the interests of its customers and to treat them fairly, is also of particular relevance to with-profits policyholders.

In June 2010, following its With-Profits Regime Review (WPRR), the FSA published a Report on the WPRR which, among other things, concluded that COBS 20 should be reviewed with particular focus on governance, post sale consumer communications, payouts, charges to with-profits funds, new business, and closed fund specifics of with-profits funds. CP 11/5 sets out the FSA's conclusions arising from this review and its consideration of the conduct of with-profits business by mutuals (known as Project Chrysalis), and suggests consequent changes to the FSA's rules and guidance.

FSA APPROACH TO RIGHTS AND INTERESTS OF WITH-PROFITS POLICYHOLDERS

It is helpful to start by summarising the FSA's approach to the rights and interests which with-profits policyholders have in a with-profits fund, particularly the rights and interests which they have in any surplus in the fund. This has been the subject of much recent discussion between the FSA and some firms, particularly in the mutual sector (see "Implications for Mutuals" below).

The starting point is COBS 20.2 (Treating with-profits policyholders fairly) which requires that:

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COBS 20.2.21R	Firms must determine on an annual basis whether their with-profits fund(s) have an “excess surplus”.
COBS 20.2.22E	If a with-profits fund has an "excess surplus", and to retain that surplus would be a breach of FSA Principle 6, the firm should either (i) make a distribution from that with-profits fund or (ii) carry out a reattribution.

In the *Commercial Union Life Assurance Company* case in 2009 the Court held that it is in the discretion of the firm's board of directors to decide whether to make a distribution from an "excess surplus". In the Court's view, with-profits policyholders have a contractual legal right to participate in distributable profits identified by the board of directors, but no legal right to require the board of directors to make a distribution. The Court held that "excess surplus" is legally and beneficially an asset of the company, managed and controlled by its directors.

However, the Court in the same case also held that with-profits policyholders collectively have a legitimate and reasonable expectation that firms will conduct the affairs of a with-profits fund in a manner that is compliant with current regulations, which will include COBS 20.2.21 and 20.2.22, and FSA Principle 6. This means that, although with-profits policyholders do not have any expectation that a distribution will occur at any particular time, they are entitled to expect that a firm will inter alia comply with the requirements of COBS 20.2.21R and COBS 20.2.22E.

In its Consultation Paper 09/9, the FSA said that:

(a) with-profits policyholders have an interest in the whole with-profits fund and in every part of it; and

(b) with-profits policyholders also have a contingent interest in any surplus in a with-profits fund, which may exist prior to distribution. This is based on the view that, although with-profits policyholders have no reasonable expectation that they will share in a special distribution from a with-profits fund during the lifetime of their policies, if a distribution does take place during the terms of their policies then with-profits policyholders have a reasonable expectation of participating in that distribution.

The FSA view the responsibilities of a firm to ensure fair treatment of policyholders as applying to the fund as a whole, including surplus, not just to notional asset shares. The FSA, in CP 11/5, has now said that it proposes to introduce guidance at the start of COBS 20 to reflect the above principles.

FSA PROPOSALS

The FSA’s over-arching requirement in its review of COBS 20 is that firms treat their with-profits policyholders fairly. The approach in CP 11/5 is driven by the fact that the FSA is concerned that some of its current rules and guidance may not be sufficient to produce this result. We discuss the key areas of change below, and in each case set out (i) the current FSA requirements (ii) the FSA's proposed changes and (iii) potential issues and implications arising from those changes.

New Business

Current Requirements

COBS 20.2.28 requires firms to write new business only on terms that, in the reasonable opinion of its governing body, are unlikely to have a "material adverse effect" on the interests of its existing with-profits policyholders.

Proposed Changes

The FSA *With-Profits Regime Regime* (WPRR) Report found that a "substantial minority" of firms have been writing new business into their with-profits funds where either (i) the new business is loss-leading in itself or (ii) not enough of it is being sold to cover the cost of acquiring it. The FSA, in this context, propose in CP 11/5 to strengthen their current rules and guidance so that:

(a) <u>No Adverse Effect</u>: new business can only be written if the relevant governing body is satisfied, so far as it reasonably can be, and can demonstrate, that there is likely to be "no adverse effect" on with-profits policyholders' interests; and

(b) <u>Evidential Requirements:</u> firms are required to have carried out or obtained all appropriate analysis (including a profitability analysis) on the impact of the new business to support their conclusion and to provide that analysis to the firm's with-profits committee or alternative arrangement.

The FSA makes clear that (i) the "no adverse effect" test above applies in relation to all with-profits policyholders (including potential with-profits policyholders) and not just existing with-profits policyholders and (ii) the FSA considers loss-leading business to be likely to have an adverse effect on with-profits policyholders' interests.

Issues and Implications

The change of the applicable test from "no material adverse effect" to "no adverse effect" is clearly a more stringent requirement than the current position, and more stringent than that proposed by the FSA in the WPRR in 2010 (in which the FSA stated that one of its desired policy outcomes was that new business is written on terms that, at a minimum, are unlikely to make existing with-profits policyholders materially worse off). The evidential requirements in (b) above will also be challenging.

These changes could have significant implications for the ability of firms to write new business in their with-profits funds (particularly for mutual firms – see "Implications for Mutuals" below). Firms will need to be able to demonstrate, for each tranche of new business, that there is likely to be no adverse effect on with-profits policyholders' interests arising from that new business, with appropriate analysis and evidence to support their conclusions. The "no adverse effect" will need to be measured against the existing with-profit policyholders expectations regarding the distribution of surplus as, even if self-funding eventually, new business may cause a strain which may delay the distribution of surplus. In practice, given that much of the appropriate analysis will be based on actuarial calculations, in our view it could be difficult for firms to demonstrate that new business has no adverse effect without regard to materiality on existing with-profits policyholders interests.

Profit Margins and Charges made to With-Profits Funds

Current Requirements

It is common for UK insurance firms to have in-house services companies which provide services to with-profits funds in their group. Such service companies typically employ staff in the group and provide administrative services to the funds, and charge the funds for their services. Some firms also have in-house asset management companies which provide asset management services to with-profits funds in their group and, again, charge the funds for their services.

COBS 20.2.23 currently requires that a firm must only charge costs to a with-profits fund which have been, or will be, incurred in operating the with-profits fund. This may include a fair proportion of overheads.

Proposed Changes

In CP 11/5 the FSA comments, based on the existing wording in COBS 20.2.23, that in-house service companies should only be able to charge with-profits funds in their group for the costs which they have incurred in providing services to that fund, and no additional profit margin can be charged.

To achieve this, the FSA proposes to amend COBS 20.2.23 to state that "a firm must only charge to a with-profits fund, in relation to services provided to the firm by another entity in the firm's group, costs which have been or will be incurred by that entity in the provision of those services, to the extent those services are used by the firm in operating the with-profits fund ... costs include, where appropriate, a fair proportion of overheads".

Issues and Implications

This proposed change could have a significant impact on UK with-profits providers. Charging structures and amounts would have to be reviewed, alongside an analysis of internal costs associated with services provided to with-profits funds in the group. CP11/5 does not make specific reference to in-house asset management companies which provide asset management services to with-profits funds in their group, but the proposed new language in COBS 20.2.23 appears wide enough to cover them. Where these asset management companies also provide services in respect of non-profit business or to third parties, this could result in a "two tier" charging structure being required, where one charge (at "cost") is made to with-profits funds in the same group and another charge (with a profit margin) is made to third parties or in relation to non-profit and linked contracts.

The FSA anticipates that firms, rather than receiving profit on services provided by in-house service companies to with-profits funds in their group, will benefit from the lower services costs charged to the fund and will therefore ultimately benefit because the lower costs should result in a higher surplus in the fund, in which the shareholders would share. For this reason, the FSA suggest that firms would still have an incentive to use their in-house service provider where the in-house provider would provide the relevant services at a cheaper price than an external provider.

However, the provisions do not recognise a number of issues, including: (i) the practice of charging fixed fees to with-profit funds, effectively removing the risk of expense overruns for the fund; (ii) defined charge business, where shareholders currently obtain their interest in the fund through a margin on the charges rather than a 10% profit distribution; and (iii) that there are many 100:0 funds, not just in mutuals, where removal of any shareholder benefit from running the fund will make them unattractive and burdensome to run and increase the likelihood of the running of the fund being outsourced to a third party provider who would be able to make a profit.

There could also be implications for the terms of existing insurance business transfer schemes under Part VII of the Financial Services and Markets Act 2000 ("**FSMA**"). Such schemes may contain defined charging structures relating to with-profits funds (which would normally also be summarised in the Principles and Practices for Financial Management ("**PPFM**") for the relevant fund) which continue to apply to the fund for a defined period following Court approval. These charging structures may not be consistent with the FSA's proposed new rules in COBS 20.2.23 as set out above, but we note that the draft amended rules do not envisage any exceptions.

Run-off and Material Reductions in New Business

Current Requirements

COBS 20.2.53 requires that a firm must (i) inform the FSA and its with-profits policyholders within 28 days and (ii) submit a run-off plan to the FSA as soon as reasonably practicable, and in any event within three months, of first ceasing to effect new contracts of insurance in a with-profits fund.

COBS 20.2.55 states that 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 (i) it is no longer effecting a material volume of new with-profits policies in a particular with-profits fund, other than by reinsurance or (ii) it has ceded by way of reinsurance most of the new with-profits policies which it continues to effect.

Proposed Changes

The FSA proposes to delete the existing COBS 20.2.55 and replace it with a rule requiring firms to discuss their position with the FSA at an early stage, including whether they should take any particular action in their with-profits policyholders interests. The new rule would oblige firms to discuss their position with the FSA whenever they experienced significant and sustained falls in either (i) the volume of new non-profit insurance contracts or (ii) the volume of new with-profits policies written into the with-profits fund.

The FSA also proposes to require that all closed funds have a run-off plan (the current rules only affect funds which have closed to new business since 2005). If closed funds do not already have a run-off plan, they will be required to submit run-off plans to the FSA within three months of the proposed rules coming into force.

The FSA proposals regarding distribution plans and management plans, which are discussed below, are also relevant in this context insofar as their intention is to ensure policyholders are treated fairly when there is a material reduction in new business.

Issues and Implications

As noted above, the FSA's proposed changes to the rules on new business, and particularly the proposed "no adverse effect" test, may make it more difficult for firms to write new business in their with-profits funds. The FSA's proposed changes to the rules relating to material reductions in new business, as outlined above, will widen the circumstances in which a firm will need to discuss its plans with the FSA, as a "significant and sustained fall" in new business will trigger a requirement to approach the FSA.

The FSA does, however, make clear in its proposed new guidance that, even if a firm is no longer writing a material volume of new contracts of insurance, if it can demonstrate that the business is expected to be (i) profitable and (ii) for non-profit business, the firm can demonstrate 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, then it is likely to be reasonable for the firm to continue to write it, as long as the firm is proposing to treat its with-profits policyholders fairly. This may give firms some flexibility in writing small volumes of new with-profits business where it can be justified in accordance with these requirements. However, there continue to be concerns about these requirements for writing non-profit business, particularly for mutuals who have seen a significant reduction in with-profits business and would find it difficult to distribute any profits arising from new long term non-profit business during the remaining lifetime of the with-profit contracts.

Distribution Plans and Management Plans

Current Requirements

There are no current requirements for firms to prepare distribution plans and management plans except where in run off.

Proposed Changes

In CP 11/5 the FSA proposes requiring firms to have fair distribution plans which are appropriate to their realistic and sustainable new business projections, and the rate at which their assets are shrinking as surrenders and maturities exceed new business. This distribution plan would be based on the firm's current business and future prospects, and the FSA would require firms to have an investment strategy consistent with it.

The FSA also proposes to require that firms prepare management plans, including contingency arrangements against their plans not being achieved or other unexpected risks arising. These management plans will be required to consider investment, credit and operational risks specifically, as well as any other relevant risks associated with running the fund in the event of significant and sustained falls in with-profits or non-profit business.

This is an ongoing requirement. CP 11/5 states that firms will be asked to ensure that their distribution and management plans are reviewed and kept up to date to reflect any material changes in both current and expected levels of new non-profit insurance contracts as well as current and expected levels of new with-profits contracts.

Issues and Implications

Preparation of these distribution plans and management plans will clearly involve a considerable amount of work for firms. It will require discussion and communication between various parties including the FSA, the firm's board, with-profits committee, with-profits actuary, investment committee and asset management provider. Firms will also need to consider the rights of their different groups of policyholders, including any applicable rights under their constitutional documents, and reflect these rights in their distribution plan and management plan. There will potentially be tensions between the requirement to identify excess surplus and make it available for distribution to existing policyholders, particularly where business is declining, and retaining funds to support new business in the future. The increased level of transparency will further limit the directors' flexibility in considering whether or not an excess surplus has arisen.

Market Value Reductions (MVRs)

Current Requirements

Currently FSA rules (COBS 20.2.16) provide that a firm must not make a market value reduction to the face value of the units of an accumulating with-profits policy unless (i) the market value of the assets in the relevant 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 (ii) there has been, or there is expected to be, a high volume of surrenders relative to the liquidity of the relevant with-profits fund. In either case, the MVR must be no greater than is necessary to reflect the impact of (i) or (ii) on the relevant surrender payout.

Proposed Requirements

In CP 11/5 the FSA proposes to change COBS 20.2.16 to remove the ability of firms to impose MVRs on the grounds of surrender volumes alone. It also proposes, however, to remove the word "significantly" from the rule so that firms can apply an MVR when the asset share is less, but not necessarily significantly less, than the face value of the policies. This means that, under the FSA's proposed changes, an MVR may only be applied where the face value of the policy is higher than the value of the underlying assets.

Issues and Implications

The FSA comments in CP 11/5 that it is possible for a with-profits fund to experience a high volume of surrenders as a result of which a need to dispose of assets can lead to a fall in the market value of those assets (and therefore would give a right to impose an MVR under the proposed new FSA rules). However, there is a risk that the proposed changes could lead to a situation where, if there is a high volume of surrenders in a short period, the policyholders who first surrender their policies will not be affected by an MVR but those who subsequently do so will be affected by an MVR, because it may only be after the initial surrenders have taken place (and the fund has disposed of assets to cover payments to those policyholders) that the fall in market value will take place which will give the firm the right to impose an MVR. This could indirectly result in policyholders being treated unfairly.

Strategic Investments

Current Requirements

COBS 20.2.36 (which is guidance, not a rule) states that if a proprietary firm is considering using with-profits assets to finance the purchase of another business, directly or by or through a connected person, or if a firm is considering whether it should retain such an investment, it should consider whether the purchase or retention would be, or will remain, fair to its with-profits policyholders. 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.

Proposed Changes

In CP 11/5 the FSA proposes to introduce a new rule requiring that, where "strategic investments" (which the FSA defines as a significant investment in a single asset which, even if tradeable, is, or has the potential to be, illiquid, difficult to sell or dispose of, or hard to value) are made or retained, the firm's governing body must be satisfied, so far as it reasonably can be, and can demonstrate, that the purchase or retention is likely to have "no adverse effect" on the interests of with-profits policyholders (similar to the rule for new business discussed above).

Issues and Implications

This new rule could present challenges for firms where one or more of their with-profits funds holds a "strategic investment" which is connected in some way with the firm's business, e.g. an office building used by the firm, or stakes in businesses whose commercial interests are aligned with those of the firm's owners, such as investment management companies or general insurance subsidiaries and advisory businesses. In such circumstances the firm's governing body would need to be satisfied, and be able to demonstrate, that continuing to hold that asset is likely to have no adverse effect on the interests of with-profits policyholders. There is no materiality threshold for this test. For example, firms would need to consider (under the new proposed guidance in COBS 20.2.36A):

(a) the size of the investment in relation to the with-profits fund, and the expected rate of return on the investment;

(b) the risks associated with the investment (including liquidity risk, the capital needs of the acquired business or investment and the difficulty of establishing fair value) and any costs that would result from divestment;

(c) whether the firm's with-profits actuary, or a knowledgeable existing with-profits policyholder in that fund, would regard it as having no adverse effect on the interests of with-profits policyholders as a class; and

(d) whether the investment should be disclosed to with-profits policyholders.

This requirement will give rise to particular challenges for mutual insurers who cannot hold strategic investments except through their with-profits fund.

Excess Surplus and Reattributions

Current Requirements

As noted above, COBS 20.2.21 and 20.2.22 require that firms must determine on an annual basis whether their with-profits funds have an excess surplus and, if they do, and to retain that surplus would be a breach of FSA Principle 6, the firm should either (i) make a distribution from that fund or (ii) carry out a reattribution.

Proposed Changes

The FSA no longer believes that a reattribution is an appropriate course of action in relation to an excess surplus. This is based in part on comments made by the judge in the *Commercial Union Life Assurance Company* case referred to above. The FSA therefore proposes to delete the part of COBS 20.2.22 allowing firms to carry out a reattribution as an alternative to a distribution where an excess surplus has been identified. Its view is that, where an excess surplus is identified, it should be distributed in the "required percentage" to with-profits policyholders.

The FSA also proposes to introduce a requirement that, where a firm proposes a reattribution, it must discuss with the FSA in advance (i) whether it has any excess surplus (ii) if so, its amount and (iii) the firm's capital requirements for future new business. The FSA indicates that it will expect any identified excess surplus to be distributed before any reattribution can take place, and firms must be able to justify the removal of the remaining working capital in the estate from the with-profits fund in any reattribution.

The FSA also proposes some further changes to its rules regarding reattributions: (a) that the policyholder advocate should have the right to communicate with policyholders without the firm initially approving the content of the communication and (b) that a reattribution scheme should not be structured so that approval of a majority of policyholders can bind a minority of policyholders (e.g. through a scheme of arrangement). It also proposes to publish a set of guidelines for use in future reattributions.

Issues and Implications

There have only been two reattributions of inherited estates in the last ten years, both by large firms and for large amounts: AXA Equity & Law (around £1.7 billion) and Aviva (around £4 billion). They are rare, lengthy and highly complex transactions and only the Aviva one was carried out under the current rules. The proposed changes reflect the experience of the Aviva reattribution and some of the criticism which the FSA received. Some of the changes, such as better defining the role of the Policyholder Advocate, are to be welcomed though since the process remains long and complex it is unlikely that we will see a significant number of reattributions in future.

Governance

Current Requirements

COBS 20.3 (*Principles and Practices of Financial Management*) includes guidance on governance arrangements that apply to with-profits funds.

Proposed Changes

In its WPRR Report in June 2010 the FSA commented that one of its main concerns arising from the WPRR was regarding governance. The Report stated that, in considering whether policyholders' interests are properly protected, the FSA identified "material shortcomings" in the effectiveness of how firms are governing with-profits funds, especially in how independent challenge is provided by firms' with-profits committees.

The FSA emphasises in CP 11/5 that its objective is to improve on the existing regime, not to devise a new approach, and it emphasises that the governing body of each firm has and will keep regulatory responsibility for treating its with-profits policyholders fairly. However, the FSA also proposes several changes to the existing with-profits governance regime, which are set out in the table below:

No.	Proposed Change
1	To require all funds other than "small" funds (which will be defined by reference to the existing definition in GENPRU 2.1.19) to have a with-profits committee ("**WPC**"), rather than any other arrangement.
2	To require a firm with one or more funds with a WPC to appoint the same WPC for all its with-profits funds.
3	To require firms to discuss the terms of reference of the WPC with the FSA and publish them on the firm's website.
4	A WPC must satisfy itself that how the fund is run is properly reflected in the PPFM (currently FSA rules require that the WPC assesses compliance by the firm with its PPFMs and addresses conflicting rights and interests of policyholders and, if applicable, shareholders, and these requirements will also remain).
5	The terms of reference for a WPC must include (i) a requirement for the board to consult the WPC in a timely manner concerning all matters the WPC could reasonably be expected to be consulted on and (ii) a requirement that all material discretionary actions proposed in relation to the with-profits business of the firm will be discussed by the WPC with the firm's With-Profits Actuary.
6	The WPC should be able to raise issues proactively that it thinks the board needs to consider (provided that they are within its terms of reference).
7	A WPC must present the relevant board with its clearly recorded and independent advice and the board must then reach and minute its own decisions in response. The source of decision-making should be clear. The firm will be required to notify the FSA in the event that the board departs from the WPC's advice on significant issues following escalation within the firm, if the WPC requests the firm does so.
8	A WPC should have the right to make a reasonable request to obtain external advice, including actuarial advice. In shareholder-owned funds, the WPC should be able to request that the advice is obtained at the shareholders' expense.

The FSA has also asked for feedback on whether the members of a WPC should be either (i) all independent and completely external to the relevant firm or (ii) made up of independent members and directors and non-executive directors of the firm's governing body, but with an independent majority. It does, though, indicate in CP 11/5 that it would prefer WPCs to be made up of a mix of (i) independent non-executives and (ii) either internal or external appointments, but with an independent majority. It also suggests that the WPC's chair should be a senior independent non-executive or external person, and that the WPC should have a quorum of at least two members.

The FSA suggests that "independent" for this purpose should be based on the Financial Reporting Council's UK Corporate Governance Code (the "**Code**"). This would mean that, when it is deciding whether to appoint a new independent member, the relevant firm's board should determine whether the person is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, that person's judgement. The Code includes examples of such relationships or circumstances, including where the individual has been an employee of the firm within the last five years, or has been on the board for more than nine years. The governing body can still appoint a person even if there are such relationships or circumstances, but only if they take the view that the person is independent and state their reasons.

Issues and Implications

<u>Structure and Composition of WPC</u>: in practice, many with-profits firms already have a with-profits committee to satisfy the "independent judgement" test in COBS 20.3.2, but for some firms (e.g. who have appointed an "independent person with appropriate skills and experience") this new requirement may require a change in their with-profits governance structure. Similarly, many with-profits firms have one with-profits committee for all their with-profits funds, but these proposed rule changes may accelerate the move towards such a structure where it is not already the case. Firms may also in some cases need to remove members and/or appoint new members to their WPC in order to satisfy the "independent majority" approach if that is the route favoured by the FSA.

<u>Powers and Responsibilities of WPC:</u> the powers and responsibilities of WPCs are clearly being extended by these proposed changes. The onus would be on the WPC to satisfy itself that the fund is run in accordance with its PPFM (rather than just to assess compliance). The WPC would be able to raise issues with the board proactively, and take external advice at shareholder cost. The WPC would also have power to require the board to notify the FSA where the board departs from its advice on significant issues following escalation within the firm. The role of the With-Profits Actuary would also grow, insofar as the WPC would be required to discuss all material discretionary actions with them.

<u>Decision-Making Process:</u> the proposed rules will require a more clearly defined decision-making process between the board and the WPC. The board must consult the WPC in a timely manner concerning all issues the WPC considers "with-profits policyholders might reasonably expect the with-profits committee or advisory arrangements to be involved". The interaction between the WPC and the board would need to become more formal in all cases, such that the WPC must present the board with clearly recorded independent advice and the board must reach and minute its own decisions in response.

Again, firms may need to consider the interaction between these proposed rules and their existing schemes under Part VII of FSMA, some of which set out required governance arrangements (such as a supervisory board or particular powers and obligations for the relevant WPC in relation to that fund) which may not be consistent with the proposed FSA rules.

Conflicts of Interest

Current Requirements

In general terms, the FSA’s concern is that the wide element of discretion given to firms in relation to with-profits business can also give rise to potential conflicts of interest. The FSA rules aim to mitigate the risks to policyholders that can result from these conflicts. Currently, COBS 20.2.1 recognises the conflicts that may arise between the interests of shareholders and with-profits policyholders.

Proposed Changes

The FSA is concerned that COBS 20.2.1 does not explicitly cover all the conflicts of interest which can arise (e.g. between with-profits and non-profit policyholders within the same fund, or between with-profits policyholders and management) and propose to make clear in COBS 20.2.1 that the rules and guidance apply to all these potential conflicts of interest.

Issues and Implications

While the FSA's rules regarding conflicts of interest relating to with-profits business in COBS 20.2.1 (and in new COBS 20.2.1A-C) would, following the proposed changes, set out more specifically the various areas in which conflicts of interest may arise, these changes do not appear to reflect any change in principle. The key point is that firms must always be alert to conflicts of interest in their with-profits business, wherever they arise.

Communications to With-Profits Policyholders

The FSA will bring forward proposals regarding policyholder communications in the next with-profits Consultation Paper, which is expected later this year. They do comment, however, in CP 11/5 that, while they remain convinced that firms should produce a short explanation of how they run with-profits funds, they are minded to revisit whether requiring consumer-friendly PPFMs (CFPPFM) is the best way to achieve this. They also comment that they have concerns over the quality of event-driven communications, such as surrender and transfer notices, and CFPPFMs.

Tax

COBS 20.2.27 currently requires that a firm must not charge a contribution to corporation tax to a with-profits fund if that contribution exceeds the notional corporation tax liability that would be charged to that with-profits fund if it were assessed to tax as a separate company. CP 11/5 notes the "considerable level of opposition" which this rule has attracted, and states that the FSA is intending to consider this issue in its further with-profits Consultation Paper later in 2011. Any changes will need to be consistent with the more general changes to life assurance taxation rules which are anticipated to result from Solvency II accounting and reporting rules (and on which HMRC consulted in 2010).

Miscellaneous

The FSA has also commented that:

(a) it will continue to permit a fair and reasonable proportion of the deficit of a relevant pension scheme to be included in the staff costs that are charged to the with-profits fund; and

(b) it does not propose to make any changes to the rules concerning compensation and redress (i.e. COBS 20.2.25, which requires that shareholder-owned firms do not use assets from a with-profits fund to pay compensation and redress arising from any event occurring after 31 July 2009).

IMPLICATIONS FOR MUTUALS

Project Chrysalis and New Business

COBS 20 applies to mutual with-profits insurers in the same way as it does to proprietary insurers. Many mutual firms, in connection with the WPRR, expressed concerns to the FSA that COBS 20 in its current form prevents them from continuing to write new non-profit business into their long-term funds where they do not write a material volume of such new business. In 2008 the FSA launched what was termed “Project Chrysalis” and, in this context, published “Dear CEO” letters in October 2009 and September 2010 which related to the fair treatment of with-profits policyholders in mutually-owned with-profits funds.

The position for mutual firms in relation to the application of FSA rules on new business is different from that of shareholder-owned firms because:

(a) a shareholder owned firm could choose to subsidise/cover costs of new business from shareholder assets, but a mutual cannot do so; and

(b) the decline in with-profits business transacted by some mutual societies means that some mutuals might cease to write a material number of with-profits policies, which could trigger COBS rules forcing them to prepare run-off plans.

This creates particular difficulties for mutuals in writing new business. CP 11/5 states that if shareholder-owned firms wish to use their own assets outside the with-profits fund to subsidise the writing of new business which is loss-making, they are at liberty to do so, but the FSA comments that it does not believe with-profits funds should be used in this way. Mutuals, which have no shareholder assets, must therefore satisfy the “no adverse effect” test before they can write new business which may effectively prevent them from using the estate to support such business. They will also have to apply the "no adverse effect" test to strategic investments as they cannot hold them outside the with-profits fund.

As discussed above, the FSA’s view is that with-profits policyholders have no expectations that a distribution will necessarily take place during the life of their policies (because directors of the relevant firm have discretion in relation to the distribution of the fund’s surplus accumulated profits). The FSA proposes to introduce guidance in COBS 20.2 to make clear that the principles summarised in the "Rights and Interests of With-Profits Policyholders" section above also apply to with-profits policyholders in a mutually-owned insurer.

The position for mutuals is given added complexity because, in its October 2009 “Dear CEO” letter, the FSA expressed the view (based on advice which it had received from Counsel) that the general position is that with-profits policyholders, in their capacities as policyholders and as members of a mutual, will be entitled ultimately to all or almost all of the assets in a mutual's long-term fund after the mutual's contractual obligations in respect of policies written into that fund have been satisfied. CP 11/5 does not specifically re-state this principle but does refer to comments received on this issue from mutual firms and states that the FSA takes a "different view". The FSA also emphasises in CP 11/5 (as they did in the December 2010 Project Chrysalis "Dear CEO" letter) that holders of with-profits policies taken out with a mutual should be treated no worse than holders of with-profits policies taken out with a shareholder-owned firm.

The fact that the FSA considers with-profits policyholders to be entitled to almost all the surplus in a mutual's fund will mean that it is particularly challenging for the board of a mutual to decide whether it can write new business without adversely affecting the existing with-profits policyholders particularly where the volume of new with-profits business is declining. In practice, the combination of the "no adverse effect" test and the FSA interpretation of the rights of with-profits policyholders may make it very difficult for many mutual firms to write new business (and may ultimately lead to their winding-up unless alternative options can be pursued). Many mutuals disagree with the FSA's position and consider that the reasonable expectations of their with-profits policyholders are not as extensive as the FSA suggests.

Split Funds and Other Options

In its October 2009 "Dear CEO" letter the FSA suggested some possible alternatives open to mutuals facing a decline in their with-profits business. In CP 11/5 the FSA also acknowledges some of these potential options. These options would, however, require consent of the with-profits policyholders in the relevant fund, although it is not clear exactly what type of consent will be required.

One option is to create "mutual capital" by splitting the long-term fund, with the agreement of the with-profits policyholders, into (a) a with-profits fund and (b) a mutual fund (in which new non-profits business could be written). For example, the regulatory capital of the firm could be held in the mutual fund and the with-profits fund could hold the technical provisions for the with-profits business. The mutual fund could provide capital support for the with-profits fund as required. Depending on the individual circumstances of the mutual some or all of the surplus capital could be held in the mutual fund and it may be possible for some of this surplus to be used to invest in non-profit business written in the mutual fund. To the extent that the surplus capital was not required for new business or other specified purposes, it could be distributed to with-profit policyholders and any other policyholders/members who have an interest in the surplus.

Alternatively, the FSA comments in CP 11/5 that a mutual wishing to cease writing with-profits business but continue writing non-profit business in a common fund could make proposals to its with-profits policyholders for continuing to write non-profit business without realising the economic value for the benefit of with-profits policyholders, and thereby creating a reserve of mutual capital over time. There is little detail in the paper however regarding how such a structure would operate.

Distribution Policy

COBS 20.2.17(2) requires that any distribution from the with-profits fund must be not less than the "required percentage". It establishes a "default" required percentage of 90% in the absence of other factors that might justify a different result.

CP 11/5 makes clear that the FSA believes that with-profits policyholders in the with-profits fund of a mutual insurer would not expect to be treated in a materially different (and less favourable) way, in relation to distributions from that fund, from with-profits policyholders in the with-profits fund of a shareholder-owned insurer. The FSA therefore takes the view that a single definition of "required percentage" should apply to mutually-owned and shareholder-owned firms. The FSA does, however, propose to add new guidance making clear that the "required percentage" should reflect a firm's established practice, even if the firm has no PPFM or its PPFM is silent on this point. Under the proposed guidance, firms will need to consider whether they have an established practice, and explain how they have reached their conclusions and whether their practice has been clearly and unambiguously communicated to their with-profits policyholders.

Other Issues and Considerations

The issues and comments above relating to the proposed changes under CP 11/5 also apply to mutual firms, with some additional issues and considerations:

<u>Distribution Policy and Management Policy:</u> as mentioned above, the economic interests of policyholders will affect the management of the funds and will need to be taken into account when determining the distribution policy and management policy. For mutuals, firms will also need to take into account the relative rights of policyholders and members, which will be based in part on the relevant firm's rules or other constitutional documents, when determining their distribution policy and management policy. This will include considering rights of members on a winding-up, run-off or demutualisation of the mutual.

<u>Conflicts of Interest:</u> for mutual firms, the FSA is also concerned with conflicts of interest between with-profits policyholders and members of mutuals (as well as its general concerns about conflicts between different groups of policyholders, and between policyholders and management, which are mentioned above).

CONCLUSION

The proposed changes to COBS 20.2 will further increase the transparency surrounding with-profits business and will further narrow directors' discretion. Whilst this must be welcomed to the extent necessary to provide adequate protection for with-profits policyholders, it is likely to make the operation of with-profits funds even more challenging. This, together with higher capital requirements under Solvency II, is likely to result in with-profits business declining further and in policyholders having less choice of investment products. It also appears to be unduly favouring a generation of policyholders who acquired their policies without any expectation of a distribution of surplus capital at the expense of future generations of policyholders and, in the case of mutuals, the policyholder membership generally. In many respects in our view the provisions go beyond what is necessary to protect the legitimate interests of with-profits policyholders and could result in damaging other interests, for example those of non-profit policyholders in with-profit funds.