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Briefing note March 2012

Protecting With-Profits Policyholders

On 7 March 2012, the FSA published Policy Statement 12/4, "Protecting With-Profits Policyholders - Feedback on CP 11/5 and Final Rules" ("**PS 12/4**"). It sets out a summary of responses by industry participants to CP 11/5 ("**CP 11/5**") (see our CP 11/5 Briefing), the FSA's feedback on those responses, and the final Conduct of Business ("**COBS**") rules, which will come into force on 1 April 2012.

This Briefing considers the impact of the COBS rules on insurers' with-profits business and the mutual sector, in particular.

Key issues

- Writing new business into your with-profits fund
- Managing your strategic investments
- Impact of a decline in business volumes
- Role of the With-Profits Committee
- Mutual Capital

Rights And Interests Of With-Profits Policyholders (COBS 20.2.1G)

In CP 11/5, and in CP 09/9, the FSA stated its view that with-profits policyholders have:

- an interest in the whole with-profits fund and in every part of it,
- a contingent interest in any surplus, which may exist prior to distribution, and
- a reasonable expectation that they will share in a distribution of surplus, if one is made.

Although this view has long been challenged by many industry participants in both the proprietary and mutual sectors, who take the view that the rights and interests of with-profits policyholders in the with-profits fund are more limited than the FSA believes, the FSA has now confirmed its intention to include guidance in COBS reflecting these fundamental principles. It is these principles which frame the FSA's approach to the scope and application of Principle 6 and the COBS rules to with-profits funds and with-profits policyholders.

The FSA does, however, make clear that the guidance is not premised on a legal analysis of the ownership of a fund, which the FSA acknowledges is generally legally and beneficially with the insurer. The FSA has confirmed that it does not take (and never has taken) the view that the with-profits fund is legally or beneficially owned by policyholders to the extent of all potential distributions but it believes 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*".

Having restated the extent of the rights and interests of with-profits policyholders in the with-profits fund, the FSA now requires firms to identify and manage conflicts of interest within the fund. This necessitates the identification of the scope and extent of the interests of all other parties in the fund, eg the firm itself, non profit policyholders, shareholders, policyholders in their capacity as members of a mutual, yet the FSA gives no guidance as to its view of the interests of these other parties. It is difficult to see how firms can manage these conflicts to the FSA's satisfaction without accepting wholesale the FSA's views on the rights and interests of with-profits policyholders. A challenge by a firm to the FSA on this issue must, therefore, remain a strong possibility

Distributions of Surplus (COBS 20.2.17R and 20.2.1G(3))

In a proprietary owned firm, with-profits policyholders typically share in any distribution of surplus on a 90:10 basis, whilst in a mutual, with-profits policyholders have, in the main, received 100% of any distributed surplus. There is no change to the COBS rule, which requires all firms to determine annually whether or not there is an "excess surplus" in its with-profits fund (whether that fund is open or closed). The FSA expects firms to distribute that excess surplus, unless, under Principle 6, it is fair to their customers to retain it. The FSA has reiterated its view that policyholders have a legitimate and reasonable expectation that firms will comply with the rules and Principle 6 following the judgment of Norris J in the *Commercial Union* case[1].

The FSA has also confirmed that any distribution which is made to with-profits policyholders, whether in a proprietary firm or a mutual, must not, in the general case, be less than the *required percentage*, for which a default 90:10 ratio will apply under COBS 20 (even in the case of a mutual insurer), although the FSA has now accepted that the constitution or the custom and practice of a particular firm may justify a different approach.

New Business (COBS 20.2.28R)

The FSA has retained the more stringent test for writing new business into a with-profits fund proposed in CP 11/5, so that firms will need to demonstrate that each tranche of new business has "no adverse effect" on the interests of with-profits policyholders. It has, however, provided additional guidance which suggests that new business which is "financially self-supporting" over its duration <u>and</u> is likely to add "sufficient value" to the fund after covering all costs, will satisfy that test. This means that new business which makes a loss for the fund during an initial period but, when looked at over the entire duration of that product, can be demonstrated to be profitable, appears to be acceptable under the new COBS rules. The FSA has also confirmed that the question of adverse effect is measured against the interests of with-profits policyholders generally not just the current generation.

The evidential requirements for the new business test have been relaxed so that the "all appropriate analysis" test proposed in CP 11/5 has been changed to "appropriate analysis". Firms can take a proportionate approach when determining what is "appropriate" having regard to relevant factors, although the burden remains on the firm in each case to demonstrate to the FSA that its approach is, in fact, proportionate and appropriate.

Notwithstanding the relaxation of these requirements, there is no doubt that the amendments to this rule remove a significant element of discretion of the directors and require a higher standard of evidence from firms developing and writing new business lines in a with-profits fund. As a transitional measure, 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.

Decline in volume of new business (COBS 20.2.41AR and 20.2.54R)

The implementation of the requirement to initiate discussions with the FSA if a firm experiences a "significant and sustained fall" in the volumes of new business (whether with-profits or non profit) means that a firm will need to discuss its position with the FSA at a much earlier stage than previously, when the notification trigger was solely related to material volumes of with-profits business (COBS 20.2.53R); although arguably the obligation to commence earlier discussions would have been triggered under Principle 11 in any event. The purpose of this discussion is to allow the FSA to comment on the adequacy of the firm's planning and to seek agreement with the firm on appropriate actions. It is clear, though, that a requirement to have such a discussion with the FSA will not automatically mean that the fund in question *must* close to new business as was feared from CP 11/5. The FSA has also confirmed that it does expect funds already closed to produce run off plans as required by the COBS rules.

While the proposal to require firms to draw up formal fair distribution and management plans has been withdrawn (although may be revisited once there is greater clarity on Solvency II reporting), it seems likely that, in practice, as part of a firm's discussions with the FSA under COBS 20.2.41AR, it will be expected to have a proposed distribution framework in place in order to be able to demonstrate the fairness of its approach to with-profits policyholders.

COBS 20.2.54R still applies to all with-profits funds so that a firm will be taken to have ceased to effect new contract of insurance if it is no longer effecting a material volume of new

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[1] Commercial Union Life Assurance Company and Ors [2009] EWHC 2521, para 40.

with-profits business in the fund *unless* the firm can demonstrate that continuing to write those smaller volumes of with-profits business is not unfair to with-profits policyholders.

Although not stated explicitly, it seems that the FSA accepts that in some cases, it may be fairer to those policyholders for the fund to remain open, even if writing only a small amount of business, than closing and winding up the fund completely. However, in such case, the onus is still on the firm to comply with the rules around distributions of excess surplus and at some point, therefore, fairness to with-profits policyholders is likely, in many cases, to require or result in closure of the fund. The FSA has not taken the opportunity to give guidance as to its view of "materiality" in these circumstances and so there remains a large element of discretion as to the FSA's approach in any particular case.

Strategic Investments (COBS 20.2.36R)

Clarificatory guidance will be implemented on the use of strategic investments in a with-profits fund. A firm's governing body must be satisfied, so far as it reasonably can be, and be able to demonstrate that the purchase or retention of strategic investments is likely to have no adverse effect on the interests of with-profits policyholders.

Guidance suggests that in order to demonstrate compliance, firms will need to analyse the relative size of the investment, rate of return, investment risks, costs of divestment and the view of the with-profits actuary. It is clear from the guidance that investments such as office buildings rented or owned by a firm, or stakes in businesses whose commercial interests are aligned with the firm's owners (e.g. investment management companies or general insurance subsidiaries and advisory businesses), are intended to be treated as "strategic investments". The FSA does not consider that this is a shift in its position, pointing to the fact that similar guidance was contained in the previous version of the COBS rules and ought, therefore, to have been in contemplation when firms were considering these issues in any event. A transitional provision will be implemented, ensuring that retaining a strategic investment based on compliant decisions taken before 1 April 2012 will be deemed compliant with the new rule until 1 October 2012.

For those firms which do hold such assets as part of their with-profits funds, their governing body will need to be satisfied, and be able to demonstrate, that, on a continuing basis, holding that asset is likely to have no adverse effect on the interests of with-profits policyholders. While proprietary companies may make use of the shareholder funds to hold investments which may not meet the new requirements, mutuals, which have no other funds in which to hold investments, may face particular difficulties. The relatively short transitional period means that firms will need to act swiftly if they determine that changes to their investments are required in order to comply with the new rules.

Reattributions (COBS 20.2.42R)

The FSA emphasises in PS 12/4 that its proposals are intended to make the difference between a reattribution and a distribution clearer, not to prevent reattributions. The FSA also makes clear that its aim is to improve the process and, in particular, to keep the length of the process following the appointment of the policyholder advocate as short as possible. Only one reattribution (Aviva) has been carried out under the current rules and these proposed rules reflect the experience of that transaction and some of the criticism which the FSA received. In practice, given the length and complexity of the reattribution process, it is unlikely that we will see a significant number in future. It is clear now that the FSA requires a firm to distribute excess surplus before carrying out a reattribution – a point debated at some length in the Aviva case under the previous rules.

Charges

The FSA is not proceeding with its proposed changes to the rules on charges to with-profits funds by in-house service companies, but is considering alternative approaches. This will be welcome news for many firms, for whom the CP 11/5 proposals could have had a significant impact on their charging structures and service arrangements, particularly for in-house asset management companies. It may also assist consolidation activity in the mutual sector, (where the previous uncertainty regarding charges had led to a degree of hesitance for mutuals around making strategic moves), and removes an obstacle for further closed book acquisitions.

The FSA does, however, state in PS 12/4 that it 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 (the FSA gives 5 years as an example in this context). The FSA also commented that there could be better disclosure of costs. This is sufficiently different from the proposal on which the FSA consulted in CP 11/5 to require fresh consultation. A further consultation and subsequent rules changes on this

issue may therefore take place at a later stage.

MVRs (COBS 20.2.16R)

The FSA's intention is to reduce the scope for imposing an MVR including by removing the ability of firms to impose an MVR on the basis of liquidity risk alone. The FSA also recognises in PS 12/4 that an element of pragmatism is needed when applying the rule on MVRs to reflect the intention to deliver asset share payouts in aggregate over time, and makes clear in this context that it would not regard smoothing as inconsistent with the rule.

Governance (COBS 20.5)

The FSA has made a transitional rule such that firms' existing governance arrangements are deemed to comply with the rules until 1 July 2012. This gives firms a relatively short period in which to prepare for the rule changes and to consider the interaction between the rule changes and any existing Part VII schemes which may set out specific governance arrangements (such as a supervisory board) which may not be consistent with the new rules.

The FSA has decided not to go ahead with its proposal to impose a requirement on all with-profits funds other than 'small funds' to have a WPC. However, the FSA continues to believe that there is considerable merit in the suggestion that a WPC should be the general rule except for firms whose low level of complexity makes one unnecessary. The FSA will therefore consider the issue further but notes that it will need to re-consult on relevant factors in deciding whether a fund is complex. In the meantime, it seems that it will be for firms to satisfy the FSA that a WPC is not appropriate in its case.

The FSA has concluded that a majority of the members of a WPC will need to be independent of the relevant firm. The question of independence will be left to the relevant board but the FSA has set out guidance in line with the Financial Reporting Council's guidelines on assessing independence.

As noted in our client briefing last year, the revised rules will require a more clearly defined decision-making process between the board and the WPC. The FSA's "vision" for the WPC is that it should provide "advice and challenge" and, if appropriate, recommendations to the Board, confirming that the role of the WPC has expanded beyond consideration of compliance with the PPFM. The WPC will also have the power to require the board to notify the FSA where the board departs from its advice on significant issues, although, the FSA has sought to clarify that any notification should only be used in exceptional circumstances.

Role of the With-Profits Actuary ("WPA")

In CP 11/5, the FSA had proposed that the FSA Handbook section on conflicts of interest should refer to the WPA not reporting to or having his remuneration determined in a way that would give rise to a conflict of interest over the advice he gives. The FSA has revised the rule it consulted on such that where a conflict of interest does arise, it should be identified and managed effectively. It was also proposed that the WPC should work closely with the WPA and obtain his opinion and input as appropriate. However, the FSA has moved this requirement into guidance so as to give the committee greater discretion over how it conducts its work.

Mutuals – Plus ça change?

As discussed in our previous client briefing, mutuals had raised concerns that the FSA's position on the rights and interests of with-profits policyholders in the with-profits fund meant that a mutual operating a single long term fund was unable to allocate any part of its fund as "mutual capital", in which policyholders had no interests or expectations as to distribution. Further, a requirement that any distribution of excess surplus by the mutual would, in the general case, be allocated in its entirety to with-profits policyholders, took no account of the purposes of the mutual or the interest of its members generally.

Furthermore, as the COBS rules apply to the whole of the with-profits fund, in the event of a material decline in the volume of new with-profits business, it was suggested that a mutual should not be able to continue to write new non profit business into the with-profits fund. Instead it would have to close to new business, enter run off, distribute excess surplus to its current with-profits policyholders, and in the absence of being able to maintain "mutual capital" from which to operate other business, ultimately wind up. This threat to the survival of mutuals led to a lengthy FSA investigation and debate with the mutual sector known as Project Chrysalis, which has been ongoing for over 3 years and has resulted in the FSA issuing 2 Dear CEO letters setting out its views of the Mutuals' position and the application of the COBS rules to Mutuals.

In CP 11/5 and in CP 12/4 the FSA has maintained its policy position on the rights and interests of with-profits policyholders generally and does not consider that there is any justification to distinguish the position of mutuals. It has confirmed its view that the COBS rules relating to the identification and distribution of excess surplus continue to apply equally to both proprietary firms and

mutuals.

Although the FSA has decided not to implement guidance around the definition of "required percentage" and a firm's "established practice" when making distributions of surplus, it seems that, for now, the FSA's position remains that, in the typical case, there is no justification for allocating mutual with-profits policyholders a lesser share in a distribution of surplus than with-profits policyholders in a proprietary firm, ie the default 90:10 split. A mutual proposing to make a distribution of less than 100% of excess surplus to with-profits policyholders will need to justify the basis on which it can do so and it will need to be able to point to an established practice if it proposes to distribute less than 90% to with-profits policyholders.

Furthermore, the FSA has clarified that the COBS rules on writing new business into a with-profits fund and on the effect of a decline in volume of new with-profits business in the fund (discussed further below) also apply to mutuals. Mutuals already experiencing significant and sustained falls in their with-profits business will need to approach the FSA with an appropriate plan for resolution.

The FSA has also acknowledged that a mutual can seek to separate out 'mutual capital' from its common fund and that the full reattribution process ought not apply in such circumstances. Whilst the FSA will consider what process might be appropriate, it is helpful that the FSA has confirmed its acceptance of the principle that mutual capital exists or can be created with appropriate consents from policyholders.

Although, in PS 12/4 the FSA acknowledges what it describes the "existential angst" within the mutual sector and it is going to revisit the issues facing mutuals and re-examine the arguments put to it, it seems that the new COBS rules do little to alleviate the existential issues identified by the mutuals and that the Chrysalis debate is ongoing. The FSA has indicated that it may issue a Discussion Paper in 2012/2013.

Somewhat intriguingly, the FSA has however acknowledged the desirability of having a sustainable mutual sector - in its words, "*protecting policyholders need not be achieved at the cost of the continued existence of with-profits funds and the firms that offer them*". The FSA also intends to consider further the "*broader consumer interest in having a diverse market in financial services provides in which mutuality has a future alongside proprietary companies*".

This represents a significant change in tone from CP 11/5 in relation to the mutual sector, and confirms that the FSA recognises that there may be wider public interest in the survival of the mutual sector - an argument which the industry has been making for some time. If the FSA ultimately accepts this argument, it leaves open the opportunity for the FSA to balance more fairly the rights and interests of current with-profits policyholders against those of current and future consumers generally (which arguably reflects the FSA's own statutory objectives under FSMA).

What next for with-profits?

In many ways the new COBS rules offer greater clarity around FSA expectations but the fundamental issues relating to with-profits business remain unchanged:

- The FSA continues to adopt a position on the rights and interests of with-profits policyholders which is at odds with many industry participants and beyond legal precedent.
- The COBS rules, which are based around that position, continue to apply to both proprietary and mutual firms with some, albeit limited, recognition of the differences in legal structures.
- Clarification of the position for mutuals, particularly around distribution of surplus and the question of mutual capital has been postponed, possibly for over a year.
- It seems likely, that any future debate will be led by the new Prudential Regulation Authority ("PRA"), which as is currently envisaged, will be the authority with primary responsibility for the regulation of with-profits business.
- The approach of the PRA to the application of its statutory objectives, including in relation to with-profits, is an unknown quantity at this stage, and it is not clear from the current Memorandum of Understanding between the PRA and the Financial Conduct Authority, how the regulators will interact in the with-profits space.

It is, on the face of it, difficult to see how the regulator (whether FSA or PRA) can move significantly from its previously stated position. The FSA has stated that the fundamental rights and interests of with-profits policyholders as interpreted by the FSA exist in law and do not derive from the COBS rules (a position not necessarily accepted by the with-profits industry or their lawyers); rather the COBS rules provide a framework for the protection of those rights. If this is correct, how can the regulator change its mind or determine that a lesser degree of protection of those policyholders' rights is fair?

However, if the FSA accepts that its approach has involved a broader perspective than simply interpreting the legal precedent (as it seems to acknowledge in CP 12/4), there may now be a regulatory basis for doing so using the new statutory objectives in the Financial Services Bill. In particular, the objective of securing an appropriate degree of protection for with-profits policyholders may be balanced against the general objective of promoting the safety and soundness of PRA authorised persons. In CP12/4, the FSA certainly alludes to the possibility that a different approach to the interpretation of its (or the PRA's) statutory objectives may afford it some flexibility. Meanwhile, the risk of a challenge to the FSA on its approach to the rights and interests of with-profits policyholders from either the proprietary or mutual sectors remains a real one.

Mutuals in particular, ought to be making contingency plans to ensure the continued strength of their business model, pending satisfactory resolution of all of these issues, for example through development of new innovative products, considering how to address the "required percentage" requirement, treatment of essential strategic investments, capital raising, and potentially restructuring to achieve recognition and ringfencing of mutual capital.

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