The Actuarial Profession
making financial sense of the future

Consultation response
Financial Services Authority

Protecting with-profits policyholders

CP11/5

May 2011

The Actuarial Profession
making financial sense of the future

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27 May 2011

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Dear Mr Morris

Protecting with-profits policyholders – CP11/05

Thank you for providing the Actuarial Profession with the opportunity to comment on the Consultation Paper, *Protecting with-profits policyholders*, and for granting a small extension to us in order to finalise our response.

The observations that are detailed in the Annex attached to this letter are the result of discussions amongst the life actuaries that have reviewed this consultation paper. We are happy for this document to be placed in the public domain.

If you have any questions or would like to discuss any of these matters further, please do not hesitate to contact us as per details below.

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Yours sincerely

Andrew Chamberlain
Chairman, Life Practice Executive Committee's Consultation Committee

Annex 1

Responses from the Actuarial Profession to questions within CP11/5 Protecting with-profits policyholders

Question 1	**Do you agree with the proposal to include guidance setting out our view of some of the interests of policyholders in with-profits funds?**
Response	We agree that it would be helpful to include guidance setting out the FSA's view of the interests of policyholders in with-profits funds. On the whole we do not find much to contest in this wording however we do not agree with the use of "required percentages" with regard to the distribution of estate. This defined term had application to normal distributions which may not be appropriately mirrored for an estate distribution.
Question 2	**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?**
Response	We do not have any issues with this proposal.
Question 3	**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?**
Response	We understand the reasons for proposing changes to the definition of 'required percentage.' We are concerned, however, that the requirement for firms to have met current standards of disclosure in order to be able to rely on an established practice is unduly onerous, especially in respect of policies which may have been written many years ago. We believe that this introduces an element of retrospection that is not justified on grounds of fairness. Indeed, and especially in a mutual, the proposals could unfairly benefit some customers to the detriment of others. This can be of particular concern with regard to mutuals as the normal operations and the special conditions which may arise with regard to estate management may differ, and the rules of the mutual may be perfectly adequate without being expressly communicated.
Question 4	**Do you agree with our proposal to strengthen our rule and guidance on the terms of new business written into a with-profits fund?**
Response	We understand the FSA's concerns about the effectiveness of the current rule that new business should be "... unlikely to have a material adverse effect on the interests of existing with-profits policyholders". We believe, however, that strengthening the governance and challenge around application of the current rule would be more effective than the proposed change, which we see as raising a number of issues which could have adverse effects on customers: - The proposed rule ignores the many different circumstances that can exist. For example, you state that you "... consider loss-leading business to be likely

	to have an adverse effect on with-profits policyholders' interests." While this is possible, there will clearly be counter-examples. Many other industries use loss-leaders as a legitimate short-term tactic, and we do not see why with-profits firms should be precluded from using it. - The definition of "no adverse effect on with-profits policyholders' interests" is too vague and too wide. If a new product is written which is expected to generate profits for the with-profits policyholders, but requires some capital support from the with-profits fund, can it be said to have "no adverse effect"? On a capital view it would seem to fail that test, even if it is a good thing to do "in the round". Similarly, with-profits works on the principle of pooling of risk and reward. Writing policies at different points in a smoothing cycle could fall foul of such a rule if it were applied to each cohort. Taking that further, a product that is profitable overall may not be so at particular ages or premium sizes. Would that be allowed? - We welcome the clarification in 2.34 that firms can comply with the current rule if products are priced to be financially self-supporting and forecast new business is expected to add value to the with-profits fund. We are concerned, however, that the draft rules and guidance do not make it clear that this will continue to be the case in future
Question 5	**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.**
Response	We think this is a reasonable requirement, provided that the resulting discussions are also informed by the firm's expectations of realistic future new business levels.
Question 6	**Do you agree with our proposal to require firms to have fair distribution plans appropriate to their reasonable/sustainable new business projections?**
Response	We agree with your point that some firms writing very low volumes of new business may not be dissimilar to closed funds, and should have better plans for distributing surplus fairly. We suggest that it is made clear that the level of detail required should be proportionate. For some funds selling good volumes of new business, where there is no need for any distribution, something close to a "nil return" may be appropriate.
Question 7	**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?**
Response	We can see that this could be merited for some firms, but it further increases the burden and cost of regulation. A proportionate response is to be encouraged, but we would not support a requirement for firms to write detailed contingency plans where the contingency is remote or where there are too many unknowns to make the exercise worthwhile. It might be more helpful for a firm to have some form of trigger point at which lower volumes would lead to more detailed contingency planning.

Question 8	**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?**
Response	We agree with your proposal to require funds closed prior to 2005 to submit a run-off plan. However, we suggest a twelve month period to do so, as firms already have a very heavy load of regulatory work to resource, and twelve months would allow firms to manage the workload within their normal planning cycle.. The content of SUP App 2.15 appears to be drafted to apply at the point of closure and so some of the information requested does not seem entirely relevant to firms that closed many years ago. Firms that closed many years ago may already have addressed most of the issues that arise at the point of closure and will now be well into the process of managing the run-off, rather than dealing with the specific issues that arose at the point of closure. If FSA do intend to implement this requirement we would suggest that a new SUP appendix is developed that is designed to suit funds that have already been closed for many years. The Pillar 2 ICA process already provides extensive information about the financial condition of the firm and available management actions, tailored to the specific risks facing the particular firm in its closed state. Some firms may also have internal run-off plans, albeit not in Sup App 2.15 format. Rather than requiring firms to incur the costs of producing further regulatory information (which may be charged to policyholders in propriety firms), it may be sufficient for FSA to receive a copy of the firms internal reports in the first instance, but with a right to request the standard information in cases where the internal reports are considered inadequate .
Question 9	**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?**
Response	Yes, we agree that a high volume of surrenders is not a sufficient reason to apply an MVR unless it results in a fall in the value of the assets underlying the policy.
Question 10	**Do you agree with our proposal to clarify our rule relating to MVRs and distribution ratios?**
Response	Yes, although there remains scope for different interpretations of the rule as we did not find the new rule particularly clear.
Question 11	**Do you agree with our proposal that the existing guidance on strategic investments should be strengthened into a rule and that the guidance formerly in COB 6.12.86G (amended to take account of the new rule) should be restored?**
Response	On the whole we agree with this. However we believe that the proposed definition of strategic investments should be clarified to make it clear that the rule relates to investments where the firm's shareholder has a commercial interest in the investment.

Question 12	**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?**
Response	Whilst we are sympathetic to the intention behind this proposal, there does seem to be a risk of unintended consequences. Unless group service companies are able to benefit from investing in their processes, such investment might not take place, particularly in groups which are able to direct their capital to other areas where they can make a return on any capital invested. With-profits funds may only be a part of the overall business of a group. Many with-profits funds are in decline and if a service company is unable to make a profit, it will be unwilling to take on risk (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 things. Risk transfer is an important element in securing the run-off and shareholders are unlikely to accept 100% of the risk for 10% of the reward.
Question 13	**Do you agree with our proposals to remove the ability of firms to reattribute excess surplus?**
Response	This seems reasonable.
Question 14	**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?**
Response	We think such a rule would be unnecessary.
Question 15	**Do you agree that the policyholder advocate should have control over the content of communications provided by the policyholder advocate for policyholders?**
Response	Yes, provided that the cost of providing that information does not prove an unreasonable burden on policyholders or the firm and that the policyholder advocate is subject to the same requirements as the firm to ensure that communications are clear, fair and not misleading.
Question 16	**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 a reattribution scheme?**
Response	As indicated in the CP, previous reattribution schemes which were agreed under the prevailing regulations have provided alternative arrangements for those policyholders not wishing to accept the 'firm's offer'. The establishment of any proposed reattribution would have safeguards in place to ensure that such arrangements are considered and more generally that the rights of all policyholders are taken into consideration. There may be circumstances where the costs of not binding the minority may be disproportionate to the effectiveness of the overall scheme. In such circumstances

	provisions like those of the Companies Act (a 75% majority vote would bind the minority) could be appropriate.
Question 17	**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?**
Response	We would not favour any change to the current rules as we are not sure that there is an adequate supply of potential members of such committees with the requisite experience, without which there may be detriment to the interests of policyholders, though this might be avoided were the threshold set at a higher level.
Question 18	**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?**
Response	Our responses to questions 18 and 19 should be read together and the following points apply to both questions. Complete independence is unreasonable but NEDs and complete independents should make up the majority but not necessarily the full membership, of the with-profits committee. In addition at least one member of the committee should be fully independent so that it is not just Board members and executives of the company on the committee.
Question 19	**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?**
Response	Yes.
Question 20	**Do you agree with defining independence using the same criteria for independence as the Financial Reporting Council's current Code?**
Response	The proposed approach seems reasonable, although the distinctive features of with-profits funds might require some adjustment to the Code criteria, which are not prescriptive and permit departures with explanation as to the reason.
Question 21	**Do you agree with the proposal to have terms of reference published on the firm's website?**
Response	We agree with this. There needs to be signposting of this in the company's report to its with-profits policyholders and in the annual bonus notice.
Question 22	**Do you agree that the conclusions of the with-profits committee and the governing body's decisions to accept or reject those conclusions must be clearly recorded?**
Response	We agree with the proposals in this area.

Question 23	**Do you agree that the with-profits committee 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?**
Response	The committee should have the right to request advice but the cost should not necessarily be borne by the shareholders. For example, advice on a conflict of interest between different classes of policyholders would seem to be a reasonable charge on the fund.
Question 24	**Are these the right areas for a with-profits committee to consider and on which to provide advice?**
Response	We suggest that the with-profits committee should also be asked to opine on a firm's proposed changes to its PPFM. Also, the reference to MVRs could be expanded to cover surrender values on traditional with-profits business.
Question 25	**Do you agree that the with-profits committee should be able to raise issues proactively that it thinks the governing body needs to consider?**
Response	We agree with this.
Question 26	**Can with-profits committees or other independent persons as described operate effectively alongside the with-profits actuary?**
Response	We believe that this is generally the case and support the inclusion (as proposed in 3.24) of a requirement for the committee to discuss all material exercises of discretion with the appropriate with-profits actuary. With regard to the proposal that the with-profits committee should have a role in assessing the effectiveness of the with-profits actuary, we would suggest that this should be an input to the firm to assist the firm in its assessment. The with-profits actuary is appointed by the firm and so the firm should take ultimate responsibility for making the assessment.
Question 27	**Is it right to introduce a notification mechanism for alerting the regulator to significant issues where there has been disagreement?**
Response	The members of the with-profits committee and board are approved persons and hence are already required to bring to the FSA's attention such matters, if they are material. An additional notification requirement would therefore seem to add another layer of regulatory complexity. Alternatively it might suggest a different level of materiality at which the notification operates but this in itself may cause unnecessary complexity or confusion unless it is very clear how it should operate.
Question 28	**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?**
Response	Although actuaries are already subject to the Actuaries' Code issued by the Actuarial Profession, which includes requirements in relation to managing conflicts of interest,

	we would welcome any measures that reduce the exposure of with-profits actuaries to conflicts of interest and the additional requirements to be placed on firms in this regard should assist with this. We are also concerned that the proposed new paragraph (6) to SUP 4.3.17R is unclear and we believe FSA should consult upon the criteria for when a reporting line might lead to a conflict of interest. Necessarily any employed with-profits actuary ultimately reports to the governing body, through one of its members and if FSA has particular issues these should be explored in a consultation exercise.
Question 29	**Are there any other matters that you think are relevant to this consultation?**
Response	We are concerned that there is no acknowledgement in this paper of the opportunity for firms to develop a more flexible approach to "with-profits" as envisaged in the 'Dear CEO' letter of 6 October 2009. We consider that the FSA could have given 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 believe that firms 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.