

Financial Services Authority

With-profits regime review report

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1 Overview

Background

- 1.1 At the end of 2009, there were around 25 million with-profits policies held by consumers representing £330 billion assets under management. While asset levels have declined from £420 billion in 2005, with-profits products clearly still represent a very significant portion of the savings market. With-profits products are commonly used for pensions and other savings.
- 1.2 We are committed to ensuring that firms operating in the with-profits sector do so fairly and transparently. This is an essential part of our role in promoting resilient, effective and attractive retail financial services markets that deliver fair outcomes to consumers.
- 1.3 As part of our oversight of the with-profits sector, we have carried out a review, ‘the review’, of how senior management in firms have implemented our rules, including principles; in particular whether they appropriately manage their commitments to their with-profits policyholders and treat them fairly.
- 1.4 The review has been comprehensive in scope and depth, and is informing both our immediate supervisory approach towards with-profits firms and our thinking on the future regulatory framework for the with-profits sector. Within this report we also reflect on findings from the initial stage of a separate ‘lessons learned’ exercise on the reattribution process, following the recent Aviva reattribution.

Why and how we undertook the with-profits review

- 1.5 The current regime, which has been in place since 2005, was the culmination of the major regulatory reforms of the with-profits sector embarked on by the FSA in 2001.
- 1.6 While we have assessed elements of the regime since its introduction, it was time to undertake a comprehensive review in light of our individual firm supervisory experience and to address concerns raised by the Treasury Select Committee (TSC) and consumer focused stakeholders.

- 1.7 We carried out detailed assessments on governance, consumer communications, payouts (surrenders and maturities), charges, new business and closed funds specific issues. We assessed 17 firms which represented approximately 80% of the with-profits market on the basis of with-profits assets held at the end of 2009.
- 1.8 The firms we assessed were representative of the full range of firms operating within the with-profits sector including; proprietary firms, mutuals and friendly societies, operating both open and closed funds. In addition to the results of this specific review we also took account of the wide range of information generated from our past and present supervisory experience of firms in general.
- 1.9 We have reviewed firms against our rules and guidance in relation to treating with-profits policyholders fairly contained in Chapter 20 of the FSA's Conduct of Business Handbook (COBS 20) and the associated Principles. The rules and guidance in COBS 20 support the FSA's Principles, in particular Principle 6, Customers' interests, Principle 7, Communications with clients, and Principle 8, Conflicts of interest.
- 1.10 We particularly tested against the rules and guidance in COBS 20 that support the following desired policy outcomes:
- governance ensures with-profits policyholders' interests are properly protected and taken into account in any actions taken by the firm;
 - current and prospective policyholders receive sufficiently comprehensive, timely and clear information to enable them to take a reasonable view of the risk and reward balance of their with-profits policy;
 - policyholders receive fair payouts and firms apply policy conditions such as market value reductions¹ fairly and proportionately to ensure all classes of policyholders are treated fairly;
 - policyholders only bear costs that are incurred in the running of the fund. Any overheads incurred by the firm charged to the fund are proportionate to its size and impact within the firm;
 - investments are appropriate to the with-profits fund and do not prevent policyholders from receiving fair pay-outs or bonus distributions;
 - new business is written on terms that, at a minimum, are unlikely to make existing with-profits policyholders materially worse off; and
 - firms running a closed fund address fully any relevant risks including financial or operational risk relating to them and have a coherent plan to distribute assets held within the fund in a way that is fair to all policyholders.
- 1.11 In October 2008 we set out a preliminary view of the process of reattributions based on our experience of the reattribution transactions in progress at that time (Aviva

1 Market value reductions are policy conditions that allow firms to reduce the face value of unitised with-profits policies where the value of the underlying assets are, or are expected to be, significantly less than the assumed face value of the policy. We have introduced rules to regulate the application of these policy conditions to ensure that their use is appropriate to the conditions. See COBS 20.2.16R.

and Prudential).² We committed to communicate further on the reattribution process set out in COBS 20 and to set out any additional lessons learned before conducting more detailed work on the policy response or other changes required to the process. Now the Aviva reattribution transaction has concluded, we have completed the initial phase of this work.

Concerns raised by stakeholders

- 1.12 We have engaged with a range of stakeholders, including those with a consumer focus, specifically on the issue of the operation of with-profits funds. The discussions have been extremely helpful in highlighting the perceptions and concerns surrounding the with-profits sector.
- 1.13 The TSC has a longstanding interest in with-profits issues. The TSC has mainly focused on firms' use of the inherited estate, expressing concerns around the fairness of the use of any estate by firms. It has also commented on the wider with-profits regime and while recognising changes made by the FSA to regulating the with-profits sector earlier this decade, remains concerned whether the conflicts of interest inherent in with-profits are being managed to ensure that policyholders' interests are adequately protected. It is also concerned about the lack of transparency in the operation of with-profits in general.
- 1.14 Other stakeholders, including both consumer focused and those from the industry, generally believed that if with-profits products worked effectively and fairly, they could, in principle, be an attractive option for consumers, as a relatively low-risk product providing some exposure to equity type investments that aimed to generate mid-range performance with, often valuable, guarantees attached to provide downside protection.
- 1.15 There was, however, an overwhelming view expressed amongst consumer stakeholders that the with-profits sector is not working effectively, resulting in potentially poor outcomes for policyholders. There were concerns that the products were often not performing well for policyholders due to poor or unfair operation of funds and that policyholders were subject to considerable cost, through market value reductions, to extricate themselves from these funds.
- 1.16 These concerns were compounded by the view that the information provided to with-profits policyholders is not sufficient to provide clarity on how a fund was being operated, or to enable policyholders to understand what was driving the performance of their investment and hence to have a clear understanding of the product's risk and reward balance of the product.

2 Only the Aviva reattribution was followed through to conclusion, the proposed Prudential reattribution was not concluded.

The main findings from the review

Firm assessments

- 1.17 We found that the majority of firms did not satisfactorily demonstrate that their practices were consistent with well run with-profits businesses in one or more areas that we assessed, potentially exposing a very significant number of with-profits policyholders to risk.
- 1.18 However, this was not found across all the firms we assessed. We also identified a significant number of firms where with-profits funds were operated with due regard to the interests of policyholders and we observed appropriate practices in most aspects of their operation.
- 1.19 Our main concerns were in the areas of governance and policyholder communications. In particular, in considering whether policyholders' interests are properly protected, we 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. We also observed significant weaknesses in what firms are doing to ensure that policyholders receive sufficiently comprehensive, timely and clear information so they can take a reasonable view of the risk and reward balance of their policies.
- 1.20 The weaknesses in governance and communications are common across a range of firms, suggesting these are sector-wide issues and are not specific to either open or closed funds. We are taking strong action against firms where such weaknesses have been identified, particularly where with-profits policyholders have been exposed to significant risks and firms are likely to breach COBS 20 or the Principles.
- 1.21 The findings are particularly disappointing in light of our previous communications to the sector. During 2007 we highlighted to the with-profits sector that firms were not doing enough to provide independent input into the management of with-profits funds. We issued a 'Dear CEO' letter that asked senior management of insurers running with-profits funds to review our findings and take prompt action to address any shortcomings.³ During 2007 we also reported on the quality of post-sale communications on life products (including insurers), after finding a significant proportion of communications that we reviewed failed to comply with Principles 6 or 7.⁴
- 1.22 Since 2007 we have continued to raise concerns on the with-profits sector as part of our work in implementing our Treating Customer Fairly framework.⁵

The reattribution process

- 1.23 This report also includes our findings from an initial 'lessons learned' exercise on the approach to reattributions, following the recently completed reattribution undertaken by Aviva.

3 Insurance Sector briefing number 12 at http://www.fsa.gov.uk/pubs/newsletters/li_newsletter12.pdf. Dear CEO letter http://www.fsa.gov.uk/pubs/ceo/with_profits.pdf

4 Insurance Sector briefing number 11 http://www.fsa.gov.uk/pubs/newsletters/li_newsletter11.pdf.

5 For example, speech by Sarah Wilson, Director, FSA, at the ABI seminar for Non-Executive Directors of insurance companies, 5 February 2009. http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0205_sw.shtml

- 1.24 We identified several areas where improvements to the process and overall approach to reattributions could be made. In particular:
- a We were concerned at the length of time the Aviva reattribution took, as this unduly prolonged uncertainty for policyholders and made effective financial planning more difficult. It also generated increased attendant costs on the firm;
 - b The more preparation that can be done to reduce the areas of ambiguity before a reattribution proposal is publicly announced the shorter the period of uncertainty for policyholders. As part of adequate preparation firms must be able to clearly present all key assumptions underlying the reattribution so all parties can understand the basis on which any proposal is being made;
 - c A governance structure designed to deal with daily with-profits issues will not necessarily be appropriate for a reattribution as it is such a significant event requiring several interested parties to be integrated into the process. It may therefore be necessary for the firm to enhance its existing governance process to ensure that with-profits policyholders are properly represented during the reattribution process; and
 - d The policyholder advocate provided an independent voice in the Aviva reattribution process and should be able to communicate with policyholders on an open, clear, independent and timely basis which should be facilitated by the firm as necessary.
- 1.25 We will conduct more detailed analysis of any policy response or other specific changes to the process that may be required in the areas highlighted above.

Next steps

- 1.26 The review has enabled us to determine how senior management in firms have implemented the with-profits regime, on both an individual firm basis and across the with-profits sector. We are focusing supervisory attention on identified areas of concern to deliver appropriate and comprehensive mitigation of risks to policyholders across the sector.
- 1.27 Consistent with our intensive supervisory approach and our consumer strategy, we are intervening now and taking strong action with firms at risk of breaching our requirements to avoid the weaknesses we have identified having the opportunity to develop and cause detriment to policyholders. In practice, this means we require firms to take quick and, in many cases, immediate action. We will be closely monitoring their responses.
- 1.28 We are undertaking enforcement investigations with firms where risks to policyholders are particularly acute and firms have failed to meet COBS 20 and principles requirements. Whether we will consider further enforcement action is dependent on the outcome of actions taken by other firms to mitigate risks either identified in this assessment or in ongoing supervision.
- 1.29 We have also considered whether any part of the with-profits regulatory regime should be subject to further policy review. The firm assessments, along with concerns

raised by stakeholders, both industry and consumer focused, and our experience from ongoing supervision of firms, have provided detailed insights into how effectively COBS 20 operates as a framework to deliver the intended outcomes.

- 1.30 We have concluded that there is a case for reviewing COBS 20 and are carrying out a detailed analysis of how COBS 20 deals with several specific areas, namely: governance, post sale consumer communications, payouts, charges to with-profits funds, new business, and closed fund specifics of with-profits funds.
- 1.31 The actions we are taking with firms now address where firms are failing or at risk of failing to comply with our rules. An important element of the ongoing policy review will be to address topics where we consider that compliance with minimum standards prescribed in specific rules may not be sufficient to ensure that policyholders are treated fairly. As set out in chapters 3 and 4 of this report, there are aspects of governance and post sale communications which indicate that our aims are not being achieved.
- 1.32 Policy analysis will also review whether the desired policy outcomes in each area remain appropriate and whether change is required, taking into account our supervisory experience over the five years since implementation of the current rules and changes in market characteristics.
- 1.33 All firms operating with-profits funds should review the findings presented in this report to ensure that they meet our current requirements to operate funds fairly and transparently.
- 1.34 The conclusions of our policy review and any proposed changes will be published in a consultation paper before the end of 2010 and, for any policy proposals which might be directly affected by Solvency II considerations, in 2011.

Structure of this report

- 1.35 This report contains seven chapters, including this Overview.
 - Chapter 2: Our approach
 - Chapter 3: Governance
 - Chapter 4: Consumer communications
 - Chapter 5: With-profits fund operations – payouts, charges and new business
 - Chapter 6: Closed funds specifics
 - Chapter 7: The reattribution process
- 1.36 Chapters 3 to 6 provide the results of our assessments on a topic by topic basis. Each chapter explains our expectations and requirements, an overview of concerns raised by stakeholders and our findings from our assessments and wider analysis. The chapters also explain our intended next steps, including actions we are requiring firms to take and further policy analysis. Chapter 7 provides an overview of the initial findings of a separate analysis of the specific reattribution process.

2 Our approach

How we conducted the review

- 2.1 To ensure the sample was comprehensive, we assessed 17 firms which represented approximately 80% of the with-profits market on the basis of with-profits assets held at the end of 2009.
- 2.2 This sample represented a broad cross-section of the with-profits market, and included a mixture of large, medium and small firms of mutual, friendly society and proprietary status. It also provided coverage of both open and closed funds.
- 2.3 We assessed the firms in our sample against our requirements in COBS 20 and relevant principles having regard to the intended outcomes. We conducted in-depth visits to firms to interview their management and other individuals who are key to operating with-profits funds. We also reviewed relevant documentation to assess how firms are in practice operating their with-profits funds.
- 2.4 In addition to firm assessments we have also considered views of stakeholders, trade bodies, the TSC and experience from our ongoing supervision of firms.
- 2.5 We did not include in the review any assessment of the rules and guidance relating specifically to the reattribution process. We conducted a separate, initial lessons learned exercise on the Aviva and Prudential reattributions.

Scope of the with-profits review

- 2.6 The review focused on the operation of with-profits funds by firms. We carried out detailed assessment of governance, consumer communications, payouts (surrenders and maturities), charges, new business and closed funds specific issues.
- 2.7 This enabled us to determine how firms are meeting the requirements of our rules and therefore whether they are appropriately managing their commitments to their with-profits policyholders and are treating them fairly.
- 2.8 Providing advice to customers or the sales process did not fall within the scope of this specific review. We have addressed advice extensively in the past through our Insurance Sector Briefing in 2007 on quality of post-sale communications and

availability of ongoing advice to with-profits policyholders.⁶ Advice and the sales process continue to be scrutinised by ongoing FSA supervision and connected thematic projects and we are committed to ensuring fair treatment of customers in this area.

- 2.9 The review also considered the case for conducting an in-depth analysis of the with-profits regulatory regime itself and whether the current rules remain appropriate to deliver the intended policy outcomes, subject to firms' compliance. The analysis was informed by the firm assessments, input from stakeholders, industry and consumer focused, as well as our experience from supervision of firms.
- 2.10 However, this report does not provide conclusions as to what specific policy changes may be required. We will publish our conclusions and any proposed changes arising from further policy analysis in a consultation paper by the end of 2010 and, for any policy proposals which might be directly affected by Solvency II considerations, in 2011.
- 2.11 Charging of compensation and redress costs to the inherited estate has also been excluded from the review as this issue was consulted on and the rules changed in 2009.⁷
- 2.12 We have highlighted the views of consumer focused stakeholders in this report. However, we have also taken industry and other views into account, including those of senior management of firms operating with-profits funds gathered through the course of assessments, when considering our assessment findings. We will consult all relevant stakeholders in the consultation process for any proposed policy changes.

Improvements in the process for reattribution of inherited estates

- 2.13 In October 2008 we set out a preliminary view of the process of reattributions based on our experience of the reattribution transactions in progress at that time (Aviva and Prudential⁸). We also made a public commitment to communicate further on the reattribution process set out in COBS 20, to set out any additional lessons learned prior to conducting more detailed work on any policy response required or other specific changes to the process. Now that the Aviva reattribution transaction has concluded, we have undertaken the initial phase of this work. Chapter 7 provides a high level summary of the key areas that should be considered for improvement.

⁶ http://www.fsa.gov.uk/pubs/other/isb_quality.pdf

⁷ http://www.fsa.gov.uk/pubs/cp/cp08_11.pdf; http://www.fsa.gov.uk/pubs/policy/ps09_13.pdf

⁸ Only the Aviva reattribution was followed through to conclusion, the proposed Prudential reattribution was not concluded.

3 Governance

- 3.1 In this chapter we set out our findings on the governance of with-profits funds and the direction of our future work in this area.

Our requirements

- 3.2 Our desired policy outcome for governance is that firms' with-profits governance ensures policyholders' interests are properly protected and taken into account in any actions or decisions taken by the firm.
- 3.3 Firms' governance arrangements must meet the requirements in the FSA's Principles for Business. Principle 6, Treating Customers Fairly, is particularly relevant, but also Principle 3, Effective Management and Control, and Principle 8, Managing Conflicts of Interest.
- 3.4 In particular, under Principle 8 firms must be able to identify and manage competing or conflicting rights and interests between different groups of with-profits policyholders and, where applicable, between non-profit policyholders such as unit-linked policyholders and annuitants and with-profits policyholders and also between with-profits policyholders and firms' shareholders or management. We note that for mutual firms, although shareholder conflicts do not arise, conflicts of interest can arise between the interests of the managers of the business and the policyholders and members, and also between different sets of policyholders.
- 3.5 Additionally, COBS 20.3 provides guidance on what governance arrangements firms should put in place to comply with our rules on systems and controls.⁹
- 3.6 With-profits firms with non-directive friendly society status are not subject to the governance requirements in COBS 20.3, Principles and Practices of Financial Management. These firms must, however, adhere to our Principles, particularly Principle 3, to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems, Principle 6, pay due regard to the interests of its customers and treat them fairly, and Principle 8, manage conflicts of interest fairly, both between itself and its customers and between customers.

⁹ SYSC 3.2.6 R or SYSC 6.1.1 R

- 3.7 Following a thematic review of industry with-profits governance arrangements in 2007, we provided feedback on our governance requirements in a letter of September 2007 to the CEOs of insurers that provide with-profits funds.¹⁰
- 3.8 With-profits committees or alternative equivalent arrangements, along with the with-profits actuary function, are important features of firms' with-profits governance. Our latest work has focused on how the with-profits committees or alternative arrangements for independent review are operating, including their relationship with the firm's governing body and how effectively they are fulfilling their role of providing independent challenge to firms' management. We have also reviewed the role and influence of the with-profits actuary.

Views of consumer stakeholder

- 3.9 There was a strong view from the consumer stakeholders we spoke to that the governance arrangements of with-profits funds did not sufficiently consider existing policyholders' interests. With-profits committees were generally viewed as a positive development, although there were concerns over how they contributed in practice to ensuring policyholders were treated fairly.
- 3.10 The concerns are summarised as:
- **With-profits committee operation:** the independence of a with-profits committee from the firm was questioned, as well as their ability and willingness to challenge the Boards or other governing bodies of the firms they served. Consumer stakeholders viewed the process used to appoint with-profits committee members as being opaque, with some believing that with-profits committee reporting lines should be to the policyholders, not to the Board and shareholders; and
 - **Engagement with policyholders:** there was a perceived lack of transparency in how firms and with-profits committees reached decisions, along with inadequate communication by with-profits committees to policyholders.
- 3.11 Consumer stakeholders believed that with-profits committees needed to play a more prominent role than they currently do, and thought governance arrangements for with-profits funds needed bolstering with regards to independent challenge, approach, and responsibility for providing information to policyholders.

Findings in relation to with-profits committees

- 3.12 The following describes our findings in relation to with-profits firms' compliance with our governance requirements.
- 3.13 Thirteen of the seventeen firms assessed had established with-profits committees, with three of the exceptions choosing instead to use an individual from outside the firm (usually a qualified actuary) to provide independent judgement and challenge. One firm used another committee as a proxy with-profits committee, and we challenged the firm on whether this was as effective in focusing on policyholders' interests as a with-profits committee should be.

10 http://www.fsa.gov.uk/pubs/ceo/with_profits.pdf

- 3.14 Our findings are a significant change from our 2007 survey which found that almost half of firms sampled did not use a with-profits committee, instead typically relying on an external actuary to provide independent review.
- 3.15 We examined how with-profits committees operated in terms of substance and not just process. We sought evidence from firms to demonstrate how issues were considered and outcomes achieved.
- 3.16 Most with-profits committees had a remit to consider issues wider than compliance with the principles and practices of financial management document (PPFM). With-profits committee members usually recognised that they had a responsibility to consider whether policyholders were being treated fairly and provide independent challenge to the firm in the assessment of how any conflicts of interest between groups of policyholders and, if applicable, shareholders have been addressed.
- 3.17 In addition, most firms could demonstrate that their Boards were engaging adequately with their with-profits committee, including being able to describe changes made by the Board as a result of challenge from the committee. Most with-profits committee members also had suitable skills and experience to provide appropriate challenge.
- 3.18 However, some firms were unable to demonstrate that their Boards were engaging adequately with their with-profits committee and consequently, that policyholders' interests were being properly protected and taken into account in actions and decisions taken by the firm. This is particularly disappointing in light of our previous communications to the sector on governance requirements, and in several cases the weaknesses in these firms' with-profits governance practices exposed policyholders to unacceptable levels of risk.
- 3.19 In some cases it was not evident that the with-profits committees in these firms were sufficiently aware of and involved in key operational issues at appropriate times, such as setting bonus rates, apportioning charges and expenses, determining asset shares or in major transactions.
- 3.20 In a few cases, when with-profits committees raised concerns on the grounds of fair treatment of policyholders, it was not always evident that these concerns were taken into account by the firm and consequential changes made to recommendations, or that there were clearly documented and reasonable justifications for the firm not changing its recommendations.
- 3.21 Some with-profits committee members held positions on the firm's Board or, in the case of executives, had other roles within the firm. In one firm, all members of the with-profits committee also sat on the Board, and it was difficult to see how the entities were in fact operating separately or as an effective challenge function. We viewed this particular arrangement as inadequate for with-profits governance purposes, as it effectively required members to provide independent judgement and challenge to themselves. That case was an exception, although there were examples of other firms relying heavily on individuals who had other roles in the firm (including those who sat on the Board) in addition to being members of the with-profits committee to recognise and effectively manage the different and potentially conflicting, responsibilities of these roles.

- 3.22 We regard the role of the with-profits committee Chair as pivotal in ensuring with-profits committee delivers necessary independent challenge. We observed one Chair who was otherwise completely unconnected to the firm, and this appeared to help enable them to provide a strong positive challenge function.
- 3.23 While we acknowledge the view that having members of the with-profits committee with corporate history of the firm and its with-profits fund can improve the understanding of the committee, such connections with the firm can reduce the level of independent input provided by the committee, and increase the inherent risk of conflicts of interest within the governance process. We believe the benefit of corporate history can be achieved in ways other than having the majority of with-profits committee members connected to the firm.
- 3.24 Most firms had support administration mechanisms in place to enable the with-profits committee, or equivalent arrangements, to operate satisfactorily. In the few firms where we found inadequate support for with-profits committees, this tended to be symptomatic of more fundamental governance concerns.
- 3.25 We observed that most with-profits committees were reactive to their firms' proposals, rather than seeking to influence the with-profits agenda proactively or considering information other than that provided by the firm. While there is no specific requirement for committees to be proactive, this observation is a useful indicator of how comprehensively the role of independent challenge was being performed. There was, for example, little use made of firms' management information. We found few with-profits committees which routinely monitored the level or nature of complaints in relation to with-profits products. On this particular point, we believe that complaints data can be a meaningful reference point for with-profits committees and we expected to see more use of it.

Findings in relation to with-profits actuaries

- 3.26 The role of with-profits actuary was introduced in 2004.¹¹ The changes in 2004 created the two roles of actuarial function holder and with-profits actuaries, where previously there was one role. The purpose of separating the with-profits actuary role from the actuarial function holder role was to enable the with-profits actuary role to focus on with-profits policyholder interests. This was intended to enhance consumer protection and confidence in relation to with-profits funds, and also to deal with both real and perceived conflicts of interest between the interests of shareholders and management, and different groups of policyholders.
- 3.27 All firms that were reviewed were found to have a with-profits actuary with relevant experience of handling with-profits issues at an appropriate level and suitably qualified to advise on the use of the firm's discretion as it relates to the fair treatment of with-profits policyholders.
- 3.28 In addition we expected the firm to have in place a structure to support the actuary in their role.

11 As part of the changes which followed FSA Consultation Paper 167 in 2003.

- 3.29 The vast majority of with-profits actuaries were internal appointments, following an internal assessment of candidates, with little or no involvement of an independent person in the selection process. As a result, those appointed to the with-profits actuary role were already ensconced in the firm's culture and hierarchy.
- 3.30 There was little recognition that, as part of the role's responsibility, the with-profits actuary was often supposed to be prepared to challenge those in the firm who later charged with rating the actuary's performance. Specifically, ongoing suitability of with-profits actuaries was usually assessed by individual executive directors or by the Board. In several cases the with-profits actuary reported directly to the firm's own actuarial function holder, which we see as a potential conflict of interest and we are challenging firms accordingly. Ongoing suitability assessments for the actuary rarely included input from the with-profits committee, despite the committee relying on the actuary for information and advice to perform its role, and potentially being able to provide an additional balanced view.
- 3.31 A few firms provided the with-profits actuary with a budget enabling independent actuarial input to be sought at the with-profits actuary's discretion. We regarded access to independent support as helpful in what could otherwise be an isolated role. In other respects, with-profits actuaries had access to suitable resources, including actuarial and legal support, as well access to systems and to other relevant staff.
- 3.32 It is evident from the findings described above that firms tend to rely heavily on the personality and professional standing of the with-profits actuary to overcome the potential conflicts of interest and of responsibilities created by the firm's management structure. We had expected to see firms doing more to ensure that the role of the with-profits actuary was supported by the management structure, rather than leaving individual actuaries to mitigate the risks created by the structure.
- 3.33 In some cases with-profits actuaries were unable to provide sufficient evidence of input on material issues and that appropriate challenge was being made. One reason given by several firms for the lack of evidence was that the with-profits actuary was usually directly involved in the development of major with-profits proposals, rather than independently reviewing a proposal developed by others. Where this was the case, we still expected to see a record of the with-profits actuary's views contributing to the development of the proposals, making it clear that these views were provided from the perspective of their with-profits actuary role.

Actions

For firms

- 3.34 We are taking actions with individual firms to address the issues identified in the findings section above:
- Where we found weak adherence to our governance requirements firms are expected to effect the identified actions quickly, reflecting a need to implement the changes to prevent these weaknesses developing into unacceptable risks for policyholders.

- Where we have found firms have not satisfactorily demonstrated compliance with our governance requirements and unacceptable risk exists for policyholders now, firms are being required to address our specific concerns immediately.
- 3.35 Additionally, some firms are subject to enforcement investigation. We will consider the need for further enforcement action dependent on the actions firms take in relation to issues identified in this assessment and ongoing supervision.
- 3.36 We expect all firms operating with-profits funds to review our findings in this report, and satisfy themselves that their with-profits governance arrangements meet our requirements, specifically Principles 6 and 7.

Policy review

- 3.37 In light of the findings described above and discussions with stakeholders, we believe a review of specific aspects of the existing COBS 20 rules on governance is appropriate. The actions we are taking with firms now address where firms are failing or at risk of failing to comply with our requirements. An important element of the ongoing policy review will be to address topics where we consider that compliance with minimum standards prescribed in specific rules may not be sufficient to ensure that policyholders are treated fairly, despite significant communication of guidance and expectations.
- 3.38 We are considering in more detail how the rules relating to governance should be strengthened to improve further the fair treatment of with-profits policyholders and the transparency of decision-making. This will include considering whether our rules should be more specific in the roles and responsibilities of with-profits governance structures and those individuals involved.
- 3.39 Our initial view is that achieving our objectives in the area of governance requires a focus both on the structures and the skills and competencies of those employed within the structures. We will consider new proposals to mandate the existence of with-profits committees more widely and bolster their role and responsibilities in providing independent judgement on with-profits matters and reporting to policyholders on issues affecting their interests, including the management of conflicts of interest.
- 3.40 In doing so we need to be mindful that the overall governing body of a firm is ultimately responsible for that firm's decisions, including the responsibility to ensure that all customers, including with-profits policyholders, are treated fairly.
- 3.41 The review findings confirm that with-profits actuaries fulfil an important role in supporting the with-profits committee in its duty as an independent assessor. We intend to consider whether our rules and guidance should give the with-profits actuary role greater prominence and be more clearly distinct from other roles in the firm. One of the areas we will consider in more depth is the management structure (including the reporting lines) supporting the with-profits actuary in light of our expectation that the role should provide effective challenge and influence at the highest levels of the firm.

4 Consumer communications

- 4.1 In this chapter we set out our findings from our assessment of post sale customer communications and the direction of our future work in this area.

Our requirements

- 4.2 Firms were assessed against the requirements of COBS 20.4 and the relevant Principles, in particular Principle 7, communication with customers and also Principle 6, treating customers fairly. This review focused on post sale customer communication by with-profits firms and did not consider communications specific to the advice or sales process connected to with-profits products.
- 4.3 In accordance with COBS 20.4 and Principles 6 and 7, firms are required to produce appropriate and timely information. This should include:
- consumer friendly principles and practices of financial management (CFPPFM);
 - annual report and, where applicable, unitised with-profits annual statements; and
 - time specific information including; conventional with-profits bonus notices, surrender or transfer notices, and pre-maturity information.
- 4.4 The expected outcome from firms' compliance with the above requirements is that policyholders receive sufficiently comprehensive, timely and clear information from firms to enable them to take a reasonable view of the risk and reward balance of their with-profits policies.
- 4.5 With-profits firms with non-directive friendly society status are not subject to the policyholder communication requirements in COBS 20.4. These firms must, however, pay due regard to the information needs of their policyholders, and communicate information to them in a way which is clear, fair and not misleading (Principle 7). They should also provide policyholders with clear information and keep them appropriately informed after the point of sale (Outcome 3 of Principle 6).

Views of consumer stakeholders

- 4.6 Stakeholders were generally critical of the value and performance of customer communications. Greater transparency was thought to be important and more relevant information should be released in addition to the CFPPFM. It was thought that the document was hard for a non-expert to follow and neither it or the principles and practices of financial management (PPFM) it is based on provided enough detail to understand how a fund was being run and the costs being charged to it. Another view was that the CFPPFM should also allow reasonable cross comparison with other with-profits funds.
- 4.7 One common suggestion was for with-profits committees to have responsibility for key customer communications and to require firms to release more information about the performance of the fund and the costs and charges ascribed to it in a standardised format. It was thought that more transparency should be built into the product and the firm's communications throughout the whole product cycle.
- 4.8 There was also a strong view, held by not just consumer stakeholders but also parts of the industry itself and trade bodies, that the CFPPFM does not provide sufficient value to policyholders in its current form.

Overall findings

- 4.9 We reviewed a variety of post-sales communications including samples of CFPPFMs, annual reports and event-driven communications such as surrender and transfer statements, pre-maturity information, conventional with-profits bonus notices and unitised annual statements.
- 4.10 We were particularly interested in how senior management have responded to our work on the quality of with-profits post-sale communications in May 2007. The earlier work found that, in too many instances, material fell short of our requirements of being 'clear, fair and not misleading'.¹²
- 4.11 Overall, we are not confident that the with-profits sector as a whole is delivering information of sufficient quality to policyholders. This is a concern found across the with-profits sector and not specific to any type or structure of firm, or whether they have closed or open funds.
- 4.12 Specifically, we are not satisfied that the quality of communications across the sector meets Principle 7 requirements especially in view of the Treating Customers Fairly (TCF) outcomes communicated to firms in 2007,¹³ namely:
- Post-sale information should be clear enough so that customers or their advisers can understand how their investment is performing and judge if the policy still meets their requirements. It should also remind customers of the key benefits of that policy, particularly if they are about to take actions which would result in them losing these benefits.

12 FSA Insurance Sector Briefing 2007, http://www.fsa.gov.uk/pubs/other/isb_quality.pdf

13 TCF Outcome 3 and TCF Outcome 5, as communicated in FSA Insurance Sector Briefing 2007, http://www.fsa.gov.uk/pubs/other/isb_quality.pdf

- Where the investment mix of the underlying fund has changed since the customer bought the policy, it is likely that it will perform differently to what they were led to expect. In these circumstances, the insurer should make the customer aware of what this might mean to them so that they can, if needed, review their financial planning.
- 4.13 There were some examples where firms had improved their communications in light of our 2007 messages and the work by the Association of British Insurers in this area. One firm in the sample had sought feedback on its literature from policyholders, as suggested by us in 2007, and the improved quality showed the benefit in doing so.
- 4.14 More detail on these issues is provided below.

Findings in relation to governance of literature production

- 4.15 Different areas within firms, including actuarial, legal and marketing/communications teams were often involved in producing with-profits literature. It was often difficult to establish which area in the firm ultimately owned the literature, with little indication at senior management level that policyholder literature was an area of high priority.
- 4.16 With-profits committees did not appear to have a significant monitoring role in the literature being provided, with less than half of the committees reviewing literature or the being involved in literature development. This finding, in combination with little evidence of with-profits committees regularly considering complaints data or other management information, makes it difficult to envisage how committees are reviewing how the firm's actions are being presented to, or are perceived by, policyholders.

Findings in relation to consumer friendly PPFMs and annual reports

- 4.17 In the majority of firms' CFPPFM assessed, we found that the wording and underlying content of the documents made it difficult to understand in any useful depth how a firm's with-profits fund is being operated or the risk and reward balance of the fund.
- 4.18 Some firms had weak explanations on basic elements of with-profits such as how smoothing works and were lacking a clear warning that yearly bonuses are not automatic so that when markets are falling there is a risk that there is no annual bonus declared for a sustained period of time.
- 4.19 In addition to the core findings above, specific areas we identified as being commonly weak across the CFPPFM samples were:
- while there were references to the prospect of expenses and charges being made, information was generic and detail limited on the nature of these and how they were apportioned.
 - there was minimal disclosure of whether the firm used the fund to make strategic investments or invest in assets held and used by the wider business and not specific to the with-profits funds.

- a significant number of firms had weak explanations on the overall discretion the firm had in how the fund was operated, and how the discretion was used.
- 4.20 Annual reports tended to be of better quality, with most adhering to the requirements in COBS 20.4.7 R and associated guidance. While changes to the asset mix were generally disclosed in the annual report, the consequences of the changes were in some instances not clearly explained. Just over half of the reports assessed did not clearly describe the investment risks to the fund and how they were being mitigated. In our interviews with firms' management, some firms viewed the risks to the fund as unchanged from those described in the CFPPFM and therefore did not reiterate these risks in the report. While this may be a reasonable position, it needs to be sign-posted in the annual report, otherwise silence in the annual report on this important point could lead to uncertainty and unnecessary confusion.

Findings in relation to event-driven communications

- 4.21 A range of time specific communications to policyholders were reviewed. These included unitised with-profits annual statements, conventional with-profits bonus notices, and pre-maturity information.
- 4.22 Concerns were identified in a significant minority of firms. For reasons previously explained in our 2007 work, we regard providing clear and comprehensive surrender related information as being crucial for policyholders, as it could result in policyholders taking action which would result in them losing valuable benefits.¹⁴ Given our extensive communications on this subject in the past we are very concerned with continuing weaknesses in this topic. The key findings are highlighted below.
- 4.23 Pre-maturity information was generally of reasonable quality. With a few exceptions, statements contained clear information on when the policy is due to end and the possible value at the end of the policy and, if applicable, that the value may change before it is paid. Where applicable, there were adequately clear explanations that taking benefits before or after the selected end date may incur a market value reduction. Directions on what the policyholder had to do to get their money were provided and were generally clear.
- 4.24 The quality in other documents was mixed, with significant number being less than satisfactory and a few being inadequate. For unitised with-profits business surrender and transfer notices, a significant number of firms did not always provide clear explanations of the dates on which a market value reduction may not apply where such policy conditions apply. It was also not always clear what the effect of any deductions and/or charges would be if the policy was surrendered. In some examples, policyholders were referred to other documents for an explanation of possible deductions, which can be unwieldy for policyholders to manage, especially if the linked documents were provided at different time intervals.
- 4.25 A significant number of firms did not clearly explain that there would be any loss of guarantees, options or other benefits, (for example, life cover) if the policy was surrendered. While most documents made it clear that the surrender value may

14 As previously explained in our 2007 communications to with-profits firms
http://www.fsa.gov.uk/pubs/other/isb_quality.pdf

change before it was paid, some firms either were unable to state if there was a period during which the stated value would be held, or were unclear in explaining what this period was.

Actions

For firms

- 4.26 We recognize the inherent complexity of with-profits products and their operation but are disappointed with our findings in this assessment, particularly in light of previous in-depth communications to with-profits providers on this topic. In order to meet our clear, fair and not misleading requirements firms operating in the with-profits sector have to explain in consumer-friendly language how they are operating their with-profits funds, and provide timely and appropriate event-driven information to their policyholders.
- 4.27 While we do not currently have specific requirements on how firms' management should oversee their communications, we believe that our findings on the governance of literature production are likely to be a contributing factor to the poor quality of some firms' communications to policyholders. We expected to see a clear ownership and oversight structure for policyholder communications with more care being taken by with-profits firms in their communications, promoting greater consistency and better quality.
- 4.28 We require those firms in our sample to take immediate and appropriate actions in order to mitigate risk to policyholders generated by a failure to meet, or only a weak adherence to, our requirement to provide clear, fair and not misleading information to policyholders. In some cases this requires firms undertake a full and comprehensive review of all with-profits communications.
- 4.29 We will be closely monitoring firms' progress on the actions we require them to take. We will consider the need for enforcement action dependent on the actions firms' take now in relation to issues identified in this assessment and in our ongoing supervision.
- 4.30 All with-profits firms should ensure that with-profits communications meet our requirements, as described in this chapter.

Policy review

- 4.31 There is sufficient information to suggest that policy change may be required to ensure the desired consumer communications outcome is achieved across the with-profits sector.
- 4.32 As such we are considering whether further changes to our consumer disclosure requirements, including CFPPFMs, are merited in order to raise standards.
- 4.33 Given the complexity and challenges presented by this topic we will give further consideration to a range of options including:
- further improvements/specifications to the content of the CFPPFM;

- possibly removing the requirement to produce CFPPFMs altogether and instead placing greater emphasis on providing other relevant information at point of sale backed up by annual reporting to policyholders on any major changes to the fund and on compliance with the PPFM; and
- consumer testing of policy documents and post-sale communications.

4.34 We will also look again at the requirements for annual statements and annual reports and consider what measures may be appropriate to ensure and strengthen the quality of reporting to policyholders.

5 With-profits fund operations

- 5.1 This chapter includes our findings on how firms are operating in relation to surrender and maturity pay-outs to policyholders and charges made to the with-profits funds. It also covers how new business is being funded, as well as strategic investments. We then set out our intentions for further work in this area.

Our requirements

- 5.2 Firms have considerable discretion over how they operate their with-profits funds, and they are required to apply this discretion in a way that results in a fair outcome for policyholders.
- 5.3 Firms were assessed against the rules and guidance contained in COBS 20.2 and the principles, particularly Principles 6 (treating customers fairly) and Principle 8 (managing conflicts of interest).
- 5.4 The desired outcomes for policyholders from firms complying with our requirements in this area are:
- policyholders receive fair pay-outs and firms apply policy conditions such as market-value-reductions fairly and proportionately to ensure all classes of policyholders are treated fairly;
 - investments are appropriate to the with-profits fund and do not prevent policyholders from receiving fair pay-outs or bonus distributions;
 - policyholders only bear costs that are incurred in the running of the with-profits fund. Any overheads incurred by the firm charged to the fund are proportionate to its size and impact within the firm; and
 - new business is written on terms that, at a minimum, are unlikely to make existing with-profits policyholders materially worse off.

Views of consumer stakeholders

- 5.5 A key concern raised by consumer focused stakeholders was that the current operation of with-profits funds results in an unfair balance, which is in favour of the firm's

interests (including shareholders where applicable) rather than with-profits policyholders. In many cases, concern centred on the use of any estate of the fund by the firm.

- 5.6 Most concerns raised by consumer focused stakeholders originate from the view that process and information available on how with-profits funds are being operated in respect of pay-outs, charges and new business remains opaque and cannot be understood by policyholders, commentators or advisers.
- 5.7 In particular, consumer stakeholders regard it as being difficult for policyholders to judge if the pay-outs they receive are fair, pointing to the existence of previously large, inherited estates as being evidence, in their view that past with-profits policyholders have been underpaid compared with asset share.
- 5.8 A perceived lack of disclosure is also contributing to stakeholders' concerns over how firms are using with-profits funds to make strategic investments or invest in assets that are of benefit to the wider business. The potential concern is that using the fund to invest in head office buildings, subsidiary businesses or large stakes in other businesses connected to the firm, which may not obviously benefit with-profits policyholders, may impede firms' ability to provide a fair value in pay-outs or in any bonus or special distribution.
- 5.9 Some stakeholders expressed strong concerns around firms' approach to funding new business from with-profits funds. They thought that using the fund to write new business should only be permitted if it was of material benefit to the fund and current policyholders. Related to this concern, is the view that firms have an incentive to project high levels of new business but achieve only low levels of new business, leading to the risk of cost overruns falling on the fund. There is also a concern that firms continue to write new business against the interests of existing with-profits policyholders in order to avoid formal fund closure.
- 5.10 What constitutes fair treatment of policyholders in with-profits funds in relation to charges has been the subject of strong debate from consumer stakeholders and firms. Some stakeholders have called for greater clarity on expenses and charges. There is also a particular concern that our rules allow (in some circumstances) for tax applicable to shareholders in relation to any distributions, to be charged to proprietary firms' with-profits funds.

Findings and actions

Payouts – surrenders and maturities

Background – policy intentions

- 5.11 During our reforms earlier this decade, we identified that the most frequently voiced concerns about the fair treatment of with-profits policyholders relate to the determination of amounts payable under these policies on maturity or surrender. To address these concerns, we introduced rules and guidance on:
 - target ranges for payouts and smoothing (including the definition of asset share for these purposes);

- the distribution of surplus; and
 - surrender values (including market value reductions).
- 5.12 The purpose of the target ranges, which are specified in the relevant PPFM and therefore publicly available, is to minimise the risk that firms might underpay, or overpay, in the shorter or longer term, leading either to excess inherited estates which may deny fair payouts to policyholders or other threats to the future interests of policyholders.
- 5.13 Firms must manage their with-profits business to achieve the targets they have set. However, this is expressed in terms of an objective rather than an obligation. We did not want our rules to force a firm to make a payout when it was imprudent to do so (for example, by over distributing to the extent that the fund is unduly weakened) and therefore contrary to the interests of policyholders. This means that, by definition, firms have a considerable degree of discretion.
- 5.14 Additionally, as a means of balancing the interests of surrendering with-profits policyholders and remaining policyholders, we have introduced rules to regulate the application of market value reductions (MVR) to ensure that their use is appropriate to the conditions. MVRs are policy conditions that allow firms to reduce the face value of unitised with-profits policies where the value of the underlying assets are, or are expected to be, significantly less than the assumed face value of the policy. Alternatively, there is, or is expected to be, a high volume of surrenders relative to the liquidity of the with-profits fund. Any reduction must be no greater than the amount needed to reflect the impact of either scenario.

Findings

- 5.15 As firms have a significant amount of discretion in this area, and our assessments focused on how firms were exercising their discretion.
- 5.16 We were generally satisfied with firms' approach to applying market value reductions when policyholders choose to surrender their policies. Firms were found to have appropriate procedures for considering when and how to apply, and withdraw a MVR and how the impact on policyholders should be assessed. Firms were also able to demonstrate that the amount of market value reduction applied is no greater than the amount required to reflect the fall in asset values backing policies, or to reflect a high volume of surrenders relative to the liquidity of the fund. This finding is applicable to both open and closed funds.
- 5.17 Most firms were able to demonstrate adequate controls in the area of setting target ranges for pay-outs and monitoring whether 90% of these fell within those ranges, and taking appropriate action regarding outlying policies as necessary. However, very wide target ranges were a common feature, with almost all firms setting target ranges of more than 30%, the majority setting ranges of more than 40%, and some setting ranges of 70% for both surrenders and maturities. Our current rules allow flexibility and discretion for firms to set target ranges to match the make up of the underlying funds, investments held and smoothing approach. However wider ranges also increase the risk that payouts at extreme ends of the range, or indeed outside of it, are unfair to either exiting policyholders or to those remaining in the fund.

- 5.18 A significant minority of firms were unable to demonstrate sufficiently that their with-profits business is being managed in such a way as to be confident to achieve the targets they set. These firms had often set very wide target pay-out ranges for both surrenders and maturities, and the reasons for setting the target ranges at those levels for surrenders and/or payouts were not always clearly documented and justified.
- 5.19 Some firms were found to be weak in monitoring the neutrality of smoothing, and a few firms had difficulty in demonstrating their strategy for smoothing to be neutral over the economic cycle. This, along with the overall smoothing strategy, is fundamental to the fair operation of with-profits funds.
- 5.20 Some firms had less than 90% of non-contractual surrender payouts falling inside their target ranges, and the resulting risk to policyholders was exacerbated by a significant number of firms having wide target ranges. Some of these firms felt that the basis and assumptions of their target ranges in relation to their smoothing approach had been severely tested by the market conditions of the last few years. While we acknowledge the increased volatility of underlying asset prices in the last two years, firms are required to have systems and controls in place that enable them to react quickly to external pressures. In some cases, firms' systems and controls did not result in them taking quick and effective decisions in response to market events.

Actions

- 5.21 We are requiring firms to take specific actions where we think there needs to be better focus in how target ranges and their smoothing strategies and processes are being managed and operated. In particular, we will be monitoring closely those firms who have a mix of weaknesses described above, especially where firms had difficulty demonstrating their smoothing strategy.
- 5.22 When the rules and guidance related to target ranges were put in place in 2005, we anticipated that in the short-term, firms would leave themselves a reasonable degree of flexibility to avoid having to manage the levels of payout from day to day and because of short term market volatility. However, over the longer term we expect average payouts to be within a much narrower range. Firms should be able to clearly justify why particularly wide target ranges generate appropriate and fair outcomes to all with-profits policyholders in all reasonable scenarios.
- 5.23 If firms are not using target ranges there must be very clear justification and evidence why maturity payments cannot reasonably be compared with a calculated asset share and alternative methodologies should ensure that all policyholders receive fair payouts on their policies.
- 5.24 Our current rules intend to allow firms a degree of flexibility in order to avoid having to manage the pay-out levels on a daily basis, which would be contrary to the smoothed nature of the returns expected from with-profits business, and to take account of market volatility. However, as we found that payments by some firms are falling outside the target ranges that firms themselves have set, even where the target ranges are wide, we are considering strengthening our rules to ensure firms manage payouts in a way that leads to fair outcomes for all policyholders. This could be done by giving the with-profits committee or with-profits actuary more explicit duties for

monitoring and reporting adherence to target ranges and the neutrality of smoothing in addition to the ongoing suitability of the target ranges themselves.

- 5.25 With regard to amounts paid to with-profits policyholders, we will also consider in more detail the rules and definitions relating to identification and distribution of excess surplus, within the confines of ongoing changes in relation to both Solvency II and potential changes to the structure of the taxation of insurance companies which are currently being consulted on by Revenue & Customs.¹⁵

Charges

Background – policy intentions

- 5.26 A source of potential unfairness that was identified as part of the 2005 reforms was if firms charge costs to the with-profits fund that are not directly incurred in the operation of the fund but rather are of benefit to the firm generally, or to the shareholders. We made rules to prevent this in 2005 and to ensure that policyholders only bear costs that are incurred in the running of the fund. Any overheads incurred by the firm charged to the fund need to be proportionate.
- 5.27 We recently revisited specific components of these rules in 2009 regarding compensation and redress related charges to a with-profits fund.¹⁶

Findings

- 5.28 The following describes our findings in relation firms' compliance with requirements on charges made to the with-profits fund.
- 5.29 Firms were able to demonstrate how expense apportionment was determined. Firms could also demonstrate that no more tax had been charged to the fund than would be if it were a standalone entity.
- 5.30 While we did not find evidence to suggest that the current charges are excessive or unfair across the sector, some firms had not identified clear benchmarks for costs or did not generate timely reviews for administration and asset management functions. While it may not be proportionate for firms to undertake a tender exercise so that in-house costs can be tested, it is reasonable to compare it against other equivalent firms using, for example, FSA data returns or engaging a private consultancy. We had expected to see more firms, including smaller firms, to have engaged in some form of reasonable cost comparison exercise to satisfy themselves that they were complying with these requirements.
- 5.31 There were no common patterns of weakness identified across different types of firm or open and closed funds. However, the impact of costs can become more acute as funds run off and therefore reasonable comparison or benchmarking of costs would be of increased value for closed funds.

15 Joint consultation by HM Treasury and HM Revenue & Customs: Solvency II and the taxation of insurance companies, issued in March 2010.

16 http://www.fsa.gov.uk/pages/Library/Policy/Policy/2009/09_13.shtml

- 5.32 There were also a small number of examples of outsourcing contracts with long durations, for example, 15-plus years. It is difficult to judge how these arrangements will remain appropriate over such a long period, and we had expected to see mechanisms such as contract break clauses to recognise the possibility of circumstances changing.

Actions

- 5.33 We are requiring firms to take specific actions where we think their approach to expenses could benefit from review, including expert input. This is particularly the case where the impact of costs becomes more acute, such as within closed funds. However all with-profits firms should ensure that their approach to expenses continues to meet our requirements. This may include reasonable review and comparisons to ensure with-profits policyholders are not subject to unfair charges.
- 5.34 Although our review as a whole did not find that the current charges are excessive or unfair across the sector, we believe there is scope to provide further clarity to our existing rule which allows expenses to be charged at 'cost, including a fair proportion of overheads' in order to safeguard against 'in-house' service companies over-recovering costs from the with-profits funds in the future.
- 5.35 In addition, in light of consumer-focused stakeholders concern around the fairness of shareholder tax being charged to the with-profits fund, we will also review the existing rule relating to the circumstances in which tax on shareholder distributions from a with-profits fund may be charged to the fund. However, we note that HM Revenue and Customs is reviewing the taxation of life insurance companies and we will have regard to this when considering options.
- 5.36 One issue of particular concern to stakeholders in relation to charges to the fund is that the current rules allow a relevant proportion of a firm's pension scheme deficit to be charged to a with-profits fund. This is allowable under our rules as one of the costs involved in employing the staff needed to run with-profits funds. We note that for mutually-owned firms there is no other source of funding to meet such deficits other than the with-profits fund. We did not identify any examples of disproportionate amounts of a firm's pension deficit being charged to a with-profits fund in our review.

New business and investments

Background – policy intentions

- 5.37 Policyholders' interests are clearly affected by a firm's approach to new business. We introduced a rule in 2005 that firms must not write new business unless, in the reasonable opinion of the governing body, this is on terms that are unlikely to have a material adverse effect on the interests of existing with-profits policyholders. This is designed to cover issues arising from the terms or pricing that new business is written on including the extent of coverage of costs (both marginal costs and overhead costs) or the volume of new business written.

- 5.38 Specifically, firms are prevented from writing products priced on terms that are not self-supporting (i.e. ‘loss leaders’), or selling potentially profitable products that had not been sold in sufficient volumes to cover overhead costs.
- 5.39 If too little business is written, then the total margins generated are insufficient to cover the firm’s overhead acquisition costs and the fund makes an irrecoverable loss. If the rate of new business is consistently too high, the year on year cost of financing the new business growth will run ahead of the margins arising, unless the cost is supported by capital which does not involve and disadvantage with-profits policyholders. Therefore, the emergence of any potential surplus available for distribution will be pushed back into the future to the potential detriment of current policyholders.
- 5.40 We introduced guidance that, in setting a target volume for new business, a firm should consider the effects of their target new business levels on the interests of existing policyholders.

Findings

- 5.41 Our assessments examined how firms had satisfied themselves that they were effecting new business in a way that is fair to all policyholders. Specifically, we looked at whether firms were deliberately writing products priced on terms that are not self-supporting (i.e. ‘loss leaders’), or had potentially profitable products but had not sold them in sufficient volumes to cover overhead costs. We also considered whether new business growth was harmful for existing with-profits policyholders.
- 5.42 We identified some concerns in several firms. These centred mainly on the existence of expense overruns, and these were, in some cases, linked to the existence of product lines that appeared to be unprofitable. While expenses can be both over and under recovered in any given year depending on the fund’s experience, we consider the issue becomes more serious where there appears to be a threat of systematic under recovery. We therefore sought a detailed understanding of what steps firms were taking to tackle overruns.
- 5.43 More generally a significant minority of firms, both of proprietary and mutual status, had questionable or unclear product strategy and governance resulting in a number of products which were close to or actually making a loss. Product and pricing strategy is subject to changes in underlying assumptions on the basis of actual experience at any given point in time. However our findings suggest that in many of these firms a lack of sufficient governance and or analysis of pricing and experience against assumptions would continue to result in risk to the fund through the sale of loss making products.
- 5.44 While in many of these cases firms’ new business was profitable overall, we did not accept ‘profitability in aggregate’ alone to be a sufficient argument for retaining those products that are, or are likely to be, unprofitable unless there is clear and strong justification as to why those products are required for cross-selling strategies that result in aggregate profitability.

- 5.45 As part of our discussions with firms, we asked about the levels of new business being written and firms' views on how this compared with their projected intentions. We also asked whether they had considered closing to new business, or identified any trigger points which would result in a further review of whether or not to close to new business. Most firms saw their future strategy as writing new business and, therefore, gave little consideration to the option of closing. One firm took a more rounded approach, and asked itself this question as part of its annual evaluations.
- 5.46 Almost all firms could provide evidence that the with-profits committee has recently satisfied itself that the investment strategy was appropriate for both new business being written and for the existing policyholders. Strategic investments such as intra-group or contingent loans were not found to unfairly constrain payouts at this stage although it is likely that the impact of such investments would become more acute as and when funds run off. Therefore consideration of these topics remains an important aspect of our supervision and policy response.

Actions

- 5.47 All firms should ensure that they meet our requirements, namely that in the reasonable opinion of their governing body, the writing of new business is on terms that are unlikely to have a material adverse effect on the interests of existing with-profits policyholders. Firms may need to review how they satisfy themselves that their new business strategy, operation and governance process for new business ensures fair treatment for all with-profits policyholders.
- 5.48 We are requiring immediate action by those firms in our sample with identified risk or failures in new business strategy or operation, including reviews of short, medium and long term new business strategy and withdrawal or re-pricing of loss making products where appropriate.
- 5.49 Firms should also consider whether they continue to have sufficient governance, monitoring and management information to ensure realistic assumptions are utilised in new business planning and that there is effective monitoring of experience against pricing assumptions with any appropriate action taken.
- 5.50 To ensure new business is not detrimental to the interests of existing with-profits policyholders and to prevent unacceptable risk being borne by policyholders in the future we will consider introducing requirements for firms to demonstrate the likely benefit to all policyholders of writing that new business.
- 5.51 In addition, to ensure strategic investments are not detrimental to the interests of existing with-profits policyholders we will also consider strengthening our rules and introducing requirements for firms to demonstrate clearly the benefit to existing with-profits policyholders of making and/or keeping such investments within with-profits funds.

5.52 While not identified as a key issue from firm assessments, given the current, long term decline of with-profits sales in total across the sector, we believe there is also a sufficient case to consider whether COBS 20 requirements for funds that are closed or that are substantially closed should be amended to move away from the current polarised position of being either formally closed or open. Instead we will consider whether to require firms to ensure distributions to with-profits policyholders reflect the actual circumstances of the fund, primarily that it is appropriate to the level of new business a firm realistically expects to write in the medium term. This could include requiring firms to create contingency run-off plans for all with-profits funds, with the focus on declining funds, for example, those where maturities and surrenders exceed the amount of new business.

6 Closed fund specifics

- 6.1 In this chapter we set out our views on issues specific to closed funds and our future intentions.
- 6.2 The assessment of specific closed funds issues was in addition to assessing the general operation of closed funds against the topics covered elsewhere in this report. Our findings on these topics for closed funds are combined in the previous chapters of this report and are not contained within this chapter.
- 6.3 Closed funds represent a significant amount of the with-profits sector holding approximately £110bn of the £330bn with-profits assets as at the end of 2009.

Our requirements

- 6.4 The desired outcomes for policyholders from firms complying with our requirements are that firms address fully any financial or operational risk relating to them and have a coherent plan to distribute assets held within the fund in a way that is fair to all policyholders.
- 6.5 In line with our Principles¹⁷, the review assessed how firms' senior management have satisfied themselves that they have:
 - an orderly and fair approach to the final distribution of the fund and its inherited estate;
 - effective control of the run-off, including unit costs, governance and risk management; and
 - a communication strategy that enables policyholders to make informed decisions.
- 6.6 Our review built on the insurance sector briefing we published in November 2005 on closed funds, and went into some detail on the nature of closed funds and how our newly introduced rules intended to operate. We also assessed how senior management had responded to our communications in 2007 to CEOs of insurers that provide with-profits funds, following our thematic review of how closed funds were being governed.

17 Specifically, Principles 3 (management and control), Principle 4 (maintain adequate financial resources) 6 (treating customers fairly), and Principle 8 (managing conflicts of interest).

- 6.7 Our assessment on issues specific to closed funds consisted of; the run-off plan (or similar firm document), investment issues and operational issues, including communications.

Views of consumer stakeholders

- 6.8 Consumer focused stakeholders questioned whether closed funds received sufficient oversight and attention from firms' management. Some commented on the inconsistency in funds which closed over five years ago and are required to submit a formal run-off plan, and more recently closed funds, which are not required to do so.
- 6.9 We were conscious of our consumer research findings in 2007, which found just over half of respondents thought it was easier to obtain information from funds that were still open than from those that were closed. Some financial advisors felt that the reason behind information being more difficult to obtain from closed funds was that many such funds had lost key staff, which had led to administrative inefficiency. There was also a degree of suspicion that some providers were slow to respond to enquiries as they wished to deter advisers seeking to withdraw funds.¹⁸
- 6.10 Several stakeholders and commentators have expressed concern over the performance differential between closed funds and open funds, suggesting that historic low performance by some closed funds results in unfair outcomes for policyholders.

Run-off plans and management

- 6.11 While we found some indications to cause us concern, generally, it was evident that firms had improved their management of closed funds in light of our 2007 communications in this area.
- 6.12 Firms that close with-profits funds to new business must submit a run-off plan to us as soon as reasonably practicable, but within three months of ceasing to effect new contracts of insurance in a with-profits fund.¹⁹ The purpose of a run-off plan is for the firm to clearly set out how it proposes to manage the run-off, how it will cope with the additional risks associated with a declining asset portfolio and how it will distribute any inherited estate. Appendix 2.15 in the Supervision Handbook specifies what information should be included in the run-off plan.
- 6.13 Our rules requiring firms to submit a run-off plan for their closed fund do not apply to with-profits funds that were closed to new business before the rules came into effect (30 June 2005). However, senior management of these firms must be able to demonstrate the appropriate management of their with-profits fund(s) that closed to new business before 30 June 2005, in line with Principles 3 (management and control), Principle 4 (maintain adequate financial resources), Principle 6 (treating customers fairly), and Principle 8 (managing conflicts of interest).

18 <http://www.fsa.gov.uk/pubs/consumer-research/crpr59.pdf>

19 COBS 20.2.53(2) R

- 6.14 In assessing firms' management of closed funds, we acknowledged not all firms were required to provide us with a run-off plan. The remainder of our assessment did not distinguish between those firms required to provide a run-off plan and those that do not. Those firms that are not required to have such plans were still required to demonstrate good management of their closed funds, as described above.
- 6.15 With the exception of two firms, plans adequately described how the firm proposes to manage the run-off and its strategy for managing the wider risks associated with run off. Firms had considered the projected shape of the fund, although two firms could not demonstrate that they fully understood the profile of all types of projected outgoings, for example, one firm modelled projected deaths, maturities and surrenders but these were aggregated when reported resulting in the detail being lost.
- 6.16 Firms had adequate plans for how the cost base will be managed down, accounting for this to happen quite rapidly later on in the run-off process, to ensure policies are charged with a fair level of expenses.
- 6.17 Several firms, however, were less prepared in terms of their strategy to assess the point in the run-off plan where the business becomes 'sub-scale'. These firms viewed the point of becoming sub-scale as still being very distant.
- 6.18 With one exception, firms had adequate plans for how any surplus in the fund would be distributed in a way that ensured all classes and generations of with-profits policyholders are treated fairly.
- 6.19 The majority of firms regularly monitored and managed how the fund was running off against the plans, although a significant number of the firms did not have processes in place for the plan to be reviewed in a reasonable time period. Some of these funds were subject to court schemes and the run-off was therefore governed by these.
- 6.20 Generally, firms were able to demonstrate how various interests were being balanced as part of running the closed fund. The funds PPFMs were also found to reflect the firm's investment strategy and plans for distributing the fund.

Investment issues

- 6.21 In running closed funds, firms were able to demonstrate that they regularly reviewed the fund's investment strategy, making changes where appropriate to reflect the changing circumstances of the fund. The regularity of review varied, with some reviewing their strategy quarterly, others annually or tri-annually. Some funds' investment strategies were governed by their particular court scheme (which was approved by the Court when the fund was closed).
- 6.22 Firms also demonstrated that they conducted a reasonable analysis of the liquidity of investments in relation to potential liabilities. Steps had also been taken to ensure that funds exposure to risk will have reduced (i.e. de-risking) by the time that liquidity becomes more important. We did not see evidence of the existence of strategic investments currently constraining the fund from making fair payouts. Firms were aware of the need to manage strategic any investments as the fund ran off, with most firms having already disposed of these or holding small amounts of

assets relative to the current size of the fund. Additionally, where firms had written non-profit business, there was a plan to ensure resulting profits would be released in time to be distributed fairly to all policyholders.

- 6.23 Around half of the funds assessed had different classes of policyholders with different options and guarantees and had different assets mixes backing their benefits. Several of these funds contained policies with high levels of guarantees but little opportunity to participate in equity growth, and where this was the case, firms were able to justify acceptably how this was fair for these policyholders and others in the fund.

Operational and communication issues

- 6.24 In regard to operational issues, just over half of the firms had outsourced their fund management to other firms. With the exception of one firm (which is now reconsidering its approach), performance was reviewed annually or more often.
- 6.25 The issue of staff retention (in order to retain key knowledge and capacity) did not appear to be a concern for firms. In larger firms, staff were able to be redeployed into other areas, and in other firms steps had already been taken, for instance outsourcing administration so the outsourcer would manage staff reductions.
- 6.26 As part of assessing how the funds were being run, we reviewed how firms were communicating to policyholders about the progress of the run-off and any possible consequences for them.
- 6.27 We have specific rules requiring firms to inform its with-profits policyholders within 28 days of ceasing to effect contracts of insurance in a with-profits fund, we did not find evidence suggesting firms have not adhered to these timeframes. Additionally, important information about the run-off should be included Consumer Friendly PPFMs, and where relevant, also be included in the firm's annual report to with-profits policyholders as part of describing how it has meet its obligations in the PPFM and how it has addressed significant relevant issues. In respect of these documents, the weaknesses we found as described in Chapter 5 apply across the sector, including to firms with closed funds. Similarly, the weaknesses we found in relation to event-driven communications (including giving adequate and timely notice of the existence of guarantees and MVR-free dates), apply to firms with closed funds.
- 6.28 The consumer literature related actions for firms running closed funds are included in our firm action section in Chapter 5.
- 6.29 Most with-profits committees were sufficiently engaged with running of the closed funds, and in the few firms where this was not the case, it was consistent with other with-profits governance concerns found within the particular firms. As described in Chapter 4 on governance, we are requiring firms to take action where necessary.

Actions

- 6.30 Several firms had not considered when sub scale issues would become apparent in the run off of funds and did not have a strategy for dealing with sub scale risk. While this is a concern, the funds concerned have a significant length of time left to run before subscale points will materialise so there is limited current risk. Nevertheless, we believe it would be prudent for these firms to undertake more robust planning around future issues and will be following up with these firms on how they intend to manage the planning process.
- 6.31 More widely, we expect firms (whether or not they are required to submit a run-off plan to us) to be able to demonstrate how their management of closed funds is ensuring all types and generations of policyholders are treated fairly. As part of the governance responsibilities for firms in order to comply with our Principles (as described in paragraph 6.6), all with-profits firms with closed funds need to plan well in advance of the next stages of their fund's run-off. This includes communicating clearly to policyholders about the continuing progress of the run-off and any possible consequences for them.
- 6.32 All firms running a closed fund are required to address fully any financial or operational risk relating to them and have a coherent plan to distribute assets held within the fund in a way that is fair to all policyholders. We are taking action with specific firms with weaknesses identified above and requiring them to take corrective action in an appropriate time period.
- 6.33 Acknowledging the historically lower average performance of closed funds as compared to open funds our assessments have focused on how firms are operating the fund and how they have implemented our requirements and therefore whether operation of funds by firms have, or could, result in unfair outcomes for policyholders.
- 6.34 As highlighted above any actions applicable to firms' general running of closed funds relevant to governance, communications, payouts and charges, have been included in each of the previous chapters and have not been included here.
- 6.35 However, in general, with the exception the issues set out above we have not identified any clear weaknesses in the general operation of with-profits funds that are a common feature of closed funds although a number of issues could become more acute in closed funds such as charges and post sale communications.

Policy review

- 6.36 As explained in the new business section in Chapter 5, we intend to consider whether COBS 20 requirements for funds that are closed or that are substantially closed should be amended to move away from the current polarised position of being either formally closed or open.
- 6.37 As explained in Chapter 4, we intend to strengthen the quality of reporting to policyholders and prevent escalation of risk in the future – and this will include consideration of information provided to policyholders in relation to closed funds.

7 The reattribution process

- 7.1 In October 2008 we gave our preliminary view on the reattribution process based on our experience of the reattribution transactions in progress at that time with Aviva and Prudential.²⁰ We also made a commitment to communicate further on this subject once the Aviva transaction was complete, to set out our intended outcomes for reattributions and any identify areas that we believe improvements can be made to the process.
- 7.2 We have now completed the initial phase of this work. Our objective in reviewing reattributions at this stage is to identify the high level key lessons learned and areas where the efficiency of the reattribution process or overall approach could be improved. We do not suggest specific changes to rules or guidance in this report. Further analysis will appraise how either our rules or guidance can better ensure the process facilitates the best deal for with-profits policyholders.
- 7.3 We reviewed previous FSA work carried out in this area during the Aviva reattribution and also during the Prudential's consideration and rejection of undertaking a separate reattribution. We looked at external representations made to us during and after the Aviva process, particularly from the Aviva policyholder advocate. We interviewed interested parties to check our understanding. We did not look in detail at the terms of the Aviva reattribution scheme itself. We concentrated instead on the process as it developed, including the practical impact of the FSA's rules and guidance.
- 7.4 There are a number of technical terms involved which may benefit from brief explanation, particularly 'inherited estate' and 'reattribution'.
- 7.5 The FSA Handbook defines the inherited estate as 'an amount representing the fair market value of the with-profits assets less the realistic value of liabilities of a with-profits fund'.
- 7.6 Both the assets and the liabilities are very large in aggregate compared with the relatively small difference between them which we refer to as the estate. They are also in constant fluctuation. Both the assets and the liabilities are subject to accounting and actuarial valuation issues and can be affected by the assumptions

20 Only the Aviva reattribution was followed through to conclusion, the proposed Prudential reattribution was not concluded.

made in a firm's strategic planning as well as by movements in asset prices, by interest rates and many other factors. Putting a definitive value on the estate at any one moment in time is therefore a highly judgemental exercise.

- 7.7 The term 'inherited estate' and 'estate' are in practice used largely interchangeably. If there is a difference between them, it is that using the phrase 'inherited estate' emphasises that the estate arose from various sources including through the experience of previous generations of policyholders. The current generation of with-profits policyholders should have no expectation that the inherited estate will necessarily be distributed to them. It will instead be used to support the fund, including the interests of future generations of with-profits policyholders. It is inherited in the sense that it has been handed down to the current generation of policyholders from previous generations. Management has to maintain a balance between retaining sufficient capital for smoothing, for investment freedom, for reducing the risk that guarantees won't be delivered and for other working capital purposes, set against the regulatory requirement to treat with-profits policyholders fairly and the regulatory and contractual need to distribute an appropriate amount of any excess surplus.
- 7.8 What current policyholders should be entitled to expect is to benefit from any distribution of excess surplus identified within a with-profits fund. One of the questions that have to be asked in a reattribution is exactly how much of the estate is it necessary to retain as working capital and how much of it can be distributed as excess surplus. In the context of an inherited estate a distribution is the process of allocating that excess surplus to asset shares either by way of a special bonus or sometimes by reversionary bonus or terminal bonus. Once the excess surplus has been identified and distributed then reattribution of the ownership of the remaining estate or working capital can take place.
- 7.9 A company which operated without an estate would have limited scope for smoothing and would distribute nearly all its investment gains to its policyholders as they arose. This direct relationship between the performance of the fund and the bonuses declared might be seen as relatively easy to understand and therefore as beneficial to with-profits policyholders. However we believe that this does not take sufficient account of the effect on such a company of either sustained falls in asset values which would reduce the value of the fund or external shocks that can impact on the level of liabilities. Our current rules require the distribution only of 'excess surplus' recognising that the retention of some working capital or estate for various reasons is in the best interests of policyholders in the longer term.
- 7.10 The FSA Handbook defines a reattribution as: 'The process under which a firm which carries on with-profits business seeks to redefine the rights and interests that the with-profits policyholders have over the inherited estate'. This clearly separates it from a distribution. In a reattribution the shareholder provides a financial benefit to policyholders, normally from shareholder funds, in exchange for those policyholders giving up the right to a share of future distributions of excess surplus. In a distribution excess surplus is identified and paid out from the estate.

- 7.11 A reattribution exercise, like a demutualisation, is of considerable significance to the with-profits policyholders of the firm affected. It may raise concerns that touch on how with-profits funds generally are run. Managing the conflicts of interest in ownership and distribution of surplus is central to with-profits governance but comes into even sharper focus in a reattribution. Issues including new business, strategic investments, costs and charges are discussed elsewhere in this report.

Our expectations

- 7.12 Our rules require a firm that seeks to make a reattribution of its inherited estate to take certain actions to help to ensure that policyholders are treated fairly. These include appointing a policyholder advocate to negotiate with the firm on behalf of the relevant with-profits policyholders and to tell the policyholders, with reasons, whether the firm's proposals are in their interests. Additionally, the firm must ensure that every policyholder that may be affected by the proposed reattribution is sent appropriate and timely information.
- 7.13 Another feature of recent reattributions is a mechanism whereby those with-profits policyholders who vote against the proposal or who abstain from voting have their interests in an appropriate proportion of the estate preserved. The decision for policyholders as to whether or not to accept a reattribution scheme has therefore been entirely voluntary since the minority is not bound by the decision of the majority. This is a significant safeguard although one that may not always be available under the current rules.

Stakeholders' views

- 7.14 The first policyholder advocate was appointed for the Aviva reattribution. Both the Aviva policyholder advocate and members of the wider consumer lobby voiced concern about the outcome of the reattribution process and its fairness to policyholders. Some of these concerns were generic to the normal operation of with-profits funds, such as the notional inter-generational transfer of estate from current to future policyholders. Indeed one of the problems with reattributions is that it is difficult to establish the precise nature of the interests in the estate which policyholders are being asked to give up. These interests can also vary from firm to firm.
- 7.15 In terms of the reattribution process the specific concerns expressed included that:
- current FSA rules, according to the Aviva policyholder advocate, do not require a degree of transparency sufficient to ensure that those exercising discretionary powers, and those who are charged with ensuring those powers are not misused, are subject to regular and vigilant external scrutiny;
 - although the Aviva reattribution resulted in an offer which the policyholder advocate was able to recommend as being in the interests of the majority of eligible policyholders, this was less than 90% of the estate being reattributed which is in contrast to the 90% share which policyholders normally receive in a distribution; and

- the Aviva policyholder advocate felt restricted in her ability to communicate directly with policyholders at the time of her choosing during the process.

What we found

- 7.16 At the time of the Aviva reattribution we concluded that the offer made to policyholders by Aviva was in the range of reasonable offers that could be made. The policyholder advocate recommended to policyholders that they accept the company's offer and the overwhelming majority of policyholders voted in favour. The judge considering the Scheme heard objections in person from policyholders and their representatives in the High Court and was able to address those points and to conclude that he should sanction the Scheme placed before him. Policyholders who voted against the Scheme or who did not make their views known had their rights and interests in the estate preserved. These are all positive factors which suggest that the outcome of the process was largely satisfactory.
- 7.17 However, we also recognise that this remains an area of significant interest for a wide range of stakeholders and a controversial one for some commentators. In reviewing the process we identified a number of areas where improvements to the process could be made and some positive features which should be carried forward to any future scheme. In particular:
- 7.18 we were concerned at the length of time that the Aviva reattribution took from announcement of the intention to explore a reattribution to the scheme receiving final sanction from the Courts. The uncertain and prolonged timescale had more than one cause, but the practical impact on policyholders was to prolong uncertainty and to make effective financial planning more difficult. Some of the delay stems from the complexity of identifying and defining policyholders' rights and interests in the estate, a theme to which we will return. Delay also means additional attendant costs on the firm and the regulator, both monetary and in terms of the opportunity cost of maintaining dedicated resources;
- a firm proposing to engage in a reattribution should be able to set out the actuarial, investment and business strategy assumptions underlying the reattribution so that the firm, the FSA and the policyholder advocate, when appointed, can understand the basis on which the proposal is being made, including the data and the modelling that will be used, before detailed discussions begin on the offer to policyholders;
 - we start from the principle that distribution is preferable to reattribution since policyholders normally benefit from a 90% share of any distribution. A balance must be struck between the degree to which the estate contains excess surplus that can be distributed and working capital which must be retained to support the fund. Assumptions about the amounts of business which will be written in the future and about the firm's risk appetite have a material effect on how much can be distributed and therefore on the outcome for policyholders. Future work will look at clarifying the rules and guidance on new business, on closed funds and on distributions as relevant to all firms but particularly to one in a reattribution;

- a corporate governance structure designed to deal with day to day with-profits issues will not necessarily be adequate for a reattribution. Firms may need to discuss in advance with the FSA how their governance could be enhanced to ensure that policyholders' interests are properly represented during the reattribution process;
- the introduction of a policyholder advocate provided an independent voice in the process. Holding public meetings attended by interested parties provided an opportunity for direct questions to be put and a wider audience to be informed through press reports. Written communications by the policyholder advocate with policyholders are also an important part of the communications strategy and the policyholder advocate should be able to communicate to policyholders in an open, clear and independent way, facilitated by the firm if necessary.

7.19 The Aviva policyholder advocate made a wide-ranging submission to our review. This raised many issues of more general significance to with-profits funds than just to reattributions. To the extent that they are not addressed in this section, we will look further at these ideas as we develop the actions we have outlined both here and elsewhere in the review.

Actions

7.20 A firm which proposes a reattribution of the inherited estate needs to focus particular attention on the conflicts of interest inherent in such a project and to conduct itself in such a way as to treat customers fairly. The FSA needs to regulate the process effectively and to give its view to the Courts on the fairness of the offer to policyholders. The policyholder advocate needs to negotiate with the firm to obtain the best available offer for policyholders. Any resulting reattribution scheme needs to be appropriate, by which we mean that is promoted for a proper purpose and operate fairly as between those classes of person whose rights are affected by it.

7.21 We will look further at what changes we should make to our rules and guidance in order to deliver these principles while emphasising our view that in order to treat with-profits policyholders fairly firms should be identifying and distributing any excess surplus before announcing a reattribution. Many of the themes in the wider review also impact on reattributions so our intention is to develop this work further and to consider what changes can be proposed.

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