Consultation Paper

# CP11/5 ★★★

Financial Services Authority

# Protecting with-profits policyholders

February 2011

FSA®
Financial Services Authority

# Contents

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 24th May 2011.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2011/cp11_05_response.shtml.

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# Acronyms used in this paper

| | |
|---|---|
| **CBA** | Cost-benefit analysis |
| **CFPPFM** | Consumer Friendly Principles and Practices of Financial Management |
| **CEO** | Chief Executive Officer |
| **COBS** | Conduct of Business Sourcebook |
| **CP** | Consultation Paper |
| **FRC** | Financial Reporting Council |
| **FSMA** | Financial Services and Markets Act 2000 |
| **GENPRU** | General Prudential Sourcebook |
| **MSA** | Management Service Agreements |
| **MVRs** | Market Value Reductions |
| **PPFM** | Principles and Practices of Financial Management |
| **PS** | Policy Statement |
| **SUP** | Supervision manual |
| **TCF** | Treating Customers Fairly |
| **WPRR** | With-Profits Regime Review |

# 1 Overview

## Purpose

1.1 The purpose of this Consultation Paper (CP) is to present proposals for a range of changes to our rules and guidance concerning the operation of with-profits funds, primarily in the Conduct of Business Sourcebook (COBS) 20.[1] It fulfils a commitment we have made to the Treasury Committee in relation to the With-Profits Regime Review (WPRR)[2] and in our *Business Plan 2010/11*.[3]

1.2 A further CP that concerns with-profits business will be published later in 2011. This will relate to changes to COBS 20 arising from the implementation of Solvency II.[4] It will also address issues about firms' communications with their with-profits policyholders.

## Background

1.3 COBS 20 sets out rules and guidance on the operation of with-profits funds. COBS 20.2 (*Treating with-profits policyholders fairly)* recognises that with-profits business normally involves firms exercising a wider degree of discretion than is the case with other types of business. This wide element of discretion can give rise to potential conflicts of interest. One of the key aims of COBS 20.2 is to mitigate the risks to policyholders that can result from these conflicts. COBS 20.3 (*Principles and Practices of Financial Management)* includes guidance on governance arrangements that apply to with-profits funds.

1 Conduct of Business Sourcebook (COBS 20).
2 FSA: *With-profits regime review report, (June 2010)*, p.8.
3 FSA: *Business Plan 2010/2011*, (March 2010), p.41.
4 For more information on Solvency II please see: www.fsa.gov.uk/pages/About/What/International/solvency/index.shtml.

1.4 How firms operate their with-profits funds and ensure they treat their policyholders fairly has been a matter of regulatory concern for some time. Comprehensive rules and guidance relating to such fair treatment have only been in place since 2005. These continue to be scrutinised as the risks inherent in the funds evolve or become more apparent as economic circumstances change.

1.5 Over the last decade our concerns have been driven by a number of significant factors and events. The closure to new business of Equitable Life in 2000 highlighted the inadequacy of governance arrangements then in place in firms, and especially the potential for conflicts of interest in the appointed actuary regime, as well as regulatory failings.

1.6 The stock market falls of 2001 and 2002 underlined the difficulties firms faced after competing for market share by declaring unsustainably high levels of annual bonuses in the 1990s. Firms had also offered expensive guarantees that were not properly funded, and in some cases had to meet the costs of pensions and endowment mis-selling.

1.7 A further consequence of the stock market falls was several firms closing their with-profits funds to new business. There were also deep cuts in annual bonuses, often to zero, and reductions in final pay-outs. These management actions may have been necessary for prudential solvency reasons but highlighted the substantial amount of discretion firms had in operating with-profits funds. We were concerned that, when conflicts of interest arose, these could often be settled to the detriment of with-profits policyholders. This again pointed to inadequate governance arrangements and the weakness of the appointed actuary regime. Significant changes to the operation of funds were often poorly communicated, leading to an even greater loss of confidence in with-profits policies than might otherwise have been the case.

1.8 The need for firms to improve their governance and to reserve properly for the realistic liabilities they held in their with-profits funds led to the 'Tiner Reforms'. These focused on the regulation of life insurance firms. A series of review papers were published that outlined proposals to implement the current with-profits regulatory regime and culminated in CP04/14.[5] A further key outcome of the reforms was the introduction of the Individual Capital Assessment regime in 2004.

1.9 However, the current rules have not been as successful as we had hoped in addressing some of the issues that had led to their introduction, and we have received criticism from a number of quarters. This resulted in Hector Sants' commitment to the Treasury Committee in 2008 to review the way in which firms have implemented the rules in COBS 20, which in turn triggered the WPRR. The WPRR covered firms representing 80% of the with-profits industry by assets under management to assess their implementation of COBS 20. The findings of the review were published in June 2010 and form the basis of many of the policy proposals set out in this CP.[6]

5 CP04/14: *Treating with-profits policyholders fairly – Further Consultation, feedback on CP 207 and near final text*, (August 2004).
6 FSA: *With-profits regime review report* (June 2010).

1.10 In addition, mutually-owned firms were making representations to us over their concerns that the rules in COBS 20 prevented them from continuing to write new non-profit business into their long-term funds if they either stopped writing a material volume of with-profits policies into that fund (other than by reinsurance), or if they reinsured to third parties most of the new with-profits policies being written. This led to what was termed 'Project Chrysalis' and resulted in the publication of two 'Dear CEO' letters in October 2009[7] and in September 2010[8] which considered the fair treatment of with-profits policyholders in mutually-owned with-profits funds.

1.11 This CP addresses some of the issues raised by the WPRR and by Project Chrysalis as well as other issues of concern about COBS 20. We will address further issues concerning communications with policyholders and the impact of Solvency II later this year. This demonstrates our intention to ensure that our framework of rules and guidance set out in COBS 20 will continue to evolve to meet future challenges.

1.12 This CP consults on how with-profits firms manage the following issues:

- conflicts of interest;
- the fair treatment of with-profits policyholders in mutually-owned funds;
- the terms on which new business is written;
- material reductions in new business;
- market value reductions;
- strategic investments;
- charges made to with-profits funds;
- excess surplus;
- reattribution of inherited estates; and
- corporate governance.

1.13 The changes proposed in this CP relate to shareholder-owned and mutually-owned firms that operate with-profits funds unless stated otherwise.

## Scope of the consultation

1.14 This CP confines itself to consulting on the issues listed in paragraph 1.12 above. But, as stated above, we intend to publish a further CP later in 2011 dealing with communications to with-profits policyholders and consequential amendments resulting from Solvency II.

7 FSA: 'Dear CEO' letter (13 October, 2009).
8 FSA: 'Dear CEO' letter (28 September 2010).

## Method of review

1.15 Our approach to reviewing our rules and guidance in COBS 20 is based on our over-arching requirement that firms treat their with-profits policyholders fairly. It is driven by the fact that some of the current rules and guidance in relation to the issues we are addressing in this CP may not be sufficient to produce the results we intend.

## Who should read this paper?

1.16 This CP is directly relevant to all firms writing new with-profits business or with existing books of with-profits business.

**CONSUMERS**

This consultation is relevant to consumers with with-profits policies, their advisers and consumer groups.

**Next steps:**

This consultation will close on 24th May 2011. We will then finalise the draft rules and guidance in light of the responses to this CP with the intention of publishing a Policy Statement giving feedback in the third quarter of the year.

# 2

# Our proposals

2.1 This chapter details all the proposed rules and guidance we are consulting on, with the exception of our proposals in relation to governance. The proposed rules and guidance changes concerning governance are set out in the next chapter and will result in some restructuring of COBS 20. The proposed rules and guidance described in this chapter will not effect any significant repositioning in the Handbook.

### The fair treatment of with-profits policyholders

2.2 We have powers under the Financial Services and Markets Act 2000 (FSMA) to make rules to protect consumers. The rules and guidance in COBS 20 are made using this power to protect with-profits policyholders.

2.3 In CP09/9 we set out our view of some of with-profits policyholders' interests as a class in a with-profits fund, and we take the opportunity of repeating it here.

2.4 'With-profits policyholders have an interest in the whole with-profits fund and in every part of it, which derives from the fact that the with-profits fund is a single, undivided fund of assets, from which any particular assets could be used to meet the fund's contractual obligations in respect of a with-profits policy written into that fund'.

2.5 'With-profits policyholders also have a contingent interest in any surplus, which may exist prior to distribution. With-profits policyholders in a shareholder-owned firm will typically receive 90% of any surplus inherited estate that is distributed. While they have no reasonable expectation that they will share in a special distribution from a with-profits fund during the lifetime of their policies, if a distribution does take place during the term of their policies, with-profits policyholders have a reasonable expectation of participating in this distribution. Therefore, we view with-profits policyholders as having a contingent interest in any surplus.'[9]

2.6 We propose to introduce guidance at the start of COBS 20 to reflect the principles described above. We also propose to make clear that those principles apply to with-profits

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

policyholders in a mutually-owned insurer, just as they apply to with-profits policyholders in a shareholder-owned firm, to ensure that they are treated fairly. The intention is to set our rules and guidance in context so firms are clear that we see their responsibilities to ensure fair treatment of with-profits policyholders as applying to the fund as a whole. We do not agree that considerations of fairness should be restricted to the part of the fund that represents notional 'asset shares' alone.

**Q1:** Do you agree with the proposal to include guidance setting out our view of some of the interests of policyholders in with-profits funds?

## Conflicts of interest

2.7 One of the central aims of the rules and guidance in COBS 20 is to ensure that conflicts of interest are settled in ways that are fair to with-profits policyholders. Conflicts of interest can arise in a wide range of situations. Currently, COBS 20.2.1G explicitly recognises the conflicts that may arise between the interests of shareholders and with-profits policyholders.

2.8 However, potential conflicts of interest may also arise between with-profits policyholders and non-profit policyholders within the same fund, between with-profits policyholders and the members of mutually-owned firms, between with-profits policyholders and management, and between different classes of with-profits policyholders, for example, those with and without guarantees. We propose to expand the guidance in COBS 20.2.1G so that these potential conflicts are also specifically highlighted. We refer to particular issues relating to mutual firms in more detail in paragraphs 2.10 to 2.32 below.

2.9 We propose to convert elements of COBS 20.2.1G relating to the fairness of a firm's operating practices into a rule. We will also amend its wording and the residual guidance to make it clear that it applies not just to conflicts of interest between shareholders and with-profits policyholders, but also to the other types of conflicts outlined in paragraph 2.8 above. The purpose of this change is to make it clear to firms that in all circumstances they must be alert to such conflicts, and have procedures to consider and properly manage conflicts that arise, and to ensure that such conflicts do not lead to the unfair treatment of a particular class of with-profits policyholders or with-profits policyholders as a whole. In this respect, this change can be characterised as sharpening firms' focus. It should be noted that introducing a new rule should not be regarded in any way as restricting the scope of, or limiting the more general application of, Principle 6. The new rule is merely intended to establish what we consider to be one aspect of the fair treatment of with-profits policyholders in a specific context.

**Q2:** Do you agree with our proposal to convert elements of COBS 20.2.1G into mandatory requirements in a rule and to clarify the types of conflicts that may arise?

### Fair treatment of with-profits policyholders with particular regard to mutually-owned long-term insurance funds

2.10 The issue of fair treatment of with-profits policyholders in mutually-owned long-term insurance funds has come into focus because of the decline in the amount of new with-profits business being written. Mutually-owned firms have been concerned that if they have significantly falling levels of new with-profits business, or if they cease to write such business altogether, this may over time lead to a distribution to with-profits policyholders from their with-profits funds of a substantial proportion of the assets in that fund. A number of mutually-owned firms have expressed the concern that this, in turn, will mean that ultimately they may no longer be able to write any other form of new business, and so will have to close and go into run-off.

2.11 Our existing rules in COBS 20 have applied to mutual with-profits insurers as well as to shareholder-owned firms since they were first introduced. We recognise that they raise some particular issues for mutuals that operate with a single 'common fund'. However, from the responses that we received to our first 'Dear CEO' letter issued in October 2009, it has become apparent that some areas of our current rules and the circumstances in which they apply have been misunderstood or misinterpreted by mutually-owned firms. We believe it may be helpful to set out how some of our current rules operate in practice regarding the fair treatment of with-profits policyholders in with-profits funds.

2.12 With-profits policyholders, whether their policies are written by mutually-owned or shareholder-owned firms, have no expectation that a distribution will necessarily take place during the life of their policies. This follows from the discretion vested in the directors of the firm in relation to the distribution of the with-profits fund's surplus accumulated profits. However, with-profits policyholders are entitled to a share of any distribution that is made, and they therefore have an interest in how the fund is used by the firm pending distribution, and the manner in which a firm exercises its discretion whether or not to make a distribution.

2.13 We have the ability to protect the interests of with-profits policyholders in their capacity as consumers. We are authorised, under s.138 of FSMA, to make such rules applying to authorised persons as it appears to be necessary or expedient for the protection of consumers. Principle 6 of our Principles for Businesses requires a firm to pay due regard to the interests of its customers and to treat them fairly. Chapter 20 of the COBS Sourcebook sets out rules and guidance concerning the fair treatment of with-profits policyholders.

2.14 We have made rules, COBS 20.2.21R and COBS 20.2.22E, which require a firm to determine on an annual basis whether it has an 'excess surplus', and to distribute such of that surplus as is attributable to with-profits policyholders if it would be a breach of our

Principle 6 to retain it. The same obligation arises as a result of Principle 6. Policyholders have a legitimate and reasonable expectation that the firm will comply with these rules and with Principle 6.[10]

**2.15** When a firm's directors are considering the exercise of their discretion in relation to an identified excess surplus, the effect of Principle 6 and COBS 20.2.21R is that those directors are obliged to distribute that identified excess surplus if they do not have a good reason for retaining it (that is, unless it is fair to their customers to retain it).

**2.16** Accordingly, although with-profits policyholders do not have any expectation that a distribution will occur at any particular time, they are entitled to expect that a firm will comply with the requirements of COBS 20.2.21R and COBS 20.2.22E.[11] The operation of those rules may make it more likely that a distribution to them will occur.

**2.17** COBS 20.2.21R and 20.2.22E apply equally in relation to distributable surplus once a with-profits fund has closed to new business and is being run off. Principle 6 also applies. The treatment of any surplus in the closed fund that remains after the contractual rights of with-profits and non-profit policyholders have been met should be consistent with the treatment of excess surplus in an open fund. It makes no difference whether that with-profits fund constitutes the only fund owned by the firm or whether the firm has other, separate funds that remain open to new business. COBS 20.2.56R requires the firm to have a plan to demonstrate how it will ensure a fair distribution of the closed with-profits fund, including the inherited estate, if any, and, in this context, we will pay particular attention to the firm's treatment of any surplus.

**2.18** In correspondence with us, some firms have referred to the concept of inter-generational transfer in with-profits funds. We regard inter-generational transfer to be an intrinsic part of the operation of a with-profits fund, including the use of the fund to support the writing of new business, but only so long as it remains fair. For as long as a firm continues to write new business that is fair to its existing with-profits policyholders, it can do so using surplus assets in the fund to support that business. If levels of new with-profits business fluctuate significantly in an open fund, levels of distributions should also reflect current business and future business plans, so that they are fair as between generations of with-profits policyholders. However, our view is that the transfer should occur between generations of with-profits policyholders with similar interests and that there should not be a transfer where there is no succeeding generation of with-profits policyholders, unless the existing with-profits policyholders give their consent.

**2.19** It is also worth making the point that, in our view, a run-off of a part or the whole of a business is not the same as a winding-up. We accept that the run-off of with-profits business may, in some cases, have the consequence that the mutual is unable to write any new business, and thus ultimately lead to the winding-up of the mutual. This is a consequence of the structure of mutual societies, which usually write all of their business into a 'common fund'.

10 *In the matter of Commercial Union Life Assurance Company Ltd and Ors* [2009] EWHC 2521 (Ch) paragraph 40 per Norris J.
11 See also ibid., paragraphs 53-54 per Norris J.

**2.20** Nevertheless, winding-up is not inevitable. In the October 2009 'Dear CEO' Letter and, in particular, the section headed 'Options for mutuals facing a decline in with-profits business', we acknowledged the ability of a mutual to create so-called 'mutual capital' by splitting the long-term fund, with the agreement of its with-profits policyholders, into a with-profits fund and a mutual fund. Similarly, a mutual wishing to cease writing with-profits business but continue writing non-profits business in a common fund, is perfectly entitled to make proposals to its with-profits policyholders for continuing to write non-profit business without realising the economic value for the benefit of with-profits policyholders, thus creating a reserve of mutual capital over time. These options are consistent with the policy intentions behind our rules so that, for example, in specified circumstances a mutual could continue to write non-profit business as the with-profits business wound down. In this context, we refer firms to Policy Statement 05/1[12] which made it clear at paragraph 2.11 that, in relation to both mutuals and shareholder-owned firms, a proposal to write new non-profit business into a with-profits fund where a material volume of new with-profits business was not being written (other than by reinsurance) would require the consent of the holders of with-profits policies in that fund.

**2.21** Over the last three years, we have given extensive consideration to how our rules in COBS 20 apply in the context of mutuals and have issued two 'Dear CEO' letters which illustrate that process. We have looked at a great deal of information as part of this exercise, including case studies and legal opinions provided to us before the issue of the first 'Dear CEO' letter, and, after this letter, the responses and legal opinions which were sent to us.

**2.22** We have also considered carefully whether we should change or develop our rules and policy for mutual insurers to accord with the views expressed by a number of mutuals in response to our October 2009 'Dear CEO' letter. Those mutuals suggested that their with-profits policyholders have no interest in the mutual's long-term fund other than to receive their contractual policy benefits and their reasonable expectations of receiving smoothed asset shares by way of bonuses. For the reasons set out in paragraph 2.12 above, we take a different view. The consequence of the position apparently advocated by those mutuals would be that there is a major difference between a with-profits policy taken out with a mutual and a with-profits policy taken out with a shareholder-owned firm, which has never been communicated to the mutual fund's policyholders. We do not believe that such an approach would be consistent with the fair treatment of mutual with-profits policyholders.

12 PS05/1: *Treating with-profits policyholders fairly – Feedback on CP04/14 and made text*

2.23 In this context, our rules relating to distributions in COBS 20.2.17R are particularly relevant. The current version of COBS 20.2.17R makes clear that any distribution from the with-profits fund must be not less than the 'required percentage'. The definition of 'required percentage' is as follows:

> 'The required percentage referred to in COBS 20.2.17R is, for each with-profits fund:
>
> '(a) the percentage (if any) required in respect of that fund by:
>
> (i) the *firm*'s articles of association, registered rules or other equivalent instrument; or
>
> (ii) a relevant order made by a court of competent jurisdiction';
>
> '(b) if (a) does not apply, the percentage specified in the *firm*'s *PPFM*, if that percentage reflects the *firm*'s established practice';
>
> '(c) if (a) and (b) do not apply, not less than 90 per cent.'[13]

2.24 This definition establishes a 'default' required percentage of 90%, in the absence of other factors that might justify a different result. It applies to the distributions to with-profits policyholders of mutual insurers in the same way as it does to distributions to with-profits policyholders in shareholder-owned firms.

2.25 We have considered carefully whether a different approach might be warranted in respect of mutually-owned firms. We have noted in particular that mutual with-profits funds have not told their with-profits policyholders that they might participate in distributions on a less favourable basis than with-profits policyholders of shareholder-owned firms.

2.26 It is also apparent to us that in the past, where mutually-owned firms have, in fact, made distributions to with-profits policyholders from their with-profits funds, virtually all have consistently done so on a 100% basis.

2.27 We believe that with-profits policyholders in the with-profits fund of a mutual insurer would not expect to be treated in a materially different (and less favourable) way, in relation to distributions from that fund, from with-profits policyholders in the with-profits fund of a shareholder-owned insurer. If anything, they are likely to expect to participate more extensively, not less, in any surplus.

2.28 We have reached the view that, taking into account the expectations of with-profits policyholders in the with-profits market and the actual practice of mutuals in relation to distributions, it is appropriate to maintain our existing policy position and retain a single definition of the 'required percentage' which applies to mutually-owned firms as well as to shareholder-owned firms. This incorporates a default percentage of 90%, in the absence of any of the other factors set out in the definition.

2.29 In the 'Dear CEO' letter of September 2010 we acknowledged the extent of diversity in the mutual sector and, in particular, the differences in form that exist among mutually-owned

13 *Glossary*, 'Required Percentage'.

firms, the different types of business written by them in the past, and the different approaches that they have adopted to the provision of discretionary benefits from the with-profits fund. However, we believe that the factors which may operate to determine whether with-profits policyholders are being treated fairly in relation to any distribution of surplus are the same for mutually-owned firms as they are for shareholder-owned companies. This is so even if the effect of applying these factors to mutually-owned firms produces outcomes that vary to some extent from firm to firm. Those factors allow mutual-specific features to be taken into account, in particular a mutual firm's established practice; this is a factor of considerable significance in generating expectations on the part of with-profits policyholders as to how a firm's discretion will be exercised in the context of distributions from the with-profits fund and, consequently, whether they are being treated fairly in such a context.

**2.30** We believe that our rules seek to secure fair treatment of mutual with-profits policyholders in a way that recognises their entitlements and expectations and produce an outcome that balances, and is not inconsistent with, the interests of the mutual's policyholders and its members.

**2.31** We do, however, propose to clarify the drafting of the definition in one respect to ensure that our original policy intentions are given proper effect; the 'required percentage' should reflect the significance of a firm's established practice, even if the firm has no Principles and Practices of Financial Management (PPFM) or if its PPFM is silent on this point.

**2.32** We also propose to add guidance to COBS 20.2.17R to highlight this significance and to clarify our expectations of firms in their approach to the issue of established practice. It is for a firm to consider whether it has an established practice and, if so, what it is. We will ask the firm to explain how it has reached its conclusions and whether its practice has been clearly and unambiguously communicated to its with-profits policyholders. If there is some ambiguity or inconsistency between the firm's behaviour and its communications with those policyholders (whether in the firm's PPFM or otherwise), we may take the view that the firm's established practice is different from what the firm has suggested or that the firm has not been able to demonstrate the existence of an established practice at all. The guidance will also outline our approach where a firm puts forward an established practice that involves allocating (but not distributing) some portion of a surplus in its with-profits fund to persons other than with-profits policyholders.

> **Q3:** Do you agree with our proposed approach to the use of COBS 20.2.17R and to the clarifying amendments to the definition of 'required percentage' that we propose to make? Do you consider the guidance that we propose to make in this area to be adequate and clear?

### New business

2.33 The current rule on new business, COBS 20.2.28R, requires firms to write new business only on terms that, in the reasonable opinion of its governing body, are unlikely to have a material adverse effect on the interests of its existing with-profits policyholders. The intention is to prevent erosion of the value of the with-profits fund receiving the new business and any consequent reduction in the prospects for future distributions to with-profits policyholders. In practice, this rule is likely to be particularly important to firms when they are designing and pricing or re-pricing products, preparing financial plans that take into account their expected costs and levels of new business, and when reviewing their actual financial performance.

2.34 If a rapid and sustained growth in new business results in amounts that would otherwise have been available for distribution having to be held back to support that business, this could potentially come into conflict with this rule. However, in most cases, broadly speaking, the firm will be complying with the rule if:

- when pricing its products, it makes sure they are all expected to be financially self-supporting over their duration; and
- its business plan, if based on reasonable and credible assumptions, shows forecast new business adding value to the with-profits fund after allowing for the forecast acquisition costs.

2.35 We accept that things may not go to plan. For example, external events may mean that reasonable sales targets are not met, with the result that not enough new business is written to cover acquisition costs and, accordingly, the fund suffers a loss. That, in itself, would not necessarily mean there had been a breach of the rule, if the original targets had been based on credible analysis and research. However, we would expect the firm to take appropriate steps in that situation to put things right for the future. Such steps could include repricing the business or cutting costs.

2.36 The WPRR found that a substantial minority of firms have been writing new business into their with-profits funds that is either loss-leading in itself – that is, it is priced in such a way as to make it attractive to advisers and/or customers but it will never break even – or not enough of it is being sold to cover the cost of acquiring it. In both cases the consequence is that the new business being written erodes the value of the with-profits fund. This, in turn, means that over time there is less money available to distribute to with-profits policyholders.

2.37 We believe that, given these findings, the rule as it is currently framed does not necessarily achieve the intention of preventing erosion of the value of the with-profits fund. It requires firms to write new business only on terms they reasonably think are unlikely to have a materially adverse effect on existing with-profits policyholders. In other words, it gives scope for minor or 'immaterial' detriment. Our concern is that over time even minor detriment, when aggregated, has the capability to become material detriment.

2.38 We propose to strengthen the current rules and guidance so that new business can only be written if the governing body is satisfied, so far as it reasonably can be, and can demonstrate that there is likely to be no adverse effect on with-profits policyholders' interests. We also propose to require firms to have carried out or obtained all appropriate analysis (including a profitability analysis) on the impact of the new business to support this conclusion and to provide that analysis to the firm's with-profits committee or alternative arrangement. Furthermore, we propose to amend the current rule to make clear that the test above applies in relation to all with-profits policyholders (including potential with-profits policyholders), and not just existing with-profits policyholders. Finally, we propose to give guidance as to the continuing effect of the rule, and to make it clear that we consider loss-leading business to be likely to have an adverse effect on with-profits policyholders' interests.

2.39 If shareholder-owned firms wish to use their own assets outside the with-profits fund to subsidise the writing of new business which is loss-making, they are at liberty to do so. We do not believe with-profits funds should be used in this way. We believe a relevant challenge is whether shareholders would be prepared to see other assets used instead of the with-profits fund's assets.

> **Q4:** Do you agree with our proposal to strengthen our rule and guidance on the terms of new business written into a with-profits fund?

### Material reductions in new business

2.40 A with-profits fund which closes to new business is likely to be seen by the policyholder as a very different proposition from the one in which the policyholder originally invested. It is understandable that such policyholders may feel concerned about their prospects and may leave the fund as a result, to their potential detriment. We therefore believe it is essential that the firm should communicate with its policyholders at such a time to explain to them why it has taken this step and, as far as it reasonably can, what this might mean for the outcomes of their policies. Closure also brings with it potential changes over time in the way some aspects of the business are managed, which need to be recognised in advance and planned for appropriately. Our current rule, COBS 20.2.53R, was introduced to ensure that such planning occurs. The run-off plan it requires should cover the operational and financial implications of the closure, including distributions to the with-profits policyholders.

2.41 A with-profits fund that writes very few new contracts of insurance has very similar financial prospects to one that has formally closed. Therefore, it would be right for such a fund to inform us and its policyholders of the change in its situation and prepare a run-off plan. We are concerned that some with-profits funds writing low levels of new business are resisting formal closure to new business and are reluctant to approach us as required by COBS 20.2.55R. This may be because they fear that notification of their position might lead to reputational damage. It may be that they want to avoid the management actions needed for such a move, including the extensive customer communications exercise that may be required. Or it may be that they are optimistic that their level of new with-profits business will substantially increase in future.

2.42 It is not our intention necessarily to compel a firm whose new business continues to add value to the fund, even if being written in very low volumes, to have to cease writing that business. In essence, we want to move away from the binary open/closed position under the current rules, which often leads firms to avoid the actions we consider to be in their with-profits policyholders' best interests. The key consideration is whether the firm is treating its with-profits policyholders fairly.

2.43 We therefore propose to amend our rules to delete the existing COBS 20.2.55R and replace it with a rule requiring firms to discuss their position with us at an early stage, including discussing whether they should take any particular action in their with-profits policyholders' interests. Firms would be obliged to discuss their position with us whenever they experienced significant and sustained falls in either:

- the volume of new non-profit insurance contracts; or
- the volume of new with-profits policies, written into the with-profits fund.

2.44 We will add guidance to make it clear that, in the context of these discussions, even if a firm is no longer writing a material volume of new contracts of insurance, if it can demonstrate that the business is expected to be profitable, then it is likely to be reasonable for the firm to continue to write it, as long as the firm is proposing to treat its with-profits policyholders fairly. However, for firms which experience particularly low sales volumes, it may be in the with-profits policyholders' interests to stop taking on new business altogether.

2.45 To ensure policyholders are treated fairly, we want to see firms generating plans for distributions that are appropriate to their realistic and sustainable new business projections, and the rate at which their assets are shrinking as surrenders and maturities exceed new business. We are also concerned, for example, that some firms have not adequately addressed the possibility that their new business strategies will not be achieved. A failure to achieve these plans can occur for several reasons. The decision to end new Child Trust Funds and the effect on some firms that are primarily or solely reliant on them for new business is a recent example of how this might happen.

2.46 Therefore, we propose to require firms to have a fair distribution plan, based on their current business and future prospects, and to have an investment strategy consistent with it. We also propose to require firms to have management plans, including contingency arrangements against their plans not being achieved or other unexpected risks arising. These management plans will be required to consider investment, credit and operational risks specifically (these are already required for run-off plans), as well as any other relevant risks associated with running the fund in the event of significant and sustained falls in with-profits or non-profit business.

**2.47** Firms will be asked to ensure that their distribution and management plans are reviewed and kept up to date to reflect any material changes in both current and expected levels of new non-profit insurance contracts as well as current and expected levels of new with-profits policies. If firms experience a significant and sustained fall in the volume of new non-profit insurance contracts written into their with-profits funds, or of new with-profits policies, we propose that they amend their distribution and management plans accordingly and submit them to us at least a week before the discussions firms will be required to hold with us (referred to above in paragraph 2.43).

**2.48** The current rules affect funds that have closed to new business since 2005. When we introduced these rules, firms that were already closed were not required to follow them. However, we now propose to apply the requirement to have a run-off plan to all closed funds. While this may create an additional burden for the firms concerned, we do not believe this will be disproportionate, as it should do no more than require documentation of existing financial and operational planning. We would expect any firm that has been closed for several years to have carefully considered these issues as normal management and governance matters. We are proposing that firms in this position submit run-off plans to us within three months of the proposed rules coming into force, if they have not done so already.

**2.49** The revised requirement to have a detailed run-off strategy in place will apply to all with-profits funds closed before the relevant date. The requirement to have a credible distribution plan will also apply to those still open to new business, as well as closed funds.

**Q5:** Do you agree with our proposal that a firm should discuss with us what actions may be required to ensure the fair treatment of with-profits policyholders if it experiences sustained and significant falls in the volume of new business?

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

**Q7:** Do you agree with our proposal that firms prepare, maintain and update a management plan containing contingency arrangements in the event they experience sustained and significant falls in new business volumes?

**Q8:** Do you agree that the with-profits funds that closed to new business before the current rules came into effect in 2005 should have run-off plans?

### Market value reductions

2.50 In principle, we accept that Market Value Reductions (MVRs) can be a legitimate tool for firms to balance the interests of different groups of with-profits policyholders. Smoothing payouts has long been presented as an inherent feature of with-profits business where, when markets are rising, part of the amount that would otherwise be paid to policyholders is held back to give some protection to the level of payments made to policyholders when markets are falling. However, in practice, such smoothing cannot be unlimited, as eventually the point may come when payments of more than the value of the assets underlying the policy will be detrimental to the interests of the remaining policyholders. We see an MVR as a means by which smoothing, when it results in payouts being higher than the underlying asset value, (normally in depressed market conditions), can be reduced or withdrawn, keeping value in the fund for longer-term policyholders.

2.51 One of the objectives of our current rules on this topic is to limit the level of MVR that can be applied to what is necessary to prevent this element of 'overpayment'. In other words, those leaving funds before their contractual dates – usually maturity or, in the case of pensions, their selected retirement dates – do not do so in a way that disadvantages with-profits policyholders remaining in the fund.

2.52 Currently our rules set limits on the amount by which MVRs can be applied to prevent firms using them as arbitrary and unfair exit penalties. They can only be applied if the market value of the underlying assets is, or is expected to be, significantly lower than the face value of the policy or there has been or there is expected to be a high volume of surrenders relative to the liquidity of the with-profits fund. In either case the size of an MVR can be no greater than the amount needed to reflect their impact.

2.53 We believe MVRs should only be applied where their use avoids potential detriment to the remaining policyholders that would arise if the payment was higher than the value of the assets underlying the policy. This logically sets a maximum limit to the amount of an MVR because, if it was so high that it reduced the payout to less than the value of those underlying assets, it goes further than avoiding detriment to the remaining policyholders. It also follows that the prospect of a high volume of surrenders without the associated prospect of any asset value shortfall does not give rise to this type of detriment to the remaining policyholders, and therefore should not justify an MVR being applied. We do not accept that an MVR is justified solely by a high volume of surrenders unless the policies' face values are more than the value of underlying assets.

2.54 A point repeatedly made to us by life insurance firms during the recent financial crisis is that, unlike banks, they did not experience liquidity problems. This is borne out by the

WPRR which found no evidence that funds were applying MVRs because of high volumes of surrenders alone.

2.55 We propose to remove the ability of firms to impose MVRs on the grounds of surrender volumes alone, so an MVR may only be applied where the face value of the policy is higher than the value of the underlying assets. It is perfectly possible for a with-profits fund to experience a high volume of surrenders, as a result of which a need to dispose of assets quickly leads to a fall in the market value of those assets. In such a case, the conditions required by the proposed rule may well apply and firms would still be able to impose MVRs on surrendering or transferring with-profits policyholders. However, we also propose to remove the requirement for the difference in value to be 'significant' as if there is a high volume of surrenders, firms may need to be able to apply an MVR when the asset value is less, but not significantly less, than the face value of policies.

**Q9:** Do you agree with our proposal to change the rule so that an MVR can be applied only where there could otherwise be a payment in excess of the value of the assets underlying the policy?

2.56 When an MVR is imposed it can have the effect of removing some or all of the bonuses that were allocated to policyholders in previous years. This is because policy values are reduced by the level of the MVR, including past bonuses allocated to policyholders, but without a parallel mechanism to deliver a similar reduction to past shareholder distributions. Where a firm is owned by shareholders and makes a bonus declaration, normally on the basis of 90% for policyholders and 10% for shareholders, the effect of an MVR is to reduce the amount paid to policyholders to less than 90% which in consequence, increases the effective percentage paid to shareholders to more than 10%.

2.57 In 2007 we amended COBS 20.2.17R(3) to ensure that where the application of MVRs by shareholder-owned firms has the effect described in paragraph 2.56, there must be a corresponding reduction in the amount paid to shareholders to maintain the overall amounts distributed to policyholders and shareholders in the specified ratio. The rule requires firms to ensure that distributions remain in line with the 'required percentage' over time, so shareholders do not gain an unfair advantage over with-profits policyholders. We remain content with the policy intention, but we believe the wording of the rule itself may lack clarity. We therefore propose to amend the rule to make it clearer. Its intended effect will not change.

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

### Strategic investments

2.58 Firms often use with-profits fund assets to make strategic investments. By 'strategic investment' we mean a significant investment in a single asset which, while it may be tradable, is often illiquid or has the potential to be hard to value and/or sell. Examples of such investments include the firm's head office building and major stakes in businesses whose commercial interests are aligned with those of the firm's owners, such as investment management companies or general insurance subsidiaries and advisory businesses.

2.59 Such investments can give rise to conflicts of interest in a number of ways. The ownership of a head office building illustrates the most obvious of these. The firm may seek to occupy it on uncommercial terms, leading to with-profits policyholders being denied a proper return on the investment. In a declining or closed fund, as an illiquid asset, it will represent an ever-increasing proportion of the with-profits fund. Its illiquid nature may mean that money is tied up, so preventing or reducing cash distributions to exiting with-profits policyholders.

2.60 A further potential issue likely to arise when with-profits assets are used to buy or fund the creation of another venture, for example an investment management company, is whether better returns would be available if the assets were invested elsewhere.

2.61 The question of whether a strategic investment should be retained is increasingly relevant, as funds which have closed to new business need to ensure they have sufficient liquid assets to meet claims as they fall due. We would be surprised if funds in this position had not already begun to address this question.

2.62 Therefore, we propose to introduce a new rule requiring that, where strategic investments are made or retained, the firm's governing body must be satisfied, so far as it reasonably can be, and can demonstrate, that the purchase or retention is likely to have no adverse effect on the interests of with-profits policyholders. This is similar to the proposed new rule for new business.

2.63 If a firm reviews its strategic investments and concludes that it is no longer in the interests of with-profits policyholders to retain them, we would not expect the firm to dispose of it on a 'fire sale' basis. That, too, would be against its with-profits policyholders' interests. We would expect firms to put disposal plans in place enabling them to realise the best price for the asset they are selling.

2.64 We also propose to restore guidance previously in COB 6.12.86G which was removed when the conduct of business rules were rewritten in 2007, and to amend this appropriately to reflect the new rule. This guidance sets out issues firms should take into account in relation to strategic investments. Chapter 24 of CP06/19[14] noted that where such guidance was deleted, it was because the rule it supported was self-evident or self-explanatory. Its reintroduction does not, therefore, impose any extra burdens on firms, but we believe it is helpful for the points it includes to be set out explicitly in the Handbook.

14 CP06/19: *Reforming Conduct of Business Regulation*, (October 2006).

2.65 These provisions will be reviewed in the light of the Solvency II Directive and further changes may be needed when Solvency II is implemented.

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

## Charges made to with-profits funds

2.66 COBS 20.2.23R prohibits firms from charging with-profits funds for costs that are more than the costs they have incurred in operating the fund. In that situation, the firm would be taking an additional element of profit from the fund beyond its share in distributions, and the fund would leak value.

2.67 It is now common for firms and groups to use an in-house service company which, for example, may employ all staff and may cross-charge other parts of the organisation for the work they do. In our view, the same principle relating to charging costs to a with-profits fund should apply however the firm or group chooses to organise itself. Otherwise a group could enable its shareholders to extract value from a with-profits fund of more than 10% of distributions, by setting up an in-house service company that adds a profit-loading element to the costs it charges to the with-profits fund. We are therefore proposing a change to the wording of our rule to make our intention clear.

2.68 It has been put to us that, if firms and groups cannot include a profit margin in the amounts their in-house service providers charge to their with-profits funds, it could lead to firms going to external suppliers for their services. Those suppliers would legitimately be able to include a profit margin in their charges that could be higher than those from an in-house provider. Therefore, the argument goes, this would disadvantage with-profits policyholders. We do not understand why firms, especially shareholder-owned firms, would act in this way. The lower the costs charged to the fund, the higher its surplus. Shareholders would have the choice of participating in the higher surplus arising from its own lower cost, in-house arrangement or of receiving less by participating in the smaller surplus that would be generated if the firm chose to use a more expensive external supplier.

**Q12:** Do you agree with our proposal to amend COBS 20.2.23R to prevent value being extracted from a with-profits fund by other group companies making charges in excess of their costs?

2.69 Our existing rule[15] applying to the corporation tax that may be charged to a with-profits fund has attracted a considerable level of opposition. The rule specifically applies to the circumstances when the part of the firm's corporation tax liability – which is based on surplus that is not reserved for policyholders (particularly the element distributed to shareholders) – can be charged to the with-profits fund.

2.70 The accounting and reporting rules that Solvency II will introduce are likely to lead to changes in the basis of taxation of life companies. HM Revenue and Customs have already consulted on this, but it is not yet clear what the new tax regime will be.[16] We will therefore return to this matter in the further consultation we described in paragraph 1.2.

2.71 Several commentators have said they believe our rules should not allow a firm that operates a with-profits fund to meet the cost of its pension scheme deficit from that fund. We wish to comment in this CP. In our view, pension benefits can form an integral part of an employee's remuneration package and, in principle, we think it is acceptable for a fair and reasonable proportion of any deficit in the scheme to be met from the with-profits fund, along with other components of staff remuneration costs. The WPRR did not reveal any examples of firms excessively charging a fund for this.

2.72 We accept that, in theory, a deficit may have arisen or been made worse if a firm had been negligent or irresponsible in funding its pension scheme liabilities. In that situation, there could be an issue over the amounts of the costs that fall at different times on different groups of policyholders. However, it is not clear to us how, in practice, such a situation might be identified and the effects assessed. We therefore propose to maintain our existing approach to this matter which is, implicitly, to permit a fair and reasonable proportion of any deficit to be included in the staff costs that are charged to the with-profits fund.

## Excess surplus

2.73 Our rules currently require firms to assess annually whether a with-profits fund has an excess surplus, and to distribute it if it would be a breach of Principle 6 to retain it.

2.74 This rule, and its associated evidential provision, does not mean a firm must compromise on its need to hold back capital for regulatory or commercial purposes where there are sound reasons to do so. A firm may have a number of good reasons for holding money in a with-profits fund that it cannot distribute. It has to comply with the prudential requirements to which it is subject; it may justifiably need to retain capital to support its future plans, including the writing of new business; or it may justifiably need to maintain a level of financial strength to support a credit rating appropriate to its status. The amount of money that has to be held back will vary from fund to fund and can be regarded as the fund's working capital.

15 COBS 20.2.27R
16 The Treasury: *Solvency II and the taxation of insurance companies*, (March 2010).

**2.75** The rule on excess surplus takes effect if, having taken all appropriate factors into account, including those outlined in paragraph 2.74, a fund finds it has additional money which there is no good reason to retain. In that situation, we believe that the need to treat policyholders fairly means a distribution should take place.

**2.76** In this situation, our current rules give the firm the option of carrying out a reattribution instead of a distribution. However, we no longer believe a reattribution is an appropriate alternative course of action in relation to an excess surplus. As Mr Justice Norris said in his judgement in the Aviva reattribution, 'a distribution and a reattribution are fundamentally different processes, and to present them as alternatives is not entirely accurate'.[17] A reattribution brings about a change to the possible recipients in the event that the working capital in a with-profits fund ceases to be required at some time in the future. But it should not alter the recipients of any existing identified excess surplus. We now take the view that where an excess surplus is identified, it should be distributed in the 'required percentage' to with-profits policyholders. Therefore, we propose to delete the part of COBS 20.2.22E allowing firms to carry out a reattribution as an alternative to a distribution where an excess surplus has been identified.

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

### Reattributions

**2.77** There have been only two reattributions of inherited estates in the last ten years, but these have been carried out by large firms and have involved substantial sums: around £1.7bn in the case of AXA Equity & Law and around £4bn for Aviva. There has therefore been a potentially high impact on policyholders affected. These reattributions also attracted significant political and media interest. It is likely that any future reattribution will also be a high-profile event that will give rise to complex issues over the fair treatment of policyholders. Some commentators have criticised the outcomes for with-profits policyholders of the two reattributions referred to, in comparison with gains for shareholders. Nevertheless, in both recent reattribution exercises, policyholders voted by overwhelming majorities to accept the offers made to them and the Court endorsed the reattribution schemes put before them. In addition, any policyholder who did not wish to accept the firm's offer could maintain his or her existing rights to surplus in the inherited estate.

**2.78** The new policyholder advocate rules introduced in 2005 meant that particular focus was given to policyholders' interests in the most recent reattribution. The policyholder advocate also challenged the rules governing the operation of with-profits funds and how firms interpreted them.

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17 *In the matter of Commercial Union Life Assurance Company Ltd and Ors* [2009] EWHC 2521 (Ch).

2.79 One of the WPRR themes carried forward into this CP is the importance of with-profits funds distributing any excess surplus in the 'required percentage', which in the case of shareholder-owned funds has generally been 90% to policyholders and 10% to shareholders. The outcome of a reattribution has, in practice, produced a much lower percentage for policyholders, not least because the certainty of getting some money now will often be more attractive to a policyholder than the chance of receiving a higher amount at an uncertain point(s) in the future.

2.80 Policyholders are entitled (at least) to participate in a distribution which is made, although they cannot require a firm to make a distribution. COBS 20.2.21R and COBS 20.2.22E require a firm to determine on an annual basis whether it has an 'excess surplus', and to distribute an identified excess surplus if they do not have a good reason for retaining it (i.e. unless it is fair to their customers to retain it). The operation of those rules may therefore make it more likely that a distribution will occur. The main point at issue will be how much of the surplus capital is excess surplus and therefore capable of being distributed.

2.81 Where a firm proposes a reattribution, we believe it should be required to discuss with us in advance whether it does, in fact, have any excess surplus and, if so, the amount of it and to discuss the firm's capital requirements for future new business. The potential actions which the firm is obliged to take and which will be discussed during this process will include the distribution of any identified excess surplus before the proposed reattribution of the remaining working capital is progressed.

2.82 In this context, the forecast level of new business is crucial as it drives the level of capital the firm will need to retain (rather than distribute), and the level of surplus to be reattributed. A firm must be able to set out:

- a solid basis for its view on excess surplus;
- its plan for distributing the excess surplus to policyholders; and
- its overall justification for removing the remaining working capital in the estate from the with-profits fund in a reattribution.

2.83 Once that is done, a policyholder advocate should be identified and brought into the process.

> **Q14:** Do you agree that a firm that proposes a reattribution should, prior to that proposal, be required to pay particular attention to identifying and distributing excess surplus?

2.84 Firms will also need to discuss governance arrangements with the regulator, including the terms of reference for the policyholder advocate. Firms with a public listing must bear this in mind to fulfil their responsibilities in terms of with-profits regulation and market-sensitive information. We are proposing to amend our existing guidance to reflect our expectation in practice that the discussions in respect of the policyholder advocate will lead to agreement with us about the policyholder advocate's precise role.

2.85 A crucial part of the reattribution process is keeping policyholders regularly informed. It is particularly helpful when communications come from the policyholder advocate. We believe it is in the interests of independence and transparency that the policyholder advocate should have the right to communicate with policyholders without the firm initially approving the content of the communication. This does not prevent firms from supplementing such communications with their own messages if they believe it is appropriate.

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

2.86 One observation from recent reattribution exercises is the importance of the option for a policyholder not to accept the firm's offer, and still be able to keep the same interest in the estate post-reattribution as they had before it. Small but significant minorities in recent reattributions have done so. This is a valuable safeguard. Our rules currently refer to firms' ability to use the statutory process of a solvent scheme of arrangement to put forward a proposal that allows most policyholders to bind the minority in a reattribution. While we acknowledge that this is a statutory process whereby a firm may be able to reach agreement with its policyholders, we do not believe that its use in the context of a reattribution will be fair, as it removes the option for policyholders to reject a firm's offer and to retain their interests in the estate.

**Q16:** Do you agree that it would be unfair for a firm proposing a reattribution to seek to bind the minority, against their wishes, by means of the reattribution scheme?

2.87 We will also publish a set of guidelines to act as a reference point for all parties in any future reattribution to ensure that the lessons learned from the Aviva reattribution and other exercises remain available. We will discuss this further with interested parties.

### Compensation and redress

2.88 In 2009 we amended COBS 20.2.25R so that shareholder-owned firms could not use assets from a with-profits fund to pay compensation and redress arising from any event occurring after 31 July 2009. The rule does not distinguish between what might be regarded as minor administrative errors and systemic issues; no compensation or redress payment, regardless of the cause, must be charged to the with-profits fund.

**2.89** In our response to paragraph 2.12 of PS 09/13[18], we said we would remain open to reconsidering the issue of minor administrative errors. However, this was subject to being presented with a practical and workable proposal to use the with-profits fund to make charges for compensation or redress, or to anomalies arising in how the rule operates. We have not received any requests from firms to waive or modify this rule. Only one firm approached us with an alternative approach, which we did not consider adequate in maintaining the principle of the new rule. As things stand, therefore, we do not propose to make any further changes to our rules concerning compensation and redress.

### Communications to with-profits policyholders

**2.90** One of the biggest sector-wide failings the WPRR identified was the poor quality of communications provided to with-profits policyholders. We have concerns over the quality of event-driven communications, such as surrender and transfer notices, and the consumer-friendly version of the PPFM (CFPPFM). The governance relating to this literature was also found to be wanting, and furthermore, a lack of ultimate 'ownership' of documents between different departments within firms exacerbated this problem. These concerns are not specific to any type or structure of firm, or whether they have closed or open funds.

**2.91** This situation is particularly disappointing given that we made clear our concerns over this issue in 2007.[19] The WPRR specifically stated that:

'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, namely:

- 'Post-sale information should be sufficiently 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.
- '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.'[20]

18 PS09/13: *With-profits funds – compensation and redress* (July 2009).
19 FSA: *Insurance Sector Briefing* (May 2007).
20 FSA: *With-profits Regime Review Report* (June 2010), pp. 19-20.

2.92 Firms must ensure that their literature is clear, fair and not misleading. We strongly encourage firms to review all their with-profits communications in light of the WPRR and, where necessary, revise and improve it.

2.93 At the same time, we are aware that firms find the current requirement to produce a CFPPFM, which gives a meaningful summary of a fund's PPFM, challenging. We recognise that requiring a summary of what is often a very lengthy technical subject may not necessarily lead to a document that provides meaningful information to with-profits policyholders.

2.94 While we remain convinced that firms should produce a short explanation of how they run with-profits funds, we are minded to revisit whether requiring CFPPFMs is the best way to achieve this. We will therefore bring forward proposals in the next with-profits CP, referred to in paragraph 1.2.

# 3

# Corporate governance

3.1 The governance of life offices operating with-profits business has been under increased scrutiny since Equitable Life's closure to new business in 2000. Significant changes have already been put in place in both mutually-owned and shareholder-owned life offices as governance raises significant issues for all firms, regardless of ownership structure. These changes address the requirement that the shareholders' and other stakeholders' interests have to be balanced against with-profits policyholders' interests; different groups of policyholders in a single fund can also have potentially conflicting interests.

3.2 In 2004 we replaced the Appointed Actuary regime with two new actuarial positions: an actuarial function holder and a with-profits actuary. The other main pillars of the current with-profits governance arrangements are the following requirements:

- all but the smallest with-profits firms must produce a PPFM;
- the firm must report to policyholders on the company's compliance with the PPFM and provide them with the with-profits actuary's report on the firm's exercise of its discretion; and
- firms' arrangements must involve some independent judgement in assessing compliance with the PPFM and addressing conflicting rights and interests, which has led an increasing number of firms to adopt a with-profits committee as the means to deliver this.

3.3 There has been criticism that with-profits committees, where established, are not sufficiently independent. It has been suggested that these committees should be completely separate from the governing body and not include any directors (executive or non-executive) of the firm.

3.4 Our objective is to improve on the existing regime, not to devise a completely new approach. The governing body, usually the main board, has and will keep regulatory responsibility for treating its with-profits policyholders fairly. We propose further changes to assist governing bodies in obtaining the best advice to enable them to balance the conflicts of interest which they face, and to deliver a fair outcome to policyholders in as transparent a way as possible. The existing requirements, which prevent the with-profits actuary from being the chairman or chief executive of the firm and introduce an element of independent judgement, are designed to prevent any one individual from dominating decision-making and to improve the quality of the governing body's decisions.

3.5 Firms' arrangements are currently required to involve some independent judgement in assessing compliance with their PPFMs and addressing conflicting rights and interests of policyholders and, if applicable, shareholders (COBS 20.3.2G). The independent judgement can be provided by means such as the following:

- a with-profits committee;
- an independent person with appropriate skills and experience; or
- for small firms, one or more non-executive members of the governing body.

3.6 We have considered the suggestion that the management of with-profits funds should effectively be transferred to some form of completely independent with-profits committee, whose members would have powers analogous to those of defined benefit pension scheme trustees. However, we believe that this would not be practical for mutual societies in particular, where with-profits policyholders are also often the owners of the business. While it is potentially applicable in principle to shareholder-owned funds we note that in practice a fund's managers are responsible not only to the policyholders but also to the shareholders who provide the firm's capital and who ultimately stand behind the fund. If the fund was mismanaged, the shareholders' capital would be at risk (as well as the policyholders' benefits). Primary responsibility should remain with a firm's management in order for them to fulfil their duties to the shareholders as the firm's owners.

3.7 When we consulted on the policy changes in 2003 we made a conscious decision not to mandate a with-profits committee for all funds because of the number of smaller life offices and mutually-owned firms for whom we felt such a requirement would be disproportionate to the scale and complexity of their business. We now wish to require certain funds to have a with-profits committee, rather than any other arrangement. We continue to believe that the insurance sector is so diverse that it could be disproportionate to require a with-profits committee for every firm in all cases. Smaller firms may not have the infrastructure to support one. So we will make them compulsory only for larger funds; smaller funds will keep the options they have now.

3.8 We propose to define what we mean by a 'small' with-profits fund, for which a with-profits committee will not be mandated. There are many possible ways in which a 'small' fund can be defined. We propose to use the size limits from the existing definition of a firm that is not subject to the realistic reporting regime as set out in the General Prudential Sourcebook (GENPRU) 2.1.19R. This applies to all insurers carrying on long-term insurance business other than non-directive friendly societies,[21] insurers with no with-profits business and insurers with with-profits liabilities that were under £500m on 31 December 2004 and which have remained below that threshold. However, for the purposes of this consultation,

21 Non-directive friendly societies are those firms outside the scope of the EU Life Directive.

our definition will refer to the fund size as of the date of these proposed rules coming into effect. We note that Solvency II will have an impact on this threshold in the future. However, our proposed definition has the merits of being a classification familiar to UK life insurers and which is relatively simple to understand while we wait for the detail of Solvency II to become clearer.

**3.9** Smaller funds will remain subject to the requirement that their arrangements should involve independent judgement in relation to, among other things, compliance with the PPFM and conflicts of interest. For particularly small or straightforward funds this might involve, for example, asking one or more non-executive members of the governing body to participate actively in the with-profits governance arrangements.

**3.10** While the limit for a 'small' fund is set at the fund level rather than the firm level, we will require a firm with one or more funds with a with-profits committee to appoint the same with-profits committee for all its with-profits funds. This will help to provide consistency.

**3.11** Increasing the number of funds with a with-profits committee means more people will be needed to staff them. We recognise the industry's concerns that there is likely to be a limited pool of appropriate people with the necessary knowledge and independence. Members of with-profits committees, whether or not they are also non-executive directors, are already treated as holding a significant influence function. We expect that many will therefore face a regulatory interview before their appointment is confirmed. Non-financial services companies can employ non-executive directors without their candidates having to face this hurdle. Nevertheless, we believe this is a relatively modest step that will enhance with-profits governance and which has the potential to deliver real benefits to policyholders. We will ensure there is sufficient time for firms to decide what needs to change and to recruit appropriate people.

> **Q17:** Do you agree that a with-profits committee should be required for all with-profits funds except small funds, and that the threshold suggested is the right one?

**3.12** A key part of the role of a with-profits committee is to challenge the management. Having an element of independence is crucial to delivering this. Related to this is how the composition of the with-profits committee facilitates its role. We do not consider that it is appropriate for either the management as a whole, or members of the management, to sit both as the majority of a with-profits committee and as a firm's Board or governing body. While it may keep down costs, it does not provide the degree of separation from the executive that we think is a necessary element of the with-profits committee's function. We have therefore considered two alternatives:

- whether members of the with-profits committee should be wholly independent and external to the firm whose with-profits funds it considers; or
- whether they can include internal appointments but with an independent majority.

3.13 A with-profits committee made up entirely of external appointments would provide the strongest safeguard against management actions that favoured either particular groups of policyholders over others, or consistently made decisions in favour of shareholders or other owners without fully considering whether policyholders were being treated fairly. However, this could be disproportionate for some funds and would place a considerable burden on its members if they met only quarterly and had to provide advice on the full range of issues a with-profits committee might wish to consider. The size of the pool of appropriately qualified people to take up such positions is also a relevant consideration.

3.14 A with-profits committee made up of a mix of independent non-executives and either internal or external appointments would be closer to the structure many funds already have in place. Such a committee would provide more flexibility for firms and its members are likely to have a better understanding of the ethos and history of a fund through their other roles than entirely external appointments.

3.15 As a safeguard, we would require the with-profits committee to have an independent majority. Our expectation is that the committee's chair would normally be a senior independent non-executive or external person. Whether the with-profits committee is external to the firm or simply independent of management, we propose to set a quorum of at least two members, to avoid undue influence from a single dominant figure.

3.16 In drafting rules to require a with-profits committee to have independent members, we will have to suggest factors relevant to the determination of independence. The Financial Reporting Council's (FRC) UK Corporate Governance Code ('the Code') has provisions at paragraph B.1.1 which essentially delegate to the board the responsibility to identify which non-executive directors it considers to be independent and gives examples of circumstances where independence may be compromised through certain relationships or circumstances.[22]

3.17 We note that the Code is not binding and applies only to FTSE 350 listed companies. Nevertheless, these criteria have the advantage of being generally well accepted, and they place the burden of establishing and publishing an individual's independence on the firm's governing body. We propose to adopt a parallel approach using the same criteria, putting the responsibility on the board or governing body to identify people independent of the firm to sit on the with-profits committee. Since responsibility for the conduct of the firm and its management remains with the board or governing body, it is right that that they appoint the members of the with-profits committee. If a firm with a small fund appoints an independent person instead of a committee, we would still expect the firm's governing body to adopt the same approach.

**Q18:** Do you agree that the members of a with-profits committee should be independent and completely external to the firm whose with-profits fund(s) they are considering?

22 The relevant section of the Code is attached at Annex 1.

**Q19:** Alternatively, should we continue to allow directors and non-executive members of the governing body to sit on the with-profits committee, subject to its having an independent majority?

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

**3.18** In our view, the governing body must consider and give due weight to the views of the with-profits committee to discharge its responsibility to treat customers fairly under Principle 6. We propose to require the governing body to establish a properly functioning with-profits committee, which it must provide with information sufficiently comprehensive to enable the committee to discharge its functions. Information must be provided far enough in advance of decisions being made to enable the with-profits committee to give proper consideration and to report to the governing body.

**3.19** We propose that a firm should discuss the terms of reference of the with-profits committee with us and publish them on the firm's website. The existing requirements for the committee to review a firm's compliance with the PPFM and address conflicting rights and interests will remain, but we will add a new requirement that the committee should also satisfy itself that how the fund is run is properly reflected in the PPFM. The terms of reference must also include a requirement for the governing body to consult the with-profits committee in a timely manner concerning all matters the with-profits committee could reasonably expect to be consulted on. The with-profits committee may also seek to involve itself in issues within its terms of reference, without being formally requested to do so.

**3.20** We propose to issue guidance to encourage a clearer separation between the with-profits committee's recommendations and the governing body's decisions. Decision-making in relation to funds would be improved if the with-profits committee presented governing bodies with clearly recorded independent advice and the bodies then had to reach and minute their own decisions in response. One feature of current arrangements is that the source of decision-making is often unclear. Firms tell us that challenge was provided but meeting minutes do not always reflect this.

**3.21** The requirements placed on a with-profits committee should also apply to the alternative arrangements used by smaller funds, e.g. the independent person or the non-executive director. We propose to include provisions to reflect this.

**3.22** We believe that with-profits committees, the independent person or non-executive director (as applicable) should have the right to make a reasonable request to obtain external advice, including actuarial advice if they believe it is necessary to aid their decision-making. In shareholder-owned funds, we also think that they should be able to request that such advice is obtained at the shareholder's expense, and we provide guidance on this. We are concerned that if this was done only at the fund's expense, firms could seek to restrict the availability of resources for the committee, thereby forcing it to make either sub-optimal recommendations or to load additional costs on to the fund. Putting the emphasis the other way round encourages firms to service their committees efficiently to minimise the need for additional costs to be incurred.

**3.23** Issues with-profits committees should consider include, but are not confined to:

- both the firm's compliance with its PPFM as currently drafted and whether the way in which the fund is run is properly reflected in the PPFM;
- how conflicts of interest have been identified and managed;
- the identification of surplus and excess surplus and the merits of its distribution versus retention;
- how bonus rates and MVRs (if relevant) have been set and applied and the application of smoothing;
- any significant changes to the risk/investment profile of the with-profits fund – including the management of material illiquid investments and strategic investments;
- the impact of any planned or implemented management actions;
- the firm's strategy for future new business in the with-profits fund;
- the firm's customer communications, e.g. annual bonus notices and periodic reviews of stock literature;
- relevant management information, such as customer complaints data;
- drafting and adherence to distribution, management and run-off plans and court schemes as appropriate;
- the costs incurred in operating the with-profits fund; and
- any other issues the with-profits policyholders may reasonably expect the with-profits committee to scrutinise.

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

**Q22:** Do you agree that the conclusions of the with-profits committee and the governing body's decisions to accept or to reject those conclusions must be clearly recorded?

**Q23:** Do you agree that with-profits committees should have the right to make a reasonable request to obtain external advice and in shareholder-owned firms request that this is at the shareholders' expense?

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

**Q25:** Do you agree that the with-profits committee should be able to raise issues proactively that it thinks the governing body needs to consider?

**3.24** The Supervision manual (SUP) 4.3.16A requires the with-profits actuary to advise the firm on its use of discretion and to make an annual report to policyholders. The with-profits actuary and the with-profits committee will normally work closely together and there is no reason why the with-profits committee should not be required to consult the with-profits actuary. We note one firm's with-profits committee's terms of reference state that 'all material discretionary actions proposed in relation to the with-profits business of the Company will be discussed by the Committee with the Company's With-Profits Actuary.' We therefore propose to require such a provision to be included in the terms of reference for with-profits committees.

**3.25** It is not our intention to duplicate functions between the with-profits committee and the with-profits actuary. The extent of any overlap will depend on the relative quality and forcefulness of the committee members and of the with-profits actuary. Any governance system is only as effective as the people who hold positions within it. In addition, the with-profits committee provides an informed challenge to the firm's decision-making as a second line of defence behind the actuarial function and the with-profits actuary.

**3.26** We propose to address this and support the with-profits actuary by adding a new item to the Handbook section on conflicts of interest (SUP 4.3.17R). This will refer to the with-profits actuary not reporting to or having his remuneration determined in a way that would give rise to a conflict of interest over the advice he gives. The with-profits committee will also have a role in assessing the effectiveness of the with-profits actuary, rather than leaving this entirely to one or more of the firm's executives. This is different from the options outlined in *The Morris Review*[23] where the with-profits actuary would either be external to the insurer or appointed by the with-profits committee. Our proposals are intended to achieve the objective of supporting the with-profits actuary in his role, while making it clear that responsibility for how the fund is managed remains with the board or governing body.

23 [ARCHIVED CONTENT] Morris Review of the Actuarial Profession – HM Treasury.

**3.27** We will also require the firm to notify us in the event that the governing body departs from the with-profits committee's advice on significant issues following escalation within the firm, if the with-profits committee requests the firm does so. This is intended to be an unusual step, but would allow supervisors of smaller firms to assess early on whether firms are delivering on TCF issues and governance. This is a less onerous variant on *The Morris Review's* suggestion that the with-profits actuary should make a full report to the regulator.

**3.28** These proposals will ensure that with-profits policyholders' interests are given greater weight in a firm's decision-making. As a significant part of the industry moves into a phase of consolidation and run-off, difficult decisions will need to be made about identifying and distributing surplus. We wish to protect policyholders by forcing funds to do more to demonstrate how their decisions affect their with-profits policyholders' interests.

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

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

**Q28:** Do the proposed changes for the with-profits actuary provide sufficient support for his independence and how practical is the arrangement for setting his remuneration?

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

## Annex 1:

# Financial Reporting Council's UK Corporate Governance Code: Section B 1.1

**B 1.1** The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director:

- has been an employee of the company or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than nine years from the date of their first election.

# Annex 2:

# Cost-benefit analysis

### Market failure analysis

1. The with-profits market suffers from information asymmetries between policyholders and firms, and between policyholders and advisers. These information asymmetries stem from the complexity of the with-profits products and the opacity of their operation. These problems are further compounded by the weak position policyholders find themselves in – this is essentially due to the high switching costs or exit penalties that are often involved, and because not all policyholders' interests are identical.[1] To highlight a number of significant issues:

- At the time of purchase, the inherent complexity and considerable discretion left to management makes it hard for policyholders and, in some instances, even their advisers to have a clear understanding of the risk and reward balance of with-profits products and what is driving funds' performance. This problem may be exacerbated by the uncertainty associated with any investment returns.
- Where advisers are engaged, as is often the case with the sale of with-profits products, there is a conflict of interest between consumers (the principals) and advisors (the agents), as advisors' and consumers' incentives are not completely aligned.
- Finally, a conflict of interest remains after consumers purchase with-profits products and become policyholders. This is because the incentives of firms that run with-profits funds are not wholly aligned with those of policyholders. This is further compounded by the limited transparency in the operation of funds and high-switching costs, both of which limit the market's ability to influence firms.

1 For policyholders whose policies are due to mature very soon, their main interest is likely to be the amount of payout in the next couple of years; however, for policyholders whose policies have many years to run before maturity, they have greater interest in the continued growth and financial strength of the fund.

2. These market failures can result in unfair outcomes for with-profits policyholders. The proposals in this CP aim to mitigate the impact of the conflict of interest between firms that manage with-profits funds and policyholders, and result in fairer outcomes for policyholders. Although there are currently rules and guidance aiming to mitigate these market failures, they have proved less effective in achieving their intended effect than hoped for.

3. Many firms' practices are inconsistent with our rules and guidance. In the recent WPRR we identified a significant number of firms where with-profits funds operated with due regard to policyholders' interests. However, we also found that most firms did not satisfactorily demonstrate how their practices were consistent with well-run with-profits businesses in one or more of the areas we assessed.

## Cost-benefit analysis

4. When proposing new rules, we are obliged (under section 155 of FSMA) to publish a cost-benefit analysis (CBA), unless we believe the proposals will give rise to no costs or to a minimal increase in costs. As a matter of policy, we also provide a CBA for significant proposed guidance relating to rules. The CBA is an estimate of the costs and an analysis of the benefits to different parties that will arise from the proposals. It is a statement of the differences between the baseline (broadly speaking, the current position) and the position that will arise if we implement the proposals. In some cases, the differences could be transfers from one party to another, rather than a change in overall welfare.

5. We consider below the incremental costs and benefits of each individual policy proposal outlined in this CP. We make two initial points here. First, many of these proposals are mainly driven by equity concerns (i.e. justice and fairness) that arise as a consequence of the market failures described above. These proposals therefore would largely result in transfers between different parties that do not directly change overall welfare. Second, to the extent these proposals mitigate market failures leading to a greater proportion of more suitable and/or a smaller proportion of unsuitable products being sold in the future, there would be an increase in overall welfare. However, we believe the additional economic benefits from these proposals may not be large. We note the possibility of such economic benefits from this package of proposals as a whole, but only discuss these for individual proposals where we think these may in particular arise.

6. There are 82 with-profits insurers and friendly societies with 114 funds. In 2009, 61 of these funds were closed and 53 were open. At the end of 2009, there were approximately £330bn of assets under management in with-profits funds supporting about 25 million with-profits policies.[2] While asset levels have declined from £420bn in 2005, they are still significant. In 2009 with-profits funds paid a total of £7.2bn to policyholders.[3]

2 FSA: *With-profits regime review report*, (June 2010)
3 Figures for 2009 bonus distribution from Standard & Poor's Synthesis Life.

## Conflicts of interest

7. The proposal is to change existing guidance (COBS 20.2.1G) on conflicts of interest into a rule, and make it clear that it applies not just to conflicts of interest between shareholders and with-profits policyholders, but also to conflicts of interest between different with-profits policyholders, and between with-profits policyholders and other classes of person. Several other specific rules – existing and proposed in this CP – are meant to deal with potential problems arising from particular conflicts of interest. However, these cannot exhaustively cover all potential conflicts of interest. Therefore, this proposed rule intends to capture such conflicts of interests that may arise but are not covered by other regulations.

8. To understand the potential impact of this proposal we have adopted the following approach. First, we have considered the nature of conflicts of interest that may arise in this market. Secondly, we have tried to establish the extent of problems in the market. Finally, we have attempted to understand the extent of change the proposal could lead to.

9. Conflicts of interest in this market can arise in a variety of forms. For example:

- Policyholders may be offered poor surrender values, either to generate surrender profits for distribution to other policyholders or to build up the fund's capital position.
- In deciding how much of a fund is needed as working capital as opposed to being excess surplus available for distribution, a firm may use excessive prudence in setting its risk appetite, to the detriment of policies that mature or are surrendered.
- Conversely, a firm may set annual bonuses higher than is consistent with prudential security to generate publicity and attract sales of new policies in the fund (as experienced in the 1990s).
- A firm may decide to fund guarantees on new policies by subsidising the cost of the guarantees from the estate, reducing the amount distributable to existing policyholders.
- Managers may hold back the distribution of excess surplus to fund other business ventures, e.g. non-profit business, general insurance business or financial advisory business. These may be profitable, in which case some policyholders will ultimately benefit, but which policyholders, and when?

Existing rules in the with-profits space aim to mitigate some of these conflicts of interest issues.

10. Several factors support the assertion that conflicts of interest exist in this market and may be a source of real detriment for with-profits policyholders:

- The opacity and complexity in this market, described in the 'Market Failure Analysis' section above, allows misaligned incentives between firms and with-profits policyholders to be exploited.

- The House of Commons Treasury Committee notes: 'Over recent decades, the with-profits sector has suffered from conflicts of interest on the part of the management of life funds by proprietary companies, leading to concern among some holders of with-profits policies that their interests have not been adequately protected'.[4] Commenting on the nature of conflicts of interest, the report further adds that these are inherently large in the with-profits market.
- Clare Spottiswoode, the policyholder advocate in Aviva's reattribution, has commented adversely on the degree of discretion firms have in dealing with conflicts of interest.[5]
- An investigation of data we hold on firms indicates that several funds have paid either no or close to no bonuses for many years. While this by itself is not proof of a conflict of interest that has resulted in with-profits policyholders being treated unfairly, the observation – at least in some firms – does suggest this possibility.
- The WPRR states: 'It is evident...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.'

**11.** Theory and indicative information suggest that conflicts of interest in this market can materially harm with-profits policyholders. We note, as before, that other specific rules, both existing and those proposed in this CP, intend to prescribe the manner in which firms should deal with many of the specific conflicts of interests noted above.

### *Transfers*

**12.** To the extent that the proposal to convert guidance into a rule results in fewer instances of conflicts of interests being settled in ways that are contrary to the with-profits policyholders' interests, there will be a transfer from shareholders to policyholders. Similarly, to the extent that the proposed requirement to ensure fair treatment of different classes of with-profits policyholders results in different (from current) settlements, there will be transfers between different classes of with-profits policyholders. As transfers, these effects reallocate but do not generally increase overall welfare.[6]

4 House of Commons Treasury Committee: Inherited Estates. Twelfth Report of Session 2007-08.
5 Ibid.
6 We note that throughout the analysis in this chapter where we discuss transfers, these do not directly change overall welfare. There may indirectly be further impacts, for example a reduction in moral hazard on the part of shareholders.

13. How large might these transfers leading to fairer outcomes be? The evidence above indicates existing problems in the market, suggesting material room for improvement. However, because of existing guidance, firms should be doing much of what we will require in any case. Furthermore, other specific rules deal with many particular conflicts of interest that arise in this market. This suggests that this specific 'catch-all' proposal may only bring marginal improvement, beyond the existing and other proposed regulation in this CP.

14. If firms do not currently conform to our existing requirements, why would we expect our proposal to lead to a material change in firms' behaviour? One mechanism for improvement is the greater scrutiny and challenge firms' decisions may come under when dealing with conflicts of interest (including proposed payments of bonuses – an issue where conflicts of interest can particularly lead to significant detriment) in light of our proposed regulation about with-profits committees. Furthermore, by raising the standard from guidance based on a principle to a specific rule, our ability to enforce against non-compliant firms increases. The deterrent effect of this may lead to fairer outcomes.

15. We are realistic in our expectations of improvements in fairer outcomes, acknowledging that these will depend critically on the degree of effective scrutiny and challenge by, among other interested parties, with-profits committees. We further realise that dealing with conflicts of interest is not a mechanical exercise with precise answers. Given the subjectivity inherent in this decision-making process, we realise that firms will continue to try and choose options that maximise their private profits.

16. Consequently, we think our proposal may lead to some, but not large, improvements in fairer outcomes for policyholders where conflicts of interest arise (greater in cases where conflicts of interest are more clear-cut).

### *Costs*

17. There are likely to be additional compliance costs for firms of our requirement. Firms should already be dealing with conflicts of interest fairly. However, the higher standard (changing guidance to a rule) and wider scope (extending the requirement to issues between different classes of policyholders), may lead to incremental costs in ensuring decisions meet these standards and in documenting decisions. Because of existing and proposed regulation that overlaps with this proposal, the true incremental nature of this may not be large. The additional incremental compliance costs for all affected firms may be roughly estimated at approximately £100,000 one-off and £50,000 ongoing per year, based on our experience of conflicts of interest regulation introduced in CP06/9 and CP07/23.[7] We do not cost here the compliance costs arising through the operation of with-profits committees, which we discuss in the governance section at the end of this chapter.

7 We recognise that the conflicts of interest requirements covered in CP06/9 and CP07/23 are different from those proposed here, and apply to different types of firms. This extrapolation therefore, may have a high margin of error. However, we note that the proposal in this CP is incremental to other specific existing and proposed requirements which deal with conflicts of interest situations which typically arise in this sector. The truly incremental part of this proposal may be small, though the administrative burden cost of this is not easy to quantify precisely. Given these uncertainties we have tried not to be conservative in our extrapolation of costs.

### Fair treatment of with-profits policyholders in mutually-owned long-term insurance funds

**18.** We propose to clarify the drafting of the definition of required percentage in one respect to ensure that our original policy intentions are given proper effect; the 'required percentage' should reflect the significance of a firm's established practice, even if the firm has no PPFM or if its PPFM is silent on this point.

**19.** Also, we propose to add guidance to COBS 20.2.17R to highlight this significance and to clarify our expectations of firms in their approach to the issue of established practice. It is for a firm to consider whether it has an established practice and, if so, what it is. We will ask the firm to explain how it has reached its conclusions and whether its practice has been clearly and unambiguously communicated to its with-profits policyholders. If there is some ambiguity or inconsistency between the firm's behaviour and its communications with those policyholders (be it in the firm's PPFM or otherwise), we may take the view that the firm's established practice is different from what the firm has suggested or that the firm has not been able to demonstrate the existence of an established practice at all. The guidance will also outline our approach where a firm puts forward an established practice that involves allocating (but not distributing) some portion of a surplus in its with-profits fund to persons other than with-profits policyholders.

**20.** As the proposals aim to clarify the definition, and give guidance on it, to ensure our original policy intentions are given proper effect, these proposals are unlikely to incur incremental costs and benefits when compared with firms' existing regulatory requirements.

**21.** We also do not believe these proposals should create substantial additional compliance costs, as firms are already producing the evidential information required in the normal supervisory framework. For the same reason, there should also not be significant additional costs for us.

### The terms on which new business is written

**22.** Where a firm writes consistently unprofitable new business supported by a with-profits fund's inherited estate, be it as a result of expense over-runs, because volumes are too low to cover the costs, or because it is deliberately offering loss leaders, it has the effect of eroding the value of the fund to the detriment of existing policyholders.

**23.** This issue has recently become more pronounced because the stock market performance in the last decade leaves less room for pricing misjudgements, and because the significant decline of the with-profits industry as a whole[8] exerts further pressure on firms' cost structures.[9] A survey in February 2008 by the Association of Independent Financial

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8 There were 340,000 new with-profits policyholders in 2006, compared with over five million in each of the years 1996-2001 (Inherited Estates, House of Commons Treasury Committee, June 2008).

9 This decline in new business was attributed to low returns, low consumer confidence following mis-selling scandals, continued competition from open-ended investment companies, and certain changes to the taxation regime which make with-profits products less attractive.

Advisers found that 87% of financial advisers no longer recommend that clients invest in with-profits business. Insurance firms' managements, on the other hand, have incentives to keep writing new business, as the size of their job, the job's prestige and remuneration is likely to be more favourable when business is growing. Under these circumstances, firms seek to incentivise advisers to sell with-profits business with high commission and/or attractive guarantee features of the products.

**24.** The WPRR found that six groups and firms, representing about one-third of the with-profits business in force, had a risk of writing loss-making new business, i.e. that the cost loadings in the new business these firms were writing were, in aggregate, insufficient to cover their new business expenses or had already significant expense overruns. These six firms wrote about £700m in new regular premium and £9.4bn in new single premium contracts in 2009.

**25.** The current rule is designed to address issues arising from the terms or pricing on which new business is written, including the extent of costs (both marginal costs and overhead costs) or the volume of new business written. However, the way it is drafted allows low-level detriment (not classed as material) to occur when firms write new business which, over time, can become significant. We propose to strengthen the current rules and guidance so new business can only be written if the governing body is satisfied, so far as it is reasonably can be, and can demonstrate, that it is likely that there will be no adverse effect on the interests of with-profits policyholders.

*Transfers*

**26.** To the extent that the proposal changes firms' behaviour, new policyholders who would otherwise benefit from lower-priced policies (e.g. attractive guarantees not properly reflected in the pricing) through the subsidy provided by existing with-profits policyholders will face higher prices. This benefits existing with-profits policyholders by reducing their contribution to the subsidy of new business, hence preventing their share of the value of the fund being eroded. This would be a transfer and would not change overall welfare.

**27.** To the extent that eliminated new business was written for the shareholders' gain in other products, there would also be a transfer from shareholders to existing with-profits policyholders.[10]

**28.** We note that these transfers to existing with-profits policyholders intend to put them in the position they would otherwise have been in if the conflict of interest between with-profits policyholders and with-profits fund managers and owners, which allows such unfavourable new business to be written, did not exist. Consequently, the proposal intends to mitigate the impact of this market failure.

10 To the extent that eliminated new business was not written for the shareholders' gain in other products, there would also be a transfer from new policyholders to shareholders. Shareholders also entitled to a share of the fund would otherwise lose out were the value of the fund to erode through the subsidy to unprofitable new with-profits business.

**29.** How large might these transfers be? Existing policy already prevents the writing of new business except on terms that, in the reasonable opinion of a firm's governing body, are unlikely to have a material adverse affect on existing or new with-profits policyholders. However, it appears many firms seek to exploit the wording of the rule in a way that goes against its underlying purpose. Our proposal sets a less subjective and higher test for firms to meet. Because this is a less subjective measure we think firms' governing bodies and our supervisors should be able to identify more easily if firms are breaching the condition, resulting in a material change in current firm behaviour. However, we are also conscious of the fact that the impact of the proposal depends on the ability to identify unprofitable businesses accurately in advance. This is not an easy exercise, which is why we do not think the proposal will prevent all new business being written on (what turns out to be) unfavourable terms.

### *Benefits*

**30.** To the extent that this policy prevents some new business that would have adverse effects on existing with-profits funds from being written, there will be benefits from greater allocative efficiency (from removing under pricing of a product in the market) and eliminating associated transaction costs (e.g. acquisition and administration costs).

**31.** The size of this benefit depends on the change in quantity that a change in price might lead to. By removing the subsidy provided by existing policyholders, firms currently writing loss-making business will have to raise charges, new policy premium rates or reduce their costs. On the surface, increased prices imply a reduction in quantity sold. However, we understand with-profits policies are not extremely price elastic, suggesting quantity may not decline hugely with price increases.[11] Research indicates that consumers' purchasing decisions in the retail investment product market are often based on past performance. If the proposal increases prices, this suggests an indirect impact on quantity through its effect on performance (net of charges) numbers, which could affect consumer purchasing decisions.

### *Costs*

**32.** The proposed rule is prospective, so we do not require business already written to be unwound. Our proposal will change how firms write new business, but it should not impose incremental administration costs on firms for reviewing their new business profitability, because we already require this of firms.

**33.** As the judgement of profitably or not is being made in advance, it is important to have a full picture of new business profitability. If the rule is interpreted too strictly and prevents firms acquiring new customers on the grounds that there are potential losses in initial years, some potential longer-term profits may not be achieved. This would mean costs associated with lost profits for policyholders and shareholders.

11 For example, a Centre for Risk and Insurance Studies study finds that the difference in charges at with-profits firms are high: '…in five of the cases the most expensive policy costs twice as much as the cheapest (which is very unlikely to be explained by differences in product characteristics)'. Centre for Risk and Insurance Studies, *The UK with-profits life insurance industry: a market review*, June 2009.

### Material reductions in new business

34. The current rules in COBS 20 do not explicitly deal with issues arising from significant declines in new business. The proposed rules address the issue of what firms should do when they write very little new business or experience a sustained and substantial fall in the volume of new business.

35. Firms are reluctant to admit that they are closed to new business. This is typically for three reasons. First, they are concerned it will damage the firm's reputation. Secondly, they do not want to go through the regulatory requirements for firms which are closing a fund to new business. Thirdly, managers may have an aversion to closing funds, as it is likely to decrease their job size, their job's prestige or even remuneration. This creates the danger that firms, in refusing to admit there may be a reason for closure, do not re-evaluate the amount of working capital they realistically need, and so do not identify any new excess surplus that could then be distributed to with-profits policyholders.

36. Under the proposed new rule, we will require firms to prepare and maintain a distribution plan updated according to the firm's changing circumstances. We propose to require a firm to prepare a contingency plan in case its volume of new business is significantly lower than it reasonably expected. We will also require a firm to discuss with us what actions it will take when it experiences significant and sustained falls in levels of new business. Finally, we are proposing that with-profits funds that were closed to new business before the current rules came into effect in 2005 should also have run-off plans.

### *Transfers*

37. To the extent that our proposals lead to the increased distribution of excess surplus, there will be a benefit for some with-profits policyholders, primarily to those with-profits policyholders whose policies will mature soon. This would largely be a transfer from with-profits policyholders with longer maturities, who would otherwise gain were the distribution to take place after with-profits policyholders with shorter maturities have left the fund.

38. It is possible that our proposal to extend the requirement to have run-off plans, to with-profits funds which closed before the current rules took effect in 2005, might lead to more equitable distribution between different classes and generations of with-profits policyholders. We understand however, that many relevant funds already have run-off plans and furthermore we would expect any firm that has been closed for several years to have carefully considered these issues as normal management and governance matters. We therefore do not expect this specific proposal to have a large impact.

*Benefits*

**39.** To the extent that the proposal to have contingency plans leads firms to take appropriate management actions sooner in the event of significantly reduced new business, there may be benefits for with-profits policyholders, as taking such actions more promptly may prevent an avoidable reduction of the inherited estate. For example, we note that some firms whose business plans were mainly reliant on selling Child Trust Funds have encountered significant issues as a result of the government withdrawing further such business.

*Costs*

**40.** While there will be no compliance costs for firms that already address the issue of significantly reduced new business as part of their strategic planning and put plans for appropriate management actions in place, there will be compliance costs for firms that currently do not have distribution or contingency plans. The complexity and cost of a distribution or a contingency plan will vary, and will increase as the firm approaches closure of the fund. It is likely that the cost of a distribution and contingency plan for a fund which is about to close would be in the same range as the cost of a run-off plan. In CP207, *Treating with-profits policyholders fairly*,[12] we estimated the total cost of producing a run-off plan to be £37,000 per fund. After adjusting for inflation, this indicates a per-plan cost of £45,000. From this, we estimate that the maximum incremental cost for the entire population of 53 open funds of setting up contingency plans will be around £2.4m. Since we already expect at least some firms to be putting appropriate contingency plans in place, actual incremental costs of the contingency plan requirement should be lower.

**41.** We further estimate that at least 20 with-profits funds were closed to new business before the current rules took effect. These would all now be subject to the requirement to have run-off plans in place. Adjusted for inflation, this would imply a total cost of about £900,000 for the industry. However, this is a substantial overestimate of the actual incremental costs, since many of these funds already have run-off plans in place.

### Market value reductions

**42.** We propose to remove the ability of firms to impose MVRs on the ground of surrender volume alone. This would remove the potential detriment for policyholders that would stem from MVRs being imposed unnecessarily on the ground of high surrender volume without this having any impact on the asset value.

**43.** We did not find during the WPRR or in our previous investigations, any occurrence of MVRs being imposed on the ground of surrender volume alone. It is possible then that the incentive to do so is very low and therefore the possibility of detriment unlikely. Relative to current practice then, this proposal implies no impact. However, it closes an avenue of potential policyholder detriment.

12 CP207: *Treating with-profits policyholders fairly*, December 2003, annex 4, paragraph 22.

### Strategic investments

44. The complex and often opaque nature of with-profits funds puts with-profits policyholders at a disadvantage as they are often unaware of how the fund is being run. This gives rise to the possibility that funds may make investments which have strategic value for the insurer as a whole, but which do not generate an adequate return for the with-profits fund itself, or that funds may make investments in projects from which the profits accrue mainly to shareholders. The proposed new rule (which enhances current guidance) aims to mitigate this problem by preventing insurers from making investments that are against the interests of with-profits policyholders.

45. Strategic investments typically include a firm's head office (and other) premises, investments in subsidiaries (for example to develop investment fund business etc.), and cross-holdings in other assets owned by the firm or its holding company.

*Transfers*

46. To the extent that this proposal leads to insurers not making future strategic investments, and unwinding existing strategic investments made from with-profits funds that are against the interests of with-profits policyholders, there will be benefits for policyholders. Part of this benefit would be a transfer from shareholders (and therefore not an overall change in welfare), but part should be an economic benefit.

47. Where these strategic investments are beneficial to insurers, and firms continue to invest in these projects using shareholder funds instead, there will be a transfer between shareholders and policyholders.

48. Where these strategic investments have not been sound – i.e. firms did not take into account full costs at the time of investment, since they did not bear the cost of the investment capital – then it is reasonable to expect that firms will not want to use shareholders' funds to keep these strategic investments. We can distinguish between two potential consequences. First, to the extent that some uneconomic investments would no longer be made, an economic benefit would accrue. Secondly, to the extent that shareholders previously benefited from unsound strategic investments which would no longer be made, a transfer from shareholders to policyholders will take place (which will be a benefit to policyholders but not an overall increase in welfare).

49. Whether or not firms decide to invest in these strategic investments using shareholder funds, by not making investments and unwinding existing investments that are against the interests of with-profits policyholders, there would be additional funds available for investment elsewhere at potentially higher returns. This potentially benefits with-profits policyholders. Below, we calculate the possible extent of this benefit, noting this includes both an economic benefit component and a transfer component. We cannot, with a high degree of confidence, say what the proportion of either component may be.

**50.** The WPRR asked firms whether strategic investments they had made could potentially affect the fund's ability to pay out to policyholders. The review covered 17 firms, which make up about 80% of the market by asset share. Almost all firms said they had not made any strategic investments which would hinder their ability to pay out to policyholders or which their with-profits committees had considered from a governance point of view.

**51.** Only seven firms identified strategic investments they had made from with-profit funds, with most stating these did not actually hinder their ability to pay out to policyholders. The strategic investments identified in the review ranged from a £1m investment in a head office building of a fund, to a £300m investment. Other than one fund where the strategic investment identified was 9%, these investments averaged less than 1% of the value of individual funds.

**52.** Based on information gathered during the WPRR, we estimate there may be around £600m of strategic investments across the entire population of with-profits funds that could potentially affect funds' ability to pay out to policyholders.[13] We estimate a potential benefit of about £10m to £42m per year for policyholders, assuming that:

- firms do not make the sort of strategic investments they have made in the past;
- strategic investments give zero return to policyholders[14]; and
- the return they would get if this amount were alternatively invested was between the average ten-year and 25-year sector performance of 1.7% to 7% per year.[15]

Since this calculation also includes an estimate of the economic benefit, it overestimates the size of the potential transfer from shareholders.

**53.** The effectiveness of the proposal depends in part on our supervisory and enforcement actions. By changing the provisions currently in the form of 'guidance on a Principle' into a specific rule, firms falling below the standards we expect of them will be less likely, or able, to argue that they are compliant. So this suggests that it is possible firms make material changes to their strategic investment decisions.

**54.** In practice, we expect the impact to be smaller than calculated above. These numbers are based on the potential impact of strategic investments on firms' ability to pay out to policyholders, and not actual restrictions on their ability to do so. Further, the proposal is likely to mostly encourage funds to dispose of such strategic investments when they are shrinking – which is something we would expect all well-functioning funds to be planning to do in any case. This suggests the incremental impact of the policy will be significantly smaller than the size of the potential transfer estimated above.

13 We should reiterate that this extrapolation includes strategic investments by firms who said in the WPRR these should not hinder their ability to pay out to policyholders.
14 In reality, we would expect strategic investments to provide some return to policyholders.
15 *Money Management magazine*, July 2010.

*Benefits*

55. As noted in the 'Transfers' section above, there would be an additional economic benefit to the extent that some uneconomic investments would no longer be made (cf. paragraph 48).

*Costs*

56. Firms should already periodically assess the value of their strategic investments as part of their standard management practices. In addition, a combination of existing regulatory requirements in SYSC 14, INSPRU 2.4, and GENPRU 2 means firms are already obliged to monitor the performance and suitability of all their investments. For these reasons, we think that assessing whether investments have detrimental effects on with-profit policyholders should raise minimal additional costs.

57. If a firm assesses the strategic investments it currently holds in a with-profits fund and concludes that their retention is expected to adversely affect its with-profits policyholders, they will have to be disposed of. A potential cost to with-profits policyholders and the firm arises if the investments are disposed of hastily or without due care and consequently a poor price is realised. However, as the rule does not require firms to make fire sales, firms' own incentives and a combination of our other rules should mean assets are not disposed of in haste and at poor value.

58. As the assessment of whether the investment will generate enough return is made in advance, overly strict criteria can stop insurers investing with-profits funds in some potentially profitable (therefore beneficial to policyholders) ventures. It is worth noting that, as policyholders and shareholders have different risk/return trade-offs, it is possible there are potentially worthwhile projects for policyholders that are not worthwhile for shareholders' funds (given the cost of capital and different investment horizons).

### Charges made to with-profits funds

59. We are concerned that, despite our existing rule, COBS 20.2.23R, some firms may be extracting undisclosed benefits for shareholders from funds by using in-house management service agreements (MSAs). This can distort the distribution ratio. When an insurer arranges an MSA on market terms this includes a profit margin above costs. If a 10% share of a distribution already compensates insurers sufficiently for carrying out the management service for funds, the profit margin in the MSA agreement means insurers receive extra compensation over and above this.

60. We propose to introduce a rule to make it clear that in-house service arrangements should not operate in this way.

*Transfers*

61. To the extent this proposed rule eliminates MSAs that include a profit element, there could be benefits for policyholders through increased bonuses or increased amounts available for distribution. This would imply a transfer from shareholders to policyholders, and not an increase in overall welfare.

62. We are currently aware of one instance where a MSA at market terms extracted £10m from a large fund over ten years which would otherwise have been available to with-profits policyholders. Anecdotal evidence suggests there may be several other MSAs made at market terms. We explored the issue as part of the WPRR; the review, 'as a whole did not find that the current charges are excessive or unfair across the sector', though it does note that there was 'scope to provide further clarity to our existing rule…in order to safeguard against 'in-house' service companies over-recovering costs from the with-profits funds in the future'.

63. There are currently 82 with-profits firms. If we assume a tenth of these would be affected by our proposed guidance, and the impact was equivalent to the £1m a year effect we find for a very large firm, there could be an annual transfer of about £8m a year from shareholders to policyholders. Therefore, we think that any transfer driven by our proposed rule would be relatively small in size.

*Costs*

64. It is possible that an MSA may bring advantages to the insurer and its policyholders. Under MSAs, insurers (in their capacity as service providers) have clearer incentives to reduce the expenses of providing the services covered by an MSA, as any expense saving would accrue to them (in their capacity as service providers), and ultimately to shareholders. Without MSAs, as only 10% of any expense saving accrues to the shareholders, the incentive to reduce expenses will be reduced. This implies the possibility of increased costs.[16]

### Reattribution and excess surplus

65. A number of changes are proposed in this CP to the reattribution regime and how excess surplus is treated. We propose to:

- remove the ability of firms to reattribute excess surplus;
- amend guidance to require our consent to the terms of appointment of the policyholder advocate;
- introduce a new rule allowing the policyholder advocate greater freedom in communicating with policyholders;

16 In addition, MSAs can also give security to policyholders about future expense charges, which may be particularly important in closed funds.

- ensure firms remove any excessive margins for prudence in valuing the inherited estate in a reattribution; and
- issue guidance on the ability to bind the minority by means of the reattribution scheme.

We discuss the likely impacts of these changes individually below.

### Remove firms' ability to reattribute excess surplus

66. Current regulation allows for the possibility of excess surplus being reattributed. Reattribution exercises typically lead to policyholders receiving a lower amount than distributions that are normally made at a 90:10 ratio. In theory, our proposal implies a transfer from shareholders (who typically benefit more in the case of a reattribution) to policyholders.

67. However, relative to the status quo, we believe this proposal has no impact. In both of the previous reattribution exercises during the last decade, AXA and Aviva, excess surplus was distributed and not reattributed. The recent WPRR also found no other firms intending to reattribute any excess surplus they have identified. Additionally, because our assessment of whether the final reattribution proposal is fair to policyholders is a hurdle that firms have to cross, it is unlikely firms would be able to proceed with a reattribution unless they had previously distributed excess surplus. Indeed, in any event, as set out in Chapter 2 of the CP, our rules already require a firm to determine on an annual basis whether it has an 'excess surplus', and to distribute an identified excess surplus if they do not have a good reason for retaining it (i.e. unless it is fair to their customers to retain it).

### Discussion of the policyholder advocate's terms of reference

68. The proposal protects policyholders by ensuring the policyholder advocate's terms of appointment are not unreasonable. Theoretically this should help improve the likelihood of a fairer deal for policyholders in case of reattribution. Relative to current practice we do not think this implies a significant change.

69. COBS 20.2.45R already provides that a firm must 'notify the FSA of the terms on which it proposes to appoint a policyholder advocate' and sets out certain factors that must be included in the terms of appointment. It is difficult to see the circumstances under which a firm would proceed with the appointment of a policyholder advocate on terms that were not acceptable to the regulator under the current rules.

70. The proposal for firms to discuss, with a view to agreeing, the policyholder advocate's terms of appointment with us is likely to include interviewing the prospective policyholder advocate and considering and commenting on the terms to the firm. There may be marginal additional management time required by the firm in dealing with any correspondence about the terms of appointment. However, these actions took place in any event in the Aviva reattribution, indicating little if any incremental costs relative to current practice.

## Communicating with policyholders

### *Transfers*

71. Granting more independence to the policyholder advocate in his/her ability to communicate may result in policyholders having more regular and better information during a reattribution exercise. This would allow policyholders to make better-informed decisions in choosing whether or not to accept reattribution.

72. In theory, this may mean firms having to offer higher amounts to better-informed policyholders in cases of reattribution. This would generally be a transfer from shareholders (who would otherwise gain from being able to secure a larger share of the estate), and not an increase in overall welfare.

73. Evidence on the quality of communication in past reattribution exercises is mixed. The judge in Aviva's reattribution noted: 'It seems to me that Aviva and the PHA have gone to enormous lengths to put relevant information in a comprehensible form to the policyholders who have to make the choice.'[17] While there does not appear to be systematic lapses in communication at the last reattribution in this market, the policyholder advocate does note she was prevented from communicating with policyholders at one particularly difficult point during the reattribution exercise.[18]

74. This suggests the possibility of some, though not very large, improvements in the quality of communication to policyholders during a reattribution. While greater or better information can, in theory, lead to changes in behaviour, we are not aware of any evidence that attempts to understand the scale of possible change given differences in communication in a reattribution exercise. We can only say past experience suggests the possibility of some improvement in the quality of communication, which may lead to more informed decisions in choosing whether or not to accept reattribution, which in theory may mean firms having to offer higher amounts to better informed policyholders (and therefore shareholders gaining less) – but we cannot estimate the size of any resulting transfer.

### *Costs*

75. The proposal could lead to more regular communication by policyholder advocates. These generally take the form of customer mailings. We understand from the Aviva reattribution case that there were four customer mailings during the process. We do not know which or how many funds may choose to reattribute in the future. The median with-profits fund is less than 2% the size Aviva was at the time of reattribution. If our proposal led to one additional mailing during a reattribution process, we estimate incremental costs of £50,000 to £60,000 for an average-sized fund, extrapolating from the communication costs available from Aviva's case. Costs will vary of course, with the size of a firm's policyholder base.

17 *In the matter of Commercial Union Life Assurance Company Ltd and Ors* [2009] EWHC 2521, paragraph 87 per Norris J.
18 A report by the office of the policyholder advocate in connection with the reattribution of the inherited estates of the CGNU Life and CULAC with-profits funds, June 2009.

### Removing excessive margins for prudence

*Transfers*

76. The proposal on margins for prudence should, in theory, lead to greater distributions of surplus to policyholders than would otherwise be the case. They should also effect a reduction in the ability of life office management to obtain a better deal for shareholders by attempting to retain surplus for pursuing strategic goals that are then not followed through, or which change post-reattribution.

77. The increased distribution for policyholders will be a transfer from shareholders who might otherwise secure a larger share after reattribution.

78. How large might the scale of these transfers be? The two examples of reattribution in the last decade, AXA and Aviva, are instructive here.

79. In the 2000 AXA reattribution there was a substantial amount of potential excess surplus that was retained in the fund after reattribution to back new business, which in the event was not written. Some of the arising surplus in the AXA case was distributed to the minority of policyholders who retained their interest in the estate following the first five-year review, as mandated by the reattribution scheme. But this was too late for the majority of policyholders who had already accepted the reattribution offer and for those who had refused it but left the fund before the date of the first five-year review.

80. In the more recent Aviva reattribution, in contrast, excessive margins for prudence were removed in valuing the estate. This led to a greater amount, in relative terms, distributed as excess surplus at a 90:10 ratio.

81. We roughly estimate the AXA reattribution led to policyholders getting about 30% of the value of the estate, and the Aviva reattribution led to policyholders getting about 70% of the value of the inherited estate.[19] Part of this increase was because of increased excess surplus identified through removing excessive margins for prudence, which was then distributed at the more favourable 90:10 ratio for policyholders.

82. Purely for illustrative purposes, based on a set of assumptions, we calculate below the potential size of the transfer in the case of reattribution for the average fund currently open to new business.

19 These are not precise calculations. In a reattribution there tend to be two payments to policyholders – the first being a special distribution which is made to all policyholders and which represents the distribution of current excess surplus, and a second which is made only to those policyholders voting in favour of the reattribution, being their compensation for disposing of their contingent interest in distributions of any future excess surplus arising. This latter payment should come from shareholder resources and not from the with-profits fund. The percentages we quote are derived from the crude sum of these two numbers – and should be considered as broadly illustrative rather than precise calculations.

83. We base our calculations on a fund of median size, roughly £12bn, with a £950m inherited estate.[20] We assume that the final outcome in the event of reattribution after the rule change would be similar to the outcome in Aviva's 2009 reattribution, where we understand excessive margins for prudence were removed in valuing the estate.

84. As an example, we have assumed that, in the absence of the proposed rule, 5% less of the estate would be identified as surplus (and would therefore be subject to reattribution rather than distribution). Assuming in this scenario the proportion of surplus distributed to policyholders, and the percentage of the remaining inherited estate policyholders obtain as a result of reattribution is the same as in Aviva's recent reattribution, we calculate the rule change would lead to a further £24m paid out to policyholders in the event of reattribution for the median fund.[21]

85. We are aware of the limits of this approach, as reattributions are rare events and difficult to compare. We are also aware that the reattribution process and the estimation of the inherited estate follow complex processes and depend on many factors. It is therefore not possible to estimate precisely the effects of the change of these policy proposals. We reiterate that the calculation of the potential transfer for the average-sized fund above is illustrative, and that change relative to current practice (the most recent Aviva reattribution where excessive margins for prudence were removed in valuing the estate) should be zero.

### *Costs*

86. Identification of excess surplus is complex, and involves professional judgement and extensive internal modelling. However, since COBS 20.2.21R already requires a firm to identify whether or not it has an excess surplus at least once a year, the added complexity of a reattribution should not in itself represent a significant additional cost. Any additional cost to firms of a more onerous rule is likely to be in management and actuarial time, in discussions with supervisors and potentially in obtaining external professional advice, whether actuarial or legal. Since much of this is generic to a reattribution already, pure incremental compliance costs of the proposal for firms are likely to be minimal.

87. Evaluating excess surplus is a difficult exercise. Retained potential excess surplus can act as a buffer if the provisions made in the reattribution plan were wrong and if the working capital retained has been improperly underestimated. The proposal then can increase the possibility of the fund being at risk in case the working capital estimated for the future is revealed to be insufficient. While recognising this possibility, we think increased risk might not be large since firms have an incentive to retain greater rather than smaller amounts of potential excess surplus and because the proposal does not over-ride firms' prudential obligations.

20 Centre for Risk and Insurance Studies, *The UK with-profits life insurance industry: a market review*, June 2009.
21 If the rule change led to a further 10% surplus identified, this would imply an extra £48m paid out to policyholders.

### Guidance on the ability to bind the minority

88. Firms conducting a reattribution have the ability to bind policyholders who have rejected the offer, and those who have not answered, to accept the reattribution. The proposal, in theory, makes it more likely that these classes of policyholders will be better off than they might otherwise have been, especially those who reject the reattribution and thus reveal their contrary preference.

89. The proposal, in theory, suggests a transfer from shareholders to policyholders who otherwise reject the reattribution but would be bound to it, and to those who are silent.[22]

90. In practice our investigation did not reveal any cases where the minority of policyholders were bound to a reattribution they rejected. Relative to current and past practice, the proposal then implies no change. However, it discourages a possible source of detriment for policyholders.

### Governance

91. We are proposing several changes to the rules:

- On with-profits committees, the proposal being consulted on is a two-tier structure where a with-profits committee is required for all except small funds.
- Most large firms already have a with-profits committee, and some firms have equivalents established by a court scheme. We estimate that up to eight firms, with an aggregate liability of £45bn, will be required to establish a with-profits committee.
- On who can sit on the committee, the options being consulted on are: (1) all members must be completely independent of and external to the firm, or (2) directors and non-executives are allowed provided there is a majority of independents, with independence defined using criteria set out in the FRC Code.
- In addition to firms that are required to set up with-profits committees, the proposal will also impact on insurers with existing with-profits committees if they do not meet the 'all independent and external' or 'majority independent' requirements.
- In relation to the operation of a with-profits committee:
  1) the firm is required to publish the terms of reference of the with-profits committee on their website;
  2) the with-profits committee is required to ensure that the PPFM properly reflects how the fund is managed;

22 Since shareholders typically benefit in the event of reattribution, in theory the proposal suggests a transfer from shareholders who would gain even more if minority policyholders not voting in favour of reattribution were bound by its terms.

3) the governing body is required to consult the with-profits committee in a timely manner concerning all matters that the with-profits committee could reasonably expect to be consulted on, and must consider reports from the with-profits committee;

4) there must be clear separation and recording of recommendations of the with-profits committee and the decisions made by the governing body;

5) the board/governing body is required to provide the with-profits committee with information sufficiently comprehensive to enable it to discharge its duties. In addition, with-profits committees will have the right to obtain external advice; and

6) with-profits committees must consider a non-exhaustive list of issues.

The expectations placed on the with-profits committee will also apply to whoever supplies the exercise of independent judgement under any alternative arrangement for smaller firms.

For firms with effective with-profits governance, these should be their current practices already. However, the WPRR found that sometimes firms could not demonstrate proper board engagement with the committee and that the committees were not always sufficiently aware of or engaged in key operational issues relating to Treating Customers Fairly.[23] Therefore these proposals will impact not only on the operation of new with-profits committees now required to be set up, but also on the operation of some existing with-profits committees.

- In relation to the with-profits actuary:

1) the with-profits actuary should not report to or have remuneration determined by anyone which would give rise to a conflict of interest in the actuarial function; and

2) the with-profits committee will have a role in assessing the effectiveness of the with-profits actuary.

This proposal will affect both newly-established and existing with-profits committees. It will also affect any firms whose with-profits actuary currently reports to or has remuneration determined by someone which could give rise to a conflict of interest.

- Finally, if the with-profits committee considers that the issue is sufficiently significant, it can request that firms notify us when the decision of the governing body departs from the advice or recommendation of the with-profits committee.

*Benefits*

92. The 'scrutiny and challenge' role of with-profits committees is intended to play an important part in implementing the other proposals in this consultation, and to facilitate the realisation of the benefits/transfers identified in those proposals. If these proposals lead to better operation of the with-profits funds (for example, saving unnecessary costs and

23 FSA: With-profits Regime Review Report (June 2010), pp.19-20.

avoiding uneconomic investment), there are benefits for policyholders and shareholders. In addition, if these proposals lead to fewer decisions in favour of shareholders at the expense of the policyholders' interests, there are benefits to policyholders in the form of transfers from shareholders. While our assessment of the practical impact of with-profits committees on outcomes for policyholders has not been universally encouraging, it also suggests that effective with-profits committees, if they have a majority of independent members on them, can go some way towards looking after policyholders' interests.[24] We reiterate that the effectiveness of these proposals is likely to be materially influenced by our supervisory and enforcement efforts.

### *Costs*

- 'All independent and external':

  a) Under 'all independent and external' requirements, for a two-tier structure, we estimate the total costs for firms to be around £3.2m a year: costs for eight firms that currently do not have a with-profits committee are estimated to be around £1.4m a year[25]: costs for 15 existing with-profits committees (to replace current members with external members) are estimated to be £1.8m a year.[26]

  b) While 'all independent and external' is more likely to be more effective in mitigating the underlying market failure of conflicts of interest, if every with-profits committee is looking for independent and external members, the compliance costs could be higher than those estimated above. This is because with-profit funds will have to select from a limited pool of appropriate people with the necessary knowledge and independence.

- 'Majority independent":

  c) Under the 'majority independent' requirement, for a two-tier structure, we estimate the total cost for firms to be around £2.3m a year, which includes around £1.4m a year[27] for eight firms that are required to have a with-profits committee but do not have one now, and £0.9m a year[28] incremental costs for 15 existing with-profits committees that may not all meet the 'majority independent' requirement.

  d) Non-executive directors in shareholder-owned firms who are with-profits committee members are exposed to acute conflicts of interest: on one hand, in the capacity of director, the non-executive would be bound to comply with his/her statutory duties to act in the best interests of the shareholders under company law; on the other hand, in the capacity of a with-profits committee

24 E.g. www.pensions-institute.org/closedlifefunds.pdf
25 Eight firms x three independents x £60,000 (based on four meetings per year with 40 hours preparation and attendance at an hourly rate of £365 gives us 4 x 40 x £365 = £60,000 approx) = £1.4m.
26 15 firms x 2 (based on replacing 2 existing WPC members on average) x £60,000 = £1.8m
27 8 x 3 x £60,000=£1.4m.
28 15 firms x 1 (based on replacing one existing WPC members on average) x £60,000 = £0.9m.

member, he/she would be required to safeguard the interests of policyholders. Relative to the 'all independent and external' option then, it is possible that the 'majority independent' option would lead to a lower transfer to policyholders but the trade-off between costs and benefits will depend on the calibre and independence of the people appointed.

### Treating with-profits policyholders fairly

93. We propose to introduce guidance at the start of COBS 20 to reflect our view that with-profits policyholders as a class have an interest in the whole with-profits fund and a contingent interest in any surplus. The existing requirements in our rules already reflect this overarching principle and the detailed proposed changes (e.g. in relation to new business, charges to with-profits funds etc.) in this paper do not alter this. We have discussed the costs and benefits of these individual proposed changes in this chapter. However, by having this overarching principle as guidance, we aim to ensure firms are aware of the context in which our rules have been made. We therefore aim to ensure firms think carefully about their actions in view of that context, and encourage them to meet the spirit of the policy it expresses, as well as the letter of our requirements. We think the introduction of this guidance at the start of COBS 20 should not have significant additional impacts beyond those discussed in the individual proposals.

### Costs to the FSA

94. We do not think these proposals will lead to significant incremental costs for the FSA. None of our proposals should require IT or system changes. In some cases the clearer tests set in these proposals may allow FSA supervisors to make judgements more easily. We expect these changes to be incorporated in on-going FSA supervision and enforcement procedures, and not lead to significant further permanent resource requirements.

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

# Annex 3:
# Compatibility statement

1. This section sets out our assessment of the compatibility of the proposals outlined in this CP with our general duties under section 2 of FSMA and with the regulatory objectives set out in sections 3 to 6.

### Duty to act in a way that is compatible with the statutory objectives

2. Our proposals for amending the rules and guidance concerning with-profits are primarily designed to meet our consumer protection objective. The changes will also have some relevance to our market confidence objective. They do not deal directly with our other two statutory objectives, which are financial stability and the reduction of financial crime.

3. The proposed changes are primarily designed to improve further the protection of with-profits policyholders' interests in with-profits funds. To the extent that the proposed changes are successful in safeguarding policyholders' interests in with-profits funds, they will support our statutory objective of securing an appropriate degree of consumer protection.

4. The proposed changes could have a positive impact on market confidence if, as a result of proposed changes, with-profits policyholders will have greater certainty that their interests are being taken into account properly in the running of such funds.

5. There are no expected implications for our financial stability objective.

### Principles of good regulation

6. Section 2(3) of FSMA requires that in carrying out our general functions we have regard to the principles of good regulation.

*The need to use our resources in the most efficient and economic way*

7. As the bulk of the proposed changes are amendments to existing rules that are already subject to supervision, we do not consider the proposed changes will significantly impact on our resource requirements. Compliance with the proposed rules will be monitored in the course of our existing supervision and enforcement responsibilities – in some cases, the

proposed changes could facilitate our supervision and enforcement – and will be integrated in the resources we commit where any market failure becomes apparent.

*The role of management*

**8.** We consider that the proposed changes could help make senior management more accountable for risk management and controls within firms. They will achieve this by:

- strengthening the rules with which it is senior management's responsibility to comply; and
- clarifying our view of with-profits policyholders' interests in the funds their firms run.

*Proportionality*

**9.** The changes proposed in this CP result from the findings of the WPRR, Project Chrysalis and our experience of the operation of with-profits funds since 2005. The changes are our response to issues identified in the course of systematic reviews of the application and adequacy of our rules. The proposals relating to corporate governance distinguish firms by size, recognising that smaller firms have fewer resources available.

*Innovation, international character and competition*

**10.** We do not expect the proposals to have a material effect on this principle.

*Regard to public awareness*

**11.** We do not expect the proposals to have a material effect on this principle of good regulation. However, we will address the issue of communications to with-profits policyholders in a further CP to be issued later in 2011.

*Compatibility with our duties under equalities legislation*

**12.** The policy proposals described in this CP are designed to improve the treatment of with-profits policyholders as a whole class of interested parties. We have conducted an assessment of the equality issues that arise in our proposals. Since the proposals deal with with-profits policyholders' interests as a whole, we believe our proposals do not give rise to discrimination and that the proposals are of low relevance to the equality agenda. We would nevertheless welcome any comments respondents may have on any equality issues they believe arise from the proposals in this CP.

# Annex 4:

# List of questions

**Q1:** Do you agree with the proposal to include guidance setting out our view of some of the interests of policyholders in with-profits funds?

**Q2:** Do you agree with our proposal to convert elements of COBS 20.2.1G into mandatory requirements in a rule and to clarify the types of conflicts that may arise?

**Q3:** Do you agree with our proposed approach to the use of COBS 20.2.17R and to the clarifying amendments to the definition of 'required percentage' that we propose to make? Do you consider the guidance that we propose to make in this area to be adequate and clear?

**Q4:** Do you agree with our proposal to strengthen our rule and guidance on the terms of new business written into a with-profits fund?

**Q5:** Do you agree with our proposal that a firm should discuss with us what actions may be required to ensure the fair treatment of with-profits policyholders if it experiences sustained and significant falls in the volume of new business?

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

**Q7:** Do you agree with our proposal that firms prepare, maintain and update a management plan containing contingency arrangements in the event they experience sustained and significant falls in new business volumes?

**Q8:** Do you agree that the with-profits funds that closed to new business before the current rules came into effect in 2005 should have run-off plans?

**Q9:** Do you agree with our proposal to change the rule so that an MVR can be applied only where there could otherwise be a payment in excess of the value of the assets underlying the policy?

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

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

**Q12:** Do you agree with our proposal to amend COBS 20.2.23R to prevent value being extracted from a with-profits fund by other group companies making charges in excess of their costs?

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

**Q14:** Do you agree that a firm that proposes a reattribution should, prior to that proposal, be required to pay particular attention to identifying and distributing excess surplus?

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

**Q16:** Do you agree that it would be unfair for a firm proposing a reattribution to seek to bind the minority, against their wishes, by means of the reattribution scheme?

**Q17:** Do you agree that a with-profits committee should be required for all with-profits funds except small funds, and that the threshold suggested is the right one?

**Q18:** Do you agree that the members of a with-profits committee should be independent and completely external to the firm whose with-profits fund(s) they are considering?

**Q19:** Alternatively, should we continue to allow directors and non-executive members of the governing body to sit on the with-profits committee, subject to its having an independent majority?

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

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

**Q22:** Do you agree that the conclusions of the with-profits committee and the governing body's decisions to accept or to reject those conclusions must be clearly recorded?

**Q23:** Do you agree that with-profits committees should have the right to make a reasonable request to obtain external advice and in shareholder-owned firms request that this is at the shareholders expense?

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

**Q25:** Do you agree that the with-profits committee should be able to raise issues proactively that it thinks the governing body needs to consider?

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

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

**Q28:** Do the proposed changes for the with-profits actuary provide sufficient support for his independence and how practical is the arrangement for setting his remuneration?

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

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

# Appendix 1

# Draft Handbook text

**CONDUCT OF BUSINESS SOURCEBOOK (WITH-PROFITS BUSINESS) INSTRUMENT 2011**

**Powers exercised**

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

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

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

**Commencement**

C. This instrument comes into force on [*date*].

**Amendments to the Handbook**

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

| (1) | (2) |
|---|---|
| Glossary of definitions | Annex A |
| Senior Management Arrangements, Systems and Controls sourcebook (SYSC) | Annex B |
| Conduct of Business sourcebook (COBS) | Annex C |
| Supervision manual (SUP) | Annex D |

**Citation**

E. This instrument may be cited as the Conduct of Business Sourcebook (With-Profits Business) Instrument 2011.

By order of the Board
[*date*]

## Annex A

## Amendments to the Glossary of definitions

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

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

| | |
|---|---|
| *small with-profits fund*” | a *with-profits fund*, of which the associated *with-profits insurance liabilities* have not, since [date of rules coming into force], exceeded £500million. |
| *strategic investment* | a significant investment in a single asset which, even if tradeable, is, or has the potential to be, illiquid, difficult to sell or dispose of, or hard to value. |
| *terms of reference* | the terms of reference of a *firm’s with-profits committee*, or the terms of appointment of the person or persons acting as the *with-profits advisory arrangement*, satisfying the requirements set out in *COBS* 20.5.3R. |
| *with-profits advisory arrangement* | an independent person or, if appropriate, one or more *non-executive directors*, appointed by a *firm* to provide independent judgement to the *governing body* in the management of a *small with-profits fund* and satisfying the requirements of its *terms of reference*. |
| *with-profits distribution plan* | a plan complying with the requirements in *COBS* 20.2.22AR(2). |
| *with-profits management plan* | a plan complying with the requirements in *COBS* 20.2.22AR(3). |

Amend the following as shown.

*required percentage* — the *required percentage* referred to in *COBS* 20.2.17R is, for each *with-profits fund*:

(a) the percentage (if any) required in respect of that fund by:

(i) the *firm*'s articles of association, registered rules or other equivalent instrument; or

(ii) a relevant order made by a court of competent jurisdiction;

(b) if (a) does not apply, the percentage that ~~specified in the *firm*'s *PPFM*, if that percentage~~ reflects the *firm*'s established practice, if it has one; or

(c) if (a) and (b) do not apply, not less than 90 per cent.

| | |
|---|---|
| *with-profits committee* | a committee, ~~of the governing body, including non-executive members, of the governing body and possibly some external non-directors with appropriate skills and experience~~ the members of which are independent of the *firm* and not part of the *governing body*, satisfying the requirements of its *terms of reference*. |

**Annex B**

**Amendments to the Senior Management Arrangements, Systems and Controls sourcebook (SYSC)**

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

Specific requirements for with-profits governance

| | | |
|---|---|---|
| 3.2.9A | G | A *firm* operating a *with-profits fund* is required, in addition to *SYSC* 3.2.6R and other requirements in *SYSC*, to comply with the specific governance requirements set out in *COBS* 20.5. |

**Annex C**

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

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

| | | | |
|---|---|---|---|
| 20.2.1 | G | (1) | *With-profits business*, by virtue of its nature and the extent of discretion applied by *firms* in its operation, involves numerous potential conflicts of interest that might give rise to the unfair treatment of *policyholders*. Potential conflicts of interest may arise between shareholders and *with-profits policyholders*, between *with-profits policyholders* and non-profit *policyholders* within the same fund, between *with-profits policyholders* and the members of mutually-owned *firms*, between *with-profits policyholders* and management, and between different classes of *with-profits policyholders*, for example those with and without guarantees. The *rules* in this section address specific situations where the risk may be particularly acute. ~~However, a *firm* should give careful consideration to any aspect of its operating practice that has a bearing on the interests of its *with-profits policyholders* to ensure that it does not lead to an undisclosed, or unfair, benefit to *shareholders*.~~ |
| | | (2) | *With-profits policyholders* have an interest in the whole and in every part of the *with-profits fund* into which their *policies* are written and from which the amounts payable in connection with their *policies* are to be paid. Those amounts include those required to satisfy their contractual rights and such other amounts as the *firm* is required to pay in order to treat them fairly (including but not limited to the amounts required to satisfy their reasonable expectations). |
| | | (3) | The fair treatment of *with-profits policyholders'* requires the *firm's* pay-outs on individual *with-profits policies* to be fair (see *COBS* 20.2.3R et seq.) and, if the *firm* makes a distribution from the *with-profits fund* into which their *policies* are written, the receipt by the *with-profits policyholders* of at least the *required percentage* (see *COBS* 20.1.17R). |
| 20.2.1A | R | A *firm* must ensure that all aspects of its operating practice are fair to the interests of its *with-profits policyholders* and do not lead to an undisclosed, or otherwise unfair, benefit to shareholders or other *persons* with an interest in the *with-profits fund*. | |
| 20.2.1B | G | (1) | Notwithstanding that there may not be a *rule* in the remainder of this section addressing a particular aspect of a *firm's* operating practices, *firms* will need to ensure that all aspects of their operating |

practice comply with *COBS* 20.2.1AR.

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

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

…

20.2.16 R A *firm* must not make a market value reduction to the face value of the units of an accumulating *with-profits policy* unless:

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

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

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

20.2.17 R A *firm* must:

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

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

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

20.2.17A G (1) *COBS* 20.2.17R(2) requires a *firm*, including a mutually-owned *firm*, to ensure that the amount distributed to *policyholders* from a *with-profits fund* is not less than the *required percentage* of the total amount distributed.

(2) The definition of *required percentage* places considerable significance on a *firm*'s established practice in determining what that percentage should be. This reflects the importance of a *firm's* behaviour in generating expectations on the part of *with-profits policyholders* as to how the *firm's* discretion will be exercised and in determining whether *with-profits policyholders* are being treated fairly in the context of distribution from the *with-profits fund*.

(3) (a) A *firm* is expected to consider whether it has an established practice and, if so, what it is, and to justify its conclusions to us. In considering what a *firm's* established practice may be, we will expect the *firm* to be able to demonstrate that an explanation of its practice, and of the justification for it, has been communicated to *with-profits policyholders* in a clear, timely and unambiguous manner. We will consider the *firm's* conclusions in the context of the *firm's PPFM* (and any other communications with its *with-profits policyholders*) and of any other factors that could reasonably affect *with-profits policyholders'* expectations in relation to distributions. If there appears to be some ambiguity or inconsistency in the *firm's* behaviour and/or its communications, we may take the view that the *firm's* established practice is different from what the *firm* has suggested or that the *firm* has not evidenced the existence of an established practice at all. In appropriate circumstances, we may also ask the *firm* to amend its *PPFM* (or send other communications to its *with-profits policyholders*) to confirm this position.

(b) If a *firm* asserts the existence of an established practice that is not to distribute all available surplus to *with-profits policyholders*, but to allocate some to persons other than *with-profits policyholders* (so that a percentage of less than 100% is the *required percentage*), we will, in considering whether *with-profits policyholders* are being treated fairly, pay particular attention to how clearly this practice has been communicated by the *firm* to its *with-profits policyholders*.

(4) The definition of *required percentage* and *COBS* 20.2.17R should be applied in respect of any distributions of surplus to *with-profits policyholders*, and when designing any *with-profits distribution plan*, or when updating it as required under *COBS* 20.2.56R.

20.2.17B R Where a *firm* adjusts the amounts distributed to *policyholders* (either by market value reduction or otherwise), including but not limited to a situation where such an adjustment has the effect of retrospectively reducing past *policyholder* distributions, in a way that, taking both the relevant distributions and the adjustment into account, would result in a distribution to *policyholders* of less than the *required percentage*, the *firm* must apply a proportionate adjustment to amounts distributed to shareholders so that the distribution to *policyholders* will not be less than the *required percentage*.

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

20.2.21 R At least once a year (or, in the case of a *non-directive friendly society*, at least once in every three years) and whenever a *firm* is seeking to make a *reattribution* of its *inherited estate*, a *firm's governing body* must …

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

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

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

Requirement to have a distribution and management plan

20.2.22A R (1) A *firm* must, in relation to each *with-profits fund* it operates, prepare and maintain:

(a) a *with-profits distribution plan*; and

(b) a *with-profits management plan*.

(2) A *firm's with-profits distribution plan* must demonstrate how the *firm* will, over time, ensure a fair distribution out of each *with-profits fund*, including its *inherited estate* (if any), to *with-profits policyholders* by reference to and including:

(a) the *firm's* analysis of the impact of both the current level of new *non-profit insurance contracts*, and the current level of new *with-profits policies*, being written into each *with-profits fund*, and the *firm's* reasonable future projections for those levels; and

(b) the impact of the *firm's* investment strategy for each *with-profits fund*.

(3) A *firm's with-profits management plan* must demonstrate how the *firm* would propose to deal with the investment, credit and operational risks, and any other relevant risks or issues, associated with a significant and sustained fall in either the volumes of *non-profit insurance contracts*, or the volumes of new *with-profits policies*, or in both, being written into a *with-profits fund*.

(4) A *firm* must ensure that the *with-profits distribution and management plans*:

(a) are reviewed and updated to reflect material changes in the current or expected levels of new *non-profit insurance contracts*, and in the current or expected levels of new *with-profits policies*, written into an existing *with-profits fund* and in any event not less than once a year; and

(b) are approved by the *firm's governing body*, including any amendments arising out of any update referred to in (a).

20.2.22B G (1) For the purposes of *COBS* 20.2.22AR(3), a *firm* should include the explanations and information set out in *SUP* Appendix 2.15.3G (Investment risk), SUP 2.15.4G (Credit risk) and SUP 2.15.5G(Operational risk), tailored as necessary, to demonstrate how the *firm* would propose to deal with the investment, credit and operational risks.

(2) The *FSA* expects *firms* to consider whether it is appropriate to publish information relating to their *with-profits distribution plan* and *with-profits management plan* in its *PPFM*.

(3) For the purposes of COBS 20.2.22AR(4), if the expected volume of new *contracts of insurance* is such that amounts that have previously been unavailable for distribution in a *with-profits fund* are expected to become available for distribution in the future then the *firm* should update its *with-profits distribution plan* to ensure fair distribution to all *with-profits policyholders*.

Charges to a with-profits fund

20.2.23 R A *firm* must only charge ~~costs~~ to a *with-profits fund* ~~which have been, or will be, in operating the *with-profits fund*.~~:

(1) unless (2) applies, costs which have been or will be incurred by the *firm* in operating the *with-profits fund*; and

(2) in relation to services provided to the *firm* by another entity in the *firm's group*, costs which have been or will be incurred by that

entity in the provision of those services, to the extent those services are used by the *firm* in operating the *with-profits fund*;

and in both cases, costs include, where appropriate, ~~This may include~~ a fair proportion of overheads.

20.2.23A G The effect of *COBS* 20.2.23R(2) is that, to the extent that a *firm* receives intra-*group* services used to operate a *firm's with-profits fund*, the *firm* may only charge to that fund the actual cost (including a fair proportion of overheads) to the *group* entity of providing those services.

…

New business

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

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

(2) the *firm* has carried out or obtained all appropriate analysis, based on relevant evidence, as to the likely impact on *with-profits policyholders*, and has provided this analysis to its *with-profits committee* or, if applicable, its *with-profits advisory arrangement* and to its *governing body* for the purposes of (1).

20.2.28A G (1) The writing of new business into a *with-profits fund* is not, of itself, automatically adverse to the interests of *with-profits policyholders*.

(2) *Firms* will need to ensure that they comply with *COBS* 20.2.28R at all times, but in practice *firms* will be expected to pay particular attention to whether they comply when they are designing and pricing or re-pricing products, when they are preparing their financial plans that take into account their expected costs and levels of new business, and, in particular, when reviewing their financial performance, if that reveals that the *firm* has not achieved its expected costs and levels of new business.

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

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

(2) *COBS* 20.2.28R requires *firms* to obtain appropriate analysis and evidence and this should include at least a profitability analysis. In the *FSA's* view, loss leading business is likely to have an adverse effect on the interests of *with-profits policyholders*.

…

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

…

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

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

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

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

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

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

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

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

(d) any costs that would result from divestment;

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

(f) notwithstanding (e), whether a knowledgeable existing *with-profits policyholder* in that fund would regard it as having no adverse effect to the interests of *with-profits policyholders* as a class;

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

(h) any other relevant material factors.

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

…

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

…

20.2.41A R A *firm* must:

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

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

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

(2) submit to the *FSA* at least one week prior to the initial discussion arranged for the purposes of (1) a *with-profits management plan* and a *with-profits distribution plan*, both updated to deal with the expected or actual fall in business described in (1).

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

(a) allow the *FSA* to comment on the adequacy of the updated *with-profits management* and *distribution plans*; and

(b) seek agreement with the *firm* on any other appropriate actions to protect the interests of *with-profits policyholders*.

(2) If the *firm* is no longer effecting either a material volume of new *non-profit insurance contracts*, or a material volume of new *with-profits policies* (other than by *reinsurance*), or both, into a *with-profits fund*; or if it is ceding by way of *reinsurance* most or all of the new *with-profits policies* which it continues to effect, then it

may also be appropriate to consider whether, in the particular circumstances of the *firm*, it should be regarded as ceasing to effect new *contracts of insurance* for the purposes of *COBS* 20.2.54R(3).

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

…

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

(1) ~~identify at the earliest appropriate point a *policyholder advocate*, who is free from any conflicts of interest that may be, or may appear to be, detrimental to the interests of *policyholders*, to negotiate with the firm on behalf of relevant *with-profits policyholders*~~ first discuss with the *FSA* (as part of its determination under *COBS* 20.2 .21R):

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

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

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

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

(i) new business volumes,

(ii) product terms; and

(iii) pricing margins;

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

…

…

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

…

20.2.45 R A *firm* must:

(1) notify the *FSA* of the terms on which it proposes to appoint a *policyholder advocate* …

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

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

(aa) …

…

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

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

(g) require the *policyholder advocate* to communicate with *policyholders* as soon as practicable after his appointment and thereafter no less frequently than every six months for the duration of the *policyholder advocate's* appointment; and

(h) allow the *policyholder advocate* to communicate freely with the *policyholders* but require him to provide advance copies of the communications to the *firm* and the *FSA* at least seven days in advance.

…

20.2.51 R A *firm* must ~~give relevant *with-profits policyholders* the option to~~:

(1) give relevant *with-profits policyholders* the option to individually accept or reject the final proposals for the *reattribution*; or

(2) if it proposes to use a ~~(if the~~ legal process ~~to be followed~~ which allows the majority of *policyholders* to bind the minority, clearly demonstrate that it would be fair to *with-profits policyholders* and would represent a better alternative to a proposal which allows *with-profits policyholders* to preserve their interest in any future distribution should they choose to reject the proposal or not to vote. ~~) vote on whether the firm should go ahead with those proposals~~.

20.2.51A G Where a majority of *policyholders* vote in favour of a reattribution proposal, the ability of the minority to preserve their interest in any future distribution provides a significant safeguard by making acceptance voluntary. An alternative legal process which allows the majority to bind the minority should only be used if it would be fair to *policyholders*. The *FSA's* view is that, in general, it would not be fair in the context of a reattribution.

…

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

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

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

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

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

(3) if the *firm*:

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

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

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

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

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

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

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

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

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

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

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

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

…

20.2.60 G (1) If *non-profit insurance business* is written in a *with-profits fund*, a *firm* should take reasonable steps to ensure that the economic value of any future profits expected to emerge on the *non-profit insurance business* is available for distribution during the lifetime of the *with-profits business*.

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

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

continuing to carry on non-insurance related business.

…

~~Governance arrangements for with-profits business~~

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

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

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

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

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

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

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

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

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

**20.5 With-profits governance**

Requirement to appoint with-profits committee or advisory arrangement

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

(1) appoint:

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

(b) a *with-profits advisory arrangement* (referred to in this section as an ‘advisory arrangement’), but only:

(i) in relation to a *small with-profits fund*;

(ii) if the *firm* has not appointed a *with-profits committee* to another *with-profits fund* it operates; and

(iii) if appropriate, in the opinion of the *firm’s governing body*, having regard to the size nature and complexity of the fund in question;

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

(3) make available a copy of any *terms of reference* on the *firm’s* website.

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

(2) A *firm* with a *small with-profits fund* will first need to determine whether it is nevertheless appropriate to appoint a *with-profits committee* to that fund, according to the nature, size and complexity of the fund in question. For example, the *FSA* would expect a *firm* to consider whether this would be appropriate if there are a number of separately identifiable, or a mixture of guaranteed and non-guaranteed, interests in the fund.

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

(4) *COBS* 20.5.1R(1)(b)(ii) has the effect that where a *firm* has appointed a *with-profits committee* to one of its *with-profits funds* it must appoint that *with-profits committee* to all of its other *with-profits funds*.

Terms of reference of with-profits committee or advisory arrangement

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

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

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

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

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

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

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

(a) decide on the specific matters it will consider in order to enable it to carry out its role described in (1)(a) to (d) as appropriate to the particular circumstances of the *with-profits funds* in question including having regard to issues which a knowledgeable *with-profits policyholder* might reasonably expect the *with-profits committee* or advisory arrangement to consider, and

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

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

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

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

(iv) the *firm's* with-profits customer communications such as annual policyholder statements and product literature and whether the *with-profits committee* or advisory arrangement wishes to make a statement or report to *with-profits policyholders* in addition to the annual report made by a *firm*;

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

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

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

(viii) relevant management information such as customer complaints data;

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

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

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

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

(a) there must be three or more members;

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

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

(a) work closely with the *with-profits actuary*, and obtain his opinion and input as appropriate;

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

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

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

(2) The annual review of performance referred to in *COBS* 20.5.3R(5)(c) may be carried out as part of any periodic appraisal process (if carried out at least annually).

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

20.5.5 R A *firm* must:

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

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

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

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

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

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

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

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

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

20.5.6 G (1) *COBS* 20.5.5R(2) requires that a *firm* provides a *with-profits committee* or advisory arrangement with sufficient resources. A *with-profits* *committee* or advisory arrangement should be able to obtain external professional, including actuarial, advice, at the expense of the *firm*, if the *with-profits committee* or advisory arrangement considers the advice to be necessary to perform its role effectively. In a *proprietary firm* the *with-profits committee* or advisory arrangement should be able to request that the cost of the external professional advice is not chargeable to the *with-profits fund* in question. A *with-profits committee* or advisory arrangement should also be adequately supported by the *firm*'s own internal resources and support functions. This may include the *firm* ensuring that relevant employees, including the *with-profits actuary*, are made sufficiently available, and provide relevant information and input, to assist the *with-profits committee* in its role, as required.

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

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

Assessment of independence by governing body

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

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

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

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

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

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

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

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

(vi) represents a significant shareholder; or

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

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

Governance arrangements in relation to the PPFM

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

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

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

…

**TP 2 Other Transitional Provisions**

| (1) | (2) | (3) | (4) | (5) | (6) |
|---|---|---|---|---|---|
| | Material to which the transitional provision applies | | Transitional provision | Transitional provision: dates in force | Handbook provisions: coming into force |
| … | | | | | |
| 2.9 | *COBS* 20.2.1G to *COBS* 20.2.23R, *COBS* 20.2.26R to *COBS* 20.2.41G, ~~*COBS* 20.2.53R to *COBS* 20.20.2.60G (Treating with profits policy~~ | R | The provisions listed in column (2) do not apply to a *firm* if, and to the extent that, they are inconsistent with an arrangement that | … | … |

| | | | | | |
|---|---|---|---|---|---|
| | ~~holders fairly)~~ | | was formally approved by the *FSA*, a *previous regulator* or a court of competent jurisdiction, on or before 20 January 2005. | | |
| … | | | | | |
| 2.11 | *COBS* TP 2.9 | G | The *rules* and *guidance* on treating with-profits policyholders fairly (*COBS* 20.2.1G - *COBS* 20.2.41G; ~~*COBS* 20.2.53R – *COBS* 20.2.60G~~) may be contrary to, or inconsistent with, some arrangements that were formally approved by the *FSA*, a *previous regulator* or a court… | … | … |
| … | | | | | |
| <u>2.15</u> | <u>*COBS* 20.2.53R to *COBS* 20.2.60G</u> | <u>R</u> | <u>(1) Unless (2) applies, a *firm* that has ceased to effect new *contracts of insurance* in a *with-profits fund* must submit to the *FSA* a run-off plan of the type described in *COBS* 20.2.53R(1)(b), if it has not done so already, within 3 months of the start date of rules regardless of when it closed to new business.</u><br><br><u>(2) Paragraph (1) does not apply to a *firm* if, and to the extent that, to comply would be contrary to or inconsistent with an arrangement</u> | <u>[start date of rules] indefinitely</u> | <u>1 November 2007 and [start date of rules]</u> |

| | | | | | |
|---|---|---|---|---|---|
| | | | that was formally approved by a court of competent jurisdiction, on or before [start date of rules]. | | |
| 2.16 | *COBS* 20.2.53R to *COBS* 20.2.60G | G | The effect of *COBS* TP 2.15 is that *firms* which were not required to submit a run off plan to the *FSA* because they ceased to effect new *contracts of insurance* before 1 November 2007 or because of previous transitional provisions in COBS TP, will need to submit a run off plan to the *FSA* within 3 months of the date in (5). However, this will not apply to the extent that it would be inconsistent with a formally approved court scheme. | [start date of rules] indefinitely | 1 November 2007 and [start date of rules] |

## COBS Sch 2 Notification requirements

| COBS Sch 2.1.G | | | | |
|---|---|---|---|---|
| Handbook reference | Matters to be notified | Contents of notification | Trigger Event | Time allowed |
| … | | | | |
| COBS 21.2.8R | … | | | |
| COBS 20.5.5R(3) | The decision of a *firm's governing body* to depart from the advice or recommendation of the *with-profits* | A description of:<br><br>(1) the decision of, and reasons given by, the *firm's governing* | The *with-profits committee* or advisory arrangement considers | As soon as reasonably practicable |

| | | | | |
|---|---|---|---|---|
| | *committee* or advisory arrangement | *body*;<br><br>(2) the recommendation and advice of the *with-profits committee* or advisory arrangement,<br><br>together with a copy of the *firm's* records of the decision, reasons, advice and recommendations. | that the issue is sufficiently significant and requests of the *governing body* that the *FSA* be informed; | |

## Annex D

## Amendments to the Supervision manual (SUP)

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

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

…

(4) …..; ~~and~~

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

(6) ensure that:

(a) the reporting lines for the *with-profits actuary*; and

(b) the way in which the remuneration of the *with-profits actuary* is determined and the related approval process;

do not give rise to a conflict of interest in relation to the role of the *with-profits actuary* and the advice he gives.

…

**App 2.15 Run off plans for closed with-profits funds**

2.15.1 G The run off plan required by *COBS* 20.2.53R should include the information described in *SUP App 2.15.2G* to *SUP App 2.15.13G* in respect of the relevant *with-profits fund*. Also, COBS 20.2.22BG(1) states that *firms' with-profits management plans* should include the explanations and information set out in *SUP* App 2.15.3G, 2.15.4G and 2.15.5G, tailored as necessary.

…

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