

January 21, 2008

RT Hon John McFall MP
Portcullis House
London SW1A 2LW

Dear Chairman

I am writing to you in my capacity as the policyholder advocate (PA) in the possible reattribution by Norwich Union of inherited estates which have built up from policyholder contributions in its 90:10 with-profits funds and in the light of the interest you expressed in reattributions of inherited estates when taking evidence from the chairman and chief executive of the Financial Services Authority (FSA) on 9 October 2007. I understand that you are to take evidence from them in respect of the 2006/7 FSA Annual Report, the cover of which contains the declaration ' Helping retail consumers achieve a fair deal' and which is at the heart of the points I wish to make in this letter.

In seeking to ensure a fair outcome for policyholders, my role as PA includes negotiating with the firm, on behalf of the relevant with-profits policyholders, the aggregate benefits to be offered to them in exchange for the rights they will be asked to give up in the Norwich Union (CGNU Life and CULAC) inherited estates, as well as commenting to policyholders on the method used for the allocation of benefits among them. The FSA also has an independent role to scrutinise the fairness of the reattribution proposals, and though the FSA is not a direct party to the negotiations, it has recognised that the negotiations may be assisted if, on request or on its own initiative, it states its position on relevant aspects at any appropriate point in the negotiations. This letter deals with general issues about reattribution and contains nothing specific to my particular responsibilities.

The PA's request for guidance and the FSA's response

The FSA letter referred to came as a result of a series of questions I asked, particularly in relation to the following uses of inherited estates.

- providing capital to subsidise the writing of new business
- paying shareholder tax
- making strategic investments
- paying the costs of mis-selling

The FSA response was disappointing in that it largely maintained the status quo and means that, despite a subsequent lengthy FSA with-profits review, the unsatisfactory outcome in the AXA Equity & Law reattribution of 2000 could be repeated, where shareholders ended up with around 70% of the estate rather than the 10% that they would have got if there had been no reattribution. That case resulted in

widespread criticism of the fairness of this split, which ultimately resulted in the FSA creating the post of policyholder advocate and in my appointment.

The FSA has not fully explained why it is consistent with the principle of Treating Customers Fairly to allow the estates to be eroded by practices which favour shareholders over policyholders. For example, shareholders have to pay their own tax if there is no estate, but the FSA allows this tax to be charged to the estate if there is one, giving as one reason for their original decision that it was 'a concession to industry'. This does not seem to be a strong reason for deviating from the 90:10 principle. More generally, a 90:10 principle covering the whole of a with-profits fund which made it clear that the estates could not be eroded for shareholders' gain, would be far stronger protection for policyholders than a set of rules which precluded particular practices. However, my main concern in the context of a reattribution relates to the FSA's guidance on the subsidising of new business, as discussed further below.

Fairness of the reattribution proposals

In negotiating to determine a fair aggregate offer to policyholders in return for giving up their rights in the inherited estates, a PA needs to consider whether an offer is fair as between the interests of policyholders and shareholders, having regard both to what the policyholders are giving up and what the shareholders stand to gain.

Gains to shareholders

As regards gains to shareholders, the most relevant aspect of the FSA's recent guidance is that the FSA has said, in the normal course of events (that is, without a reattribution), it is content for current policyholders to be made to subsidise new business by allowing a firm to retain capital in an inherited estate to support new business which would otherwise have been available to be paid out to current policyholders as special distributions. This has the effect of passing on rights to an inherited estate from current policyholders to future policyholders, until such time as the with-profits fund is closed to new business when, under FSA rules, the full inherited estate must be paid out to current policyholders and shareholders in the normal 90:10 proportions.

Given the FSA's stance on this matter we have requested further guidance from the FSA on its position on the appropriate sharing of an inherited estate between current policyholders and shareholders in a reattribution.

The point we have made to the FSA is that, in a reattribution, the situation is similar to the one where a with-profits fund is closed to new business. As noted above, when a fund is closed to new business, where there are no future policyholders who can benefit from distributions of an inherited estate, the FSA rules require the capital in the fund to be returned to current policyholders and shareholders in the normal 90:10 ratio. After reattribution, by definition the reattributed estate belongs to shareholders, so future policyholders will not receive special distributions from any reattributed inherited estate. In other words, the portion of the inherited estate which current policyholders would pass to future policyholders, as a result of the capital subsidy provided by current policyholders to fund the firm's new with-profits business, will pass instead to shareholders. The higher the forecasts for new business, the larger will be the capital subsidy required from current policyholders and the greater is the proportion of the estate that will pass to shareholders in a reattribution (and to future policyholders without a reattribution). We consider that current policyholders should receive a proper share of these monies, via an enhanced reattribution payment. The FSA's rules and guidance do not specifically address this vital point.

The FSA's letter says "If the reattribution proposal is to divide value between policyholders and shareholders on a basis that is different to the 90:10 starting point, we look at the basis for that proposed division and decide whether it is fair, compared with policyholders awaiting a potential future 90:10 distribution." This may indicate that the FSA is expecting as a starting point a 90:10 split as between policyholders and shareholders which includes the estate which would have gone to future policyholders. However, it is not clear that this is the FSA's intention which is why we have sought further clarification on this issue. The FSA's decision could make a very real difference to the aggregate level of benefits being offered in a reattribution to policyholders and hence to the overall fairness of any deal.

Current Policyholders' Benefits Forgone and Policyholders' Reasonable Expectations

The FSA's recent guidance confirms that it expects firms to distribute excess capital in an inherited estate as it arises. The FSA has also said that "The PA will take into account the probability that there may be future surpluses generated by the fund that would be distributed to policyholders". The combination of these statements does appear to mean that policyholders do now have clear expectations that they will receive special distributions from these estates over time, that these expectations are capable of being forecast for each individual policyholder, and need to be taken into account in a firm's offer to policyholders in a reattribution. However, this is such an important issue for ensuring the fair treatment of policyholders that we have asked the FSA to confirm that this means that Policyholders' Reasonable Expectations (PRE) can no longer be assumed to be zero.

This question arises because it is often stated by the industry that 'PRE' equals zero. If that is the case, any incentive payment offered in respect of a reattribution is regarded as a windfall, and the firm may consider that, not only could it limit its offer to the rights that current policyholders are giving up (taking the share of the estate that would otherwise fall to future policyholders for free), but also that it may offer current policyholders very little for giving up those rights.

PA Advice to Policyholders.

Clarification that current policyholders should at least be compensated in line with the distributions of the inherited estate that they could expect in the future would be an important step forward in ensuring a fair deal. However, there might be an unfortunate outcome, should the FSA not clarify that current policyholders should be compensated for the fact that the shareholders would be taking over the whole of the inherited estate. A PA may have to determine that the aggregate offer to policyholders is unfair given the amount shareholders stand to gain, yet would have to advise current policyholders that it could be appropriate for them to accept the offer, if it is in line with the future distributions that they could have expected from the inherited estate. It is vitally important, therefore, that the FSA does indeed make clear that shareholders should not obtain potentially large proportions of the inherited estate without a suitable payment to current policyholders.

Conclusion

The key questions that arise for the FSA from this letter are:

1. When a fund is 'closed' to future policyholders the estate is distributed over time 90:10 to current policyholders. A reattribution closes off an estate to future policyholders, just like closing the fund completely. Does the FSA think that fairness requires that current policyholders should be compensated for the fact that shareholders are purchasing the whole of the inherited estate?

2. The FSA has advised that its rules require firms to distribute excess surplus capital in inherited estates as the excesses arise. Can the FSA confirm that this means that companies with inherited estates can no longer claim that policyholders` reasonable expectations are zero, where distributions of excess surplus capital are expected to arise?

It would be helpful if the FSA would make its position clear when it gives evidence to your committee on 22 January 2008.

Yours sincerely

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