

Treasury Select Committee: Tuesday 21st January 2008

Video Conference Transcript

John McFall, Chairman: Good Morning Sir Callum, Mr Sants. Welcome to the Committee's hearings on your Annual Report. We have taken evidence previously on Northern Rock and this is the opportunity for us to focus exclusively on your Annual Report. So, can you introduce yourselves for the shorthand writer please first.

Sir Callum McCarthy: Certainly chairman, Callum McCarthy, Chairman for the FSA.

Hector Sants: Hector Sants, Chief Executive, FSA.

John McFall: Good, Mr Sants, when you were here in October, I asked you a question at the end, in terms of inherited estates, and you said that you were going to take a personal interest in this issue. The FSA has advised that its rules require firms to distribute excess capital in Inherited Estates, as the excesses arise. Can you confirm that this means that companies with Inherited Estates can no longer claim that policyholders' reasonable expectations are zero? [2.32]

Hector Sants: Yes, I think that is clear...I think our material which we have recently produced, including our exchange of letters with the policyholder advocate Clare Spottiswoode, I think makes that point absolutely clear. [2.47]

John McFall: The reason I am asking is that Sarah Wilson (Director in charge of Insurance), said in October, that it was insurance firms not policyholders, who own the Inherited Estate and that policyholders had at best a (quote) 'contingent claim' (unquote). So, you are saying for the record that is not the case. [3.09]

Hector Sants: No, I think that both the statement 'yes' and the comments that you have read out are compatible with each other, so maybe just to elaborate, I was trying to be very clear in my answer. [3.20]

John McFall: Oh, on the point about insurance firms owning Inherited Estates, we know how this came about, with-profit funds, the smoothing and insurance firms held this money back, so it's not really insurance company monies here, it's policyholders' monies and I think that it is important to get that on the record. [3.37]

Hector Sants: No, I think we should place on the record, because there has, as you say, rightly so because there has been a lot of debate around this and media commentary. It is undoubtedly the position, it is legally the position, that those estates are not owned by the policyholders, they are part of the company's assets under which, on which the policyholders have a contingent claim. So they are not owned by the policyholders' and I think some of that...that belief has coloured some of this debate and that is a legal matter not a matter of FSA rules. [4.22]

John McFall: Ok, let's (cut off by Mr Sants)

Hector Sants: But the reason I answered 'yes' is that we absolutely agree that they have a contingent claim on those assets. We are completely aware of and our rules are framed around the ministerial statement concerning the 90:10 point. [4.38]

John McFall: Is that the 1995 statement?

Hector Sants: Yes, and therefore it is absolutely reasonable for policyholders to have an expectation they will get more than zero, which is the answer to the question, yes. [4.50]

John McFall: In that Ministerial statement of 90:10 – do you abide by that?

Hector Sants: Yes we abide by that fully and if you are fully distributing then we base it on the 90:10 rule. If you are making a re-attribution, which is not a distribution but the movement of the assets out of the fund into the company, so that they can then go forward solely at the disposal of the shareholders and obviously the policyholders are entitled to be compensated for removing their contingent rights when the company takes control of that money and places it solely at the disposal of the shareholders. And we agree that compensation discussion should be referenced on and based on the 90:10 rule, but it is not the same as a distribution of surplus assets. [5.45]

John McFall: Right, well, I mean do you think it's fair that insurance companies are able to take money from Inherited Estates to pay the shareholders tax bill to subsidise new business and, indeed, pay compensation for miss-selling claims?

Hector Sants: Those are three separate points with different answers. At the moment our rules do allow all those three points you have articulated. We have recently announced because we have... sorry your opening comment – I have been very personally focused on this matter and the FSA is very focused on the matter and we thought it proper to reassess our current rules. And as part of that reassessment process we have said we will take a look again at the issue of being able to charge mis-selling costs and will consult on that. And, therefore, it follows, obviously, we think there is an argument that says that miss-selling costs should not be chargeable and that we should consult with the industry to assess that argument. So, on the third point, no we don't think that it is absolutely the case that miss-selling costs should be charged and we shall look again on that rule. On the first two points, I think we need to bear in mind that this is not a closed end fund. I think all policyholders understand when they buy into such vehicles that they are buying into an open-ended vehicle which in normal circumstances continues over a long period of time, with new policyholders joining and policyholders falling away. It is an open-ended process and I think as part of an open-ended process it is reasonable to charge those types of costs that you've alluded to, do with new business and tax because a vibrant and successful long-term fund is to the advantage of policyholders in the long-term. [7.36]

John McFall: So you think that it is fair that tax bills by shareholders could be taken out of this fund and policyholders could lose as a result. [7.50]

Hector Sants: That is a long standing practice that has been reflective of the philosophical approach I've described and was in place when we properly reviewed our rules and it seems reasonable to allow that practice to continue. I come back to the point that this is not a

closed end fund that has a finite life solely for the benefit of the current policyholders. It is an open-ended vehicle that is meant to have a long-term (interrupted by the speaker). [8.18]

John McFall: OK, OK on that point though, when a fund is closed to future policyholders the estate is distributed over time 90:10 to current policyholders. Correct. But a reattribution closes off an estate to future policyholders? Am I correct there?

Hector Sants: The reattribution takes away that particular set of money from the policyholders which is why they have a contingent claim and can be compensated for the removal of that money to be placed at disposal of shareholders

John McFall: So reattribution closes of the estate to future policyholders?

Hector Sants: No, uh not necessarily, but depends on the circumstances of the particular reattribution. Individual circumstances can be different. [9.00]

John McFall: Yes, but largely speaking what we have seen is that in a reattribution...(cut off by Mr Sants)

Hector Sants: Yes, largely speaking

John McFall: Exactly, right. So that is just like closing a fund completely. So therefore do you think that fairness requires current policyholders to be compensated for the fact that shareholders are purchasing the whole estate? [9.19]

Hector Sants: They should be compensated, yes, that is why we made it clear that they should have an expectation of more than zero.

John McFall: You see the reason I am asking you Mr Sants is that people have contacted us saying that the FSA has not been clear. That there is no clarity on the situation and I want clarity. And, indeed, I will be following this up in letters to you but it is the clarity element that I want you to answer.

Hector Sants: Actually we would very much like to clarify this. We have been taking an approach to keep everyone fully informed which is why we published on our website our correspondence with the policyholder advocate. We completely support your objective of getting clarity here. If there are any areas we are not clear on, I will be more than grateful to respond with further public communication in response to any further questions. I absolutely agree with you we are seeking to ensure a fair process for the policyholders as well as the company, and the shareholders here and that process should be one that is fully understood by all. If there are any confusions we will be more than happy to clarify issues. [10.18]

John McFall: The Sandler review of 2002 stated that inherited estates distorted competition between insurers. He said insurers who built up this money are allowed to use it as an alternative source of investment funding to subsidise new business and an alternative place to charge expenses. Therefore, Ron Sandler goes on, certain providers, not necessarily the most efficient ones, have pools of capital which can be used to subsidise various activities. Do you agree with Sandler that it distorts competition issues? [10.51]

Hector Sants: Our current rules would not allow what I think most people interpret when they hear the word 'subsidy'. We do not allow new business to be subsidised. We do believe

it is reasonable, for reasonable costs of new business to be charged, that is not the same as a subsidy. So I think my response to that point would be that we have amended our rules and we are not supportive of subsidising new business out of funds. [11.26]

John McFall: OK, have you discussed this issue with the OFT (Office of Fair Trading)? You know, mindful of the FSA's job along with the OFT's, is to ensure a healthy and a vibrant financial services sector where competition flourishes?

Hector Sants: I am not aware of us having any specific conversations with the OFT around the particular point that I think you're raising in relation to subsidies for new business. We however take a rigorous regulatory supervisory approach to ensuring that our rules in respect of new business are not being breached and we have a number of ongoing supervisory engagements on that topic. One particular one I am thinking of... (cut off by speaker)

John McFall: OK, well I will perhaps copy the OFT into any correspondence I have with you. I would be grateful for any information you can send us on any discussions you have had or will have with the OFT. And you know the reason I am raising this Mr Sants is, that over the insurance industry those estimates of 20 to 25 billion pounds being at stake here for people and the press in particular are beginning to catch on to this issue I noted The Economist in October described the FSA as a watchdog that didn't bark! And that The Times are saying in December that it is up to the FSA to act as an honest broker and to push harder to secure these assets for policyholders. And the Sunday Telegraph have said policyholders across the insurance industry could end up being diddled out of £8 to £ 9 billion pounds, a colossal amount of money. So what is the FSA playing at and why aren't the politicians kicking up a fuss? Now in my own understated way I am doing that just now and putting you on notice in that we will keep communicating. [13.33]

Hector Sants: And I'd just like to reassure you that, as I said before, we are treating this matter with great seriousness. We consider it a very important issue for the FSA to focus on. We are absolutely aware of our obligation to ensure a fair deal for policyholders. I believe I genuinely believe we are very focused on achieving a fair deal for policyholders and making clear the deliberations and the basis under which we reach those conclusions on any given set of circumstances. I also remind you certainly at least so that there are there can be individual variances around this certainly in relation to the two cases which currently have the most prominence, that a court deliberation is certainly required and also the policyholders will have an opportunity to express their own individual view. So we are part of a process, but we take our part of the process extremely seriously and I completely reject any suggestions of the nature that the media, not yourself, of the media, are making that we are not properly focused on ensuring a fair deal for policyholders. I just don't believe that is the case. [14.46]

John McFall: OK and Sir Callum I am sure that as a former regulator, and as one to see keen competition in the market, you will have lot more than a passing interest in this over the next couple of months.

Sir Callum: Absolutely, as will the FSA board as a whole.

John McFall: Thank you very much. Phillip you wanted to follow up with anything there.

Phillip Hammond: No problem if I may. One of the main issues about reattribution and causing one of the biggest difficulties is over this new business and subsidy. You said has been banned. But can you clarify. If the cost of them doing new business generates losses and that those losses can be absorbed by the surplus, doesn't that amount to the existing policyholders, in effect, subsidising the new business channel and acquisition. [15.35]

Hector Sants: I think, as you rightly say, this is a complicated area and I think we seek to make an individual judgement on any particular set of circumstances. It is clearly, the general concept that new business is a reasonable and, indeed, a requisite part of a healthy long-term fund which is then a benefit, over the long term, to that fund. And, therefore, policyholders, in the round, over generations, I think are understood, and therefore it has to be reasonable to say that working capital can be used from the existing funds to help the generation of new business. And as I am sure you will appreciate that type of business at its initiation, if you look at it in narrow terms, in terms of, costs negate return in the opening period, i.e. the nature of that type of business is not going to be profitable so you can't say if you look at the very, very short term, that we would not allow business which is not making an absolute immediate return to be conducted through the fund, because I think given the nature of the business it would be unreasonable. We just have to make a judgement as to whether that degree of start costs is reasonable in the circumstances and we try to make it on a fund by fund basis. What we wouldn't be allowing is clear unreasonable degree of subsidisation against what would be considered reasonable industry norms.

Phillip: It's very judgemental though isn't it?

Hector Sants: Indeed it is, but unfortunately a lot of what we do is very judgemental, in order to be fair and reasonable to the particular. [17.20]

Phillip: Does it also raise competition issues? If you happen to be an operating insurer with an established pool of inherited estates you are in a much stronger position because of your rules than a new entrant coming into the market.

Hector Sants: I think you're right in saying that those issues are also raised and taking into account on the individual judgement and I think it's another reason why it's difficult to make hard and fast quantitative generic rules here – you do have to look at the particular. But I repeat the basic point; we certainly do not want to see people unreasonably putting through loss-making business, at the expense of current policyholders. [18.00]

Phillip: Final question chairman, will you regard it as a success, if on the two outstanding cases, the two significant ones, that you achieve a better result for a distribution towards policyholders compared to shareholders than happened in the AXA case?

Hector Sants: Well we've amended our rules since the AXA case so I think it follows logically from that that we thought there were some issues to be taken up. Therefore would expect a different result next time around, but we should perhaps emphasise that whether or not there is a deal done at all remains a commercial matter for the firms. [12.35]

John McFall: Andy, you wanted a question on inherited estates...

Andrew Love: Yes, because it's about the AXA case. I'm quoting from Clare's response to your letter to her. She says the FSA's response was disappointing and that it largely

maintained the status quo and then goes on to quote that in the AXA case 70% of the estate went to the shareholders. Is that fair? If there isn't any change in your response and we ended up with 70% going to Norwich Union or others, is that fair? [19.10]

Hector Sants: Well, I don't want to pre-judge individual cases but I think when she is talking about the status quo, she is talking about our current rules. She was asking us to review our current rules which is the exercise we did do, which resulted in us reaching the conclusion that we should consult again on the miss-selling point, which is the comments I made earlier to the chairman. So I think you're not actually looking at this, talking about the situation prevailing at the time of the AXA distribution. As to the answer I have already offered, I don't wish to repeat myself to the committee. We obviously have looked again at the set of circumstances and there would be reason to assume the result would be different. But it would be wholly wrong for us to pre-judge or for us in any way indicate a numerical out-turn that we are looking for. This is meant to be a negotiation between the policyholders and the firm, where we have set up a policyholder advocate role to represent the policyholders as part of that negotiation and then we look at the outturn of the negotiation. We are not seeking to pre-determine that discussion and the policyholder advocate is quite rightly vigorously going about her job of negotiating on behalf of the policyholders. [20.36]

Andrew Love: Well, I mean, can I just ask one other question? She does say you could be repeating the same thing if you read the comment but I won't press that. Let me just ask you finally, you have already mentioned a difference between reattribution and distribution which is, if I interpret it correctly, in favour of the shareholders. Taking on board the fact also that they have decision power over the timing of when this was happening, in other words they could withhold a distribution to the policyholders, doesn't that bias the whole system in favour of the shareholder?

Hector Sants: I think that takes us back to my earlier comment which I do think it important to recognise that those funds in the context of the reattribution are not owned by the policyholders. They have a right to those funds but they are not their funds in the most simplistic sense and I do think that a lot of the debate in the media fails to acknowledge that point of law. The starting point is that they have a right to those funds and, therefore, if there is a reattribution it's reasonable for them to expect more than zero, which is my answer to the opening question. But they do not own those reattribution, those funds which are being discussed in the context of reattribution, so their rights are not the same as something that somebody owns and somebody else is seeking to take away from them. [22.08]

Andrew Love: But that is an enormous power in the hand of the company by saying "we'll just withhold this, you won't get a distribution at all, unless you get a distribution on our terms".

Hector Sants: Obviously those funds if they are not out rightly owned by the policyholders then it is not for them to determine whether they will be offered a distribution or not. That seems reasonable. But in terms of the balance of power, I think that has been recognised in the FSA appointing a policyholder advocate and putting forward that proposal. We absolutely recognise the policyholders' need professional support and representation in that negotiation and, again, I make the point that I think the volume of correspondence in front of you reflects the fact that it has been done actively and professionally and we very much support those actions by the policyholder advocate. It is a role that we have proposed and

therefore we are delighted to see a proper negotiation taking place, which will hopefully give a fair result to all parties. [23.12]

John McFall: And the public are very much aware how this, these monies came about in the smoothing process of the with-profit fund, so at the end of the day, you know, everything was paid out to policyholders at a particular time 'cause monies were held back in order to smooth the process at a later date. So we have got to keep in mind the origins of these monies, and I think that's important and I think that is where the public feel that there could be any unfairness. Finally on that point, do you agree with the principle that shareholders should not obtain potentially large proportion of inherited estates without a suitable payment to policyholders?

Hector Sants: Yes, I mean, absolutely there is a contingent liability. If they want them to give it up, if shareholders want them to give it up, they need to be properly compensated for it.