

Appendix 4

The Regulatory Background

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

Contents

1.00	Introduction	3
2.00	The Statutory Framework	3
3.00	Reviews relevant to with-profits insurance regulation	12
4.00	The FSA Handbook of Rules and Guidance	23
5.00	Subsequent Developments	36

1.00 Introduction

This paper discusses the regulatory background to the UK with-profits industry, including with regard to inherited estates. The second section describes the statutory framework itself – specifically that established by the Financial Services and Markets Act 2000 (FSMA) and competition legislation. The roles and responsibilities of the various regulators established under these provisions, most notably the Financial Services Authority (FSA), the Office of Fair Trading (OFT), and the Competition Commission are discussed in this context.

The third section includes references to a series of reviews of the with-profits industry which have been instrumental in the changes made to FSA with-profits regulation in recent years.

The fourth section provides further information about the actual operation of the regulatory framework, including a discussion of the relevant rules and guidance and the way in which they are implemented. Section five outlines subsequent developments.

2.00 The Statutory Framework

2.01. Background

There have been significant changes over recent years to the regulatory framework which relates to the oversight of the UK insurance industry, and within that, the UK with-profits industry. Prudential regulation was formerly the responsibility of the Secretary of State, although in practice this was delegated to the Insurance Directorate of the Department of Trade and Industry. Regulation of the Conduct of Business of insurance companies was formerly separately approached through a system of self-regulation, pursuant to the Financial Services Act 1986. This self-regulation meant that insurers were required to be members of the Securities and Investment Board or a Self-Regulating Organisation¹.

On 20 May 1997, the Chancellor of the Exchequer announced the Government's intention of creating the FSA, a single UK financial services industry regulator, which would be independent of Government. The FSA would be responsible for both financial services

¹ Examples of Self-Regulating Organisations were the Personal Investment Authority (PIA) and the Investment Management Regulatory Organisation Limited (IMRO).

prudential regulation and conduct of business regulation. The FSA would be financed directly by the industries it regulated. The responsibility for prudential regulation of the insurance industry was passed to the Treasury between January 1998 and January 1999, after which the day-to-day supervision of the industry was contracted out to the FSA. The FSA took over the Securities and Investment Board in 1998, and thereby took over responsibility for the conduct of business regulation. The FSA assumed its full powers in December 2001; however, the Treasury remains responsible for the scope and regulatory powers of the FSA. The FSA's powers and duties derive from the Financial Services and Markets Act 2000 (FSMA) which came into force in December 2001.

2.02. The Financial Services and Markets Act 2000 (FSMA)

The Treasury

The Treasury has retained overall responsibility for the structure of UK financial services legislation, and within that, regulation of the UK with-profits industry. The Treasury also has a role in the negotiation of European Directives. The Treasury is the responsible government department which is accountable to Parliament and as such it has a duty to inform Parliament about the management of serious problems in the financial system and any measures used in the resolution of these problems.

The Treasury also has responsibility for the scope and regulatory powers of the FSA. The FSMA² grants the Treasury the right to conduct reviews or instigate inquiries to aid it with this task. The Treasury may commission a review to consider the economy, efficiency and effectiveness with which the FSA has used its resources in discharging its functions but the scope of a review does not extend to a review of the merits of the general FSA principles or policies³. The Treasury also has the right to instigate inquiries with a broader scope, if it appears to the Treasury that:

² Part I, Sections 12-18.

³ The Treasury may appoint a person independent of the FSA to conduct the review. The FSMA grants this person rights to obtain information. Once the review is completed a written report must be produced for the Treasury setting out the results of the review and making any appropriate recommendations. The Treasury invited the National Audit Office to conduct such a review, which was published in April 2007.

- an event has occurred in relation to a collective investment scheme or a person who is, or was at the time, carrying out a regulated activity; and
- this event posed, or could have posed a grave risk to the financial system; or
- this event caused, or risked causing significant damage to the interests of consumers; and
- the event might not have occurred, or the risk or damage might have been reduced but for a serious failure in either the system established by the FSMA or the operation of that system⁴.

The Financial Services Authority (FSA)

The FSA was granted its statutory powers by the FSMA. Part I, Section 2 of the FSMA outlines the general functions of the FSA, namely:

- to make rules;
- to prepare and issue codes;
- to give guidance; and
- to determine the general policies and principles by reference to which it performs particular duties.

These general functions should be discharged insofar as is reasonably possible, in a way which is compatible with four regulatory objectives, and that the FSA considers to be the most appropriate for the purposes of meeting these objectives⁵. The four regulatory objectives are⁶:

- Maintaining market confidence in the financial system;
- promoting public understanding of the financial system, including the benefits and risks of different kinds of investment or other financial dealing;

⁴This inquiry would be conducted by an independent person appointed by the Treasury. This person has the same powers as the courts in respect of the attendance and examination of witnesses and the production of documents. This person must produce a written report to the Treasury.

⁵ Part I, Section 2(1) of the FSMA.

⁶ Part I, Sections 2-6 of the FSMA.

- securing the appropriate degree of protection for consumers, whilst having regard to the general principle that consumers should take responsibility for their own decisions⁷; and
- reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime, such as money laundering, fraud and market abuse.

In addition to these regulatory objectives, the FSMA also established a series of issues to which the FSA must have regard, when discharging its general functions⁸:

- the need for the FSA to use its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of authorised persons;
- the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits considered in general terms, which are expected to result from the imposition of that burden or restriction;
- the desirability of facilitating innovation in connection with regulated activities;
- the international character of financial services and markets and the desirability of maintaining the competitive position of the UK;
- the need to minimise the adverse effects on competition that may arise from anything done in discharge of those functions; and
- the desirability of facilitating competition between those who are subject to any form of regulation by the FSA.

⁷ The FSA must, however, have regard to the differing degrees of risk inherent in different types of investment; the differing experience consumers may have in regard to regulated activities; the needs that consumers may have for accurate advice and information and the general principle that consumers should take responsibility for their decisions.

⁸ Part I, Section 2(3) of the FSMA.

The FSA must also have regard to the principles of good corporate governance⁹ and the FSA's general duty to consult practitioners and consumers¹⁰ on the extent to which the FSA's general policies and practices are consistent with its general duties under Section 2 of the FSMA.

Part I, Sections 9-11 of the FSMA require the FSA to establish a Practitioner Panel and a Consumer Panel. These panels are independent of the FSA, and are intended to help assess the extent to which the general policies and practices of the FSA are consistent with its general duties as outlined in the FSMA. The panels have the right to make representations to the FSA, stating a view or making a proposal, and the FSA must consider any such representations made to it by the panels. Should the FSA disagree with a view expressed or a proposal made by either panel in a representation, the FSA must give the panel a written statement explaining reasons for disagreeing.

The Financial Services and Markets Tribunal

It is possible to appeal decisions made by the FSA through the Financial Services and Markets Tribunal (FSMT) established by Part IX of the FSMA. The FSMT has the power to call witnesses and to award costs. It may determine what action the FSA should take and give directions to the FSA in order to give effect to its decisions. The FSMT also has the power to make recommendations about the FSA's rules and procedures.

It is possible to appeal against a decision taken by the FSMT on a point of law. In such instances, the case is taken to the relevant appeal court. For such an appeal, however, permission needs to be given by the FSMT or the relevant appeal court. If the appeal court finds that the FSMT decision was wrong, it may remit the matter back to the FSMT or make a decision itself. An appeal from the appeal court may be made to the House of Lords with the permission of either of these courts.

⁹ Part I, Section 7 of the FSMA.

¹⁰ Part I, Section 8 of the FSMA.

The Financial Ombudsman Service

The Financial Ombudsman Service (FOS) was established under Part XVI of the FSMA and is responsible for resolving disputes between members and consumers in a fair manner. In some cases the FOS may perceive an issue with wider implications, which then may be escalated to the FSA. The FOS is independent of the FSA; however the Board of the FOS is appointed by the FSA, and the FSA makes or approves its rules and also approves its budget.

The Financial Services Compensation Scheme

Part XV of the FSMA established the Financial Services Compensation Scheme, the UK's statutory fund of last resort for customers of financial services companies¹¹. This means that the Financial Services Compensation Scheme can pay compensation to consumers if a financial services company is unable, or likely to be unable, to pay claims made against it, for example if it has been placed in provisional liquidation or administration and so is not able to meet the claims against it. As with the Financial Ombudsman Service, the Financial Services Compensation Scheme Board is appointed by the FSA, and its rules are made or approved by the FSA¹². The Financial Services Compensation Scheme may levy charges against authorised financial services firms to cover its expenses, with such a levy also being subject to FSA approval.

The Office of Fair Trading

Part X, Chapter 3 of the FSMA mandates that the Office of Fair Trading (OFT)¹³ must keep the FSA's practices and regulating provisions under review to consider whether they are having any adverse effects on competition¹⁴. The OFT has the power, at any time, to investigate the FSA's practices and regulating provisions, in order to consider whether, either singly or in combination, the practices and regulating provisions have a significant adverse

¹¹ The functions of the Policyholders' Protection Board (established under the Policyholders Protection Act 1975) were transferred to the Financial Services Compensation Scheme under the FSMA in November 2001. The 1975 Act continues to apply.

¹² Particular rules from the FSA which govern the Financial Services Compensation Scheme are found in the FSA Handbook under Redress and Compensation (COMP 1 - 14).

¹³ The FSMA actually refers to the Director General of Fair Trading, however this position was abolished by the Enterprise Act 2002 and its functions were transferred to the OFT.

¹⁴ It should be noted that in late 2003, the OFT launched a Financial Services and Markets Act Competition Review. The objective of the review was to sift through markets affected by the FSMA to identify those areas that might raise competition concerns. The review did not find any indications that the FSMA had a significant adverse impact on competition in financial services markets.

effect on competition. If this investigation yields a result which says that the policies and/or regulating provisions do produce a significant adverse effect on competition, or if the OFT would like to pursue the matter further, the OFT is required to produce a report. The Competition Commission must then consider the matter. It too must produce a report stating whether or not it finds that there is a significant adverse effect and, if so, whether the effect is, given the FSA's legal obligations, justified. The Competition Commission report should also state, if relevant, what action ought to be taken by the FSA in the light of any unjustifiable anti-competitive effect, such as the FSA changing its rules or guidance in specified ways. If such suggestions for action are made, it is up to the Treasury to direct the FSA to take appropriate action¹⁵.

2.03. FSA Interaction with other regulators

The FSMA outlines the way in which the FSA should interact with some other regulators such as the Treasury and the OFT. Further agreements between these organisations have been published since the enactment of the FSMA.

The Treasury, the Bank of England and the Financial Services Authority

There is a tripartite Memorandum of Understanding between the Treasury, the Bank of England and the FSA, the object of which is to encourage information-sharing between these organisations and also to secure the common objective of financial stability in the UK. This relationship is overseen by the Tripartite Standing Committee which comprises the Chancellor of the Exchequer, the Governor of the Bank of England and the Chairman of the FSA.

The OFT and the FSA

There is a joint action plan, published in 2006, between the OFT and the FSA to ensure the effective regulation of the jointly regulated population. It identified areas where the two organisations can work more closely together such as communications with firms and

¹⁵ In exceptional circumstances, the Treasury may decide that actions directed by the Competition Commission are not appropriate and it can require the FSA to make changes even if the Competition Commission says that the adverse effect is justified. The Treasury cannot, however, require the FSA to take any actions which the FSA itself would not have the power to take.

consumers. It also set out steps to reduce burdens on jointly regulated firms. The FSA and the OFT share a common interest in consumer protection. It should be noted, however, that under the FSMA and the FSMA 2000 (Disclosure of Confidential Information) (Amendment) Regulations 2003 only limited gateways exist for the FSA to disclose information to the OFT. The National Audit Office review of the FSA, published in April 2007, said that in terms of working with other UK regulators, the FSA should focus on working collaboratively with the OFT where the latter's interests in competition and consumer protection coincide with the FSA's interests in financial markets.

The FSA's interaction with the Financial Ombudsman Service and the Financial Services Compensation Scheme

The FSA also has a Memorandum of Understanding with the Financial Ombudsman Service. It should, however, be noted that the Financial Services Practitioner Panel report in November 2006 indicated that practitioners they surveyed who had had dealings with the Financial Ombudsman Service, perceive that there is still some disconnect between the Financial Ombudsman Service and the FSA. The Financial Services Compensation Scheme provides regular updates to the FSA on the main issues it confronts and the FSA and the Financial Services Compensation Scheme have dedicated teams to liaise with each other.

2.04. UK Competition Legislation

The UK with-profits industry is also subject to general competition legislation. The competition legislation and competition authorities are of particular significance in the financial services sector generally because the FSA, unlike many other UK sector regulators, does not have concurrent powers for the enforcement of competition legislation¹⁶.

The UK Competition Act 1998 and the Enterprise Act 2002

The Competition Act 1998 prohibits agreements between undertakings, decisions by associations of undertakings, or concerted practices which may affect trade within the UK and

¹⁶ This is set out in paragraph 4 of the FSA's Memorandum submitted to the House of Lords Select Committee on Regulators, which states: "the FSA is not a competition regulator. However, where we are concerned about developments that may have an adverse impact on competition, we work closely with the competition authorities – the OFT and the CC". House of Lords, Select Committee on Regulators, First Report of Session 2006-07, UK Economic Regulators, Volume II, Evidence, page 162

have as their object or effect the prevention, restriction or distortion of competition within the UK. Furthermore any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the UK. The Competition Act 1998 established the OFT and the Competition Commission¹⁷.

The general functions of the OFT, as outlined in the Competition Act, include the acquisition of information, the provision of information to the public, the provision of information to Ministers and other public authorities and promoting good consumer practice.

The powers of the Competition Commission were extended by the Enterprise Act 2002. The OFT may conduct market investigations if there is a suspicion that one or more features of a market prevents, restricts or distorts competition in relation to the supply or acquisition of goods or services in the UK and may make references to the Competition Commission for fuller investigation¹⁸.

To aid understanding of how the OFT fulfils its statutory requirements, the OFT has produced a prioritisation framework¹⁹ to clarify the factors which it may consider when choosing whether or not to take enforcement action, including an assessment of consumer benefits which would arise from intervention, an assessment of the likely deterrent effect arising from intervention and also any mitigating factors, such as very short duration of the offence. The prioritisation framework states that the OFT will also consider whether the offence has occurred in a new sector, a priority sector or whether there is a need for more policy clarity.

The Competition Commission has published a series of documents outlining the Competition Commission rules and procedures for investigations in accordance with the Competition Act. These procedures include the procedures for market and merger references as well as information about reports, remedies and undertakings.

Under the Enterprise Act 2002, claims made on behalf of consumers by designated consumer bodies (termed “super-complaints”) may be made to the OFT about any feature, or

¹⁷ The Competition Commission took over the functions of the Monopolies and Mergers Commission.

¹⁸ Part VI of the Enterprise Act sets out the power of the OFT and the Secretary of State to make references to the Competition Commission to investigate a specific market in the UK.

¹⁹ Competition prioritisation framework, October 2006.

combination of features, of a market in the UK for goods or services which is or appears to be significantly harming the interests of consumers.

The Competition Act 1998 sets out exclusions in Schedules 1-3, including an exclusion for an agreement which is subject to the competition scrutiny under the FSMA.

2.05. European Competition Legislation

The prohibitions in UK competition legislation mirror those in the relevant EU legislation. Article 81(1) of the EC Treaty prohibits “all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between member states and which have as their object or effect the prevention, restriction or distortion of competition within the common market”. The European Commission has introduced a collection of block exemptions for different types of contract. Article 82 of the EC Treaty applies to conduct by one or more undertakings which amounts to an abuse of a dominant position in a market and which may affect trade within the common market or a substantial part of it and which may affect trade between member states.

3.00 Reviews relevant to with-profits insurance regulation

Since the late 1990s, a series of reviews has highlighted the need for change in the regulation of the UK with-profits industry. As a result, the FSA has made a number of changes to its Handbook (see section 3 below)

3.01. The Baird Report

The Baird Report was commissioned by the FSA in 1999 to report on the failure of Equitable Life and was issued in 2001. It covered the FSA’s regulation of Equitable Life from the beginning of 1999 until it closed to new business in December 2000. The Report said that changes to the prudential framework for the life insurance companies needed to be made: “the current framework needs to be restructured so that the required minimum capital reflects all the risks in the business... there would be significant advantages in both transparency and

costs in having such a common basis”²⁰. The report went on to say that: “We recommend that the purpose, content and frequency of regulatory returns be reviewed. The information provided by all firms must be both timely and sufficient to assess the risk of customer detriment which might arise from issues relating either to solvency or PRE [policyholders’ reasonable expectations]”²¹.

The report said that the regulator needed to be prepared to be more proactive: “while the FSA is understandably concerned to guard against unnecessary intrusion into firms’ businesses or being seen to influence inappropriately management decisions, and particular concerns have been expressed in this context about the consequence of the regulator acting as a shadow director, it should also be recognised that the management of a life company may have a number of competing interests to balance, only one of which will be the interest of their policyholders, both current and prospective. We therefore recommend that the FSA, in its regulation of the long term insurance industry:

- Where appropriate to do so, be prepared to act more proactively in pursuance of its statutory objectives to ensure that the interests of customers are properly protected;
- Forms and articulates a clear view of what are the permissible boundaries of proactive regulation;
- Reviews its approach to the use of its powers of investigation, influence and intervention so that it acts in a way proportionate to the perceived risk; and
- Adopts a more proactive, risk-based approach so that the frequency, depth and breadth of contact with firms are related to the risk category of that firm.”²²

The report also said that there needed to be a clarification of some of the key concepts: “we recommend that in situations where regulators have to have regard for concepts such as PRE, which are undefined or capable of more than one interpretation, FSA should develop policy templates so as to ensure the consistency of interpretation and application across the

²⁰ The Baird Report, ‘The Regulation of Equitable Life: an independent report’, published by The Treasury, October 2001, paragraph 7.2. The author was the Director of Quality Assurance and Internal Audit at the FSA.

²¹ The Baird Report, paragraph 7.4.

²² The Baird Report, paragraph 7.7.

regulatory process. In particular we encourage the FSA to carry through to completion its current work on clarifying the meaning of customer interests and PRE.”²³

The report stated that there needed to be changes to the appointed actuary system: “the reliance on one individual with no external, detailed check of his work inevitably poses risks. We recommend the Appointed Actuary should be subject to independent external review. This may be carried out by the FSA or by independent firms, but must be conducted to a level which would provide comfort equivalent to that of an external audit.”²⁴

The FSA response²⁵

In October 2001 the Economic Secretary to the Treasury asked the FSA to report on the actions it intended to take to implement the recommendations about the regulation of the insurance sector set out in the Baird Report.

The FSA issued a letter in response in which it said ‘the report does not pretend to be a comprehensive analysis of the full background to the current position of the society. But it makes some important recommendations about the future regulation of life insurance, which you ask us to take forward as a matter of urgency.’

The FSA went on to say that ‘some of the issues to which the report draws attention have already been addressed...the most important bringing prudential and conduct of business regulation together’ (implemented in April 2001). In an annex to the letter the FSA listed a) changes already made by the FSA, which included its review of with-profits policies, announced in February 2001, and b) planned project work streams in response to the Baird Report, which were comprised of 1) a review of prudential standards for life and general insurance business, 2) a review of regulatory reporting and disclosure of information to the FSA, 3) an examination of the role in insurance regulation of professional advisers and skilled persons, including auditors, the Appointed Actuary and actuarial quality assurance, 4) an

²³ The Baird Report, paragraph 7.9.

²⁴ The Baird Report, paragraph 7.3. A similar point was made by the Report of the Corely Committee of Inquiry regarding The Equitable Life Assurance Society, which was published September 2001 which concluded that an actuary “should resist holding the dual role of Chief Executive and appointed actuary or any role which compromises his or her ability to fulfil the duties of appointed actuary”. The Baird Report, paragraph 68.

²⁵ FSA/PN/134/2001, 17.10.2001 Equitable Life: FSA Response to Baird Report

overhaul of conduct of business and other requirements designed to ensure fair treatment of customers (including governance of insurance companies) and 5) a re-examination of all relevant aspects of its regulatory processes, with particular emphasis on proactive risk identification and mitigation and the use of appropriate regulatory tools.

John Tiner, the then FSA Managing Director, took the work forward and the FSA's with-profits review (see 3.04) became part of the Tiner insurance reform programme.

3.02. The Penrose Report: “Report of the Equitable Life Enquiry”

The Penrose report was commissioned by the Treasury and was published in 2004.²⁶ As well as commenting in particular on the FSA's regulation of Equitable Life, Lord Penrose also commented on the regulation of life insurance more generally and its need for reform.

The report said that there needed to be more information available for regulators about bonus and smoothing policies: “I consider that it is essential for the regulators to have a clear statement of a life office's approach to the financial management of its with-profits fund, and its approach to smoothing returns to policyholders in particular. The absence of such a statement was without doubt a serious impediment to effective regulation of Equitable”²⁷.

It also said that there needed to be more clarity about what constituted a free estate: “it should be clear from the Equitable experience that the need for an estate must reflect the volume, and the nature of the business conducted by the life office”²⁸.

On the subject of accounting treatment and actuarial assumptions the report said that there needed to be more oversight and an independent audit of the actuaries' work.

Penrose said that changes needed to be made to governance: “The Board at no stage got fully to grips with the financial situation faced by the Society: information was too fragmented, their collective skills were inadequate for the task, and there were no effective arrangements for ensuring that there was a detailed examination of, and onwards reporting to the Board on

²⁶ Report of the Equitable Life Inquiry, Rt Hon Lord Penrose, House of Commons, HC 290, 8 March 2004

²⁷ The Penrose Report, Chapter 20, paragraph 6.

²⁸ The Penrose Report, Chapter 20, paragraph 20.

actuarial reports. Equitable's non-executive directors were so wholly dependent on actuarial input from the executive and in particular from the chief executive/actuary that they were largely incapable of exercising any influence on the actuarial management of the Society."²⁹

On the appointed actuary system, the report stated that changes needed to be made: "clearly, every life office must have actuarial staff. Should the existing appointed actuary system continue, it is clear that on no account should it be permitted that the appointed actuary should also be the chief executive. That combination should simply be banned under the approved persons regime. It undermines fundamentally the 'whistle blowing' obligations of the appointed actuary"³⁰.

The report said that "the consumer of financial products should be informed, clearly and succinctly, of the scope of regulation and what can be expected of it... Regulators must also take care not to circumscribe their responsibilities in such a way that they create negative expectations: if regulation truly contributed little or nothing in ensuring that policyholders and potential policyholders were treated fairly, for example, it might be better to abandon that aspect of regulation altogether."³¹

The FSA's response

In March 2004 the FSA issued a letter setting out its response to the findings of the Penrose Inquiry, as they related to the work of the FSA. It said that the FSA welcomed the support given by Lord Penrose to the extensive programme of reform of life insurance regulation that was already under way, 'the main objective of which is to provide policyholders with greater protection and to improve consumer confidence in the life insurance industry more generally. We are doing this by introducing policies which recognize the characteristics of life insurance products, the risks insurers run and the information needs of consumers and their advisers, and by making the day-to-day supervision of insurance companies much more proactive and risk-based'. The FSA said that the main elements of its modernisation of the regulation of the insurance sector could be summarised as:

²⁹ The Penrose Report, Chapter 20, paragraph 50.

³⁰ The Penrose Report, Chapter 20, paragraph 58.

³¹ The Penrose Report, Chapter 20, paragraph 70-73.

- `Moving to realistic accounting and reporting for with-profits business, which will require capital to be held against the discretionary terminal bonus expectations of policyholders;
- Increasing transparency and fairness of with-profits funds, including the introduction of Principles and Practices of Financial Management (PPFM). These require insurance companies to detail how they set annual and final bonus rates; smooth profits through the bonus system; manage their investment portfolios; and manage their inherited estates. We are currently consulting on treating with-profits policyholders fairly, including greater protection for consumers in closed funds;
- Phasing out reliance on “future profits”, and, for the period before they are finally phased out, tightening the criteria against which requests for these are assessed;
- Reforming audit arrangements and the appointed actuary system;
- Bringing together the prudential and conduct of business regulation of life insurance companies; and
- Boosting the resources (numbers and skills) dedicated to insurance regulation.’

The FSA went on to say that, whilst this programme was dealing with the main issues Lord Penrose identified, he raised two important additional issues which the FSA would examine: the interpretation of the term `policyholders` reasonable expectations’ (PRE) as part of the FSA`s consultation on `treating customers fairly`, and dealing with ineffective Boards.

3.03. The Sandler Review: “Medium and Long Term Retail Savings in the UK”

Mr Ron Sandler`s review of competition in the retail savings market ³² was commissioned by the Government and was published in July 2002. It included recommendations on how with-profits business should be structured and operated in future and highlighted a series of problems with with-profits products.

³² Medium and Long Term Retail Savings in the UK: A review, July 2002
17 of 38

The review said that the products were opaque and this opacity resulted in the inhibition of effective competition:

- “In particular the return on with-profits products is composed of four distinct elements: the underpinning investment return, smoothing of this return, either up or down, the contribution from participation in the provider’s other business, and the charging of costs. Even once the policy has matured, although customers can see what the overall return on their money has been, they do not know how these four components have contributed to it;
- During the life of a policy, consumers usually cannot even establish if the policy is performing well, since the final payout on the policy may well form a significant part of the total return. So assessing the quality of the product on its investment strategy is impossible; and
- Focus on price and costs is equally weak. Charges are also not routinely reported to customers as they are for unit-linked funds or unit trusts, and there is no clear notion of one with-profits product being cheaper than another.”³³

The review said that the products give rise to conflicts of interest because: “the policyholders’ rather vague contractual rights contrast with the unambiguous duties of the provider’s directors to shareholders. Consumers also have very little information about how funds are invested and how expenses are charged to them. This situation creates a danger that the provider’s decisions will benefit shareholders at the expense of policyholders.”³⁴

It also stated that the 90/10 structure of these products creates problems because of limited incentives towards efficiency and opacity: “costs are charged directly to the fund and disclosure of the costs is limited, [so] incentives towards efficiency are weak ... the justification for the shareholders receiving 10 per cent of payouts of the fund is that shareholders stand ready to provide capital to the fund should it be required, and part of their share of bonus payout is in return for this. It is true that the with-profits funds need to have

³³ The Sandler Review, Summary, paragraph 60.

³⁴ The Sandler Review, Summary, paragraph 61.

capital underpinning them, and the provision of this capital should be related to the quantum of capital and the level of risk involved.”³⁵

On the subject of inherited estates, the review said that they led to inhibition of competition and increased opacity: “Providers may use these [i.e. inherited estates] subject to regulatory constraints, to subsidise activities in a variety of ways, or to provide capital for instruments that have wider benefits for the shareholders’ business. This distorts competition and increases opacity still further.”³⁶

The review described a new ‘best practice’ model for with-profits funds. In the best practice model, new with-profits funds would have three sets of assets, an investment account (unsmoothed asset shares for each policy would consist of premiums paid into the investment account plus the accumulated investment return, net of tax, earned less the charges made), a smoothing account and supporting capital.

The fund would ideally operate on a 100 per cent basis, with policyholders entitled to the whole return on the investment account and the firm making specified charges on the fund. There would be a separate management company to make explicit charges to run the fund (and bear expense risk). The life cover protection element would be separately identified and a charge paid to a further separate company that would bear the mortality risk. Any guarantees would be treated similarly.

Payments would be made to or from the smoothing account by way of adjustment to the amount going to the investment account to terminating policies. The object would be to reduce the impact of sudden sharp changes in investment markets on the values of terminating policies. A specified charge to support this cost of providing smoothing would also be deducted regularly from the investment account. The supporting capital would normally be provided by shareholders (paras, 10.125 -133).

In relation to inherited estates, the review (10.133 and 10.159-162) proposed that future new with-profits business should not participate in any distribution from an existing inherited

³⁵ The Sandler Review, Summary, paragraph 63.

³⁶ The Sandler Review, Summary, paragraph 64.

estate; and the capital used to support future new business should normally be provided by shareholders, either from their own funds or from their share of any distributable assets from an existing inherited estate. This would lead to a situation in which an existing inherited estate would provide support only for the existing with-profits business. If the existing business runs off in a closed fund as envisaged by the review, the inherited estate could be expected to be distributed in accordance with existing participation rights (commonly 90:10 to existing policyholders and shareholders) (paras 10.133- 10.159-162).

The review recommended adoption of a new simplified with-profits product conforming to its best practice model and that the FSA should, following consultation, set a date for the implementation of the model and that (with the exception of the 100:0 participation requirement) the FSA should require all new with-profits policies to adopt the best practice model.

The FSA`s response

In February 2003, the FSA issued Discussion Paper 20, which addressed the recommendations put forward in the Sandler review on how with-profits business should be structured and operated in the future. The key issue the FSA sought views on was the recommendation that a mandatory `best practice` model should be introduced for future new with-profits business.

The FSA issued feedback on its Discussion Paper 20 in December 2003 (Treating With-Profits Policyholders fairly – Consultation Paper 207). The FSA said that it was persuaded by points made in a number of responses that mutual firms would not be able to operate the model proposed without being placed at a considerable disadvantage. This would arise from restricted access to capital, and the lack of a clear mechanism for policyholders to participate in the benefits of membership if future new business could not participate in a firm`s business experience.

The proposal that any inherited estate should be retained in the closed fund for the existing business would impair the firm`s access to capital, since there are fewer opportunities for mutuals to raise capital than for proprietary firms.

The FSA said that it considered the proposition that mutuals be required to adhere to an alternative, less restrictive model. However, the FSA concluded that discrimination to such an extent would not be an attractive prospect because of the potential market distortions that it might produce. The FSA also observed that it had serious doubts over whether adopting the Sandler recommendation would comply with the consolidated Life Directive and believed that Article 6(5) would render some of the original proposals to mandate the product, and so define terms, illegal or unenforceable since the Directive prohibits a requirement for systematic pre-approval of policy conditions.

The FSA therefore concluded that the recommendation that the new Sandler model should be a mandatory requirement for future with-profits business should not be taken forward. However, it said that many of the concerns of the Sandler Review were ones that the FSA recognized and shared. It appeared to the FSA that the range of work it was carrying out to change the regulation of with-profits business would address many of the Sandler concerns, albeit, in some cases, through a different approach.

3.04. The FSA`s With-Profits Review

The FSA With-Profits review was announced in February 2001 and was completed in 2005³⁷. The review thus ran concurrently with the publication of the above-mentioned reports and aimed to resolve some of the key issues highlighted in those reports. In particular, the FSA said it would concentrate on:

- “The extent of the discretion available to management over the operation of with-profits funds and how that discretion is exercised;
- “Improvements in the transparency of published information about with-profits funds;
- “Better information for policyholders about the progress of their investments, including the language used to describe returns, and greater clarity about investment strategies and the way in which terminal bonuses are determined; and

³⁷ See FSA, Treating with-profits policyholders fairly, Policy Statement 05/01, January 2005

- “The principles which underpin the ‘reasonable expectations’ policyholders may have in relation to their pooled investments.”³⁸

The With-Profits Review was conducted in two stages. The first stage consisted of five issues papers which covered governance of with-profits funds and the future role of the appointed actuary; regulatory reporting; disclosure to customers; discretion and fairness in with-profits policies; and the process for the reattribution of inherited estates.

The feedback to these issues papers was summarised in the “Feedback Statement on the With-Profits Review” published in May 2002. The FSA stated that the extent of the discretion available to companies in managing the with-profits funds and setting levels of return are features which give rise to concerns about the lack of transparency and problems in consumer understanding. The FSA’s preliminary conclusions were that there was need to:

- a. strengthen the governance framework for with-profits funds to give greater confidence over the fair treatment of consumers, including reviewing the role of actuaries in the governance of life insurers;
- b. improve the availability and accessibility of information on the financial condition of firms and their with-profits funds for users of the regulatory returns, including clearer presentation of solvency of with-profits funds and disclosure of realistic liabilities;
- c. provide better information to consumers, including disclosure on with-profits both pre- and post-point of sale; and
- d. develop a more open and transparent process for the handling of the reattribution of inherited estates.

The second stage of the review consisted of a series of consultation papers and discussion papers which considered further the issues highlighted in the first stage of the review. Many of these papers included draft versions of the new rules and guidance which the FSA wanted

³⁸ FSA press release, 23rd February 2001.

to introduce to resolve the issues raised. Interested parties were given an opportunity to respond to these consultation papers.

Final proposals were published in January 2005. They included a new section 6.12 for the Conduct of Business Sourcebook (COB) on Treating Policyholders Fairly which included rules and guidance covering the determination of amounts payable under with-profits policies; an approach to surrender values intended to balance better the interests of departing and remaining policyholders; distribution of surplus in a with-profits fund; the basis on which new with-profits business must be written; the production of formal run-off plans when firms cease to write new with-profits business (closed funds); final proposals on the production of consumer-friendly PPFMs; and the final rules and guidance on the process for the reattribution of inherited estates.

After the end of the review, the FSA issued new rules and guidance in the FSA Handbook, particularly in the Conduct of Business, Prudential Regulation and Supervision sections.

4.00 The FSA Handbook of Rules and Guidance

4.01. The FSA's approach

The FSA described its approach to regulation in written evidence given to the House of Lords Select Committee on Regulators 2007: “We introduce new rules, where we have discretion, only where this is justified by evidence of market failure and after a cost-benefit analysis – in other words where we judge that market forces will not rectify the problem, and where it is likely that the benefits of that intervention would outweigh the costs. Cost-benefit analysis helps achieve a proportionate response to the risks identified; our approach is widely regarded as well ahead of practice by financial services regulators in other jurisdictions. We consult firms on proposed initiatives and publish detailed cost-benefit analysis to enable industry participants to evaluate and comment on our policy proposals”³⁹.

The FSA also stated that: “We operate a risk-based approach, which enables us to focus our resources and activities on the most significant risks; we accept that some failure neither can

³⁹ Paragraph 11, House of Lords Select Committee on Regulators, Memorandum by the FSA.

nor should be avoided. We are moving towards a more principles-based approach to regulation. This means a greater focus on high-level principles and fewer detailed and prescriptive rules, so that firms' senior management has more flexibility and discretion over how best to run their businesses, while meeting our regulatory requirements"⁴⁰.

In this written evidence, the FSA also stated the "the FSA is not an economic regulator; we do not set prices, nor (with limited exceptions) do we approve products."⁴¹

4.02. The FSA Principles for Businesses

Following consultation, the FSA published 11 "Principles for Businesses" which are set out in its Handbook of Rules and Guidance. These principles are a general statement of the fundamental obligations of firms under this regulatory system. Breaching a Principle makes a firm liable to disciplinary sanctions⁴².

The "Principles for Businesses" are as follows:

1. Integrity: a firm must conduct its business with integrity.
2. Skill, care and diligence: a firm must conduct its business with due skill, care and diligence.
3. Management and control: a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4. Financial prudence: a firm must maintain adequate financial resources.
5. Market Conduct: a firm must observe proper standards of market conduct.
6. Customers' interests: a firm must pay due regard to the interests of its customers and treat them fairly.
7. Communications with clients: a firm must pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading.

⁴⁰ Paragraph 12, House of Lords Select Committee on Regulators, Memorandum by the FSA.

⁴¹ Paragraph 4, House of Lords Select Committee on Regulators, Memorandum by the FSA.

⁴² The onus would be on the FSA to prove that the firm had been at fault in some way in determining whether or not a breach had occurred.

8. Conflicts of interest: a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9. Customers' relationships of trust: a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.
10. Clients' assets: a firm must arrange adequate protection for clients' assets when it is responsible for them.
11. Relations with regulators: a firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

The FSA has stated that five of its Principles for Business are particularly relevant to the operation of with-profits funds⁴³. They are:

- Principle 4 (Financial prudence)
- Principle 6 (Customers' interests)
- Principle 7 (Communication with clients)
- Principle 8 (Conflicts of interest)
- Principle 9 (Customers' relationship of trust)

4.03. Changes to the FSA Conduct of Business Rules

Principles and Practices of Financial Management

Following its With-Profits Review, the FSA introduced in 2005 a requirement on with-profits firms to produce a "Principles and Practices of Financial Management" document (PPFM) which must cover issues that have had, or it is reasonably foreseeable may have, a significant impact on the on the firm's management of its with-profits funds. The PPFM should cover:

- the amount payable under a with-profits policy;
- the investment strategy;
- business risk;

⁴³ Feedback Statement on the With-Profits Review, May 2002

- charges and expenses;
- management of the inherited estate;
- volumes of new business and arrangements on stopping new business; and
- equity between the with-profits fund and any shareholders.

The PPFM serves in part to limit the discretion of the firm's governing body. Governance arrangements must be designed to ensure that the conduct of with-profits business complies with, maintains, and records any applicable PPFM. These governance arrangements should have an element of independence. The firm must produce an annual report to its with-profits policyholders, stating whether in the financial year it has complied with the obligations set out in the PPFM and the firm's reasons for this belief⁴⁴. This report must include the way that a firm has exercised or failed to exercise its discretion and addressed competing or conflicting rights, interests or expectations⁴⁵ of its policyholders and shareholders⁴⁵ and should have a report by the With-Profits Actuary (see below) annexed to it⁴⁶. It should be noted that COBS 20.3.1(4)R limits the changes that can be made to a PPFM.

One important matter which must be covered by the PPFM is the firm's approach to smoothing maturity payments and surrender payments, including:

- the smoothing policy applied to each type of with-profits policy;
- the limits (if any) applied to the total cost of, or excess from, smoothing; and
- any limits applied to any changes in the level of maturity payments between one period and another.

Consumer-friendly PPFM

With-profits firms are also required to produce a consumer-friendly PPFM (CFPPFM) describing the most important information set out under each of the headings in its PPFM and keep it up to date as the PPFM changes over time⁴⁷. The CFPPFM must be written in clear

⁴⁴ COBS 20.4.7(1)R.

⁴⁵ COBS 20.4.7(2)R.

⁴⁶ COBS 20.4.8(1)G.

⁴⁷ COBS 20.4.5R.

and plain language that can be easily understood by a with-profits policyholder, or potential with-profits policyholder who does not possess any specialist or technical knowledge.

Governance arrangements for with-profits business

The new rules also include guidance on how a with-profits firm should comply with the general obligation under FSA Rules to take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system and for countering the risk that the firm might be used to further financial crime.

The guidance⁴⁸ states that a firm should maintain governance arrangements designed to ensure that in the conduct of with-profits business it complies with, maintains and records any applicable PPFM. The governance arrangements should, among other things “involve some independent judgment in the assessment of compliance with PPFM and how any competing or conflicting rights and interests of policyholders and, if applicable, shareholders have been addressed”.

This independent judgment can be provided in different ways including but not confined to (a) establishing a with-profits committee or (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.

Governance arrangements for with-profits funds are considered further in Appendix 30 – With-profits governance arrangements.

Treating customers fairly in the running of with-profits funds

The With-Profits Review also led to the introduction of specific rules (now at COBS 20.3) on treating customers fairly. These rules cover a variety of different themes including payments, excess surplus and distributions from the inherited estate, charges to with-profits funds, writing of new business, loans and guarantees, investment strategy and risk appetite, and material transactions including fund closure.

⁴⁸ COBS 20.3.2G.

- **Payments:** firms are required to establish a target range for maturity payouts (except where a firm cannot reasonably compare a maturity payment with a calculated asset share)⁴⁹. This target range should be expressed as a percentage of unsmoothed asset share and include 100% of unsmoothed asset share. Over the longer term, the aggregate maturity payments should be 100% of unsmoothed asset share (i.e. smoothing should be neutral). If a policy is surrendered, the firm should only make a deduction from the appropriate percentage of unsmoothed asset share, if it is necessary in the reasonable opinion of the governing body to protect the interest of the firm's remaining with-profits policyholders⁵⁰.
- **Surrender payments:** a firm must not make a market value reduction (MVR) to the face value of the units of an accumulating with-profits policy unless (i) 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 (ii) there has been, or there is expected to be, a high volume of surrenders, relative to the liquidity of the relevant with-profits fund and the MVR is no greater than is necessary to reflect the impact of (i) or (ii)⁵¹.
- **Tax on transfers to shareholders:** if, on a distribution from a with-profits fund, a firm incurs a tax liability on a transfer to shareholders, it must not attribute that tax liability to a with-profits fund, unless: (1) the firm can show that attributing the tax liability to that with-profits fund is consistent with its established practice; (2) that established practice is explained in the firm's PPFM; and (3) that liability is not charged to asset shares⁵².

⁴⁹ COBS 20.2.5(1)(a)R.

⁵⁰ COBS 20.2.13R.

⁵¹ COBS 20.2.16R.

⁵² COBS 20.2.20R.

- **Excess surplus and distributions from the inherited estate:** A firm’s governing body must assess at least once a year whether the firm’s with-profits funds have an excess surplus⁵³. COBS 20.2.22(1)E states that if the fund has excess surplus and to retain it would be in breach of Principle 6 (see above), a firm should make a distribution from that fund or carry out a reattribution. A firm must not make a distribution from a with-profits fund unless the whole cost of that distribution can be met without eliminating the regulatory surplus in the fund⁵⁴. The amount distributed to policyholders must not be less than the “required percentage”⁵⁵.
- **Charges to with-profits funds:** A firm must only make a charge to a with-profits fund if the firm has incurred or will incur a cost in the operation of that fund (which may include a fair proportion of overheads)⁵⁶. Compensation or redress should not be paid from a fund unless the payment is to a past or present policyholder of that fund⁵⁷. Payments to past or present policyholders may be paid from the inherited estate or from assets attributable to shareholders. If the inherited estate and shareholder funds prove insufficient, then the firm is allowed to pay for the compensation or redress from assets which would otherwise be attributable to asset shares⁵⁸. Corporation tax may not be charged to a fund if the contribution exceeds the notional corporation tax liability that would be charged to that fund if it were assessed to tax as a separate body corporate⁵⁹.

⁵³ COBS 20.2.21R.

⁵⁴ COBS 20.2.18R. The “regulatory surplus” in a fund is a measure of the excess of the “regulatory value” of the assets of the fund over the “regulatory value” of its liabilities.

⁵⁵ The required percentage is that stated in the articles of association or made in a relevant order by court of competent jurisdiction or is in line with current practice. If these do not apply – a distribution share to policyholders may not be less than 90%.

⁵⁶ COBS 20.2.23R.

⁵⁷ COBS 20.2.24R.

⁵⁸ The FSA has however proposed that insurance companies will no longer be permitted to charge compensation for mis-selling to the inherited estates of with-profits funds (see CP08/11 published on 3 June 2008).

⁵⁹ COBS 20.2.27R.

- **Writing new business:** New business should only be effected on terms that are, in the reasonable opinion of the firm's governing body, unlikely to have a material adverse affect on the interests of its existing with-profits policyholders⁶⁰. If non-profit business is written into the with-profits fund, the firm must regularly assess the profitability of this business⁶¹.
- **Loans and guarantees:** loans and guarantees should not be made to a connected person using the assets in a with-profits funds, unless they are on commercial terms, will in the reasonable opinion of the firm's senior management be beneficial to the with-profits policyholders in the relevant with-profits funds and will not expose those policyholders to undue credit or group risk⁶².
- **Investment strategy and risk appetite:** a firm's investment strategy and risk appetite should take into account the extent of the guarantee in its with-profits policies and any representations it has made to with-profits policyholders. It should also take into account established practice and the amount of capital support which is available⁶³.
- **Material transactions:** a firm must not enter into a material transaction relating to the with-profits fund, unless, in the reasonable opinion of the governing body, the transaction is unlikely to have a material adverse effect on the interests of that fund's existing policyholders⁶⁴.

⁶⁰ COBS20.2.28R.

⁶¹ COBS 20.2.37G.

⁶² COBS 20.2.32R.

⁶³ COBS 20.2.35G.

⁶⁴ COBS20.2.39R.

- **Fund closure**⁶⁵: the FSA and the with-profits policyholders should be informed within 28 days of a decision to close and the firm must submit a run off plan to the FSA as soon as is reasonably practicable, and not later than three months from the decision. This run off plan should explain how the firm will ensure a fair distribution of the fund and any inherited estate. This plan should be approved by the firm’s governing body⁶⁶.

Reattribution of inherited estates

Issue Paper I of the FSA’s With-Profits Review outlined the role of the FSA in a reattribution: “there is no statutory limitation on the matters which the FSA may put to Court, but those matters will clearly include the FSA’s assessment of the effect that the proposed scheme would have on the interests of policyholders ... the role of the FSA in the context of a Schedule 2C scheme [now superseded by a Part VII transfer] is also not limited to submissions to Court. The FSA also expects to scrutinise such proposals in detail as they are developed. As regards this scrutiny process

- a. “the FSA has a responsibility to ensure that prudential requirements are met. In particular this includes a responsibility to ensure that an attribution or re-attribution and/or subsequent distribution of the inherited estate leaves sufficient resources within the company such that the security and other interests of both current and future policyholders are not adversely affected.
- b. “to the extent a scheme concerns the ‘price’ which a company (or acquirer) should pay to policyholders to buy out their interests in the estate, the role of the FSA will include assessment of a number of factors including whether the terms of the offer to policyholders are such that, set against the likely value to policyholders and to the company itself, the offer is within a reasonable range; and that policyholders have sufficient information to properly assess the decision they are being asked to make. The FSA has set out its position on the

⁶⁵ Closure to new business may be a conscious decision by the firm not to seek out new business. It may also be the case that a fund is closed when the company is no longer writing new contracts but is only effecting new business through increments.

⁶⁶ COBS 20.2.53 – 20.2.60 deal with closure to new business.

principles to be followed in carrying out this role⁶⁷. One underlying principle has been that policyholders should be given the opportunity to choose to maintain the status quo, that is to retain their interest in the estate without suffering detriment as a result.

- c. “Following its scrutiny, it has not been the FSA’s practice to give a positive endorsement of the specific scheme proposed by the company. Instead the FSA will not object to the scheme if it considers that it is within the parameters of acceptability, having regard to the responsibilities set out in a. and b. above and any other relevant issues. The FSA may, however, make representations to the Court to explain its position”.⁶⁸

Issues Paper I also considered the process for dealing with the reattribution of inherited estate and it noted that in the past there had been no “negotiator” on behalf of policyholders with the specific responsibility to get the best possible deal for policyholders. This had meant in the past that the FSA had acted as the “de facto negotiator” for policyholders as well as acting as being responsible for the regulatory scrutiny. The paper also highlighted the need for transparency about the details of the negotiations and also the process of the negotiations and scrutiny of the proposals.⁶⁹

The new rules introduced in 2005 included rules and guidance for the process of the reattribution of the inherited estate (originally at COB 6.13 and since November 2007 at COBS 20.2.42 – 20.2.52). Under these rules, a policyholder advocate must be appointed to negotiate with the firm on behalf of relevant with-profits policyholders. More information about the role of the policyholder advocate and the process for a reattribution, as outlined by the FSA rules, is included in Appendix 1, ‘The Reattribution: Roles and Process’

⁶⁷ Footnote AXA case, first witness statement of Martin Roberts, 22 November 2000.

⁶⁸ Issues Paper I, Paragraphs 16 and 17.

⁶⁹ The Issues Paper I considered a variety of options to resolve the problems highlighted – such as a “modified status quo” option with more disclosure to policyholders; the FSA as the negotiator; the independent expert as the negotiator; a proxy negotiator or policyholder consultation. The paper also looked at the options for policyholder information.

4.04. Changes to Prudential Regulation

FSA Issues Paper II on Regulatory Reporting highlighted that the Companies Act accounts did not give sufficient detail of the financial condition of the with-profits fund of an insurer. Additional information was required to give full disclosure at the level of individual with-profits funds; to give more information about financial engineering and also to give information about the support available from other funds. Furthermore the paper highlighted the need for the development of a clearer understanding of a company's ability to meet both guaranteed and discretionary benefits – including disclosure which would recognise the liabilities reflecting the full amounts that can be expected to be paid to policyholders after adding discretionary bonuses and also disclosure which would recognise the value of assets not recognised in the regulatory return (as it then stood) which nonetheless form part of the value of the operation for policyholders.⁷⁰

Following this paper and subsequent consultation in 2003, revised capital requirements for insurers were introduced at the beginning of 2005.

Pillar I Capital Requirements

“Realistic basis” long-term insurers (i.e. those insurers with with-profits liabilities over £500 million) have to attain the higher of:

- the ECR (“Enhanced Capital Requirement”) which requires a calculation of the complex “with profits capital component” and
- the MCR (the “Minimum Capital Requirement” derived from the Life Insurance Directives).

In practice this usually means complying with the ECR. The ECR is calculated using the “twin peaks approach” under which the firm carries out two solvency calculations and is required to hold sufficient capital to cover the more onerous of these two tests.

- The Peak 1 test is the traditional calculation of assets, liabilities and minimum solvency requirements (this is the regulatory peak). In particular, the liabilities

⁷⁰ Issues Paper II considered a variety of options for addressing these issues such as making changes to the Companies Act, the extension of current changes to the regulatory returns and the introduction of a new form of summary financial information.

are valued on a basis that is intended to be prudent, although the calculation is limited to guaranteed benefits only.

- The Peak 2 test is conducted on a so-called “realistic” basis, where liabilities are based on asset share, and include a market-consistent valuation of options and guarantees. Other elements of the calculation aim to ensure that the calculation is done in a way consistent with how the business is actually managed, for example, allowing for financing costs and for charges made to policyholders. The calculation also includes the realistic capital margin, which is assessed by “stress tests” i.e. requiring firms to estimate the capital needed to cover adverse circumstances (in particular adverse movements in share prices and interest rates).

Pillar II Capital requirements

A firm may also be required to hold additional capital under the so-called Pillar II capital requirements which are based on the firm’s Individual Capital Assessment (ICA). The ICA framework is a self assessment by firms to determine how much capital the firm feels is appropriate to suit its individual risk profile. This approach requires the company to consider major sources of risk and use stress tests and scenario testing to measure the impact of the risks identified and to calculate the ICA.

If the FSA believes the firm’s ICA is insufficient, it may impose its own assessment indicating how much capital the firm needs to maintain. This is the Individual Capital Guidance (ICG). This approach is outlined in INSPRU 7.⁷¹

4.05. Changes to FSA Supervision Rules

FSA Issues Paper 5 “Governance of with-profits funds and the future role of the appointed actuary” stated that the governance structure for with-profits funds may need to be strengthened in relation to:

⁷¹ The FSA has a system to assess risk and decide where to focus supervisory activity known as the Advanced, Risk-Responsive Operating Framework (ARROW) which is referred to in INSPRU 7.1.91G.

- the breadth of discretion retained by companies' management over the operation of with-profits funds and in determining the amount of a policyholders' investment return;
- a lack of transparency over how discretion will be or has been exercised and also over how potential conflicts (potential or actual) between different groups and generations of policyholders, and also between policyholders and shareholders, are managed; and
- the potential for conflicts of interests as a result of the appointed actuary having other board or senior management responsibilities, or being an employee of the firm.

The With-Profits Review led to significant changes to the rules in the FSA supervision handbook relating to actuaries, SUP 4 (Actuaries). The role of the appointed actuary was replaced by the roles of the Actuarial Function Holder (AFH) and the With-Profits Actuary (WPA).

The Actuarial Function Holder (AFH)

The AFH must advise firm's management on the risks the firm runs in so far as they may have a material impact on the firm's ability to meet liabilities to policyholders in respect of long-term insurance contracts as they fall due and on the capital needed to support the business, including regulatory capital requirements. The AFH must also monitor those risks and inform the firm's management if he has any material concerns or good reason to believe that the firm:

- is not meeting liabilities to policyholders under long-term insurance contracts as they fall due, or may not be doing so, or might not have done so, or might, in reasonably foreseeable circumstances, not do so;
- is, or may be, effecting new long-term insurance contracts on terms under which the resulting income earned is insufficient, under reasonable actuarial methods and assumptions, and taking into account the other financial resources that are available for the purpose, to enable the firm to meet its liabilities to policyholders as they fall due (including reasonable bonus expectations);

- does not, or may not, have sufficient financial resources to meet liabilities to policyholders as they fall due (including reasonable bonus expectations) and the capital needed to support the business, including regulatory capital requirements or, if the firm currently has sufficient resources, might, in reasonably foreseeable circumstances, not continue to have them.

The AFH must also advise the firm's governing body on the methods and assumptions to use in calculations of its capital requirement.

The With-Profits Actuary (WPA)

The WPA must advise the firm's management, at the level of seniority that is reasonably appropriate, on key aspects of the discretion to be exercised affecting those classes of the with-profits business of the firm in respect of which he has been appointed. The WPA must also advise the firm's governing body about whether certain assumptions used in the calculations are consistent with the firm's PPFM. At least once a year, the WPA must report to the firm's governing body on key aspects of the discretion exercised in respect of the period covered by the report affecting those classes of with-profits business of the firm. In respect of each financial year, the WPA must make a written report addressed to the relevant classes of the firm's with-profits policyholders, to accompany the firm's annual report as to whether, in his/her opinion and based on the information and explanations provided to the WPA by the firm, and taking into account where relevant the rules and guidance in COBS 20, the annual report and the discretion exercised by the firm in respect of the period covered by the report may be regarded as taking, or having taken, the interests of the relevant classes of the firm's with-profits policyholders into account in a reasonable and proportionate manner.

5.00 Subsequent Developments

5.01. Revised FSA Rules – November 2007

On 1 November 2007, the entire FSA Conduct of Business Sourcebook was replaced by new rules, largely to reflect the implementation of a new European directive regulating investment services (the Markets in Financial Instruments Directive or MiFID). The COBS rules relating

to reattributions (and with-profits more generally) were not impacted by MiFID directly, although the FSA did take the opportunity at the time of introducing new COBS rules to rationalise the previous COB rules⁷² for with-profits which were introduced in 2005 following the FSA's with-profits review. The FSA stated at the time of introducing the new MiFID-compliant COBS rules⁷³ that it would not undertake a fundamental review of the with-profits material in the previous COB rules until it had had enough time to see how it works in practice. However, consistent with its general policy on principles-based regulation, it did propose to:

- move to higher-level rules in some areas;
- make some changes in wording suggested by its experience so far of how well the rules had operated in practice;
- remove unnecessary guidance, particularly where it was either self-evident or implicit in the rules;
- re-order more logically material that was made at different times; and move some material on reattribution on to a new web page.
- Insofar as reattributions are concerned, there is little substantive difference between the previous COB rules and the new COBS rules although the FSA did, as it said it would, remove some of the guidance (rather than substantive rules), most of which was transferred to the FSA's 'frequently asked questions' web page.

5.02. The Policyholder Advocate's requests for guidance

Since her appointment in the proposed reattribution of Norwich Union's CGNU Life and CULAC with-profits funds, the policyholder advocate has asked the FSA for further guidance on various of its rules relevant to the proposed reattribution. These requests for guidance and the FSA's responses are published as Appendix 26 (FSA guidance letters and responses).

⁷² These were known as 'COB' as distinct from the new rules which are known as 'COBS'

⁷³ See summary in FSA Policy Statement 07/6, paragraph 23.1

5.03. House of Commons Treasury Committee: Inherited Estates, Twelfth Report of Session 2007-08

On 26 February 2008, the Treasury Committee announced its inquiry into inherited estates and invited written evidence. In April 2008 the Committee held two oral evidence sessions from Which?, the policyholder advocate on behalf of Norwich Union for the CULAC and CGNU funds, the FSA, Norwich Union and Prudential. The Committee published its report in June 2008. See Appendix 27 (House of Commons Treasury Committee Report: Inherited Estates) for further information.