

Appendix 15

International experience: Developments in clarification of the rights of participating policyholders

A report for the policyholder advocate in connection with the reattribution of the inherited estates of the CGNU Life and CULAC with-profits funds

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1.00 Introduction

The purpose of this paper is to offer some comparative context as to how, in life assurance, the balance of the rights of policyholders and shareholders is sustained and monitored in jurisdictions outside the United Kingdom, including changes in legislation and practice.

The right of policyholders to participate in profits is a common feature of life assurance contracts in a great many jurisdictions, and reflects the origins of scientific life assurance prior to the 20th century when levels of mortality were much less predictable than they are considered to be today. It was common to set premiums at a very prudent level, and the practice grew up of returning the resulting excess or ‘surplus’ funds to policyholders, either as an offset to premiums or as an additional benefit.

Policyholders were granted rights of participation both by mutual (policyholder-owned) and by shareholder-owned companies. The former had the potential for conflict between the interests of different generations of policyholders, while the latter added the potential for conflict between the rights of policyholders as a class and the rights of shareholders. This paper addresses recent developments in protecting the rights of policyholders as a class vis-à-vis shareholders.

2.00 Australia

The position in Australia has for a long time embraced the concept of one or more statutory funds which hold the assets representing the interests of a particular policyholder class (companies may have more than one such fund), corresponding to, for example, 80% or 90% participation by policyholders in profits. Such funds, into which policyholders’ premiums are paid, and from which benefits, expenses and shareholder transfers are disbursed, are deemed to represent assets belonging to the corresponding class of policyholders collectively.

To a significant extent, this principle underlies the treatment of participating business under the Australian Life Insurance Act 1995 (and substantively under the predecessor Life Insurance Act 1945). This is reflected in the following section of that Act (paraphrased to key points):

- S31: There is a requirement to maintain a statutory fund for a company's life insurance related business.
- S36-S40: All premiums and investment returns related to the statutory fund must be credited to it, and only related expenses and policy benefits may be paid out of it (see further below on profits).
- S59, S60: Where there is participating business in a fund, the fund must have sub-funds that separate the accounting of the participating and non-participating business (as quasi-sub-statutory funds). All profits/gains/losses in the statutory fund have to be fully allocated to the sub-funds and between policyholder and shareholder interests, with at least 80% of any participating policy related gains (90% where this is the relevant proportion) allocated to the participating policyholders.
- S62: Only profits allocated to shareholders within the statutory fund may be distributed to them, and in the case of participating policy related-profits, only at the same rate the policyholder profits are "distributed" to the policyholders (i.e. shareholders can't get \$1 out of the fund unless they declare/pay \$4 in an 80:20 fund or \$1 for policyholders' \$9 worth of bonuses in a 90:10 fund).
- S63: The only other money a shareholder could obtain from the statutory fund under any circumstances would be a return of identified capital they had previously put into the fund. And if this was in the participating sub-fund, any investment gains on this would have had to have been allocated 80/20 (or 90/10) along the way. It would however be unusual for the shareholders to have injected money into the fund. In practice any support capital would be placed into a non-participating sub-fund within the Statutory Fund, and 100% of gains would then fall to shareholders.
- S32, S48: The over-riding requirement is to give priority to the interest of policyholders in the management of the statutory fund (i.e. the policyholders

come first, and their interests are to be properly protected within the statutory fund).

- These provisions have on occasion served to protect the interests of policyholders against creditors of the life insurer. There is no equivalent to unattributed estate in Australia, although there has on occasion been transfer of surplus between generations of policyholders. It is also worth noting that during 1995/6 all Australian life companies had to allocate any unallocated surplus, and the following process was followed:
 - the participating policyholder share was allocated to the policyholders' retained profits in the statutory fund's participating sub-fund.
 - Another amount equal to 20/80 times the policyholder amount (or 10/90 or whatever the appropriate ratio may be) was allocated to the shareholders' retained profits in the same participating sub-fund.
 - The balance was allocated to shareholders' retained profits or shareholders' capital in a non-participating sub-fund.
 - There was also a statutory default basis that could be used:
 - i. For a participating-only fund, all surplus was split 80/20 policyholders/shareholders (or the actual policyholders' distribution ratio, if more generous). No "orphan estate" was identified or allocated just to shareholders (even any original seed capital from the shareholders, albeit typically small, was split 80/20).
 - ii. For a mixed fund, excess surplus was first split in proportion to the liabilities between with-profit and non-profit. The with-profit allocation was then split per point i above.

All Australian mutual life companies had demutualised by 2002 following the full allocation exercise in 1995/6, and this crystallised the respective interests of policyholders and shareholders. In such demutualisations, any undistributed surplus within statutory funds was specifically allocated between policyholders and shareholders. It is worth noting that the ring-fencing of the interests of different policyholder groups in Australia as set out here meant

that it was unnecessary to create the ‘closed block’ approach on demutualisation adopted by Canada and the United States.

3.00 Germany

Traditionally, German life insurers invested predominantly in fixed-interest assets. Contracts almost universally included participation by policyholders, and premiums were set according to stipulated tariffs, with the consequence that bonus levels were the main arena for competition. Since these levels reflected principally the proportion of interest income distributed, competition operated so as to keep the distributed proportion high, often well over 90%. Assets were valued both for supervisory and general accounting purposes at the lower of cost or market value.

The position changed somewhat as interest rates declined, premium tariffs were no longer enforced, and companies began to diversify investment strategies. During the 1990s many life insurers began to invest usually minor proportions of their funds in domestic and international equities. The status of the gains (being the difference between the market value of assets and the book value of the assets held on the balance sheet) on these was ambiguous, in that they constituted a ‘latent policyholder surplus’, also termed ‘hidden reserves’ but there were no provisions for distributing this. The ambiguity caused understandable policyholder concern, resulting in a case being taken ultimately to the German Federal Constitutional Court (*Bundesverfassungsgericht*, **BVerfG**) which ruled on the matter in July 2005.

The BVerfG ruled that policyholders were entitled to a fair profit participation at the end of the policy period, based on the fair value of the insurance company’s assets. Furthermore, the court thought that current rules for calculating profit participation were not transparent enough and it required the German legislature to establish fair and precise standards to determine profit participation rights. However, the court did not decide if the full amount of hidden reserves should always be included in the calculation and has left this decision to the legislature.

The German government addressed this issue with a new insurance contract law passed in 2006. Key elements of this law are as follows:

- As of 1 January 2008, all asset classes of life insurers will have to be shown at market values. These details are to be provided in the notes to the accounts and they also apply to existing policies. There are no changes to the balance sheet and the P&L statement for the time being.
- Upon maturity, or when the contract is cancelled, 50% of latent reserves (net of early surrender charges) must be credited to the policyholder.
- Policyholders must be notified annually of their total bonus, including latent reserves.
- A relaxation of writing-down rules, introduced to deal with the consequences of the equity market decline earlier in the decade, will be retained.

The original idea of allocating latent reserves definitively, as early as two years after their creation, was abandoned in the face of sustained resistance from the industry and the actuarial profession. Such a scheme would have forced insurers to make short term investments, which would have jeopardised the medium-term solvency of the sector. Under the new rule, the policyholder will also benefit from latent reserves created in the interim, without forcing the insurers to realise profits. Commentators expect the new law to cause insurers to build up substantial latent reserves, which will be allowed to count towards satisfying European Union solvency requirements.

The latent reserves are held inside the fund, and these can absorb losses and allow investment freedom (much like in the UK), but unlike in the UK the companies have no real intention or driver to distribute, particularly since the shareholders receive no part of this distribution.

4.00 Sweden

There has been controversy in Sweden relating to the use of undistributed policyholder surplus and to potential conflicts of interest between policyholders and shareholders.

Specifically, a legal challenge was mounted on behalf of participating policyholders against the proposal of shareholder-owned life companies to use undistributed surpluses arising from participating life business to defray unrelated losses arising from the increasing life

expectancy of annuitants. This move was defeated when the court held that life companies were indeed entitled to use surplus in this manner.

Nevertheless Finanspektionen, the Swedish regulator, has made conflicts of interest a significant theme in its recent activities, particularly in the situation (common in Sweden) where participation is achieved within a separate ‘mutual’ member of a proprietary group, which pays fees to another member of the group for investment management, administration, marketing and other services provided. Finanspektionen has been critical of the governance arrangements of several groups and has required them to take action to raise the level of assurance that such fees are on a genuinely ‘arms-length’ basis.

5.00 Canada

Until relatively recently, the Canadian life insurance industry was dominated by a small number of mutual insurers, the largest of which had expanded internationally, and in some cases into other elements of financial services business¹. All the largest companies concluded more or less simultaneously that for strategic reasons they should demutualise and seek external capital. The largest firms were effectively precluded from selling themselves to other financial services firms and therefore sought to demutualise by means of public offerings of equity (IPOs).

At the time in 1998 when the major companies announced their intention to demutualise, virtually no enabling legislation or regulation existed, and the process to be followed was therefore developed during 1998 and early 1999. At the heart of the process was the requirement for approval of the transaction by the relevant regulator, usually the federal Office of the Superintendent of Financial Institutions (OSFI). OSFI in turn required opinions from both the appointed actuary and an independent actuary that the transaction was fair and equitable to participating policyholders. This reflected a desire to balance the potentially conflicting interests of existing policyholders and investors providing new money in the offer for sale.

¹ This form of expansion is tightly controlled in Canada. The largest insurers had operations in US, UK, Asia etc. Although some had diversified into asset management, the Canadian authorities are generally reluctant to approve moves by insurers and banks to operate in each other's fields.

Two principal safeguards were adopted to protect existing policyholders in their roles as beneficiaries and owners respectively:

- The existing participating business was ring-fenced as a ‘closed block’ with its own asset portfolio intended to be sufficient to assure policyholders of bonus distributions consistent with what they would reasonably have expected in the absence of demutualisation; and
- The transaction had to allocate all the value of the company (prior to the addition of any new capital) to policyholders in the form of shares in the company to be floated.

Based on this regulatory environment, the demutualisations generally proceeded without controversy. It is worth noting that OSFI imposes continuing obligations on demutualised companies, including a requirement to report on the operation of the closed block and some rights for participating policyholders to elect directors.

6.00 USA

The life insurance industry in the US has traditionally included both mutual and proprietary companies, with the former more dominant in the participating business market (i.e. the market for with-profits contracts). The industry is more tightly regulated than is the case in either Canada or the United Kingdom, often including prescription of encashment values and of the formulae for distribution of surplus (the ‘contribution method’, analogous to approaches used in continental Europe). The general funds of life insurers have invested in equities only to a very limited extent, with the result that amounts of ‘orphan surplus’ (directly comparable to ‘inherited estate’) have been relatively modest.

Like Canada, it is the planned demutualisation of several ‘household name’ insurers which is seen as having created the greatest potential for conflict between participating policyholders (as both owners and beneficiaries) and new investors. Unlike Canada, the regulatory issues fell to be addressed at the level of the state of domicile. It is worth noting that the US actuarial profession favoured the ‘continuing entity’ view of mutuals, so that directors are not required

to consider the advantages and disadvantages to policyholders of closing down the participating element of the business.

Although there have been differences of detail, the core of the approach taken by US authorities to guarding against conflict of interest between the interests of policyholders and new investors has been similar to that adopted in Canada:

- a ‘closed block’ with its own ring-fenced assets and liabilities was created with a view to preserving the ‘dividend’ (bonus) expectations of policyholders;
- companies were required to allocate all the market value of the business in a manner fair to participating policyholders.

Somewhat controversially, demutualisations in the US have generally involved highly complex mechanical processes for allocation of value between contributing policies based mainly on historical calculation. As with any prescribed formulaic basis of allocation, there has been scope for commentators to question the fairness of allocation to particular groups of policyholders.

7.00 Other

As mentioned at the outset, the ubiquity of participating forms of life insurance, including such forms offered by shareholder-owned companies, means that the potential for conflict of interest between policyholders as a class and shareholders is not confined to the jurisdictions mentioned above. They are however the foremost examples of where regulatory policy has clearly addressed the issue on a global basis. Case-level examples from other jurisdictions would be likely to cover the same range of issues described above.

7.01 International bodies

The international body which promotes best practice in insurance supervision, and which plays a broadly similar role to that of the Basel Committee/Bank for International Settlements in the banking context, is the International Association of Insurance Supervisors (IAIS). The IAIS has been engaged for some years in the development, with input from stakeholders, of principles and guidance for insurance supervision.

The IAIS sets out principles which it regards as “fundamental to effective insurance supervision. The principles identify areas in which the insurance supervisor should have authority or control.”

These form the basis from which standards and guidance papers are developed. Periodically, IAIS members carry out self-assessments to determine whether they comply with the insurance core principles.

Core principles relevant to the potential for conflict of interest between policyholders and shareholders include:

ICP 9 – Corporate governance

The corporate governance framework recognises and protects rights of all interested parties. The supervisory authority requires compliance with all applicable corporate governance standards.

This principle includes as one of the essential criteria to be monitored by supervisors that the board of a supervised insurer should: “set out policies that address conflicts of interest, fair treatment of customers and information sharing with stakeholders, and review these policies regularly”

ICP 25 – Consumer protection

The supervisory authority sets minimum requirements for insurers and intermediaries in dealing with consumers in its jurisdiction, including foreign insurers selling products on a cross-border basis. The requirements include provision of timely, complete and relevant information to consumers both before a contract is entered into through to the point at which all obligations under a contract have been satisfied.

Under the essential criteria in relation to this principle it is stated that: “The supervisory authority sets requirements for insurers and intermediaries with regard to the content and timing of provision of information:

- on the product, including the associated risks, benefits, obligations, and charges

- on other matters related to the sale, including possible conflict of interest to (*sic*) existing or potential policyholders.”

8.00 Conclusions

Based on the foregoing, the following conclusions can reasonably be drawn:

- Participation by policyholders in profits is a widespread feature of life assurance business but the detail is unique to each jurisdiction. Legal and/or regulatory measures to enhance clarity of policyholder rights are however an observable trend across jurisdictions.
- Until recent developments following the FSA’s review of with-profits and the introduction of Principles and Practices of Financial Management (PPFM), UK life insurers enjoyed more discretion in bonus distribution than their counterparts in most jurisdictions. Such counterparts were usually constrained by contract law or regulatory requirements.
- Most regulators (including the UK’s FSA) have implemented frameworks which give them a role in representing the interests of policyholders in the context of a reconstruction with potential for conflict such as demutualisation.
- ‘Orphan surplus’ or ‘inherited estate’ has been a minor issue other than in jurisdictions where insurers have had discretion to invest in equities or similar assets – particularly the UK but also in the German case. Where such an issue has arisen within a mutual context, regulatory frameworks have effectively attributed it to policyholders as a class at demutualisation - this could be considered appropriate because policyholders, in a mutual, also provide the risk capital and hence are effectively shareholders.
- Although the new German contract law admits of accumulation of unrealised ‘orphan surplus’ and may encourage this in the short-term, it does not contemplate any permanent re-attribution of this to shareholders.