

Appendix 27

Extracts from the House of Commons Treasury Committee Report: Inherited Estates Twelfth Report of Session 2007- June 2008

A report compiled 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

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1.00 Introduction

On 26 February 2008, the House of Commons Treasury Committee announced that it would hold an inquiry into the inherited estates of with-profits funds. On 22 April the Treasury Committee took evidence from Which?; the Norwich Union¹ policyholder advocate; and the chairman of the Financial Services Authority (FSA). On 30 April the Committee heard evidence from Prudential and Norwich Union.

The Treasury Committee report was published on 19 June 2008. The full report is available on the Committee's website at:

<http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/cmtreasy.htm>

This appendix provides extracts from the Treasury Committee's report, comprising the Treasury Committee's conclusions and recommendations, and the written evidence of the policyholder advocate, Norwich Union, the FSA and the Office of Fair Trading (OFT).

The appendix also includes the responses to the Treasury Committee's report from the FSA and the OFT which were published by the Committee on 27 October 2008 in the Fifteenth Special Report of Session 2007 – 08, Appendix 1. The responses are also available on the Committee's website at:

<http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/1132/1132.pdf>

¹ Norwich Union changed its name to Aviva on 1 June 2009. However in this Appendix references to Norwich Union have been retained.

2.00 The Treasury Committee's Conclusions and Recommendations

Understanding inherited estate

1. During our inquiry, it became evident that inherited estates have arisen from a variety of sources; including contributions from generations of shareholders and policyholders, and that the relative contributions made by stakeholders have varied across firms and funds. Some funds have histories dating back centuries, to a time when record-keeping was inadequate to enable determination of precise contributions, but the most significant contribution to inherited estates has resulted from the way that inherited estates have been managed over time. (Paragraph 10)

Uses of the inherited estate

2. Inherited estate plays an important role in providing security to policyholders investing in a with-profits fund. The existence of inherited estate enables the life firm to mitigate risks to its ability to meet its liabilities and guaranteed returns to policyholders. Furthermore, an inherited estate provides an important comfort blanket, enabling the fund to invest in higher risk, but potentially higher return, asset classes, which is of tangible benefit to policyholders. (Paragraph 22)
3. It would be in the interests of life firms to improve the transparency of their application of smoothing techniques. If the industry does not introduce such transparency by the end of 2008, the Financial Services Authority should use its regulatory powers to ensure that firms' provide sufficient disclosure to enable greater understanding of how smoothing has impacted on policyholder returns over various time periods. (Paragraph 25)
4. The funding of new business from the inherited estate represents an intergenerational transfer from current policyholders to the future beneficiaries of the inherited estate. By the same token, current policyholders benefit from such transfers made prior to

their investment in the with-profits fund, and this capital recycling has been a common feature of with-profits funds. However, this recycling causes particular problems during reattribution's because the future beneficiaries of this intergenerational transfer will be shareholders, who have (through the firm's managers) discretion over both the strategy and portion of the inherited estate to be put aside for the funding of new business. A firm has a clear incentive to maximise the amount set aside for the funding of new business prior to a reattribution, even if that new business might prove to be loss-making. The Financial Services Authority does not permit the funding of loss-making business, which gives firms the incentive to make over-ambitious forecasts. In this context, it is vitally important for the Financial Services Authority to conduct rigorous assessment of the reasonableness of assumptions made by the firm during reattribution negotiations, ensuring that these assumptions reflect the trend of the declining popularity of with-profits products. Once a reattribution has been completed, firms should not be permitted simply to distribute (to themselves) set-aside funds intended for new business. The Financial Services Authority has indicated that such distributions will be limited, and we expect it to set out how this would be achieved in its response to this Report. (Paragraph 34)

5. We note that the Financial Services Authority was unaware of any evidence that the use of with-profits funds' assets gave rise to competition concerns, and the similar findings of the Office of Fair Trading's preliminary analysis. Whilst welcoming this reassurance, the continuing concerns raised by some witnesses deserve full analysis and we urge the Office of Fair Trading to consider performing a more thorough analysis. As a minimum we expect the Office of Fair Trading, alongside the Financial Services Authority, to monitor the competition aspects of the funding of new business from inherited estates on an ongoing basis. (Paragraph 39)
6. We view the charging of mis-selling compensation costs to the inherited estate as inappropriate. All businesses make mistakes and some residual level of mis-selling may be in the "nature of the beast", for which charging the inherited estate may be justifiable. But the vast bulk of mis-selling costs must be borne by shareholders, as it

is the duty of shareholders, through the managers of the firm, to ensure that staff behave appropriately when selling products. We are unconvinced by the argument that the charging of mis-selling compensation costs to inherited estates has no impact on the likelihood of current policyholders receiving special distributions. Any use of an inherited estate that reduces the estate's size has a direct bearing on such a prospect. We therefore welcome the publication of the Financial Services Authority's consultation paper on this issue, and the fact that the Financial Services Authority also believes that the charging of mis-selling compensation costs to the inherited estate is inappropriate. (Paragraph 46)

7. The charging of shareholder tax to the inherited estate is, in our view, a striking example of how certain life firms are able to use their discretion in a way that furthers shareholder interest to the detriment of policyholders. This tax liability is only incurred as a result of shareholder involvement in the with-profits fund (no such liability would arise in a mutual fund, for example), so it seems unfair that policyholders should pay anything towards this charge. It would seem that the FSA shares our view, given that firms in general are disallowed from charging the estate shareholder tax, unless they have been doing it in the past. In the case of the charging of shareholder tax to inherited estate, different rules apply to different firms, providing yet more complexity. We believe consistency in regulation is paramount. We urge the FSA to consult on the charging of shareholder tax to the inherited estate by the end of 2008. Our view is that it should not be permitted. (Paragraph 50)

Special distributions

8. The requirement for life firms to assess whether they have excess surplus in their with-profits funds, on an annual basis, is welcome. We are somewhat concerned, however, that firms might not be trying particularly hard to identify such excess surpluses. A situation where firms only identified excess surpluses as a result of launching into reattribution's would be unsatisfactory, but the rarity of special distributions across the industry may indicate such a situation is not too far from reality. The Financial

Services Authority should do more in this area to convince policyholders that its scrutiny of firms' self-assessment of excess surpluses is sufficiently robust to protect policyholders' interests. The Financial Services Authority should give due consideration to the suggestion that actuarial limits be placed on the accumulation of assets in with-profits funds. (Paragraph 56)

9. The suggestion that a single payment would seriously destabilise a fund making a special distribution would appear to suggest that policyholders were desperate to leave that fund, and continued as policyholders only to receive their special distribution payouts. If so, the phasing of payouts, in our view, must be considered an unreasonable barrier to exit. We expect the Financial Services Authority to set out why it considers such barriers to be reasonable in its response to this Report. We do not believe that the Financial Services Authority has so far put forward an adequate case for permitting the phasing of special distribution payouts. If this permission is to persist, the Financial Services Authority must provide a very strong case indeed. (Paragraph 69)

Reattribution

10. The Financial Services Authority has made clear that parties to a reattribution negotiation should consider not just the value of potential special distributions to current policyholders, but also the total value that the firm's shareholders stand to gain from the transaction. The bargaining power of the policyholder, however, is limited to the former consideration, because a firm undergoing a reattribution would know that most policyholders would accept any offer that provided adequate compensation for the foregone chance of benefiting from future distributions. If a firm decides to tell policyholders not to expect any special distributions at all whilst they remain policyholders, that bargaining power is weakened further, to such an extent that most policyholders would accept even a derisory offer. Given, this weak bargaining position, the Financial Services Authority has a crucial role to play in a reattribution. The Financial Services Authority must ensure that, when the firm concerned frames its

offer to policyholders, a fair value has been assigned to the gains accruing to shareholders in the transaction. In these circumstances, it is incumbent upon the FSA to ensure that a fair price is offered, not just an adequate price. They are two quite different things. (Paragraph 74)

11. We welcome the advent of the role of policyholder advocate, to negotiate on behalf of policyholders in a reattribution negotiation. One specific power we wish to see future policyholder advocates armed with would be the ability to communicate with policyholders whenever they wished to. The Financial Services Authority should stipulate that policyholder advocates' contracts and terms of reference allow such communication. (Paragraph 79)
12. Given the complexities involved in with-profits funds, and the widely differing views from various stakeholders about what might constitute a fair offer to policyholders, reattribution negotiations may be expected to take a long time. We do not believe that the Financial Services Authority should impose a rigid timetable for any future reattributions, or permit companies to do so, because the most important outcome is that an appropriate offer should be made. (Paragraph 86)

Protecting policyholders' interests

13. We recommend that the Financial Services Authority require companies to provide an appropriate level of support for policyholders' interests to be protected by With-Profits Committees. (Paragraph 100)
14. We see a good deal of merit in the proposal that With-Profits Committees consider the principle of Treating Customers Fairly as well as checking the firm's compliance with its own Principles and Policies of Financial Management. It is important that With-Profits Committees have such a strong, clear commitment to protecting and promoting policyholder interests, so the Financial Services Authority should consider consulting on whether such a role should be granted to With-Profits Committees. Efforts must also be made by firms to raise the visibility of With-Profits Committees, to reassure policyholders that their interests are being represented and protected. This could mean,

for example, With-Profits Committees having their own dedicated website, linked to the relevant firm. We will continue to monitor the performance of With-Profits Committees during our ongoing scrutiny of the Financial Services Authority.

(Paragraph 101)

15. Despite changes made by the Financial Services Authority to the regulation of the with-profits sector earlier this decade, we still have serious concerns about the extent of disagreement between stakeholders across many issues in with-profits funds. We are not satisfied that the Financial Services Authority has done enough to provide a robust framework based on strong principles against which decisions can be made and performance assessed. Issues raised by the special distribution and ongoing reattribution of the Norwich Union with-profits fund have highlighted the inadequacy of the regulatory regime. Rather than developing clear principles for the regulation of inherited estate, the Financial Services Authority has become embroiled in making judgements "in the round" and micro-regulation of particular firms' situations, including providing ad-hoc guidance in the middle of a reattribution negotiation. In the case of the charging of shareholder tax to inherited estate, different rules apply to different firms, providing yet more complexity. This approach seems a long way from the philosophy of 'principles-based regulation' to which the Financial Services Authority aspires. Whilst we accept that the with-profits sector is a complex business, all stakeholders in with-profits funds deserve a framework which provides as much simplicity, certainty and clarity as possible. If the Financial Services Authority believes that with-profits is just too inherently complex for such a regulatory panacea to be achieved, it must make a strong rationale for its support for the continuation of with-profits investment products in the marketplace. We would welcome a reopening of the debate about the overall regulatory system for with-profits funds and, to this end, recommend that the Financial Services Authority consult on such a redesign during 2008. We will closely monitor the Financial Services Authority's progress towards improving its regulation of the with-profits sector and will return to this issue.
- (Paragraph 109)

3.00 Memorandum from Clare Spottiswoode CBE, Policyholder Advocate for Norwich Union

Memorandum by Clare Spottiswoode CBE, Policyholder Advocate

A Summary of the Key Issues underlying a Reattribution under current FSA rules

1. In a `reattribution`, an insurance company with an `inherited estate` (a surplus built up from the under-distribution of profits derived from the investment of policyholders` premiums) offers a payment to its with-profits policyholders to buy out their interest in future distributions from that estate. My role is to negotiate with Norwich Union this “policyholder incentive payment” (PIP) on behalf of policyholders. I then produce a report to policyholders explaining whether the company’s proposals are in their best interests. The FSA’s rules about how companies are permitted to use their inherited estates affect policyholders` expectations about distributions they can expect from an inherited estate and therefore play a crucial role in determining the size of the PIP.
2. I was surprised to discover that insurance company managements enjoy an unusually large amount of discretion in determining what part of the return on a fund’s investments should go to policyholders and what to shareholders. The FSA therefore has a particular responsibility to protect with-profits policyholders. Nevertheless, and despite the FSA’s claim that the intention of its rules is that companies treat their with-profits policyholders fairly, in practice its rules, particularly about the permitted uses of inherited estates, seem to favour shareholders over policyholders. Under these rules, the size of the estate can be diminished before it is distributed and so the proportion which goes to policyholders is less than the 90 per cent which is supposed to be the norm.
3. I have requested guidance from the FSA on appropriate uses of the inherited estate. In December 2007 the FSA agreed to re-consult on whether mis-selling costs could be charged to the estate but it has not so far reconsidered some of its other rules that favour shareholders over policyholders. I believe that this is unfortunate and consider that the FSA should undertake a more wide-ranging review of its position. I would like to see a

general principle adopted by the FSA that any amount not required to secure the guaranteed benefits to which policyholders are entitled should be distributed 90:10 in favour of policyholders.

- 4 The most important single issue is that existing FSA rules allow a degree of subsidisation of new business from an inherited estate. In response to my request for guidance, the FSA clarified its new business rules to the extent that it said that new business should not permanently erode the estate. However, a company can still hold back capital in a fund to support new business. This has the effect of delaying distributions from an inherited estate, thereby reducing distributions to current policyholders and “gifting” via “intergenerational transfers” a proportion of an estate to future policyholders.
5. As well as suppressing competition (because it gives an advantage over potential entrants to incumbents with inherited estates which can subsidise new business in this way) such action clearly disadvantages policyholders in a reattribution. The company only need offer them a payment to compensate for what they might have expected via future special distributions – which excludes the proportion of the estate “gifted” by current policyholders to future policyholders under current FSA rules. In effect the shareholders would get the future policyholders’ estate for free.
- 6 The company also has an incentive to forecast over-ambitious level of new business when formulating its PIP, making the question of future new business a contentious issue which complicates negotiations between the policyholder advocate and the company. The danger is that, without robust and clear guidance from the FSA to firms about the division of the estate between policyholders and shareholders in a reattribution, the reattribution offer will be unduly generous to shareholders.

B Introduction

- 7 I am the appointed policyholder advocate in relation to Norwich Union’s proposed reattribution of the inherited estates of its CGNU Life and CULAC with-profits funds.

8 This memorandum is submitted in advance of my appearance before the Committee on 22 April. I look forward to elaborating on it in oral evidence. The memorandum:

- provides background information on my role as policyholder advocate in respect of Norwich Union policyholders;
- summarises key issues that can affect the outcome of reattributions under current regulations;
- provides answers to the Committee's questions; and
- gives further details, in annexes from some of my advisers, on some important matters.

C Background information

9 Under FSA rules put in place in 2005, the position of with-profits policyholders in a reattribution was strengthened by a provision that a policyholder advocate should be appointed by the company proposing the reattribution to represent the interests of policyholders. I was nominated to perform that role in respect of the proposed Norwich Union reattribution in spring 2006, following FSA approval, and formally appointed in November 2006. To assist in negotiations with the firm on behalf of policyholders, I appointed advisers on legal, economic, actuarial, tax, communications, and other issues related to the proposed reattribution, including a small group of eminent advisers (Prof. Sir Alan Budd, Sir Bryan Carsberg and Mr. Bill Knight).

10. In a reattribution, policyholders are offered a one-off payment by the insurance company (a policyholder incentive payment or PIP) in return for giving up their rights in the relevant inherited estate, in particular their right to participate in future distributions from the estate. My role, as outlined in the FSA's rules, includes negotiating with the company on behalf of policyholders the benefits to be offered to them in exchange for their rights in the inherited estate, and producing a report to

policyholders telling them whether the company's proposals are in their interests. Negotiations with the company are currently in progress.

D Key Issues

1. FSA permitted uses of the inherited estate

11. It became clear at an early stage of my negotiations with Norwich Union that the way in which firms are permitted by the FSA to use inherited estates could have a significant impact on the level of any future distributions that policyholders could expect from an inherited estate. It would therefore potentially affect also the level of any incentive payment that the insurance company might offer to policyholders in return for their forfeiting their rights to such future distributions. I and my advisers (see, for example, Annexe 1 by Sir Alan Budd and Sir Bryan Carsberg) consider that the FSA has particular responsibilities with respect to the regulation of with-profits life assurance policies.
12. These policies are a prime example of a complex financial product which individuals purchase infrequently and about which they often lack the experience to protect their own interests. In the case of with-profits policies the degree of discretion about the management of funds is unusual in that the insurance company has been able (by exercising discretion whether and if so when to distribute surplus in the with profits fund) to decide what part of the return on investments should be attributable to the shareholders and what part to the policyholders. Such discretion involves a clear conflict of interest so that the regulator must, in our view, pay particular attention to how this discretion is exercised.
13. The FSA has said that the over-riding intention of its rules is to ensure that firms treat their with-profits policyholders fairly and that it recognises that the risks of unfair treatment are particularly acute when they arise from potential conflicts of interest within with-profits funds.

14. I and my advisers have therefore been surprised to find that the FSA rules, especially those that relate to the permitted uses of inherited estates, sometimes seem to further the interests of shareholders at the expense of policyholders, thereby effectively distributing the surplus in a fund in a ratio more favourable to shareholders than the normal 90:10 rule. That is because the size of the 90:10 distribution of surplus is first reduced by using the estate in ways that favour shareholders. For that reason, in August 2007 I requested guidance from the FSA.
15. I was disappointed that in its December 2007 response, whilst the FSA stated its intention to re-consult on whether mis-selling compensation costs should be charged to the inherited estate, it did not consider it necessary to reconsider some of its other rules and guidance which, in my view, clearly favour shareholders over policyholders.
16. One such rule which I believe the FSA should change relates to the permitted use of inherited estates to pay shareholders' tax (see Annexe 2 by my adviser, Chris O'Brien, University of Nottingham). I have asked the FSA to explain further its stance on this issue and I await its response.
17. More generally, I and my advisers consider the FSA should adopt a general principle that would require that an inherited estate is subject to the same discipline as the rest of the with-profits fund. That is, it would contribute to securing the guaranteed benefits to which the policyholders are entitled and any amount that was not required for this purpose would be distributed in the normal ratio of 90:10. Such a general principle would preclude the use of inherited estates in ways that favoured shareholders' interests over the interests of policyholders.

2 New with-profits business and FSA rules

18. In my view, one of the most controversial permitted uses of an inherited estate is the subsidisation of an insurance company's new with-profits business. Depending on the scale of the firm's forecast new business, it has the potential to reduce greatly the

amount that current policyholders can expect to be distributed from an inherited estate. It is an issue which presents particular difficulties in a reattribution.

19. The FSA's December 2007 guidance letter says that an inherited estate should not be used to subsidise new business such that it permanently erodes the estate over time. However, the FSA does continue to permit the 'intergenerational transfer' of estate between policyholders by allowing a firm to hold back capital in a fund to support new business. This could otherwise be distributed in special bonus to current policyholders. In the absence of a reattribution this rule has the effect of transferring estate capital to future policyholders from current policyholders. It is also anti-competitive since it enables an incumbent with-profits firm with an inherited estate (invariably created by the under-distribution of profits built up from the investment of policyholders' premiums) to subsidise its new business in a way which other firms (without inherited estates) are unable to do.
20. However, in the context of a reattribution, the FSA's ruling on permitting capital to be held back to support new business can be particularly disadvantageous to policyholders. That is because the rule creates the peculiarity that the company, in order to make a policyholder incentive payment worthwhile to current policyholders, only needs to offer to compensate them for the value of the estate which they themselves might expect to receive by way of special future distributions. This means that in the absence of a reattribution the estate which would have been 'gifted' by current policyholders to new policyholders could potentially be transferred to shareholders for free unless the FSA intervenes to ensure a fair outcome.
21. The FSA's new business rules are particularly unfortunate because the firm has an incentive to forecast overly ambitious levels of new business when formulating its policyholder incentive offer. I have asked industry experts for advice on likely trends in the with-profits market in the future. I attach as Annexe 3 a summary report compiled by Cazalet Consulting. The analysis suggests that:

- with-profits policies will continue to appear unattractive to potential purchasers compared with other financial products
 - a continuing fall in with-profits sales seems more likely than a recovery
 - the AXA post-retribution new business levels suggest it is unlikely a company will continue to write the same level of new business after a retribution as it predicts before a retribution.
22. However, it remains a fact that it is not possible to forecast new with-profits business with any degree of certainty. Retribution negotiations have to consider a wide range of possible new business forecasts and without FSA intervention the outcome will be strongly influenced by these assumptions. As noted above, this could result in a retribution offer that is unduly generous to shareholders, unless the FSA gives robust and clear guidance to firms as to how the proportion of the estate that in the normal course of events could be distributed to future policyholders should be divided between current policyholders and shareholders in the event of a retribution.

3 The FSA's assessment of fairness review and transparency of process

23. Because of its significance, I asked the FSA to give specific guidance as to how the proportion of the inherited estate, which, under FSA new business rules, is projected to be passed without compensation to future policyholders, should be treated in a retribution. In recent correspondence, the FSA chairman said that this tranche of capital has a value attached to it and so should be included in the negotiated payment made by the shareholder. The FSA Chief Executive similarly confirmed that, in negotiating with the firm, I should take into account the value shareholders will unlock from the *whole* of the inherited estate by its retribution.
24. However, as Mr. Bill Knight points out in Annexe 4 to this evidence, whilst the policyholder advocate negotiates the PIP offer with the company and then makes her views known to policyholders, the formulation of the offer is a matter for the

company. The policyholder advocate has no power to affect the terms of the offer, save that of persuasion. Moreover, the directors of the company which makes the offer have a duty to act in good faith in what they believe to be the interests of the company, which can also be described as a duty to act in the interest of the general body of shareholders. The FSA's own consideration of the fairness of a firm's reattribution offer, in the light of views expressed both by the firm and by the policyholder advocate, is therefore of particular importance.

25. The FSA usually makes its report on the fairness of a reattribution scheme available to the court which is required to give or withhold sanction for the scheme. Mr. Knight suggests that the FSA should either make, or commission, an assessment of any reattribution offer before it is made to policyholders and, if the company then decides to proceed, the assessment should be published and full reasons should be given.
26. As a matter of good practice, I will be publishing a detailed report which will be available to policyholders and other interested parties. I have therefore particularly welcomed the FSA's recent statement that it will "make public its conclusion on what fair treatment would require for consumers" in a reattribution and that the FSA expects to publish what it perceives as a "reasonable range" for any reattribution payment.

4 Policyholder communications

27. The normal process for a reattribution is that the company makes an incentive payment offer to policyholders to give up their rights to future special distributions from the inherited estate. A court then sanctions the arrangement under Part VII of the Financial Services and Markets Act 2000.
28. The policyholders decide whether or not to accept the company's offer. There is no policyholder meeting, but the FSA requires that policyholders be given the choice whether to accept the incentive payment or to reject it and maintain the status quo. The

effect of the court sanction of the reattribution scheme is to prevent any policyholder who does not accept the PIP from subsequently challenging the scheme.

29. As policyholder advocate I have sought to communicate frequently with policyholders, including seeking their views in an open and constructive way (see Annexe 5, provided by my director of communications). This communication with policyholders has been particularly important since Norwich Union's proposed reattribution is the first since the FSA established the role of policyholder advocate.
30. It was clear from the outset that it would take time to obtain all the necessary information and to examine all the issues that can affect a fair outcome of a reattribution for policyholders. It was also almost inevitable that further clarification of the FSA's stance on the rules pertaining to a reattribution would be required, given that it is the first since the FSA's new with-profits rules were put in place in 2005. In order to communicate properly with policyholders and to be accountable to them, I have held open meetings, written twice to each policyholder, established call and correspondence centres to answer queries, and also communicated often via the internet.
31. It has been plain in my contact with policyholders that the complex nature of the with-profits product means that clear communication is essential with 'industry jargon' kept to a minimum. It has also been clear that there is little understanding among policyholders about the uses to which the inherited estate can be put and that much greater openness from the industry is essential if Treating Customers Fairly is to be meaningful.

E Answers to the Treasury Committee's questions

32. Following are brief answers to the questions on which the Treasury Committee has particularly requested written evidence. These answers complement the discussion of key issues in my Memorandum to the Committee.

The regulatory definition of the inherited estate in a with-profits fund.

33. The FSA defines the inherited estate as “an amount representing the fair market value of the with-profits assets less the realistic value of liabilities of a with-profits fund”. At the end of 2004 the FSA required companies with with-profits funds to calculate their “realistic balance sheet” for the first time as part of their annual solvency returns. The regulatory changes were designed to measure the true economic solvency of the fund. Under the regulations the realistic value of the fund’s assets are the market value of the all the investments held. The realistic liabilities include a retrospective assessment of the liabilities to policyholders based on the experience and management of the fund up to the valuation date and a prospective assessment based on the projected future experience and management of the fund. The excess capital in the fund (“the inherited estate”) is then the difference between the realistic assets and the realistic liabilities.
34. The term “realistic balance sheet” could create an artificial impression of the precision of the calculation, which in practice relies on sophisticated actuarial valuation techniques and are inevitably based on a series of assumptions. The policyholder advocate’s advisers consider that published realistic value of liabilities, calculated in accordance with FSA requirements, are a prudent valuation of the liabilities and that some adjustments are appropriate to establish an estate valuation which is more relevant as a starting point for a reattribution.

The extent to which life assurance companies should be permitted to diminish inherited estate in order to subsidise corporate activity, including financing new business, making strategic investments, paying shareholder tax and paying the costs of compensation for mis-selling.

35. If certain costs are not allowed by the FSA to be charged to policyholders’ asset shares, then they should not be able to be charged to inherited estates. An inappropriate charge to asset shares could be expected to have a detrimental effect on policyholders’ reversionary (annual) or terminal (final) bonuses. A charge to the

inherited estate will have a similar outcome, in that it could reduce the value of policyholders' special bonuses from distribution of the inherited estate. It is difficult to see how different uses of the inherited estates, as compared to the remainder of the with-profits funds, can be justified. If an insurance company seeks to use an inherited estate in ways that benefit shareholders over policyholders, and is not prevented from doing so by the FSA, this in effect circumvents the 90:10 Ministerial rule on distributions, since it artificially reduces – in ways that benefit shareholders – any 'excess surplus' that would have otherwise been available for 90:10 distributions.

Whether allowing life assurance companies to use inherited estate to subsidise corporate activity has any adverse effects on competition.

36. An important factor inhibiting new entry is that incumbent firms writing new with-profits business which have inherited estates have a cost advantage over other providers and would-be new entrants that is anti-competitive. This is because they are allowed by the FSA to use the inherited estate to pay costs such as mis-selling compensation costs and shareholder tax, and also to provide capital to support new business. Inherited estates can therefore distort competition and lead to inefficient capital allocation. While it may ordinarily be that capital should not be a barrier for new entrants – who should be able to raise capital if the new business is profitable – this would mean putting shareholders' capital at risk in a way that does not apply to existing firms with inherited estates, where most of the risks can be borne by the inherited estate. There have been very few new entrants to the market in recent years. Only one firm writing with-profits business has been established since 1995: Pension Annuity Friendly Society. The top four with-profits companies, by market share, in 2006 were: Prudential (28.3%), Aviva (20.0%), Standard Life (9.3%), and Legal and General (6.2%). The Prudential's market share grew from 20.2 per cent in 2003 to 31.5 per cent in 2005. Aviva's market share has grown from 7.6 per cent in 2004 and 13.6 per cent in 2005. Aviva and Prudential have substantial inherited estates, while Legal and General also has a small inherited estate. (Source: Chris O'Brien, from FSA returns).

The principles that should guide the division of inherited estates in 90:10 funds between policyholders and shareholders upon reattribution of the estate.

37. The starting point for any reattribution proposal should be 90:10, according to the chief executive of the FSA, Hector Sants, in a letter to me dated 7 February 2008. I therefore consider that any reattribution offer must both exceed what current policyholders are giving up in terms of their expected future distributions and ensure that they also receive a fair proportion of the estate which, under FSA rules, would have been distributed to future policyholders. Otherwise the shareholders would be getting the future policyholders' proportion of the estate for free which would provide shareholders with an unfairly high rate of return from the reattribution, and would not represent fair treatment for policyholders. The FSA agrees that in a reattribution there is a value to be placed on the proportion of the estate which would have gone to future policyholders.

The appropriate sharing of inherited estate between current and future policyholders.

38. As noted above the FSA rules permit the estate to be used to provide capital subsidy for new business, thereby transferring a proportion of the inherited estate from one generation of policyholders to another. This means that under FSA rules the proportion of the inherited estate distributed to current policyholders rather than future policyholders depends on the level of new business which the firm is forecasting. In a reattribution, more significantly, this intergenerational transfer will no longer occur. This is because the company's PIP offer to policyholders is for the whole inherited estate. I asked the FSA how the tranche of inherited estate which would otherwise fall to future policyholders should be treated in a reattribution. In response a letter from Sir Callum McCarthy on 1 February 2008 confirmed that the future policyholders' tranche of capital has a value attached to it and so should be included in the negotiated payment. Mr. Sants similarly confirmed, in his letter of the 7 February 2008, that in negotiating with the firm a policyholder advocate should take into account the value shareholders will unlock from the *whole* of the inherited estate by its reattribution.

Whether policyholders' reasonable expectations of distributions from inherited estate should be zero or have a positive value.

39. On 22 January 2008 at an evidence session with the Treasury Select Committee the chief executive of the FSA confirmed that since FSA rules require firms to distribute excess capital in inherited estates as the excesses arise, then companies with inherited estates can no longer claim that policyholders' reasonable expectations of a special distribution are zero. This guidance should ensure that any incentive payment offered by a company in a reattribution has proper regard to the quantifiable future surpluses that are likely to be generated by the fund and distributed as special bonuses to policyholders. This clarification therefore has a very positive benefit to policyholders in that it should prevent a company from offering them very little for giving up their rights in an inherited estate, on the basis that any offer should be regarded as a "windfall".

Whether any distribution of benefits from the inherited estate should be made in a single payment or phased over several years.

40. The money should be fully distributed once it has been deemed as excess to the requirements of the fund. A staged distribution discriminates against policyholders who have been in the fund for longest and whose policies will naturally mature at some point during the phasing period. Staging the payments also could be seen as anti-competitive, and would appear to be in contravention of the FSA requirement that "Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim, or make a complaint"².

The role and responsibilities of the Policyholder Advocate.

41. The FSA rules which established the role of the policyholder advocate came into effect in 2005, and followed the AXA reattribution in 2000, the outcome of which was widely seen to be unfair to policyholders. The rules require a company to appoint a

² The FSA has defined six outcomes for consumers which summarise what it wants "Treating Customers Fairly" to achieve, of which this is the sixth.

policyholder advocate if there is to be a reattribution. As noted in the FSA rules, the precise role of the policyholder advocate will depend on the type of firm concerned and the nature of the reattribution. However in general terms the policyholder advocate negotiates the aggregate value of the PIP offer with the company and other terms and conditions and then makes his or her views known to policyholders. It is important to note however that the policyholder advocate has no power to affect the terms of the offer except that of persuasion. It is the FSA which formally considers the fairness of the reattribution proposals, although it has said that it will have regard to the views of the policyholder advocate in this regard. The FSA would be expected to make a report to the court which considers whether it is appropriate to sanction the reattribution scheme, if it is made under Part VII of the Financial Services & Markets Act 2000, as is Norwich Union's proposed reattribution.

The framework for negotiation between the Policyholder Advocate and the life assurance companies.

42. It is the company that makes the PIP offer in a reattribution, and the company that can withdraw an offer at any time during the process of negotiations with the policyholder advocate if it sees fit. In this sense the policyholder advocate has effectively no power to affect the terms of an offer, or to insist that an offer be put to policyholders. However the FSA has taken steps within its rules to ensure that the policyholder advocate is independent and well resourced and properly supported by advisers in his or her negotiations on policyholders' behalf with the company. The policyholder advocate is therefore well equipped to analyse carefully a firm's offer to consider whether any aggregate PIP offer is fair and whether it should be put to policyholders. The FSA made clear in its December 2007 guidance letter that the policyholder advocate can challenge any part of the operation of the with-profits fund in the course of negotiations with the firm. The FSA also made clear that if the policyholder advocate does not believe that the proposals are in the interests of policyholders, he or she should make that conclusion clear and communicate it to policyholders.

The role of the with-profits committees of life assurance companies.

43. I consider that a truly independent with-profits committee can in theory play a useful role in policing conflicts of interest and protecting policyholders' interests. Independence requires, in our view, that no member of a committee is an employee (or ex-employee) of the company and a very clear rule that the committee's role is to act in the interests of policyholders alone (and if for shareholders at all, then only to the extent of their pro rata interest in the relevant fund). However, we are sceptical as to their effectiveness as a practical matter. The asymmetry of information and resources (including time) as between committee members and the company is stark. I have witnessed at first hand the extent to which there is "devil in the detail" and how long it takes to gain an adequate understanding of models, and the implications of the results they produce. Even more important, however, is that the extent of the conflict of interest under the current rules regime is extreme, and the absence of clear principles by which to reach consistent judgments on what constitutes a fair resolution of those conflicts leaves far too much scope for subjectivity and inconsistency.

The approach of the Financial Services Authority to the issue of inherited estate.

44. The FSA began its with-profits review in 2001, the outcome of which established the role of the policyholder advocate and also, amongst other things, set out rules relating to the uses of the inherited estate. Since my appointment as the policyholder advocate in the Norwich Union proposed reattribution, the FSA has given further guidance on the uses of the inherited estate and some indication of its position as to what conditions need to be met in order for a reattribution offer to be considered fair to policyholders. However the FSA's rules still favour shareholders over with-profits policyholders in some instances. I and my advisers consider that the FSA should adopt a general principle that would require that an inherited estate is subject to the same discipline as the rest of the with-profits fund. Such a principle would preclude the use of an inherited estate in ways that favoured shareholders' interest over the interests of policyholders. If the FSA decides that the current rules should remain in place, then it is imperative that the FSA provides clear rules to ensure that in a reattribution

shareholders offer a fair price to policyholders for the proportion of the inherited estate which, without a reattribution, would pass to future policyholders. If the FSA does not change its rules on the uses of the inherited estate or give robust guidance as to its position in a reattribution, then it is much less likely that a policyholder advocate will be able to negotiate a reattribution offer that is fair to policyholders and not overly generous to shareholders.

Annexe 1: Regulation and the role of the FSA

Note to Treasury Committee by Sir Alan Budd and Sir Bryan Carsberg

1. Introduction

45. We are members of a small group of advisers to the policyholder advocate who is acting on behalf of policyholders in relation to a proposed reattribution of life assurance funds by Norwich Union. This note sets out certain views that we have formed in the course of our advisory work on the regulatory framework for life assurance.

2. Competition and Regulation

46. There is a general principle that free competition between actual and potential suppliers is the best way of meeting consumers' preferences and providing goods and services efficiently. Regulation of markets may be needed when the markets concerned are not producing effective competition. However, regulation can inhibit competition if it imposes significant compliance costs on suppliers and raises barriers to entry. Therefore regulation should be proportional and limited to cases in which free markets are likely to fail. It should also focus first on promoting effective competition, by improving the information available to participants and in other ways, and resort to specific controls only where competition cannot be made effective.
47. Regulation can be justified in the case of sales of financial products in retail markets. The justification is that individuals who purchase financial assets often do so infrequently and lack the experience to protect their own interests in what can be complex transactions whose consequences are both uncertain and delayed. There is a considerable risk of "asymmetric information" – that is, the information available to the buyer about the consequences of a transaction is much smaller than the information available to the seller. In many cases, the uncertainty of the outcome is

inevitable because of the nature of the associated investments. However, regulation should, as far as possible, ensure that purchasers are aware of the risks involved and it should also seek to remove or reduce certain types of risk associated with the liquidity or solvency of the supplier. The one-off nature of many transactions (even where they involve a commitment to a future stream of payments and receipts) adds to the problem that the products are themselves often highly complex.

48. The challenge to the Financial Services Authority in balancing the benefits of competition with the need to protect the consumer is recognized in the first two of the FSA's tasks that it sets out as conducive to meeting its objectives:

I. promoting efficient, orderly and fair markets; and

II. helping retail consumers achieve a fair deal.

3. With-profits products

49. The FSA has particular responsibilities with regard to the regulation of with-profits life assurance policies. Here is a long-term savings product, which purchasers will, presumably, be purchasing to provide a lump sum when it is needed at some time in the future and perhaps to provide income at a time when income from employment will fall or cease. One might expect certainty and security to be prime considerations. However, purchasers are encouraged to undertake some risks in the expectation of higher returns. "With risks policies" might have been a better label than "with profits policies" but investors should understand that the "profits" are earned because the premiums that they pay for their policies are partly being used to buy equity shares and other risky assets. At the same time there is some offer of certainty through the guaranteed payment to the policyholder at the end of the term of the policy or at earlier death. And the risks associated with returns above the guaranteed minimum can be reduced in two main ways: through the choice of assets purchased by the provider on behalf of the customer and by smoothing returns between cohorts of investors. The

latter can only smooth out fluctuations around a trend; it cannot remove the risk that returns on investments fall permanently.

50. Life assurance companies need to build up a fund to meet their obligations under life policies. They need a fund to make reasonably sure that they can meet the guaranteed minimum payments on policies, including where the policyholder dies prematurely, even if the value of investments held by the fund has declined, and they need a fund to undertake the smoothing of returns. It is important for a regulatory authority to ensure that reasonable steps are taken to enable prospective policyholders to understand this and the terms on which distributions will be made to policyholders in the form of additions to the values of their policies. They should be informed about the extent of any discretion granted to the managers of the fund over distributions.
51. Discretion in the use of asset management usually means that funds can be managed, and assets bought and sold, without reference to pre-established rules and without reference to or permission from the person on whose behalf the funds are being managed. Policyholders may be familiar with that kind of discretion and will assume that such discretion is being exercised in their interest. In the case of with-profits policies, however, the degree of 'discretion' is unusual: the insurer has been able to exercise discretion in determining what part of the return on investments should be attributable to the shareholders and what part should be attributed to the policyholders. Such discretion involves a clear conflict of interest. Since competitive forces, which might have protected the policyholder, are weak in this part of the financial industry for the reasons we have described, the regulator must, in our view, pay particular attention to how this discretion is exercised.
52. The possibility of the use of discretion in this sense and the fact that life assurance is a complex product leads one to expect that the FSA will be particularly vigilant on behalf of the retail customers.

4. Economic principles of regulation

53. The framework for regulation outlined above leads to the conclusion that an important function of regulation is to deal with conflicts of interest between policyholders and suppliers, in a way that protects customers: uncontrolled conflicts of interest prevent the market from working with maximum efficiency.
54. As mentioned above, one potential conflict arises in relation to the level of distributions from a life fund. Distributions are divided between policyholders and shareholders in a fixed ratio that is communicated to policyholders. The normal ratio is 90:10 although this can be varied by agreement between the parties. If an insurer can accumulate funds out of interest, dividends and other earnings from investing premiums paid by policyholders, by limiting distributions, and, at some time, declare that it has a larger fund than is needed; and if it can then undertake a reattribution in relation to the surplus in the fund and distribute it in a ratio more favourable to shareholders than the 90:10 rule, then the insurer will have an incentive to limit regular distributions so as to have a large sum for reattribution. The FSA should set actuarial limits to the amount that can be accumulated in a with-profits fund, having regard to the guaranteed minimum payments on policies, and require any remaining surplus to be distributed 90:10. An alternative would be to allow the firm to choose what practice it will follow, subject to the requirement that its practice must be clearly agreed with policyholders as part of their contracts. (This would apply to new policyholders - the regulator would still need to take action for existing policyholders who made no such agreement.) We understand that the FSA takes the view now that insurers should not be allowed to accumulate life funds that are surplus to actuarial requirements. To be effective, that view needs to incorporate actuarial rules for determining a surplus. Evidently such surpluses have not been prohibited in the past, otherwise the large surplus funds currently being considered for reattribution would not have arisen. The proportion in which reattributed funds should be divided should also be decided by the regulator. One cannot expect a fair outcome to be reached by

negotiation when the insurer can simply retain the funds without any regulatory sanction.

55. An insurer will need to hold an amount in the life fund, over and above the amount required to ensure that guaranteed minimum payments on policies can be made, in order to meet its objectives for smoothing income. Here, too, there is a conflict. Here too the FSA should set a limit to the amount that can be retained for income smoothing or require that the procedure should be agreed as part of the initial contract for life assurance.
56. A second potential conflict arises in relation to charges against the life fund of expenses that should be borne by shareholders. Examples are fines and expenses that the insurer is required to bear in relation to mis-selling. It seems simply unacceptable that such expenses should be borne by the life fund and regulators should ensure that they are not.
57. A third potential conflict may arise in relation to new business. At one stage members of the industry used the with-profits life fund to *subsidise* new business. This was clearly unfair to existing policyholders. It may be acceptable for the life fund to be used to finance new business, where such business involves net cash outlays followed by net inflows, provided that the pricing of the business is set to achieve at least break-even over its lifetime. Financing new business would not be inconsistent with fairness to existing policyholders, as long as the cash needed is not deducted in determining the amounts available for distribution to existing policyholders.
58. An effectively competitive market would tend to ensure that the conflicts described above were resolved in ways that were not detrimental to policyholders. This would be brought about by the insurer's making explicit and clear promises in the contract agreed with policyholders. To the extent that competition in with-profits assurance is not fully effective in relation to the way firms use the inherited estate and distribute surplus funds, then effective economic regulation is needed to protect policyholders' interests.

59. In addition to specific rules to deal with the conflicts described above, a regulatory principle which prevented undue discrimination/preference as between groups of policyholders and between policyholders and shareholders could help to bring about the desired competitive outcome. Such a principle would require that an inherited estate was subject to the same discipline as the rest of the with-profits fund, that is it would be used to secure the guaranteed benefits to which the policyholders are entitled and would thereafter be distributed in the normal ratio of 90:10. If the regulatory regime was to establish clearly, by way of such a general principle, that shareholders were not able to benefit from inappropriate uses of an inherited estate (uses that had detrimental effects on policyholders) then a firm's incentives in relation to the making of distributions would also be more correctly aligned. This is because, in these circumstances, a firm would have less reason to under-estimate the potential of or postpone the possibility of distributions. In the absence of more profitable alternatives (that is, the use of the inherited estate to give undue preference to shareholders), it would be in shareholders' interests to make calculations about possible distributions as accurately as possible. Such a principle would also better facilitate competition between with-profits insurers with or without inherited estates, since shareholders would no longer be able to use funds that would otherwise be distributed 90:10 to subsidise new with-profits business.

5. The FSA's guidance on reattribution.

60. In a letter dated 6 December, the FSA accepts that in a 90:10 with-profits fund, such as the Norwich Union funds, any surplus is to be distributed 90 per cent to policyholders and 10 per cent to shareholders. Given the particular features of with-profits policies, as described above, one looks for strong and convincing arguments for any departure from this principle. As the letter says, "It is for firms, and their senior management in particular, to manage their business effectively, including treating customers fairly, managing conflicts of interest and maintaining adequate systems and controls and financial and other resources."

61. The letter describes, in particular, FSA policy on four issues, of which two have especially exercised the advisers to the policyholder advocate, namely financing new business and paying mis-selling compensation costs (that is, the costs of compensating policyholders who are judged to have been misled when they purchased their products) from the inherited estate. As noted above, at one stage members of the industry used the inherited estate to *subsidise* new business. Fortunately the FSA letter appears to reject this practice. We do not believe that there are any arguments that could be used to justify such a use of the funds since it would clearly be contrary to the interests of the policyholders. However the letter does say that it is acceptable to use the inherited estate to meet the set-up costs of new with-profits business “provided the business is managed with a view to recovering those costs, and repaying them to the inherited estate, over a reasonable period”. On the face of it, that may seem reasonable but it means that special steps have to be taken to ensure that policyholders whose policies mature before the set-up costs of new business have been recovered are not disadvantaged. In the negotiations on the Norwich Union reattribution, the company has presented estimates of the capital required for new business based on its own forecasts of new business and on the assumption that the capital concerned would be provided out of the inherited estate. Quite apart from the question of whether those estimates are reasonable, there is the far more important point that the effect is that the sum available for reattribution is at the discretion of Norwich Union. As will be clear from our earlier comments on discretion, we consider that is precisely the sort of discretion that should be avoided. It is difficult to believe that policyholders realized, at the time they invested in with-profits funds, that the insurer would be able, at its own discretion, to keep part of the fund to finance the start-up funds of new business. This goes far beyond any reasonable concept of smoothing.
62. In relation to mis-selling compensation costs, the FSA say that they decided, in 2003, to allow insurers to charge such costs to the inherited estate. However, in the light of the strength of views put to them more recently, they think that “it is appropriate to invite further consideration of the issue of charging mis-selling costs”. We do not

think that there is room for difference of opinion regarding what the outcome should be.

Annexe 2: Shareholders' tax

Note to Treasury Committee by Chris O'Brien, Director, Centre for Risk and Insurance Studies, Nottingham University Business School

63. The note considers the extent to which life assurance companies should be permitted to diminish the inherited estate by paying shareholder tax (being one of the subjects in the invitation to submit written evidence to the Committee).
64. This note concludes that the FSA should prohibit life assurance companies from using the inherited estate to pay shareholders' tax. We appreciate that any rule change will involve a consultation with interested parties.
65. The taxation of life assurance companies is complex, but the main points are:
 - On pensions business:
 - the income and capital gains of companies are not subject to tax;
 - the part of the surplus attributable to shareholders (which is typically 10 per cent for with-profits business) is subject to tax at the usual corporation tax rate (28 per cent).*
 - On life assurance business:
 - the income and capital gains of companies are subject to tax at a lower policyholder rate of 20 per cent;
 - and further tax is payable on the part of surplus attributable to shareholders, because the usual corporation tax rate applies to this, which exceeds the lower rate for policyholders. *
 - (* The asterisked parts of the tax bill are known as "shareholders' tax".)

66. Who pays this shareholders' tax? It could be:
- deducted from the asset shares of policyholders, leading to lower distributed surpluses and bonuses than otherwise, meaning that the shareholders' tax is effectively borne 90 per cent by policyholders and 10 per cent shareholders;
 - deducted from the amount of surplus transferred to shareholders, i.e. the shareholders pay the tax; or
 - paid from the inherited estate.
67. We regard it as appropriate for shareholders' tax to be paid by shareholders, not policyholders, because:
- this tax is payable as a direct result of part of the surplus being attributable to shareholders (and is not payable by mutual life assurance companies).
 - the tax rate applied is the usual rate of corporation tax payable by companies, not the rate applied to policyholders; and
 - certainly in the case of pensions, companies have generally marketed these policies as free of tax to policyholders.
68. We believe that the tax should not be paid from the inherited estate because this means it is being largely borne by policyholders:
- policyholders would have lower expectations of receiving future payments from the inherited estate (we add that FSA has accepted that policyholders have a non-zero interest in the inherited estate); and
 - by reducing the strength of the fund, it reduces policyholders' security and may lead to a more conservative investment strategy than would otherwise be the case, potentially to policyholders' detriment.

69. FSA reviewed this topic as part of its with-profits Review. They introduced a rule in 2004 which prohibited companies from charging this tax to asset shares, but allowed companies to charge the tax to the inherited estate provided this has been their past practice and is explained in their Principles and Practices of Financial Management (PPFM) document.
70. Many companies use this to justify charging shareholders' tax to the inherited estate, although some companies do charge shareholders' tax to shareholders.
71. We regard the rule as unsatisfactory. We expect shareholders to pay shareholders' tax, and this cannot be justified by companies having used the inherited estate to pay it in the past. We cannot expect policyholders to accept this as part of the contract just because a company has referred to it in its PPFM: many contracts began before PPFMs were first issued in 2004; and most policyholders have not read the PPFM (or would not understand the significance of this point if they had). Policyholders may have read the Consumer-friendly version of the company's PPFM, but this may make no reference to shareholders' tax.
72. FSA did not explain, in their consultation, why they adopted this stance. Recent FSA statements suggest some reasons:
- (1) Hector Sants, in his statement to the Treasury Select Committee on 22 January 2008, said, "as part of an open-ended process it is reasonable to charge those types of costs that you have alluded to, to do with new business and tax, because a vibrant and successful fund is to the advantage of policyholders in the long term."
- However, charging shareholders' tax to the inherited estate for new business means that new business is being subsidised, which Hector Sants indicated to the Committee its rules did not permit;

- the statement may suggest FSA would not allow shareholders' tax to be charged to the inherited estate in a closed fund, but its rules do not prohibit this.

(2) David Strachan, in his letter of 6 December 2007, said this rule was introduced “to avoid policyholders suffering any deductions from their benefits, while preserving a change in the tax law.”

- However, we have been unable to establish what change in tax law this was and have asked FSA to clarify this.

73. Indeed, FSA has referred to the decision to allow companies to charge shareholders' tax to the inherited estate as a “concession” (as described in Consultation Paper 04/14, August 2004, Annexe 4, page 4). The consultation process about the new rules in 2003-05 was unsatisfactory, with no real explanation of why it adopted its position and no feedback on the objections.

74. We have therefore been urging FSA to review its position on shareholders' tax. While FSA has stated that it had previously consulted on the subject, we wish to see a new consultation, which takes into account the need to protect policyholders' interests, rather than simply make a concession to the industry and shareholders' interests.

Annexe 3

With-Profits: Commentary for the policyholder advocate

Cazalet Consulting

Note to Treasury Committee by Cazalet Consulting

1. Introduction

75. This paper is an abbreviated version of a more extensive paper produced for the policyholder advocate by Cazalet Consulting concerning the future of the with-profits business, in particular relating to the Norwich Union reattribution. It examines the future of with-profits business in the UK, by investigating whether there is a fundamental market for with-profits products, and whether with-profits is a unique investment format. Finally, it examines the writing of new business after a reattribution, via the AXA reattribution, concluding that:

- there is no fundamental market for with-profits;
- sales of products in with-profits format have been markedly unpredictable from time to time, and in recent years have generally been in sharp decline;
- while with-profits may be capable of providing investors with access to risk assets at the same time as providing downside protection and/or guarantees, nowadays this is not the only format that can provide such a combination. Increasingly providers are now actively developing and marketing “third-way” with-profits alternatives; and
- revisiting the AXA reattribution with the benefit of hindsight, it can be seen that projection of future with-profits new business levels from recent experience can be fraught with difficulty. In the case of AXA the actual post-reattribution with-profits new business levels achieved turned out to be very

considerably below expectations at the time of the transaction, meaning that the capital requirements for such business were far in excess of what turned out to be needed.

No Fundamental Market

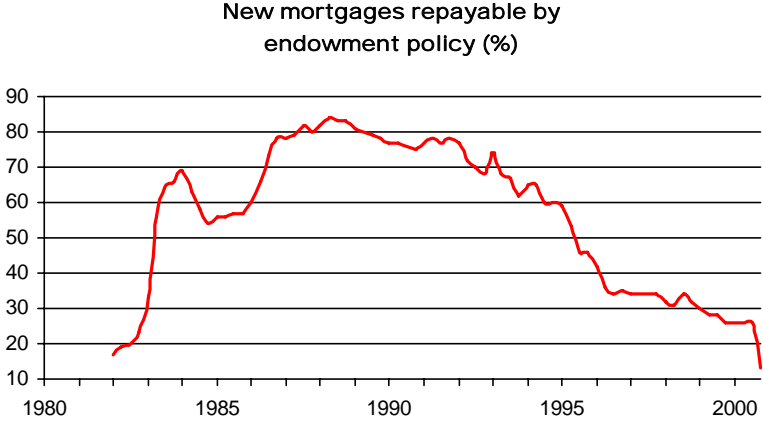
76. The vast bulk of the business that is written by or in-force within UK life assurance companies is savings or investment related. We think that it is demonstrably the case that, as a whole, life assurance companies have had no consistent product base and that, accordingly, making long term future extrapolations of new business volumes in most cases is a highly speculative activity.
77. We do not think that with-profits should be regarded as a “product type”, but rather as an investment format, and we do not think there is any fundamental market for with-profits, by which we mean that with-profits is not a financial necessity.

Example – endowment policies

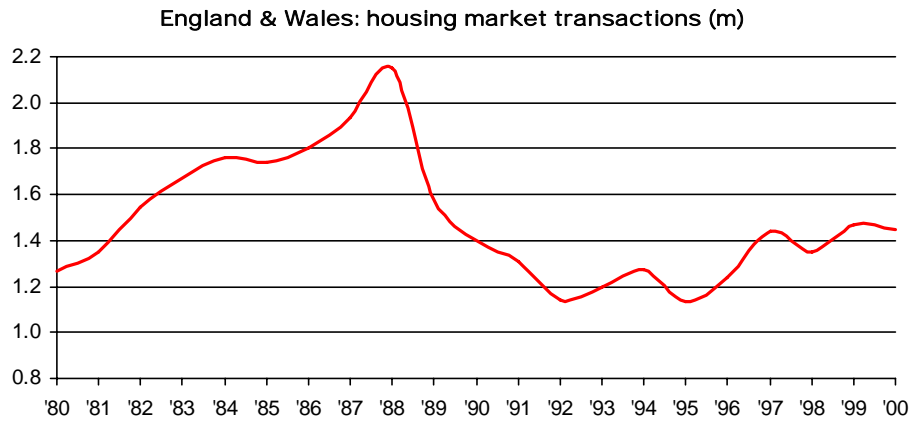
78. For a period in the 1980s and 1990s, the main product line of the UK life industry was the mortgage endowment policy – a regular premium savings plan, most commonly in with-profits format. What appeared a core product line subsequently was almost totally wiped out during the space of a few short years as far as new business was concerned.
79. Back in the 1980s, the market for mortgage endowment policies expanded rapidly. The reasons for its sudden surge (in part related to a change to mortgage interest rate tax relief) could not reasonably have been foretold by anyone in 1980.
80. We suggest that the almost complete eradication of mortgage endowment new business that took place in the late 1990s/early 2000s (resulting initially from the emergence of evidence that the vast majority of such contracts were not capable of fulfilling their purpose – i.e. to pay off the associated home loan) was not recognised by any life offices in 1995.

81. We think that the tainting of mortgage endowments not only caused the drying up of sales of this product, but also helped contribute to the very substantial decline in sales of non mortgage-related endowments, which happened so quickly as to defy prediction by life office business planners.

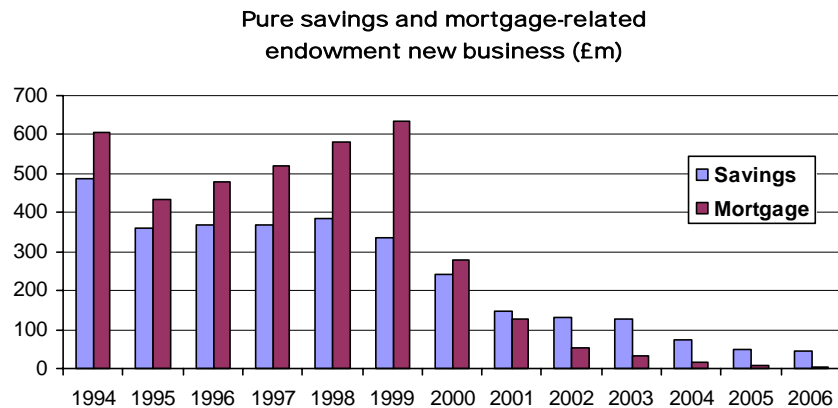
82. The chart below tracks the proportion of new mortgages that were repayable by an endowment. The sudden and massive uptake of the mortgage endowment concept arose not only because of the optical attraction of the monthly outlay comparison and prospects of a lump sum at the end of the period, but was also heavily influenced by the actions of intermediaries (principal among them the building societies and banks), who quickly came to realise that there was much more money to be made from selling low cost endowments as opposed to mortgage term assurance. Depending on various factors, including interest rates, a £50,000 25 year mortgage on a repayment basis might have required an initial total monthly outlay of £360 (of which, say, £350 was interest and capital repayment and £10 was for the term assurance contract), whereas the same amount borrowed on an endowment basis might have required an initial total monthly outlay of £340 (of which, say £290 was interest and £50 for the low cost endowment). The difference in remuneration for the intermediary was quite striking, up-front commission paid for the £50 per month endowment would have been something like £400, compared to maybe only £70 for a £10 per month term policy.



83. Not only were the vast majority of new mortgages suddenly being set up on an endowment basis, the number of housing market transactions increased rapidly.



84. From the early 1990s, the mortgage endowment market suddenly fell from favour and all but disappeared from view, taking the non mortgage endowment with it.

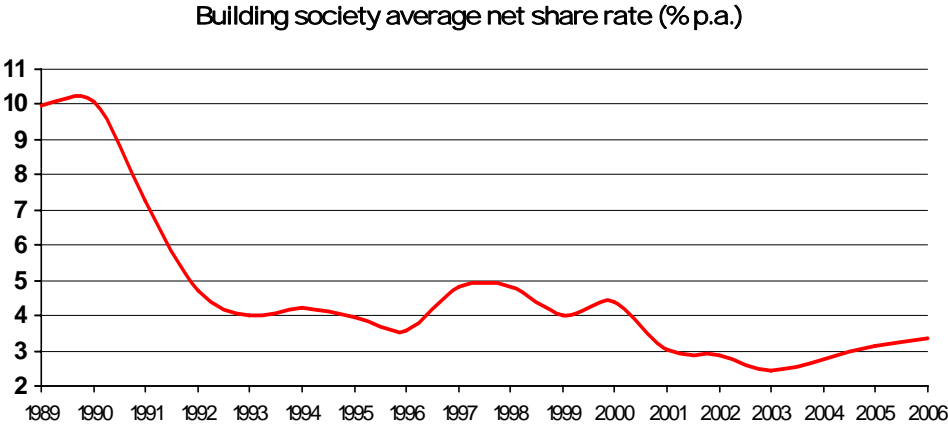


With-Profits Bonds

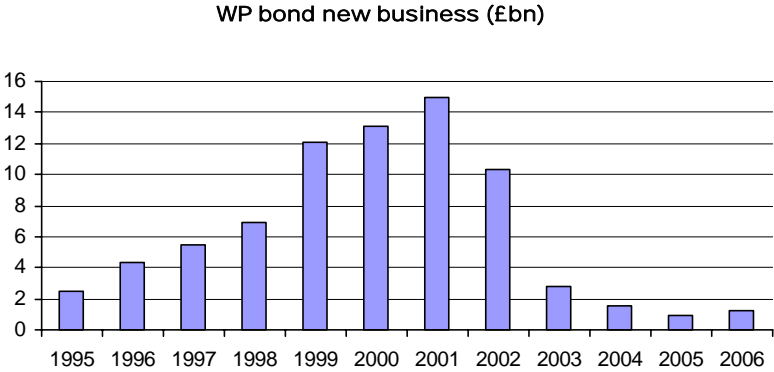
Not a core product

85. With-profit bonds were invented in the late 1980s, and new business volumes in the early years were rather modest and somewhat patchy.

86. Sales exploded in the second half of the 1990s and early 2000s as a result of two main factors: the UK's exit from the exchange rate mechanism and subsequent sharp declines in interest rates combined with a major marketing drive by companies.



87. The relatively low short-term interest rates of the late 1990s and early 2000s were a boon for writers of with-profits bonds as retail investors shifted assets from deposit accounts in pursuit of what they were led to believe would be higher returns.



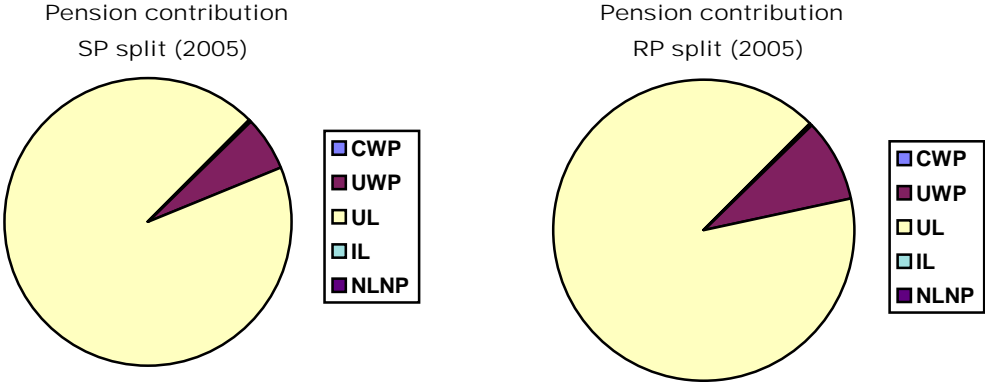
88. The with-profits bond surge and slump that straddled the turn of the decade was characterised by a product development race, as providers competed to offer the highest guarantees, highest bonus rates and highest commissions in order to gain market share and boost sales volumes.

89. Judging by the chart above, with-profits bonds could not be said to be a key financial services product. Rather, the market’s heights were founded on a market optimism that helped cause considerable damage to the balance sheets of a number of providers, including one time market leaders such as Scottish Mutual and Royal & Sun Alliance.

Pensions Saving

Contribution split

90. The charts below describe the split according to investment format of pension accumulation (i.e. excluding pension annuities-in-payment) new business in 2005. The underlying data is derived from the Cazalet Consulting new business data set, which is based on detailed bottom-up analysis derived from FSA returns.



Legend	
CWP	Conventional with-profits
UWP	Unitised with-profits
UL	United linked
IL	Index-linked
NLNP	Non-linked non-profit
SP	Single premium
RP	Regular premium

91. It can be seen that, overwhelmingly, new pension business is in unit-linked format.
92. In 2005, there was £25bn of pension new single premium business written, of which only £1.6bn was in with-profits format (6.4 per cent of the overall new business written).
93. In 2005, there was £2.6bn of new pension regular premium written, of which only £0.2bn was in with-profits format (7.7 per cent of the overall new business written).
94. Further, much of the with-profits so-called “new” business recorded in 2005 was not “new” at all, but was in the form of incremental payments made to pre-existing pension plans.

Dwindling with-profits share of new business

95. The percentage of pensions saving new business attributable to with-profits has been shrinking.
96. In 1999, 19 per cent of new pensions saving single premiums were with-profits, compared to 6 per cent in 2005.
97. As for new pensions saving new regular premiums, 37 per cent of these were with-profits in 1999, compared to only 9 per cent in 2005.

“Third Way” Products

98. There are those that assert that there always will be consumer demand for with-profits (although given the trend in new business levels set out earlier on, such a view might be considered a little contentious) on the grounds that such offerings incorporate valuable guarantees and thereby are attractive to risk retail averse investors who seek exposure to risk assets (such as equities) while wishing to limit their risk.
99. Leaving aside the absolute and relative merits of individual with-profits based products currently available, what is clear is that with-profits is now not the only

investment format under which retail investors can gain exposure to risk assets while limiting their risk and accessing valuable guarantees.

100. The last couple of years or so have seen the development of so-called “third way” products in the UK, many of them styled as “variable annuities”, importing techniques widely used and very popular among retail investors in the US and Japan, and which facilitate exposure to equities and other risk assets at the same time as incorporating investment guarantees to reduce the risk to the investor. Further, those providers offering or planning to offer variable annuity or similar “third way” contracts in the UK include a number of life assurance groups (such as AXA, Prudential, Royal London, Scottish Equitable and Standard Life) with a long with-profits heritage and substantial books of in-force with-profits business, but which are now focusing on “third way” approaches in developing new products for risk averse investors.

AXA Sun Life’s With-Profits New Business

Decline

101. In 1999, AXA Equity & Law Life Assurance Society plc (the with-profits business of which was the subject of the AXA reattribution, as a result of which it was transferred into AXA Sun Life plc) wrote £64m of new with-profits regular premiums and £699m of new with-profits single premiums.
102. In 2000, the year immediately prior to reattribution and transfer to AXA Sun Life, AXA Equity & Law’s with-profits new business fell to £46m of new with-profits regular premiums and £476m of new with-profits single premiums.
103. AXA Sun Life’s new with-profits business has been in decline post reattribution, to the point where, in 2006, new regular premiums totalled £7m and new single premiums were £45m.

104. Stripping out increments and pension rebate business, new regular premiums in 2006 would have been £4m and new single premiums would have been £22m, being absolutely and proportionately very small amounts.

AXA Sun Life plc with-profits new business (£m)				
Category/Premium type	2005		2006	
	RP	SP	RP	SP
UK life				
Endowment/bonds etc	4.4	1.5	1.7	0.7
Reinsured bonds	0.0	0.9	0.0	1.2
UK pensions				
Non-increments	1.2	17.6	1.7	16.8
Increments	12.2	36.2	3.4	20.3
Rebate business	3.8	18.8	0.0	1.3
WP drawdown	0.0	1.9	0.0	2.8
Overseas				
Miscellaneous	0.0	5.1	0.1	1.7

Assumptions prior to reattribution

105. In the run up to the making of reattribution proposals, investigations were made into the financial position of AXA Equity & Law as at 31 December 1998. It was confidently stated in the reattribution proposal policyholder circular that, based on the 31 December 1998 investigations, it would be “highly unlikely” that reviews of the company’s financial position as at end 2005 and every 5 years thereafter would show that it had more capital than it needed to support its new business development plans
106. In the AXA Equity & Law policyholder circular it was conceded, however, that the possibility existed that AXA Sun Life’s actual future experience might not to be in

line with assumptions made when performing financial investigations based on the 31 December 1998 position. It was stated that analyses had been done to quantify the extent to which actual experience would be need to be different for there to be excess working capital at the end of 2005. For illustration, the circular set out various scenarios (being variations from the assumptions made based on the 31 December 1998 position) that would result in the fund having excess capital of £50m as at end 2005, including the following:

- An illustrative £50m excess capital position as at end 2005 was projected to arise if new with-profits business fell on average by 5.5 per cent per annum from the budgeted 2000 level. Interestingly, the text on page 56 of the policyholder circular states, "...new With Profits business would actually [our emphasis] need to fall...", which indicates incredulity on the part of the writer that new with-profits business levels could ever fall!
- A further illustration of how an excess capital of £50m as at end 2005 might be caused, was if actual new with-profits business was c30 per cent less than budgeted levels in 2000 and then increased in line with an assumed annual growth rate of 2 per cent above price inflation.

107. We do not know what the budgeted level of new business was for 2000. If we assume that the budgeted 2000 level was the same as the 1999 level (£64m of new regular premiums and £699m of new single premiums), then a 5.5 per cent per annum rate of decline (based on the first scenario above and being a rate of fall seemingly thought by AXA to be incredible) would have resulted in a 2005 new business result of £48m of new with-profits regular premiums (compared to an actual outturn of £22m) and new with-profits single premiums of £527m (compared to an actual outturn of £82m).
108. Taking the second scenario above, and assuming that the 2000 budgeted level of new with-profits business was the same as achieved in 1999, and factoring in inflation at a constant 2.5 per cent per annum for convenience, the resulting 2005 levels of new with-profits business being sufficient to result in the emergence of £50m of excess

capital would have been something like £56m of new with-profits regular premiums (compared to an actual outturn of £22m) and £610m of new with-profits single premiums (compared to an actual outturn of £82m).

Annexe 4

Governance in a reattribution

Note to Treasury Committee by Mr. Bill Knight, former senior partner at Simmons and Simmons

109. I am one of the group advising the policyholder advocate in the reattribution of the Norwich Union inherited estate. This note is written for the Treasury Committee enquiring into the inherited estate held by life assurance companies' with-profits funds. It examines briefly the governance issues surrounding a reattribution and concludes that if a reattribution offer is to be made to policyholders it should first be independently assessed as fair.

1. The Process

110. In a reattribution policyholders give up their rights in the inherited estate, including the right to participate in future distributions from the inherited estate. The timing and amount of any future distribution is uncertain and this uncertainty is the greater because the interests of the policyholders are temporary – if a surplus is distributed after their policies have matured they will get no part of it. In return they receive a payment (the policyholder incentive payment or PIP) which is normally funded by the shareholders of the company in whose favour the estate is re-attributed.

111. A reattribution therefore involves a balancing of the interests of policyholders and shareholders. They do not negotiate directly between themselves but their interests are mediated by a process involving the directors of the insurance company, the policyholder advocate, an independent expert, the FSA and, usually, the court.

112. The normal process is that the company makes an offer to policyholders to surrender their rights to future distributions from the inherited estate in return for the PIP. The court then sanctions the arrangement under Part VII of the Financial Services and Markets Act 2000.

113. The roles of the parties are as follows:
114. The company makes the offer. The directors are responsible for it, and their duty is to act in good faith in what they believe to be the interests of the company. While the company is solvent this can also be described as a duty to act in the interest of the general body of shareholders. Recent statutory codification of directors' duties has not affected this basic principle.
115. The policyholder advocate represents the policyholders. The policyholder advocate exists because FSA rules require the company to appoint one if there is to be a reattribution. The policyholder advocate negotiates the offer with the company and then makes his or her views known to policyholders. The formulation of the offer is a matter for the company. The policyholder advocate has no power to affect the terms of the offer save that of persuasion. Although called an advocate, the policyholder advocate has no tribunal before which to appear.
116. The independent expert, normally an actuary, reviews the proposals, his primary concern being to ensure that the proposals will not damage the security of the policyholders' normal benefits. His report is made available to the FSA, the policyholder advocate and the court and a summary is provided to policyholders.
117. The FSA considers the fairness of the scheme and usually makes a report to the court. The full extent of the FSA's role in this respect is not completely clear to those advising the policyholder advocate, but it seems that the FSA will publish its "reasonable range" assessment, of any reattribution offer, although timing is unknown at present.
118. The policyholders decide whether or not to accept the offer. There is no policyholder meeting or vote in the case of a Part VII transfer, but the FSA requires that policyholders be given the choice whether to accept the PIP or, as regards their policy, maintain the status quo

119. The court considers whether it is appropriate to sanction the reattribution scheme, if it is made pursuant to a Part VII transfer. The effect of the court sanction is to prevent any policyholder who does not accept the PIP from subsequently challenging the scheme.

2. The company's duties to the policyholders.

120. The policyholders have rights and it must follow that the company owes them corresponding duties. The policies themselves are generally brief or even silent on the extent and nature of the policyholders' rights but policyholders have such rights (for example guaranteed rates of return) as the express terms of the policies do confer. Collectively they have the right to receive a defined amount (generally 90 per cent) of any distribution of the funds or sub-fund in which they participate. This right arises from the constitutional documents of the company or from the policies. FSA rules restrict the uses to which the fund can be put and the policyholders would be entitled to compensation if these restrictions were broken.

121. But the policyholders' rights which are set out in the policies or in FSA rules do not amount to a comprehensive scheme for the management of the fund and leave crucial areas to the discretion of the company and therefore to the directors. So for example the risk appetite of the fund and consequent decisions as to how much can safely be distributed are essentially matters for the directors. The directors are allowed to tie up fund capital by writing new business and the amount of new business and the projections of that amount (which can significantly affect the amount of the fund available for distribution) are matters for the directors.

122. How should the directors exercise these discretions? Companies have for many years been advised that the directors' duty is to the company or, as explained above, to the general body of shareholders. Of course this may not be to the policyholders' detriment. Competitive considerations require that the policyholders receive a reasonable rate of return, so that it is in the interests of the company to maintain its competitive position by seeing that they do. And it is in the interest of the company

that the directors should pay strict regard to the policyholders' rights and the regulatory rules. However, the existence of the inherited estate raises problems all of its own where it far surpasses any amount which might be thought necessary to provide guarantees or otherwise maintain policyholders' returns at a competitive level.

123. The inherited estate is an asset of the company and in these circumstances any board should use it for the benefit of the company to the extent that they are advised that they can. The estate has come to be used for funding the start up of new business, for the payment of taxes on shareholder transfers, for the payment of penalties for mis-selling for which the company is liable and to make strategic investments. These uses of the estate have been permitted by the FSA, although it is now re-considering its position on mis-selling and has prohibited the writing of new business on terms that are likely to erode the estate.
124. Until now the policyholders have not had a voice in this, but the creation of the Office of Policyholder Advocate has allowed their position to be re-evaluated and the policyholder advocate in the Norwich Union reattribution, Clare Spottiswoode, has received advice from leading counsel that although the inherited estate is an asset of the company it is a necessary implied term of the policies that in dealing with the fund, including the inherited estate, the company should have regard to the objectives of the fund as a vehicle for the provision of financial services to policyholders. The legal analysis usually adopted by those advising insurers is very much at odds with this.
125. Both sides cannot be right. Until we have a decision, or a series of decisions, of the court we will not know the rights and wrongs of it. However vehemently each side advances its position, the extent of the policyholders' rights and the basis for the directors' decisions are matters which are in dispute, and they are matters which critically affect the negotiation of the amount of a PIP in a reattribution.
126. However some things can be said.

127. First, in a reattribution companies are not willing to proceed on the basis that policyholders have no rights over the inherited estate. They seek policyholders' consent, they pay them a PIP and they usually seek the sanction of the court. If the policyholders had no rights over the inherited estate the company could simply appropriate the estate out of the fund so long as the FSA agreed – nobody is seriously suggesting this.
128. Second, to the extent that policyholders have rights the company owes them a duty. But unless and until the policyholders' rights in the inherited estate are agreed or defined by a court this is territory which is disputed between the policyholders and the company – each side seeking a greater share. In this dispute the company has the initiative.
129. Third, if the extent of the interests of the policyholders was agreed this conflict would be much easier to deal with. It is generally in the interests of a company to observe policyholders' rights and if that involves a conflict between the duties of the directors to the company and the duty of the company to the policyholders no doubt means would be found to manage it. The difficulty comes before those rights are agreed.
130. Fourth, a reattribution will solve the problem so far as the reattributed assets are concerned, not by defining policyholders' rights in those assets but by terminating them.
131. In deciding whether or not to accept a reattribution offer, policyholders will naturally compare it with the value of the distributions from the estate that they might receive if they do not accept. Given the directors' power to take decisions which directly affect the likelihood that policyholders will receive such distributions, and given that they perceive their duty as being to act in the interests of the company in exercising these discretions, is it right that they should also set the terms of a reattribution offer without a mechanism to deliver a fair result?

3. Conclusion

132. In defence of the status quo it can be said that an offer is only an offer. The policyholder will have the benefit of the policyholder advocate's views and can accept it or reject it according to his circumstances. But consider the position of a policyholder who receives an offer of a cash sum in return for rights which he never knew he had. If he rejects it, how will he assess his chances of his receiving any equivalent sum during the lifetime of the policy, given the discretion of the directors over the sums he will receive and the fact that, as they would say, they are bound to exercise those discretions in the interests of the company? In many cases, the company will have made him an offer he cannot refuse.
133. It might be thought that the court would provide an appropriate safeguard. It is not suggested that a court would sanction a scheme which it thought to be unfair. But the courts have recognised that it is not for them to set the terms of the scheme – the role of the court is to give or withhold sanction. Moreover the court will act on the evidence before it. By the time the scheme comes to court it will have been accepted by policyholders and the policyholder advocate may be constrained from arguing against the scheme and thereby seeking to deny a PIP to policyholders who have accepted it. In particular, the policyholder advocate may conclude that the offer is in the interests of a significant percentage of policyholders, but overall at a level which is unfairly beneficial to the company. In those circumstances it would be difficult for the policyholder advocate to oppose the scheme
134. If it were a condition of the making of the offer that an independent and suitably qualified third party, taking account of the arguments of the company and the policyholder advocate, must have pronounced it fair in amount as well as in process terms then the result, given the uncertainties, would likely be rough justice. But at least justice, however rough, would be seen to be done. If in the future the courts do hold that policyholders have substantial rights over the disposition of the inherited estate, then accepting policyholders will have lost those rights forever through the reattribution to the advantage of the company. Without an effective independent

assessment of the offer the customer will not have been treated fairly. If such an assessment is to be persuasive it will have to deal with the legal position as well as the regulatory position, analysing the directors' duties, explaining how different approaches may affect the outcome, and reaching a conclusion on the right approach to take.

135. It would be unreasonable to force a company to make a reattribution offer at a level higher than it is prepared to pay, so the introduction of such a requirement may result in the company deciding not to make an offer at all, but in this developing situation continuing uncertainty may be better than an offer which would terminate policyholders' rights without fully recognising them.
136. For these reasons I believe that the FSA should either make, or commission, an assessment of any reattribution offer before it is made. If the company then decides to proceed the assessment should be published and full reasons should be given.

Annexe 5

Role and responsibilities of the policyholder advocate – policyholder communications

Note to Treasury Committee by Jonathan Haslam, CBE, MCIPR director of communications, the Office of the Policyholder Advocate

137. This note sets out:

- the Norwich Union policyholder advocate's approach to policyholder communication
- some of the practical considerations important in trying to communicate with a large body of policyholders, including the difficulties posed by industry jargon

138. It concludes that:

- policyholders have not been well served by the information available to them prior to making their investment;
- that more effort is being made to explain the circumstances and issues in a reattribution; and
- that the work must continue and intensify to meet the standards of Treating Customers Fairly.

The policyholder advocate's general approach to policyholder communication

139. In determining how best to be accountable to those she represents the policyholder advocate in the Norwich Union reattribution has sought to make herself as available as possible to policyholders, setting in place a range of communication mechanisms which have included:

- visiting various cities in the UK and the Republic of Ireland and holding open meetings;
- writing to each potentially eligible policyholder on appointment and subsequently;
- establishing a call centre in India;
- establishing a correspondence centre in Norwich;
- publishing a website and encouraging users to register for email updates and to post comments to the policyholder advocate about the reattribution
- being willing to enter into a dialogue with the media in respect of general issues while seeking to respect the necessary confidentiality of the process of reattribution negotiation

140. One element of the open meetings was to ‘consult’ with policyholders, as required by the then Conduct of Business Rules from the Financial Services Authority.

141. Even more time will need to be spent explaining the result of a negotiation, whether positive or negative, using all the media described in this paper.

Practical considerations³

Open meetings

142. The policyholder advocate’s office had no means by which to judge the likely level of interest in open meeting and made assumptions. In the event the number of acceptances was far greater than those ultimately attending. There has been a small number of complaints from policyholders that more events should have been undertaken. It is accepted that an open meeting in the North West of England at least,

³ The Office of the Policyholder Advocate would like to acknowledge the assistance of Norwich Union employees in organising events, running the correspondence and call centre operations and facilitating policyholder mailings. Some issues with mailings are explained in the body of the text.

should have been included. In part that omission was met by providing a DVD recording of an event to those who complained.

143. The meeting demonstrated that policyholders in general were not well informed about the nature of with-profits, that they were entirely unfamiliar with the concept of a reattribution and that they saw the meeting as an opportunity to vent their frustration at the performance of their policies.

Internet consultation

144. Recognising that policyholders might wish to express a view but not attend an open meeting, an internet-based questionnaire was developed. The questionnaire sought to make real the FSA injunction to consult to inform the policyholder advocate in the subsequent negotiations.
145. The information gained was of interest and was a way of trying to involve policyholders in a process from which otherwise they were likely to feel remote. Nonetheless, it was an imperfect mechanism and policyholders' expectations needed to be managed so that its importance was not overstated.

Industry jargon and openness

146. Both policyholder mailings sent from by the policyholder advocate have been done jointly with Norwich Union and have been market tested. The quality of communication has been considerably improved as a result of this testing.
147. It is instructive, however, to look at the jargon of the industry and the extent to which ordinary policyholder literature fully sets out key issues. Sir Howard Davies made the point, while chairman of the FSA, that industry jargon was unhelpful. He cited the term 'inherited estate' and questioned why it was not simply called 'accumulated assets'. There is misunderstanding about 'reattribution'. Policyholders find the use of 'surplus assets' unhelpful, and more so when there is 'excess surplus' which is made the subject of a 'special bonus', which is differentiated from the 'reversionary' bonus

(annual) or 'terminal' bonus ('final'). The industry is trying to address some of these issues but it has further to go.

148. Aside from the language there are issues about openness. The Principles and Practices of Financial Management and other papers refer to uses of the estate and 'tax obligations'. It is unfortunate that openness does not dictate the acknowledgment that the estate bears the cost of tax on shareholder transfers under a distribution. Similarly, explanation in everyday language of the way the estate is used in respect of new business in the written material that policyholders are most likely to read would be an improvement. The consumer-friendly versions of these materials have not gone far enough.
149. Admittedly, the concepts in a reattribution are particularly difficult to explain to a lay audience with a limited appetite for written material. However, that puts an onus on all concerned to produce the clearest possible documents.

The mailings

150. Policyholders should be informed by the company on the appointment of the policyholder advocate and at intervals (supposed to be no more than six months) throughout the process.
151. In general the mailings have been harmoniously organised in conjunction with the company. This makes good sense in that different aspects of the process can be presented to achieve balance and costs (which are considerable) can be contained. However, the tensions inherent between negotiating parties and the different views about what to tell policyholders about a continuing process have resulted in at least one, and arguably two, company mailings being issued without a balancing piece from the policyholder advocate. This is unfortunate.

Correspondence and call centres

152. Both of these facilities have been essential to meeting the needs of policyholders. This office has been fortunate in having seconded to it a Norwich Union expert on customer experience to manage these processes and for the dedication of seconded staff working in the correspondence and call centres.

Conclusion:

153. There needs to be greater openness from the industry to explain the nature of with-profits and sues of the inherited estate.

- Industry jargon is a barrier to understanding and needs to be phased out wherever possible;
- commendable efforts by Norwich Union to introduce more market testing of written materials is welcome and needs to be encouraged;
- policyholder advocates need the ability to communicate more readily with policyholders, even though the result might be greater cost;
- commitment to explain the result of reattribution negotiation directly and indirectly to policyholders is an essential component of accountability.

4.00 Memorandum from Norwich Union

NORWICH UNION WRITTEN EVIDENCE

Treasury Select Committee Inquiry into the Inherited Estates

About Norwich Union

Norwich Union Life is the largest provider of life, pensions and long-term savings in the UK. Norwich Union Life is part of the Aviva group, which is the fifth-largest insurance group in the world and the biggest in the UK. Norwich Union Life has more than six million customers and employs more than 10,000 people in 10 locations throughout the UK.

Executive Summary

- Norwich Union is currently considering a reattribution of two with profit funds (CGNU and CULAC) which have a combined fund size of £33bn which supports the policies of 1.1 million policyholders.
- Norwich Union is the first company to undertake a reattribution under the new FSA process, which it believes will bring clarity to over 1.1 million policyholders.
- The Norwich Union proposed scheme will not force any policyholder to accept the offer made to them. The proposed scheme is not a majority vote. Each policyholder would be able to decide whether or not to wait for any potential future distribution. Their rights would not be affected if they did not accept an offer.
- None of the current generation of policyholders have contributed to the inherited estate, nor is it an orphan asset.
- Legally, the inherited estate belongs to the company and not the policyholder. Policyholders have a contingent interest in possible future special distributions from the estate which would be paid in the proportions of 90% to policyholders and 10% to shareholders. They have no right to expect such distributions during the lifetime of their policy
- Norwich Union believes it can make a fair offer in cash to policyholders for their contingent interest. The benefit to the individual policyholder is a certain cash

- payment now versus uncertain distributions in the future. The benefit to the shareholders is the ability to use the capital in the fund more efficiently.
- No money leaves the fund to finance the payment to policyholders. The shareholder provides this money from their own resource which enables a cash payment to policyholders today.
 - Norwich Union and the Policyholder Advocate have been working together for two years following a closely regulated process which defines a reattribution. As part of this process there are seven controls in place which protect the consumer and ensure a fair outcome:
 - i. Norwich Union's own commitment to treat its policyholders fairly
 - ii. A majority Independent With Profit Committee
 - iii. Appointment of an Independent Expert
 - iv. With Profits Actuary
 - v. Appointment of an Independent Policyholder Advocate and team of experts to negotiate on behalf of policyholders.
 - vi. Scrutiny by the Financial Services Authority
 - vii. Approval by the High Court
 - Norwich Union can withdraw from the process at any time if it does not believe such an exercise is in the interests of both policyholders and shareholders. However, were this to happen the shareholder would meet the full cost of the process.
 - If the reattribution is successful the estate is locked in until it is no longer required to support investment freedom, bonus policy, smoothing, security and new business. When it is no longer needed it can be released over time to shareholders. The minimum lock in period where the estate cannot be accessed by shareholders will be 6 years.
 - The shareholder is not guaranteed a return on the money it pays policyholders today. It is dependant on uncertain factors such as investment volatility, interest rate changes, changes in tax or regulation and the actions of policyholders

themselves. This means that shareholders take on 100% of the risk rather than their current 10% level.

- This uncertainty, together with the fact that the money is locked in the fund for many years (at least 6 years in Norwich Union's case) mean that it is not economic for shareholders to pay £1 to policyholders for £1 of today's estate.
- In summary, the issue is a commercial and economic one. From the shareholder perspective the question has to be asked is this the best use of scarce resources versus other financial opportunities. For policyholders the question is whether this a better deal than waiting for a potential, albeit uncertain, distribution on a 90:10 basis in the future.
- Norwich Union has distributed as much of the inherited estate as possible on a 90:10 basis. To distribute any more capital from the estate would undermine the performance and security of the fund to the disadvantage of both current and future policyholders.

Norwich Union is pleased to provide written evidence to the Committee's inquiry into the inherited estate and have addressed below all the questions raised in the initial call for evidence.

1. What is the inherited estate?

- 1.1 An inherited estate is money that has built up in a with profits fund over many generations, which is over and above the amount that is expected to be needed to meet current and future policyholder commitments and other obligations of the with profits fund.
- 1.2 From both a legal and regulatory perspective it is clear that the inherited estate is an asset of the company and represents its working capital. However, the amount of this asset is by no means fixed. It is perhaps best described as the difference between two very large amounts. These being the assets and liabilities of the with profit company, both of which are highly volatile and susceptible to external influences such as interest rates, equity movements and property markets. The simplest practical description of the inherited estate is that it represents the excess assets in a with profits fund over and above the money expected to be required to meet policyholder liabilities.

Please see the appendix for a full background to what makes up Norwich Union's inherited estate

2. What is a Special Distribution?

- 2.1 There are times when the value of the inherited estate rises to such an extent that not all of it is necessarily required to fulfil the objectives of providing security to stakeholders (d in Appendix 1). On these occasions we would consider whether to distribute some of this surplus capital with 90% going to current policyholders and 10% to shareholders. In February 2008, Norwich Union was able to distribute £2.4bn. Norwich Union is unable to distribute more without compromising the performance or security of policyholders' investments or its commitment to Treating Customers Fairly.
- 2.2 Given a special distribution is a benefit that cannot be expected under normal

circumstances and that the current generation of policyholders has not contributed to the estate there is no right answer with regard to how payouts from the inherited estate are made. The Board and the independent With Profits Committee (WPC) considered a range of options from an immediate distribution to one spread over a ten year period.

2.3 On balance the Board and the WPC concluded it was fair to distribute over three years because:

- It rewards loyalty - and policyholders have indicated that they support this
- It rewards the vast majority of existing policyholders (around 96 percent)
- It does not disproportionately reward a policy which has just been taken out, especially substantial, single premium policy types

2.4 There were also real concerns expressed by the Board and the WPC that the with-profits funds could become destabilised as a result of increased surrenders – which could seriously affect the potential returns of both remaining and future policyholders

2.5 Now this distribution of surplus capital has taken place a further sizeable special distribution is extremely unlikely in the short to medium term and existing policyholders are therefore unlikely to benefit from future distributions.

3. What prevents the entire inherited estate from being distributed to policyholders and shareholders on a 90:10 basis?

3.1. The primary purpose of the inherited estate is to support the features of with profits business and provide security to policyholders. This manifests itself in how the inherited estate is used to support the investment strategy of the fund and to deliver flexibility in the smoothing of maturity payments. It also meets the excess between the cost of guarantees and asset share, and provides capital to support the writing of new business.

- 3.2. As we enter a period of global economic volatility, the value of the inherited estate becomes more apparent. Norwich Union has concluded that the funds whose estate it is planning to reattribute should operate between a AA strength fund and a AAA fund to align with policyholder expectations. As a result these funds have survived and continued to provide good returns to policyholders despite many historic economic depressions, including both World Wars, the 1929 Great Depression and the 1974 OPEC oil shock.

4 What is a reattribution?

- 4.1 A reattribution is the legal process to decide how much (in cash) a policyholder should receive today to forgo their contingent rights to future uncertain distributions. It is heavily regulated, but by nature of being a negotiation has the potential to fail. If a fair deal cannot be negotiated, then the policyholders_ position does not change – they continue to enjoy the advantages and benefits of a strong and open with profits fund, supported by the inherited estate.

5 What ensures policyholders are treated fairly in a reattribution?

- 5.1 Norwich Union takes its responsibilities under Treating Customers Fairly seriously which is why from the outset we voluntarily designed a reattribution process with the policyholder at the heart of it. It is important to stress that in addition to all the other controls which form part of this regulated process the decision to accept any deal agreed by the policyholder advocate and Norwich Union ultimately rests entirely with the individual policyholder. The reattribution scheme that Norwich Union is proposing cannot and will not force any policyholder to accept the offer made to them. They can decide whether or not to wait for any potential future distribution. Their rights are not affected if they do not accept the offer.

- 5.2 Under the new process, the FSA has sought to address the disparity between the knowledge of providers and the understanding of consumers by creating the role of the Policyholder Advocate, backed up by available resource for a team of experts to ensure a balanced negotiation which results in a deal that is fair to both policyholders and shareholders.
- 5.3 The current process gives policyholders negotiating power in the commercial transaction. The sharing of the estate is influenced by their collective bargaining power and determined by their individual choice.
- 5.4 The role of the Policyholder Advocate delivers “collective bargaining” negotiating power for the policyholders – this means that any deal offered to them has been negotiated first with their interests in mind. The Policyholder Advocate does not replace the FSA’s role as regulator and in particular the FSA’s role to consider the fairness of the offer but provides a negotiating counterparty whose role is solely to look at the interest of policyholders.
- 5.5 As part of the regulated process Norwich Union are following, the terms of a reattribution also need to be supported by the independent With Profit Committee and commented upon by the Independent Expert in his report to the High Court. It should also not be forgotten that the FSA has an important over-arching role to act as the final arbiter of fairness above and beyond the policyholder advocate, but the decision to sanction the scheme lies with the High Court. All these controls are in addition to Norwich Union’s own commitment that it will only proceed with a reattribution if it is fair to both policyholders and shareholders.

Please see appendix 2 for more detail on the process of reattribution

6. The role of the With Profits Committee

- 6.1 The new majority independent With Profits Committee advise the Board on the day to

day activities of the with profits funds and ensures that the Board's ability to exercise discretion is subject to appropriate scrutiny and challenge.

7 Does the current process for reattribution, including the role of the policyholder advocate, work satisfactorily?

7.1 Norwich Union is committed to the policyholder advocate process as it gives a form of collective bargaining power to policyholders. To us, this seems fair. Its creation sought to protect policyholders from the potential conflict of interest between shareholders and policyholders that is inherent in a reattribution, and to distinguish between the role of negotiator and that of regulator. It also ensures that if the Policyholder Advocate and Norwich Union are unable to agree a deal which is fair to both policyholders and shareholders then the entire cost of the negotiation process will be met by the shareholders.

7.2 However, as this is the first time that such a process has been undertaken it is inevitable that there have been teething problems. Since we are in the middle of a legal process we cannot elaborate further at this stage beyond the following three observations, although we would be willing to discuss them with the Committee once the negotiation process is complete.

7.3 We would however make the following recommendations which we believe would improve the negotiation process:

- A timetable must be agreed and stuck to by both parties to avoid negotiations becoming open ended and unnecessarily protracted.
- The FSA must be able to intercede and act as a final arbiter on points of dispute.
- Firms must be free to set rigorous terms of reference.

7.4 Norwich Union chose a policyholder advocate who would provide policyholders with a strong voice at the negotiating table, and was given unrestricted access to all relevant

information because we wanted policyholders to have confidence that a fair process had been undertaken.

7.5 The principles which characterise the framework of negotiation are outlined by the FSA and it has set clear guidance about the policyholder advocate's role. Norwich Union is content that the framework, as established by the FSA, provides a fair and transparent process for policyholders whilst recognising that a reattribution is a commercial negotiation.

7.6 In summary, a reattribution is essentially a commercial and economic transaction. Shareholders take into account the high degree of uncertainty surrounding future release of capital and compare the investment needed to compensate policyholders today against the return the shareholders could receive by investing the same money elsewhere. Underlying this commercial foundation is a fundamental principle that any reattribution of the inherited estate must be fair to both policyholders and shareholders.

8 What are the wider benefits of conducting a reattribution?

8.1 It is historic legacy rather than deliberate design which has created much of the complexity surrounding with profits funds, and added to the perceived lack of transparency. The FSA's recent approach can be seen to seek to remove much of this complexity and introduce greater transparency and accountability which is welcomed by both Norwich Union and the wider industry providing that this is not at the expense of policyholder security and a degree of management flexibility which is necessary to support the with profits concept.

8.2 If large with profit providers are able to complete a reattribution successfully then many of the issues raised by the Select Committee in this inquiry will be addressed, for example the cost of mis-selling, cost of investing in new business and cost of transfer tax on releases of surplus will all be met effectively by the shareholder. In exchange for accepting these liabilities the shareholder will become entitled to the

benefits as and when they accrue in the form of releases from the reattributed inherited estate. A reattribution also gives the policyholders an immediate benefit from the inherited estate without weakening the fund or the security of present or future policyholders.

9 What expectations do policyholders have that they will benefit from a distribution from the inherited estate?

- 9.1 The expectation of policyholders of distributions from the inherited estate will derive from the insurers constitutional documents, policy literature, marketing literature, past practice and any relevant regulatory requirements. They will therefore need to be assessed on a case by case basis.
- 9.2 Norwich Union has always made it clear in policy literature and communications with customers that they should not expect a distribution from the inherited estate. Any distribution on top of their _asset share_ should be considered a windfall and therefore not something they can reasonably expect.
- 9.3 Policyholders as a group should, however, expect that if and when the Board determines that surplus assets have arisen then these assets may be available for distribution and in Norwich Union's case such distribution would be on a 90:10 basis. The exact amount and timing of a distribution will be determined by the company and its with profits committee.
- 9.4 No individual policyholder should have any real expectation of a special distribution since the company is under no obligation to distribute the inherited estate to any or all policyholders at any particular time and in addition to the uncertainty of the timing and amount of any such distribution the individual policyholder is affected by the uncertainty as to whether they will still hold the policy at the relevant time without which he will not in any event qualify to participate. However, on an aggregate basis, policyholders may have some reasonable collective expectation of a distribution of an

uncertain amount at an uncertain future time.

10 Why is the with profit company able to use the estate to pay for things which would ordinarily be paid for by the shareholder?

- 10.1 If you were to go back 200 years the only contract you could buy was a non-profit policy which simply promised to pay a benefit in return for a premium. However, due to limited actuarial tools companies were understandably very cautious in setting premiums and over time a surplus built up. For a limited company this was simply shared with shareholders. However, mutual companies decided to use this surplus, minus any costs incurred by the company, to increase guaranteed benefits and discretionary bonuses – with profits policies were born.
- 10.2 We believe it is misleading to say that the estate is being diminished in order to subsidise corporate activity. On the particular examples highlighted by the committee we would make the following comments:
- 10.3 **New business** – The suggestion that financing new business out of the inherited estate necessarily involves diminishing the inherited estate is misleading. The inherited estate does provide the capital to write new business but this capital is expected to be repaid (during the term of the policy) at a rate of interest equivalent to the "lost" investment earnings on the inherited estate. The inherited estate is therefore not reduced by writing new business.
- 10.4 The effect of financing new business capital in this way is to transfer part of the inherited estate from the current to the future generations of policyholders. This is a fundamental feature of with profits and has benefited previous and current generations of policyholders. Current policyholders benefit from an open fund which is able to maintain a high equity backing ratio and therefore invest in more risky assets with the potential for higher rates of return.
- 10.5 **Costs of Mis-selling** -New business is written for the benefit of with profit funds and

the benefits of this are divided 90:10 so it is logical for any costs arising to also be shared on a 90:10 basis.

- 10.6 **Shareholder tax** -This is not payment of the shareholders_ corporation tax bill or a tax payment on shareholder dividends as might be implied. Rather, it describes the incremental effect on the insurance company's tax charge of profits being released out of the with profits fund. Therefore, the effect of charging this tax to the inherited estate is not to subsidise the insurer's corporate activity or the shareholder's return but to ensure that the insurance company's shareholders actually receive their 10% share of distributions.
- 10.7 The Principles and Practices of Financial Management (PPFM) (which is available to policyholders) is clear that tax associated with shareholder transfers will be charged to the inherited estate and this is consistent with the constitutional documents for the fund and the treatment of other costs associated with operating with profits business.
- 10.8 **Strategic investments** – Strategic investments have been made by the company in the past to support its distribution and corporate strategy. Given that the funds benefit from new business it is sensible for the funds to invest in distribution opportunities that increase this opportunity.
- 10.9 Corporate investments have also been made where there are strategic benefits to the with profit company or parent company. Such investments do not impact the returns due to policyholders under the terms of their policies and can only be maintained whilst they continue to satisfy Conduct of Business Rules. Over the last fifteen years these investments have significantly outperformed the stock market and all profits from these investments have benefited the with profit fund and are shared on a 90:10 basis.
- 10.10 Furthermore, where the inherited estate does provide investment this is very often matched by investment directly from shareholders, ensuring that interests of

policyholders and shareholders are aligned.

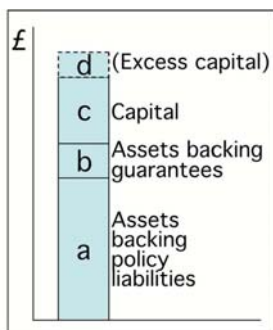
11 Does use of the inherited estate undermine a competitive long term savings market?

- 11.1 UK investors have a multitude of needs and whilst with profits are a very suitable product for some they are not right for all and the market has responded to this with a wide range of competing products.
- 11.2 If with profit funds were the only avenue open to people wanting to invest money for the long term then having an inherited estate which has built up over many years might be seen as an advantage and represent a barrier to entry – but this is not the case.
- 11.3 The long term savings market in the UK is highly competitive with numerous other products vying successfully for market share. A number of other insurance and non-insurance products offer alternatives to with profits products both to suppliers and consumers. If having an inherited estate resulted in an unfair competitive advantage then you would expect everyone investing for the long term to buy a with profit policy from insurers with an inherited estate but this is simply not happening.
- 11.4 Use of money from the inherited estate to support capital strain is not a subsidy since it must be repaid over a period of time.

Appendix 1 what makes up the inherited estate?

Fund assets comprise money / investments:

- (a) To back (or “equal”) policy liabilities; plus
- (b) To back guarantees attaching to those policies; plus
- (c) To mitigate risks to assets in (a) and (b) such as the risk of a stock market fall making asset values insufficient to back liabilities / guarantees (“capital”); plus, potentially
- (d) In excess of what is needed, because there is no realistic prospect of there being insufficient capital to support the fund (“excess surplus”).



All the fund assets are “at risk”, e.g. of values falling with stock markets, but when assets in (a) and (b) fall, their value is topped up from capital (c), so the capital changes to reflect the increase in the costs of guarantees. Broadly the inherited estate comprises the aggregate value of (c) and (d) from time to time.

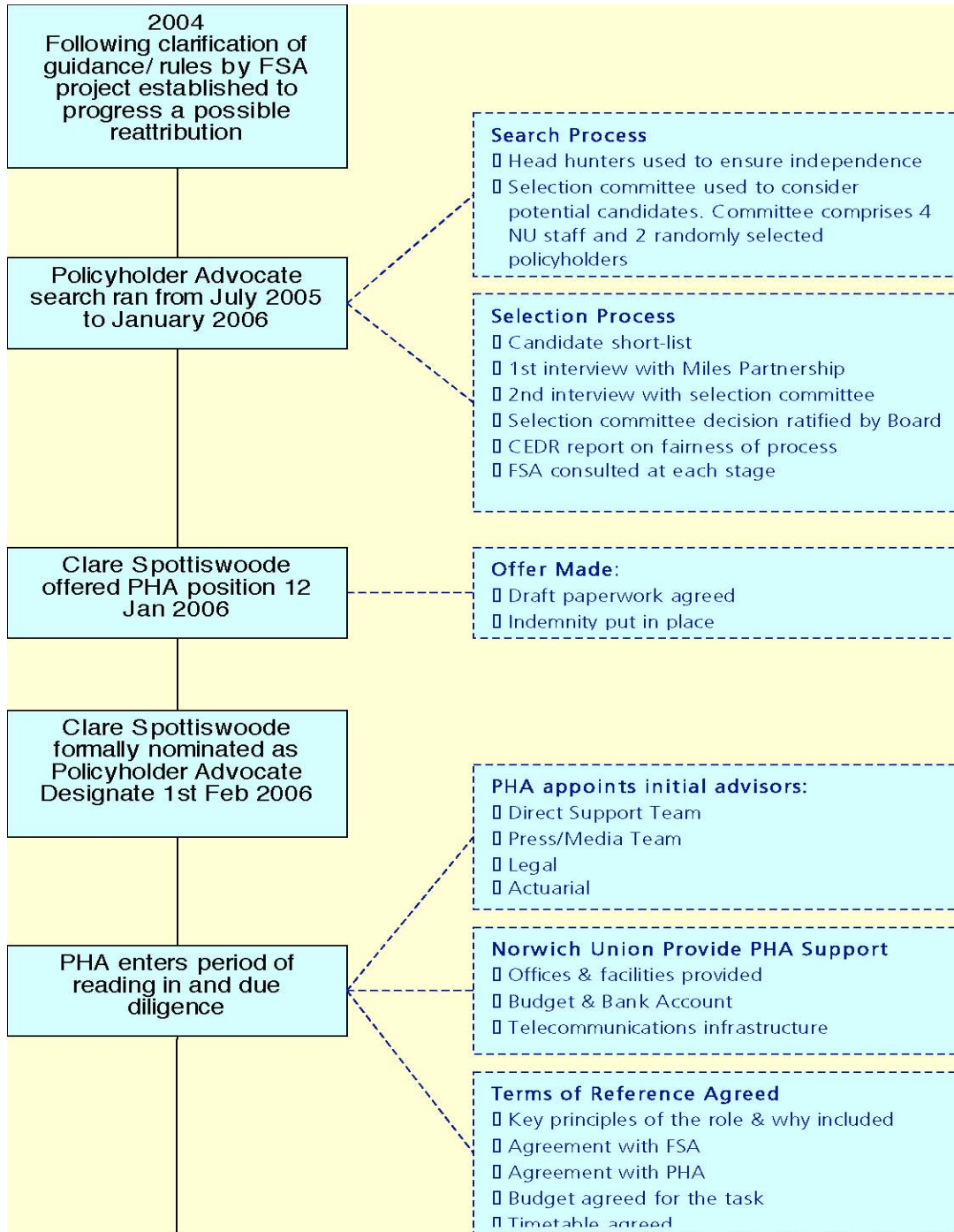
The FSA requires Norwich Union to hold a particular minimum amount of capital but requires Norwich Union’s management to determine the appropriate level of capital to be held in respect of its with profits fund. As the largest UK provider Norwich Union wants to maintain a high level of confidence in our funds and ensure that they will remain strong for the long term. Norwich Union therefore hold more capital than the minimum FSA

requirement. The amount we hold is determined by our risk appetite, which is a measure of the strength we want to maintain, taking into account Norwich Union's preferred strategy. Norwich Union's funds were sold to policyholders as very strong funds with high equity backing ratios.

In February 2008, Norwich Union was able to distribute £2.4bn which was created after Norwich Union reduced the capital required to meet the guarantees within the fund (b) through new de-risking techniques.

The remaining £2.6bn (as at 1 January 2008) within the estate (c) is not excess surplus since it is required to support the strength of the fund and it is therefore not available to distribute. At the end of 2007 fund strength was in the middle of AAA and AA whereas it is currently towards the bottom of this range following significant market falls and increases in market volatility in the first 3 months of 2008. The risk appetite of the fund must aim to remain within the range of AA to AAA because this is not only prudent in fluctuating economic conditions but is also the basis upon which the funds were sold to our customers.

Appendix 2 – The process of Norwich Union’s retribution



...

PHA enters period of reading in and due diligence
(continued)

Due Diligence

- ☐ PHA advisors review materials provided by NU
- ☐ PHA advisors request any further information required
- ☐ PHA & advisors understand proposals & confirm 'no show-stoppers'

Clare Spottiswoode appointed as PHA 21st November 2006 & formal negotiations commence

Further PHA Advisors In Place

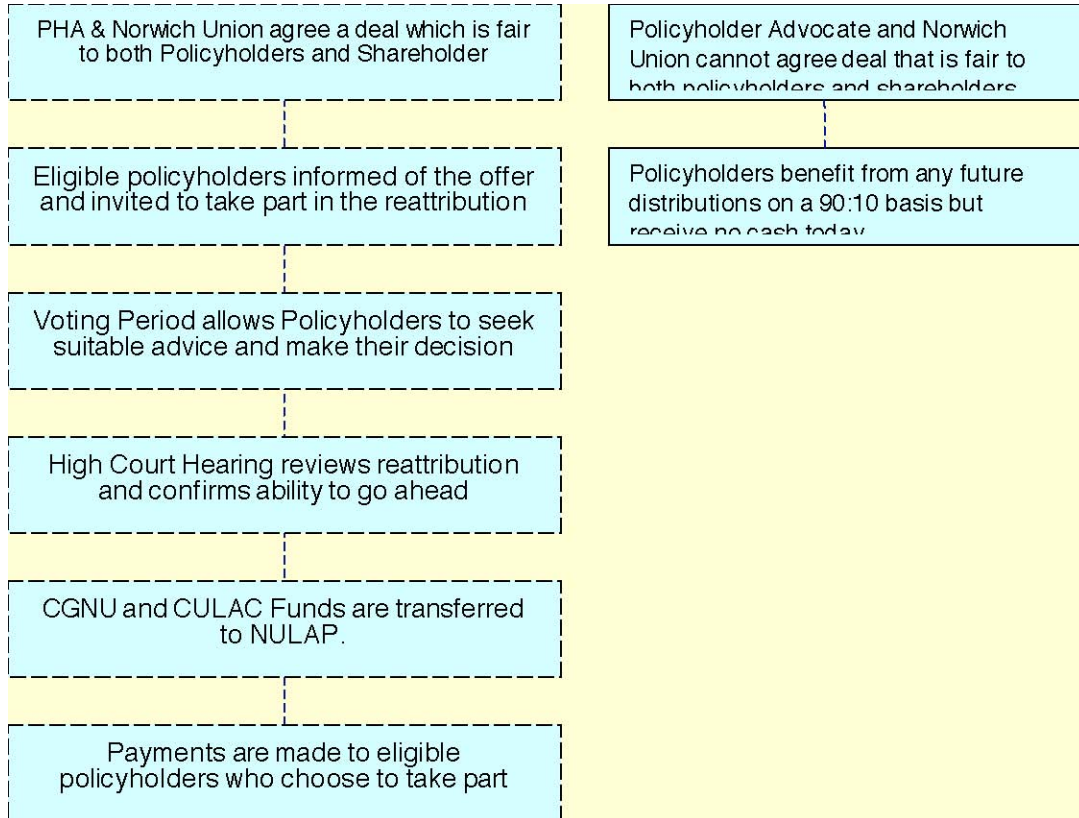
- ☐ LECG appointed
- ☐ Prism Group Established
- ☐ Merchant Bankers (Gleachers & FPK) and a number of professors retained to look at specific topics
- ☐ Hockley's (Internet & Print Media)

Early Consultation with policyholders

- ☐ PHA Website launched
- ☐ UGOV survey launched on website
- ☐ PHA Call Centre put in place
- ☐ Policyholders informed of appointment and potential eligibility
- ☐ PHA runs road-shows in February 2007
- ☐ Negotiations meetings commence
- ☐ Eligibility agreed December 2007

April 2008

Possible Future Events



5.00 Memorandum from the Financial Services Authority

The Treasury Select Committee
Inquiry into Inherited Estates
Memorandum from the Financial Services Authority

Introduction

1. This Memorandum is submitted by the Financial Services Authority in the context of the Committee's inquiry into inherited estates. We look forward to elaborating on it in oral evidence on 22 April. The Memorandum draws on material already published by the FSA, including guidance to firms and advice to consumers on the FSA website and correspondence with the Aviva Policyholder Advocate.
2. The Memorandum covers:
 - A. Introduction to with-profits;
 - B. Overview of inherited estates, distribution and reattribution;
 - C. The regulatory framework for a reattribution;
 - D. The FSA's role in a reattribution;
 - E. The role of the Policyholder Advocate;
 - F. The specific questions the Committee has asked the FSA; and
 - G. The general questions in the Committee's call for evidence (to the extent not covered elsewhere).
3. In the light of the current debate on reattribution proposals by insurance companies and the ongoing public debate on the fairness of such reattributions, we would like to make one point at the outset. In the case of a firm wishing to reattribute the inherited estate from its with-profits fund, it is entirely a matter for the firm itself whether to undertake a

retribution. However, if a firm does choose to, then the retribution needs to be conducted within the regulatory framework described in this Memorandum, including ensuring that policyholders are treated fairly. If there is no retribution, or if retribution negotiations do not proceed to conclusion, policyholders will not be worse off than they would have been if the negotiations had not begun.

A. Introduction to with-profits

4. With-profits products are sold as long-term investments, and have certain features which traditionally have included:

- Policyholder premiums are held in a pooled fund that is invested in a range of assets, a significant proportion of which are usually in equities and property;
- Certain guarantees, which usually increase over the lifetime of the policy - for example, the payment of a guaranteed amount at maturity or on retirement, or on death. The guaranteed amount may build through the duration of the contract by the addition of regular bonuses. A final bonus, which does not form part of this guaranteed amount, may be added at the end of the contract;
- ‘Smoothing’ of returns to policyholders, to cushion policyholders from the extremes of fluctuations in the property and equity markets; and
- Sharing in the profits or losses of the other business in the pooled fund, including, for example, those arising from mortality risks and expense risks.

Among other considerations, these characteristics give rise to capital requirements if the fund is to be able to deliver to policyholders the features they offer to provide.

5. The with-profits sector attracted particular scrutiny in the early part of the decade, prompted by concerns about: the high degree of discretion given to the insurance company's management over how the with-profits fund is operated; the complexity and opacity of the products; poor early surrender values; and a lack of consumer understanding of the nature of the risks. More recently there has been publicity about inherited estates and fund closures. A significant number of with-profits funds are now closed to new business (amounting to around £100bn out of £420bn in terms of with-profit liabilities).

6. In response to these concerns, in 2005 the FSA implemented a much improved regulatory regime for the with-profits sector (and insurance more generally). The overall objective has been greater policyholder protection. After extensive consultation, the new rules have delivered:
 - Rules and guidance to firms on the management of with-profits funds;
 - Clarity and disclosure on how management exercise discretion;
 - Express limits to that discretion in key areas; and
 - Improved assessments of the true extent of firm liabilities (to include guarantees) and of the resulting capital requirement.

7. Specifically, the main elements of this enhanced regulatory regime are:
 - Requirements for governance of firms' with-profits business in recognition of the conflicts that can arise between shareholders and policyholders; these include a requirement for independent input (possibly through a With-Profits Committee) and appointment of a With-Profits Actuary;
 - A requirement on firms to publish a document called 'Principles and Practices of Financial Management' (PPFM) and a consumer-friendly PPFM describing how they manage their funds;

- New rules to help firms determine what it means to treat customers fairly, that cover the decisions on payouts, surrender values and charges to the fund;
- Requirements for a firm to appoint a Policyholder Advocate (PA) to represent policyholders in negotiations with the firm in the event of a reattribution; and
- Rules about firms' obligations should a fund close to new business.

B. Overview of Inherited Estates, Distribution and Reattribution

8. An inherited estate is part of the with-profits fund. The inherited estate is the part of the with-profits fund over and above what is required to meet the fund's liabilities that the insurer retains as working capital. It will also include any excess surplus in the fund. It may in future be distributable to with-profits policyholders (see below). Legally the whole fund (including the inherited estate) is an asset of the insurer. In most with-profits firms the inherited estate has built up over many years, from premiums from past generations of policyholders and the investment returns on them, and/or past injections of capital from shareholders or reinvestment of shareholders' dividends. Our rules constrain the firm so that it cannot use the assets in the inherited estate in ways that are detrimental to with-profits policyholders.
9. The working capital required by the with-profits fund is of two kinds - the capital the FSA requires the fund to hold to ensure it can meet its liabilities in changing future circumstances; and the capital the firm chooses to hold to support the business. The FSA requires a fund to hold capital at a confidence level of 99.5% over one year, which is equivalent to a BBB credit rating, and is the minimum level of regulatory capital. However if a firm's risk appetite is in excess of the regulatory minimum, FSA's rules require it to hold capital commensurate with that risk appetite. And, for any given risk appetite, a fund will need to hold more capital if it chooses to hold riskier, more volatile assets. The working capital may be held inside the fund as a part of the inherited estate, or outside of the fund. In either case the capital is required until such time as policyholders'

interests can be sufficiently protected without it – for example, if the risks in the fund decrease in some way.

Distribution

10. Our rules require firms with with-profits funds to consider at least once a year whether the fund(s) contain an 'excess surplus' (which is a surplus over and above the value of the assets required to match the fund's liabilities and the amount required as working capital). If they do, firms must consider whether retaining it would be in breach of Principle 6 of our Principles of Business – "A firm must pay due regard to the interests of its customers and treat them fairly". We expect firms to be able to justify why it would not be unfair to keep the surplus assets, which are assets which are not required for the purposes of the fund's business. If the firm cannot properly justify retention of the assets then we would expect it to be distributed on a 90/10 (policyholder to shareholder) basis in line with the 1995 Ministerial Statement (see para 20 below), or other basis applicable to the particular fund.

Reattribution

11. In a reattribution, the firm chooses to negotiate to *reattribute* the inherited estate held within the with-profits fund so that it moves outside the fund. In order to do this, the firm effectively buys out the right policyholders have to a share of any future distributions from the inherited estate. Policyholders normally receive a one-off cash payment. This payment reflects the rights they are giving up and the value shareholders are gaining from the transaction. After paying policyholders, the firm gains control over the funds from the inherited estate. These funds will need to be kept for the foreseeable future to continue to provide the working capital as support for the with-profits fund and for this reason are not immediately payable to the shareholder.

12. As noted above, capital held as part of the inherited estate is needed as working capital (both to protect policyholders against adverse market conditions and to allow the fund to stay open to new business). It may therefore not be available for distribution to policyholders (and shareholders) in the foreseeable future and, indeed, may never be distributed during the lives of many current policies. Furthermore, during the time the capital is employed as working capital it can go up or down in value, and hence any future distributions, if made, would be of an uncertain amount. Therefore, in a reattribution, policyholders are being compensated for giving up their rights and interests to receive an uncertain amount at an uncertain time.

C. The Regulatory Framework for Reattribution

13. Firms who wish to carry out a reattribution must follow a process set out in FSA rules and guidance. The process is designed to ensure that:

- policyholders are treated fairly during the reattribution process, including by ensuring that there is someone completely independent of the firm (the policyholder advocate) representing policyholders' interests during the process;
- taking account of the circumstances in which the firm finds itself, the reattribution is within the range of reasonable outcomes available to the firm and takes due account of policyholders' interests and treats policyholders fairly; and
- the process itself is as open and transparent as possible.

14. Specifically, when undertaking a reattribution, we require firms to:

- identify and appoint a policyholder advocate (PHA) to negotiate (on behalf of eligible with-profits policyholders) the benefits to be offered to them in exchange for the rights and interests they are being asked to give up. The PHA must be approved by the FSA.

- notify us of the PHA's terms of appointment;
- depending on the legal process used, appoint an expert (called an independent expert or a reattribution expert) to assess objectively the reattribution proposals and prepare a report for the benefit of a Court and the FSA;
- send appropriate and timely information to every policyholder that might be affected by the proposed reattribution; and
- give eligible policyholders the option individually to accept or reject the proposals or, if the legal process being followed allows the majority of policyholders to bind the minority, to vote on whether the proposals should go ahead.

15. We require any firm that does propose a reattribution to comply with our Principles for Business. For example, the firm must act with integrity, have due regard to their policyholders' interests, must ensure that their policyholders have adequate information and must avoid or manage conflicts of interest. Policyholders must be treated fairly during the reattribution process and as a result of the reattribution.

16. We recognise that firms have different circumstances and may adopt different legal procedures to achieve a reattribution. For example, some firms may give effect to a reattribution using the transfer of business procedures in Part VII of FSMA. Other firms may use the procedures in Part 26 of the Companies Act 2006. In each case the Court will have a role in deciding whether it is appropriate for the reattribution to go ahead. Our rules will accommodate these different legal processes.

D. The Role of the FSA in a Reattribution

17. Our role in a proposed reattribution is to scrutinise the fairness of the proposals.

18. In relation to the negotiation between the firm and the PA, the FSA also has a duty to oversee the process and to assist in the process where appropriate, but we are not a party

to the negotiation between the PA and the firm. In carrying out this role, we look at whether it appears that the PA and the firm are able to conduct a full and fair negotiation.

19. Once the PA and the firm have completed their negotiations, we form a view on whether the overall proposals are fair to policyholders. In doing so, we take into account the interests of all policyholders, including the relevant with-profits policyholders, and the implications of the proposals for the financial position of the firm. We consider carefully the detailed information provided to us by the firm and other relevant stakeholders. The information provided by the firm will include the views expressed by the firm's with-profits actuary. We take into account the report prepared by the independent expert or reattribution expert (who is required to undertake an objective assessment of the proposals and to report on this) and the report prepared and the opinions expressed by the PA. We ask the firm to demonstrate to us that the proposals are fair and that they are consistent with all other relevant FSA requirements.

20. In a reattribution of a 90:10 fund, our assessment of fairness starts with the principle set out in the Ministerial Statement of February 1995 – namely, that the basis of *distributions* to policyholders and shareholders will be in the proportions of 90% and 10% respectively. If the *reattribution* proposal is to divide value between policyholders and shareholders on a basis that is different from this 90:10 starting point, we look at the basis for that proposed division and decide whether it is fair, compared with policyholders awaiting a potential future 90:10 distribution. (There is no guarantee that circumstances will arise in which the inherited estate will become available for distribution. Therefore what is at stake for the current policyholders is the certainty of receiving a payment now from the reattribution against the possibility of an uncertain amount at an uncertain time in the future – see also paragraph 10.)

21. We will also focus on the fairness of the offer being made to policyholders vis-à-vis the overall benefit to the shareholder. One of the ways we approach this is to review the return to the shareholder.

22. Where the firm and PHA agree that a reattribution deal should be put to policyholders, our assessment of fairness will form part of our submission to the Court (and so will be made public). Our assessment of fairness will include the range of outcomes that we assess to be fair. Making our assessment of fairness public at this stage is consistent with our commitment to act transparently. Should the two parties agree that a deal can be put to policyholders and that it would facilitate the process to know our preliminary view on fairness (including the range of outcomes), we would privately inform the parties at that point.
23. We will make our assessment of fairness before the reattribution proposals are put to policyholders by the firm. If we conclude that the proposals are unfair to policyholders, we will take steps to prevent the firm from putting the deal to policyholders.

E. The Policyholder Advocate's role

24. The precise role of the Policyholder Advocate (PHA) will depend on the type of firm concerned and the nature of the reattribution proposals. We developed the PA role so that with-profits policyholders have an informed and independent person, properly supported by advisers, who can negotiate on their behalf with the firm; this is particularly important, given the complex nature of with-profits business. The negotiation centres on the value of the benefits which will be offered to policyholders in exchange for the rights or interests they will be asked to give up. The PA can challenge any part of the operation of the with-profits fund in the course of negotiations with the firm.
25. A key responsibility of the PHA is to explain to policyholders whether, in the PHA's view, the firm's proposals are in their interests. In particular, the PA compares the firm's proposals for a reattribution with the position as it would be if the reattribution did not go ahead. The PHA takes into account the probability that there may be *distribution* of surpluses in the future and other factors such as the value that should be attached to capital

retained to finance new business. If the PHA does not believe that the proposals are in the interests of policyholders, he or she should communicate that conclusion to policyholders.

F. Specific questions addressed by the Committee to the FSA

Has the FSA raised the potential competition implications of the rule which allows companies to use the inherited estate to finance new business with the Office of Fair Trading?

26. We have been in contact with the Office of Fair Trading on this issue and understand that they will be making their own position clear.

What is the view of the FSA on Norwich Union's proposal to stagger distribution payouts over 3 years (so that people whose policies mature before 1 January 2010 do not receive the full amount), and does this comply with FSA rules and the FSA's requirement to Treat Customers Fairly?

27. We review the nature and scale of the proposed distribution against our Principles for Business, in particular against the need for a firm to maintain adequate financial resources, to treat its customers fairly, and to communicate in a manner which is clear, fair and not misleading.

28. As noted above, firms should distribute excess surplus to policyholders if they do not have a proper justification for retaining it. However, the phasing of such distributions can have advantages for policyholders. Receipt of a single lump sum could create an incentive for some policyholders to cash in their policies. In determining how large a payment is appropriate and how to phase payments, the firm needs to guard against the risk of a significant increase in surrenders of policies and so protect the strength and security of the

continuing fund for remaining policyholders. Phasing payments may help to mitigate this risk. Whilst this will mean that those policies which mature during the three years will be eligible for only part of the distribution, it serves to protect the continuing interests of those policyholders who remain in the fund. A firm needs to consider the interests of all groups of policyholders in ensuring that the actions it takes are fair.

Will the FSA be encouraging other life assurance companies (for example, the Prudential) to follow Norwich Union's decision to distribute its excess surplus?

29. As noted above, our rules require firms with with-profits funds to consider at least once a year whether the fund(s) contain an 'excess surplus' (over and above the working capital of the fund). If they do, we would expect it to be distributed on a 90/10 basis, or other basis applicable to that particular fund, in line with the 1995 Ministerial Statement.

30. It is for the senior management of firms, advised by their Actuarial Function Holder, and with input from their With-Profits Committee or equivalent, to decide whether an excess surplus exists and what they should do with it. No two companies are alike and each, in light of the risk appetite determined by the Board, will need to consider the level of regulatory and working capital they will need taking account factors, such as:

- The degree of (in particular) investment risk that policyholders have been accustomed to taking in the with-profits fund;
- Level of guarantees given to policyholders;
- Investment policy of the fund;
- Management actions that a company is permitted to apply (in accordance with its PPFM) to protect its financial position;
- Projected new business volumes.

31. As part of our supervisory work we challenge firms on the decisions they make on how much of any surplus they should retain, for example, to support new business, strategic investments and the firm's risk appetite, and how much might be available for distribution.
32. If a firm looks to retain, rather than distribute, an excess surplus without being able to justify why they are not being unfair in doing so, then we will take appropriate regulatory action.

According to the FSA's Conduct of Business Rules, a firm must assess whether there is an excess surplus in the inherited estate every year, and make a distribution or carry out a reattribution if having this surplus is a breach of Treating Customers Fairly. Given that the Prudential's inherited estate is estimated at £8.6 billion, has the FSA made an assessment of whether the Prudential was in breach of these rules?

33. A firm will normally carry out an assessment of whether it has an excess surplus in its with-profits fund by reference to, amongst other things, a Financial Condition Report (FCR) prepared by the firm's Actuarial Function Holder. The FCR is ratified by the Board of the firm before submitting it to the FSA. We then challenge the firm on the basis on which this decision has been reached in order to satisfy ourselves as to the adequacy of this decision within the requirements of our rules. Recent discussions with Prudential have centred on the FCR submitted for the year end 2006 and are on-going.

G. Questions asked by the Committee as part of its Call for Evidence

The extent to which life assurance companies should be permitted to diminish inherited estate in order to subsidise corporate activity, including financing new business, making strategic investments, paying shareholder tax and paying the costs of compensation for mis-selling.

34. Our rules require firms to ensure that they do not use the inherited estate in ways which would adversely affect existing policyholders. We set out below some of our expectations of firms in managing and using the inherited estate, including in managing the conflicts of interest between policyholders and shareholders in the inherited estate.

FINANCING NEW BUSINESS

35. In principle, we agree that the inherited estate can be used to provide capital to back new business in the with-profits fund where this does not have a material adverse effect on the interests of existing policyholders. Writing new business utilises capital that is subsequently released back over the life of the policies. This is because regulatory requirements and accounting conventions prevent the full expected economic value of the new business from being immediately brought onto the firm's balance sheet. The writing of new business, even where that business is expected to be profitable, will usually be associated with relatively heavy administrative, commission and set-up costs in the initial period. We consider that it is acceptable to use the assets in the inherited estate to meet those initial costs, provided the business is managed with a view to recovering those costs over a reasonable period.

36. The volume and pricing of the new business is key, and our rules do not permit, for example, the marketing of loss leaders or a firm to persist in marketing products where actual volumes experienced are insufficient to justify costs. We monitor this as part of our ongoing supervision.

37. One of the results of writing new business into the fund is that the fund, or the inherited estate, is then effectively supporting the new policies as well as existing policies. This transfers the benefit of the inherited estate between the generations of policyholders and is an intrinsic feature of with-profits business where a fund is open to new business.

38. While relevant during the normal course of supervision, at the time of a reattribution process, we take particular interest in reviewing the firm's assumptions for its new business flows post-reattribution. We will consider the significance of the assumptions about the volume and nature of new business which the firm expects to undertake, and whether the firm's assumptions are reasonable in the context of the reattribution scheme.

PAYING TAX ON TRANSFERS TO SHAREHOLDERS

39. With-profits funds are not taxpayers and do not have their own separate official tax assessments. The firm is the taxpayer. Its corporation tax assessment takes into account factors including some arising from its with-profits business. The firm makes a charge to its with-profits fund as a contribution towards its overall corporation tax liability.

40. Our rules provide that the maximum amount of this charge is the notional corporation tax for which the with-profits fund would be liable if it were, itself, a taxpayer subject to its own separate tax assessment. We expect firms to carry out the exercise of doing this computation each year. Two elements of this corporation tax are:

41. Firstly, the tax on the investment returns from assets that back policyholder benefits. We consider this element of corporation tax to be an appropriate charge to the fund because the investment returns help to increase the policy benefits to policyholders.

42. Secondly, part of the tax liability arising within a with-profits fund comes about when there is a transfer of money from the with-profits fund to shareholders. Firms are not permitted to charge any of this part of the with-profits funds' tax liability which is identified with a distribution to shareholders to the with-profits fund unless it has been their established practice to do so and that established practice is disclosed in its PPFM (which will include disclosure in the consumer friendly PPFM where tax is material). We concluded at the time, and continue to believe, that this is reasonable in the context of the wide-ranging review we undertook and the overall framework of policyholder protection which was introduced.

FINANCING STRATEGIC INVESTMENTS

43. Our rules also allow firms to make 'strategic investments' - investments in businesses in which the firm, or an affiliate of the firm, has an interest - using assets in the inherited estate.
44. Firms can undertake such investments and continue to hold those investments as long as they do not prejudice the interests of existing policyholders. When reviewing such investments, we expect firms to consider whether the purchase or retention of such an investment is fair to its with-profits policyholders. We expect firms to consider the likely returns from the investment compared with other activities which the firm might undertake and the risks associated with the investment. We also expect firms to review such investments on an on-going basis to ensure that they continue to be suitable. We monitor this as part of our ongoing supervision work.
45. While relevant during the normal course of supervision, at the time of a reattribution process, we take particular interest in considering any strategic investments held in the with-profits fund and whether their continued retention, or the making of the initial investment, appears fair. If we have reason to doubt that the investments were made or retained in line with our rules and guidance, we will consider appropriate regulatory action.

PAYING MIS-SELLING COMPENSATION COSTS

46. Our rules currently allow firms to charge mis-selling compensation costs to the inherited estate on the basis that with-profits policyholders share in both the gains and losses arising from the business in the long-term fund. In the light of representations received on this and the above three uses of inherited estates, we have recently reviewed all aspects of our rules in this area. In the light of the strength of views now put to us, we have decided to invite views on the issue of charging mis-selling costs, and on whether, given the nature of those costs, they should be borne solely by the shareholder. We will consult during the

first half of 2008 on whether we should change our approach to require shareholders to meet mis-selling costs.

Whether allowing life assurance companies to use inherited estate to subsidise corporate activity has any adverse effects on competition.

47. We do not accept that life insurance companies are allowed to use assets in their with-profits funds to subsidise corporate activities. In fact, there are fewer regulatory constraints on the use of surplus assets in long-term funds that do not contain any with-profits business. Moreover, we have seen no evidence that the uses of assets of with-profits funds that we permit give rise to any adverse competition issues. The two life assurance firms that have written the largest amounts of business in recent years have no with-profits business and therefore no inherited estates. In 2006, the last year for which we have data, only 5% of all new life and pensions business was with-profits business and approximately 80 firms wrote only other than with-profits business (most of whom had no inherited estate). We understand that the OFT will be making their own report on this matter.

Whether policyholders' reasonable expectations of distributions from inherited estate should be zero or have a positive value.

48. Policyholders have a right to a share of a distribution from an inherited estate if one is made. There is no guarantee that a distribution will be made during the lifetime of their policy and policyholders have no right to a distribution during the life of their policy. In line with the Ministerial Statement of 1995, the right to a share in any distribution gives policyholders as a class an interest in any surplus retained in the inherited estate. That interest has no absolute value unless and until a distribution is made, and it is not an interest of any individual policyholder. In the context of a reattribution, however, its value can be negotiated and we expect a value to be placed on it and paid to current policyholders in a reattribution. As we confirmed in our oral evidence to the Committee in January 2008, we take the view therefore that policyholders' interests are not zero.

THE ROLE OF THE WITH-PROFITS COMMITTEES OF LIFE ASSURANCE COMPANIES

49. As part of the enhanced regulatory regime for with-profits introduced in 2005 we introduced guidance requiring firms to have in place governance arrangements which: are 'appropriate to the scale and complexity of their with-profits business'; which 'involve some independent judgement in the assessment of compliance with the PPFM; and explain 'how any competing or conflicting rights and interests of policyholders and, if applicable, shareholders have been addressed.' The independent judgement can be provided in different ways including, but not confined to, establishing a With-Profits Committee which includes some non-executive directors and external non-directors, or using an independent person with appropriate skills to perform the role.
50. We require a firm's governance arrangements to support the overall outcomes we are seeking – that firms should treat their policyholders fairly and manage their conflicts of interest effectively. We expect senior management of firms to ensure that they consult their with-profits governance arrangements on all significant issues affecting with-profits policyholders' interest (e.g. changes to investment strategy, charges and bonuses). These governance arrangements should also be able to provide an independent challenge in the firm's overall assessment of how any conflicts of interest between policyholders and, if applicable, shareholders have been addressed.

14 April 2008

6.00 The FSA's response to the Treasury Committee Report

Treasury Select Committee

Report into Inherited Estates

Response from the Financial Services Authority (FSA)

6 October 2008

Introduction

1. We welcome the Committee's report into inherited estates. In this paper we respond to the Committee's detailed points and we set out the work which the FSA is planning or already undertaking to review aspects of the with-profits regime. Where future work is planned we will keep the Committee informed about developments.
2. We recognise that the supervision of the with-profits sector generally, including in relation to inherited estates, remains an area of significant interest for a wide range of stakeholders. It also remains high on our agenda. Although new with-profits business has significantly reduced, some 31 million with-profits policies are still held by consumers supported by £400bn of assets⁴. We continue to believe that with-profits products are a useful part of the savings market.
3. We embarked on a major reform of the regime for the regulation of with-profits in 2001-2002. At the time we recognised that the management of with-profits funds was too opaque and allowed firms too much discretion. We increased the transparency of the operation of funds and introduced new limits to management's discretion.
4. The current regime is the result of that process and delivers protection for holders of with-profits policies on a day-to-day basis across all the firms in the sector (for further details see our written evidence to the Committee in April 2008). We regard our current

⁴ Figures as at end of 2007

regime as a great improvement on what went before, but as with all FSA regulation, we do seek to provide clarification and further guidance as necessary.

5. Since the introduction of the regime, we have published a number of clarifications of our expectations, and have published these on our website⁵. We have also continued with supervision of the sector and have discussed the application of our rules with individual firms.
6. Specifically, in the case of the Aviva and Prudential reattribution transactions (the latter terminated by the company at an early stage), we believe our rules, which are aimed at the protection of policyholders, have performed well. In relation to the Aviva transaction, we have expressed the preliminary view that the reattribution proposal negotiated with the Aviva policyholder advocate is fair, based on current market conditions.⁶ The policyholder advocate has said that it is a good proposal in all respects for with-profits policyholders. In the case of the Prudential transaction, the company's decision to halt the transaction has had no detrimental impact on policyholders.
7. Whilst noting the Committee's detailed recommendations, our response to the Committee's report has two key elements outlined here:
 - Firstly, at paragraphs 12 to 15 we set out the lessons we have learned about the process of reattributions from our experience during the ongoing Aviva transaction and the Prudential transaction, and how we believe these will lead to process improvements in the future.

⁵ http://www.fsa.gov.uk/Pages/Library/Other_publications/Profits/index.shtml; see also our two sector briefings on closed funds at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2005/127.shtml> and http://www.fsa.gov.uk/pubs/other/isb_withprofits.pdf

⁶ <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/084.shtml>

- Secondly, at paragraph 36 we set out how, three years into our new regime, we plan to conduct a review of how senior managements of with-profits firms have implemented our new regulatory framework.
8. Additionally, as the Committee is aware, and we detail at paragraph 18, we are currently re-consulting on the appropriateness of charging mis-selling costs to the inherited estate.
 9. Further to these pieces of work underway or planned, we would like to comment on some of the specific points raised by the Committee and do so here by grouping our response into several broad categories:

The process of a reattribution

10. A number of the Committee's points relate to the process of the reattribution, and the role and responsibilities of the various parties (particularly the policyholder advocate).
11. We agree with the Committee that reattributions are highly complex transactions. We agree that a principles-based approach is the correct one for regulating the area, but also, as the Committee acknowledges, that there are areas in which it is inevitable that a close and detailed scrutiny of firms' proposals will be required.
12. The recent Aviva re-attribution, and the Prudential transaction, have provided us with significant experience of operating the new reattribution regime in practice. In the light of this experience, we have considered what aspects of our regime may benefit from clarification or potential change. These fall into three categories.
13. First, we believe it is now helpful to publish in more detail the outcomes which the FSA would expect a deal to achieve before it could be put to policyholders, or – put another way – the fundamental criteria which the FSA will consider in forming its preliminary view of whether a reattribution is fair. Of course, there will be different circumstances for each reattribution, so whilst the outcomes represent a position from which we expect

to begin our considerations, they may not be the only relevant points⁷. These outcomes are set out in the table below:

Figure 1: Outcomes used by FSA to judge the appropriateness of reattribution transactions

The FSA will consider a reattribution proposal against these intended outcomes:

- The deal offered to policyholders is fair vis-à-vis the benefits received by shareholders and takes account of both the value to current policyholders of the possibility of future distributions and the value shareholders will unlock from the whole of the inherited estate by its reattribution;
- The proposals are fair between groups of policyholders;
- Policyholders' benefit security is no worse under the proposals than if the reattribution does not take place;
- Ignoring the scope for future distributions, policyholders' benefit expectations are no worse under the proposals than if the reattribution does not take place;
- The reattribution provides a genuine choice for policyholders. The implications of the choice must be capable of clear communication; and
- Those policyholders who vote to oppose the transaction should be no worse off than if the transaction does not take place.

⁷ It is important to reiterate that the FSA's role is to form its own view of the fairness of the proposed transaction, (for the purpose of deciding whether or not to object to the transaction, and whether to exercise our regulatory powers), and that will be at first a preliminary view and then, once all relevant information is available, a final view which we will communicate to the court. In communicating a view on fairness to the court our intention is to assist the court, which will make the decision whether or not to sanction a reattribution and in doing so will form a view of whether the scheme as a whole is fair.

14. Second, there are a number of aspects of a reattribution process which we believe could be improved by providing either informal clarifications or formal changes to our rules and guidance. In order to ensure that we take into account lessons learned from all aspects of the reattribution process, we will communicate fully on these once the current Aviva transaction has completed its court process, which is expected to take place in late spring 2009. However, the table below sets out the areas where we currently believe that improvement could be made:

Figure 2: Potential improvements to the guidance on reattributions

<p>We believe that there would be benefit in the FSA:</p> <ul style="list-style-type: none">• Publishing further information on the roles and responsibilities of all the parties to a reattribution;• Specifically, setting out in more detail what we expect to be included in a policyholder advocate's terms of reference, including his/her responsibility to negotiate the best deal for policyholders, and details of his/her ability to communicate with policyholders; and• Setting more detailed expectations about policyholder communications more generally (including from the firm).

15. Finally, we also believe that there may be benefit in requiring a firm to receive our permission before announcing a reattribution. In this situation, we would give such permission only when the firm was ready to appoint the PHA (with terms of reference agreed by us) and also in a position to carry out the capital modelling necessary to negotiate. This would prevent the premature announcement of a reattribution (with attendant uncertainties for policyholders), without imposing any constraint on the time allowed for the two parties to negotiate. We will explore the advantages and disadvantages of this option and consult on it if necessary in the first half of next year.

Use of the inherited estate

16. We welcome the Committee's agreement that it is reasonable for the inherited estate to be used to provide capital to back new business in the with-profits fund where this does not have a material adverse effect on the interests of its existing with-profits policyholders.
17. In view of the Committee's comments, we will include further scrutiny of this area in our forthcoming review of the way in which firms have implemented the with-profits regime (see paragraph 36). In the meantime, while we have seen no evidence that the uses of assets of with-profits funds that we permit give rise to any adverse competition issues, we will provide the OFT with any assistance it seeks in reviewing the competitiveness of the market.
18. As the Committee notes we have consulted on the charging of mis-selling and compensation costs. We have received a substantial response to the consultation, representing a wide spectrum of strong views. We are currently considering the responses and intend to issue a policy statement before the end of the year.
19. On charging of shareholder tax to inherited estates, we have acknowledged that the judgement is a difficult one. We do not think the position is as clear cut as the Committee argues.
20. With-profits funds do not have their own separate tax assessments. Instead, the firm makes a charge to its with-profits fund as a contribution towards its overall corporation tax liability, where its corporation tax assessment takes into account factors including some arising from its with-profits business. In particular, our rules allow firms to apply to the with-profits fund a charge which must be no higher than what the fund would pay, if it were a separate entity for tax purposes.

21. The taxation of life insurance companies is very complex. In this response we will refer to just two of the elements involved. The first is the tax on investment returns from assets that back policyholder benefits. We understand from paragraph 47 of the Committee's report that this element is accepted as reasonable and is not the subject of the subsequent paragraphs.
22. The second element is the tax liability on any surplus arising that is not reserved for policyholders. Firms are not permitted to charge any part of this tax liability that relates to transfers to shareholders to the with-profits fund unless it is their established practice and has been disclosed in their Principles and Practices of Financial Management (PPFM), a document produced by the firm which sets out how the with-profits fund will be run.
23. We do not believe - as the quotation from Which? in paragraph 49 of the Committee's report implies that we do - that the charging of this element of tax is "*wrong*" in principle. In the context of a wide-ranging review of our rules, which imposed a number of significant constraints on the uses of capital in the with-profits fund, we remain of the view that the decision to permit this specific practice to continue where it was disclosed to new and current policyholders was reasonable. We of course in accordance with usual practice keep this rule, along with the overall framework, under review.
24. More generally, we believe that our framework of rules already covers the range of activities that might take place in managing a with-profits fund⁸ and the ways in which firms might use their discretion in doing so. Therefore we do not currently believe that there is a need to specify more closely the uses to which a with-profits fund can and cannot be put, over and above those rules and guidance which we have already issued. We believe that our Handbook sets out very clearly the principle underlying these rules and we reproduce this wording below.

⁸ Our framework of rules generally applies to the with-profits fund as a whole – not just the inherited estate. There are just a few instances where we make a distinction and make specific reference to the inherited estate.

25. Specifically, our rules (COBS 20.2.1G) say, “With-profits business, by virtue of its nature and the extent of discretion applied by firms in its operation, involves numerous potential conflicts of interest that might give rise to the unfair treatment of policyholders. The rules in this section address specific situations where the risk may be particularly acute. However, a firm should give careful consideration to any aspect of its operating practice that has a bearing on the interests of its with-profits policyholders to ensure that it does not lead to an undisclosed, or unfair, benefit to shareholders”.
26. We expect firms' with-profits governance arrangements to scrutinise very closely the uses of the fund and any changes to them which the firm proposes, and we intervene if we believe that such changes might jeopardise the fair treatment of customers.

Excess surpluses and special distributions

27. We require firms to maintain adequate resources to support their with profits business, both in the ordinary course of that business and against adverse effects. However, as we have said in our previous evidence to the Committee, if the with-profits fund has assets beyond those that the firm can reasonably justify as being needed for this purpose, we take the view that there is then a presumption that a distribution should be made.
28. In respect of the identification of excess surpluses, this forms part of our review of the end-of-year returns provided annually by all with-profit firms. We have challenged firms on their submissions where we believe that is appropriate.
29. In establishing whether an excess surplus exists, firms need to make assumptions about the future volume of new business. There are clearly incentives for the shareholder to overstate the quantity of new business, so limiting the size of excess surplus / distribution. The Committee rightly points out that this incentive also exists in the context of a reattribution. It is therefore essential that the With-Profits Committee (or

similar arrangement) scrutinises carefully and where necessary challenges new-business forecasts, and also that – where a reattribution is in prospect – the policyholder advocate does the same. We also intervene in the course of our supervision where we see forecasts that appear unjustifiable and which might jeopardise fair treatment.

30. Considering the possible phasing of any special distribution, our rules do not include any requirements as we believe this should be assessed in the light of the particular circumstances of the firm at the time. It would be for firms, having taken advice from their With-Profits Committee (or similar arrangement), to determine a fair basis for the distribution.
31. In the case of Aviva, as the Committee is aware, the With-Profits Committee was in favour of the phasing of the distribution.

Governance and Smoothing

32. We intend the With-Profits Committee (or alternative governance arrangement) to be an integral and powerful part of a firm's decision making procedures – although final decision making powers and the responsibility to treat policyholders fairly rest with the firm's Board.
33. We note the Committee's recommendation that firms should improve the transparency of their smoothing process. We strongly support transparency in principle but we also recognise that wider questions of fairness and stability need to be considered. We believe, therefore, that it is a matter of getting the right balance.
34. Our current rules deal with the matter of smoothing in a number of ways.
 - a. First, in relation to individual policy payouts, we require firms to publish the limits within which their smoothed payouts can vary from the policy's asset share. (We also have a rule that limits the amount of any market value

reduction that can be applied to certain types of with-profits policy as a means of reducing or suspending upwards smoothing.)

- b. Secondly, we have a requirement that firms must operate smoothing in a way that is neutral over time so as to avoid either systematic over-distribution or the accumulation of an inherited estate. This requirement, together with that in the preceding paragraph, sets out the framework within which firms must operate smoothing.
- c. And finally, larger firms have to disclose, in their annual returns, the amount of their with-profits fund that is earmarked to support smoothing. The change in this amount from year to year gives some indication of the effects of the smoothing that has taken place over the last year. This requirement allows monitoring of how the firm has actually applied smoothing in practice. We do not support more detailed disclosure as it is also important that the fund is not destabilised by policyholders surrendering policies simply to take advantage of times when smoothing has been upward.

Review of Implementation of the Regime

- 35. The existing with-profits regime has been in place for three years. While we supervise individual firms as issues arise, we have not yet carried out a systematic information-gathering exercise to determine conclusively how senior management in firms have implemented the rules, individually and collectively. We believe now is the right time to do that. We will therefore be conducting a comprehensive review. We aim to publish the results of this review by the end of 2009. It will enable us to focus our supervisory attention on areas of concern, and consider whether aspects of the rules need amendment or clarification.

Note on mutuals

36. Reattributions are most relevant to proprietary companies. However, we are aware of concerns in the mutual sector about the application of our rules to mutual insurers, and in particular to the interests of the various stakeholders in a mutual business. We are currently giving further consideration to these and will set out our position before the end of the year.

7.00 Memorandum from the Office of Fair Trading

OFFICE OF FAIR TRADING



Treasury committee inquiry into inherited estates

April 2008

OFT993

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EXECUTIVE SUMMARY

The Office of Fair Trading (OFT) is responding to an invitation for written evidence issued by the Treasury Select Committee (the TSC) on its inquiry into inherited estates held by life assurance companies' with-profits funds.⁹ This paper considers the extent to which the permitted uses of these inherited estates have any adverse effects on competition. We do not consider issues of consumer fairness in the distribution of the estates as it is more appropriate for the Financial Services Authority (FSA) to comment upon these issues.

In drafting this paper we have had a series of discussions with the FSA on factual issues and also received information from Which?. Our analysis draws upon these discussions as well as other information held in the public domain. Given time constraints, we have not consulted industry representatives.

With-profits is the name given to a class of investment products that smoothes out returns on money invested over the period of time the policy is held, limiting returns in years of good investment growth in order to top up returns in less successful years. In addition to the smoothing of benefits, they often offer investors guaranteed minimum payouts from a pooled investment fund.

One of the features of a with-profits fund is the existence of the inherited estate, which is defined as those assets set aside, over and above the fund's realistic liabilities.

The inherited estate consists of working capital which under the FSA definition 'supports the business of the with-profits fund... [and] other uses for the fund

⁹ Treasury Select Committee Press Notice No. 26 issued on 26 February, 2008

such as funding new business'. It is inherited in the sense that it is made up of many generations of policyholder and shareholder contributions.

If in any given year the size of the inherited estate exceeds what a company can justify as necessary working capital to support the fund the surplus is commonly distributed between policyholders and shareholders, in accordance with FSA rules on treating consumers fairly. In some circumstances shareholders may choose to carry out a reattribution of the inherited estate whereby policyholders are financially compensated for giving up their interest on it.

This paper considers whether allowing life assurance companies to use their inherited estates to finance new business, make strategic investments, pay shareholder tax and pay the costs of compensation mis-selling is having an adverse effect on competition.

For the purposes of this competition assessment we did not consider it necessary to reach a conclusion on market definition, since the competition assessment is similar whether we consider with-profits and non-with-profits to be in same (wide) or separate (narrow) markets. We noted, however, that the effect on competition could be felt in a separate market for non-with-profits products only, since with-profits firms can also write this type of policies into their with-profits funds.

Taking with-profits policies separately, it is notable that these have significantly fallen in popularity in recent years. They now account for only a very small proportion of all new business written. We note in particular that a number of suppliers have withdrawn their with-profits products altogether. The fall in withprofits policies has been mirrored by a rise in popularity of other similar products. It would appear, therefore, that even if new with-profits policies were being subsidised by inherited estates, in order to curb the decline in sales, for

example, that this strategy is not being successful.

Accordingly, in considering the competition impact of the various uses of inherited estates, we believe a more serious concern would be if inherited estates were being used to subsidise the supply of new non-with profits policies. The harm in this case would be that with-profit companies would gain a competitive advantage in the supply of non-with-profits policies (either in a narrow market for these policies only or in a wider market encompassing both types of policies) and prevent other, perhaps more efficient firms, from expanding or entering the market.

Evidence that this was occurring could be if with-profit companies with large inherited estates were holding persistently high shares of new non-with-profits business in the relevant market(s) and/or, in the absence of other barriers to entry, if we observed little new entry.

We could not obtain share of supply data for the main with-profits companies in the time available, however. Instead, in assessing this theory of harm we tried to examine whether the cost of capital to with-profits firms of using their inherited estates is indeed lower than the cost of capital from alternative sources to non-with-profits companies and new entrants. The available evidence suggests that this is not the case.

First, there are FSA rules on the terms in which new business can be written in a with-profits fund, which raise the cost of using the inherited estates and suggest that the cost of capital to with-profits firms from this source is not significantly different from, at least, the cost of capital to non-with-profits companies, some of which have also retained funds for working capital purposes.

Second, there is evidence that non-with-profits companies have been able to obtain a large share of the new business being written despite not having an inherited estate.

The evidence on entry also does not suggest that it is the inherited estates that are inhibiting entry in the relevant markets: twenty or so year ago, when withprofits business had a much larger market share than it has now, and inherited estates were already substantial, entry did occur. Nothing material seems to have changed since and, if anything, inherited estates have shrunk relative to realistic liabilities.

While there may have been very few new entrants in the last 10 -15 years, this is appears to be due to other factors.

Independent research by other parties has revealed that it is difficult for new entrants to establish distribution outlets, which is one reason why in the UK life market new entrants have had only modest levels of sales. It also appears that it is difficult for a new entrant to establish a reputation that will result in high levels of sales from independent financial advisers.

Finally, regarding with-profits products in particular, the fact that consumer interest on these policies is declining appears to be a more significant barrier to entry into the supply of these policies than the existence of inherited estates.

Based on our preliminary analysis it would appear to us that inherited estates and the various uses that with-profits companies make of them do not significantly distort competition in the relevant market, whether the markets are narrow markets for with-profits products and non-with-profit product separately or a wider one encompassing of both types of products.

This conclusion rests on the arguments that (a) the opportunity cost for withprofits

companies of using their inherited estate is not different from the opportunity cost of using the capital set aside by non-with-profits competitors and new entrants and (b) that the inherited estates have not increased significantly, nor have regulatory restrictions on their use decreased, from 20 or so years ago, when entry in competition with with-profits companies did occur. We have no evidence to suggest that these arguments are incorrect.

1 ABOUT THE OFFICE OF FAIR TRADING

1.1 The Office of Fair Trading (OFT) is the UK's competition and consumer authority. Our mission is to make markets work well for consumers. Our vision is for competitive, efficient, innovative markets where standards of consumer care are high, consumers are empowered and confident about making choices and where businesses comply with consumer and competition laws but are not overburdened by regulation. We adopt a market-informed approach with a focus on outcomes that support productivity growth and consumer and business welfare. We believe this approach is in the best interests of both businesses and consumers as well as to the benefit of the UK economy.

1.2 As part of its activities, the OFT monitors the services sector of the economy. This includes financial services such as banking, credit cards, insurance and credit licensing and enforcement.

1.3 It is in reference to these activities that the OFT is responding to the Treasury Select Committee's invitation to submit written evidence on inherited estates. The Office has also been approached by the Policyholder Advocate for Norwich Union and by Which? on this matter. As part of the process of writing this paper we have discussed the issues with these parties (and also the FSA) and received evidence.

1.4 This paper responds directly to the Select Committee's question of whether allowing with-profits companies to use inherited estates to subsidise corporate activity has any adverse effects on competition. We do not comment on consumer fairness issues as we consider the Financial Services Authority to be best placed to comment on these issues.

2 BACKGROUND

With profits

2.1 With-profits is the name given to a class of investment products that smooth out returns on money invested over the period of time the policy is held. With-profits investments can be allied to life assurance, pensions, endowments, bonds or annuities. With-profits funds are pooled investments with funds typically invested in much the same way as other pooled funds.

2.2 Clay et al. (2001)¹⁰ conclude that the typical characteristics of a withprofit product compared to other products are:

- the smoothing of benefits
- the build up of guarantees over time
- the fact that, in many cases, the policyholder participates, through the operation of a bonus pool, in the profits and losses of the company.¹¹

2.3 Policyholders often receive guaranteed returns in the form of a minimum payout amount, provided the policy is not broken. This minimum amount is supplemented by the payment of additional, discretionary bonuses. Once these bonuses are added they become part of the guaranteed amount, under certain conditions.

2.4 Compared to other pooled investment funds, the fundamental difference in with-profits funds is that they often offer policyholders a guaranteed

¹⁰ Clay G.D. et al. (2001) '*Transparency with-profits – Freedom with Publicity*', presented to the Institute of Actuaries on 26 February 2001 and 21 May 2001 and to the Faculty of Actuaries on 19 March 2001.

¹¹ These are very similar to the distinguishing features of with-profits pointed out in the 2002 Sandler Review.

minimum amount, which could be taken to mean that they are a safer form of investment. The choice for consumers is essentially their appetite for risk.

Inherited Estates

2.5 A with-profits fund includes assets owned by the company that will be used to meet realistic liabilities to policyholders. The term inherited estate refers to the part of the with-profits fund set aside over and above its realistic liabilities. The estate is inherited in the sense that it contains contributions from the premiums of multiple generations of policyholders. Shareholders may also have contributed to through capital injections.

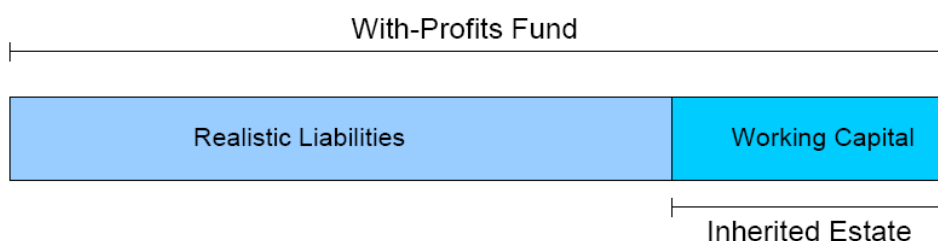
2.6 As stated by the FSA the inherited estate 'provides working capital for the with-profits fund in the longer term and supports its operation'.¹²The FSA set out the definition of working capital in relation to with-profits products in its Briefing Note BN017/06:

2.7 'With-profits funds typically have working capital which is the excess value of assets over and above that needed to cover the current estimated realistic liabilities of each fund. It supports the business of the with-profits fund but can also be put to other uses for the fund such as funding new business. The working capital will have been derived from money paid in by policyholders and shareholders over the years. Once a firm closes for new business it no longer needs working capital to fund new business.'

This is illustrated in Chart 1 below.

¹² FSA, 'The Process for Reattribution of Inherited estates'

Chart 1: The With-Profits Fund



2.9 It is important to stress, therefore, that funds inside the inherited estate are meant for commercial operations and not simply to facilitate a company's smoothing policy. In a 2003 consultation paper, the FSA stated that a with-profits company may retain part of its investment returns, for example, to ensure that it has a strong capital base or so that it can invest in more volatile investments that provide scope for greater long term returns¹³. The FSA has further clarified that such funds in the inherited estate have been used to:¹⁴

- provide investment flexibility by enabling a higher proportion of the fund to be invested in more risky assets (such as equities) which have greater potential for yielding higher returns over the long term
- facilitate the smoothing policy of the fund
- provide a cushion against unexpected adverse events
- develop the firm's business, by investing to improve the efficiency or

¹³ FSA Consultation Paper 207 (CP207), 'Treating with –profits policyholders fairly', at paragraph 5.2

¹⁴ In its letter to Clare Spottiswoode and Mark Hodges of 6 December 2007.

the provision of additional services to customers

- provide capital to support the writing of new business and development of new products.

2.10 It follows that in many ways the inherited estate is not different from surplus assets that arise in excess of the amount of policy liabilities that non-with-profits companies retain during the course of their activities. When these companies write new business into their funds, they are able to draw on any surplus assets to provide support in much the same way that inherited estates do in with-profits funds.¹⁵

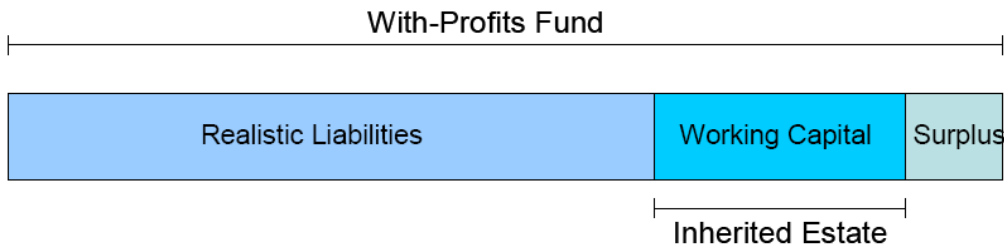
2.11 It is important to note, however, that there are FSA rules that restrict how the inherited estate can be used. In particular, a with-profits company is required to justify the size of the inherited estate that is required for to support the fund. If its inherited estate exceeds this requirement, the surplus has to be distributed where it would be unfair to policyholders not to do so.

Distribution and reattribution

2.12 From time to time, as chart 2 shows, a company might find itself with a surplus over and above what it requires for working capital in a particular year. A surplus may have arisen due to over-cautious actuarial assumptions. The chart below summarises how a surplus relates to a fund's inherited estate and realistic liabilities.

¹⁵ This opinion is based on information provided by the FSA, but in the time available we have not verified it with industry participants.

Chart 2: The With-Profits Fund with a Surplus



2.13 Any surplus arising may be distributed between policyholders and shareholders.¹⁶ In a 90:10 fund, policyholders receive 90 per cent of the surplus, and shareholders 10 per cent. There is, however, no guarantee that a surplus will arise.

2.14 The money allocated for policyholders is then added to their bonuses, while the money allocated for shareholders is removed from the with profits fund and placed elsewhere. The surplus is spent.

2.15 At this stage it is worth noting that the inherited estate itself is the property of the with-profits company. This has been clarified in a number of FSA publications and also its evidence to the Treasury Select Committee of 22 January 2008. In particular, it has been stressed in CP 207 that policyholders do not have a claim on the whole of the inherited estate, but only on distributions arising from it.¹⁷

2.16 While distributions are normally made once a year, a reattribution is much rarer. Reattribution is the term used to describe when a company is able to buy out the contingent interests that policyholders have over the inherited estate. A reattribution occurs when the shareholders of the

¹⁶ See paragraph 5.4 of CP207. Surpluses can be carried forwarded undistributed, within reason according to our discussions with the FSA in the course of preparing this paper.

¹⁷ See paragraphs 5.6 and 5.7 of CP207

company compensate the policyholders for giving up their claim on distributions that might occur due to a surplus arising. By accepting financial compensation, policyholders (current and future) give up their claim on distributions arising from the inherited estate. It should be noted that not all reattribution's will take place in the same way.

2.17 Unlike in the case of distributing the surplus, a reattribution of the inherited estate does not move the money out of the long term fund because the money will still be required for fund support. Only when that money is no longer required (at some point in the future when the fund finally closes) can the inherited estate finally be removed from the long term fund.

3 COMPETITION ASSESSMENT

Scope of the market

Product scope

3.1 When consumers are choosing an investment product, they will seek to choose the product most appropriate to their requirements. Thus, for the purposes of defining the scope of the market what is important is not so much whether there are alternative products that exactly replicate the features of with-profits policies, but rather whether consumers regard there to be other products that are substitutable in meeting their requirements.

3.2 As discussed above, one of the main features with-profits policies have vis-à-vis other policies is they often guaranteed minimum payment amounts. It is possible that there is a group of consumers for whom

these guaranteed minimum payouts and low risk are the most important features of an investment policy. These consumers may choose withprofits products even if there was a small but significant permanent rise in prices even if they offered lower returns over alternative products.

3.3 In the time available to us we have not been able to determine whether this is the case or whether such a group of consumers would not be protected by other (marginal) consumers switching away from withprofits and/or choosing non-with-profits products instead.

3.4 However, the evidence available to us suggests that for a large proportion of consumers, there are some non-with-profits products that may be a suitable, if not preferred, alternative to with-profits. The most relevant statistics being:¹⁸

- the new with-profits regular premium business has declined in recent years from £4,108m in 1985 to £295m in 2005
- in contrast, non-profit business has risen in the same period from £1,062m to £3,723m
- within the with-profits sector, pensions business has overtaken life assurance as the mainstay.

3.5 Data provided by the FSA also shows that the number of new withprofits policyholders in 2006 numbered approximately 340,000 compared with over five million in each of the years 2001 and 1996.¹⁹

¹⁸ Quoted in O'Brien (2007), *The UK with-profits life insurance industry: a market review* Centre for Risk & Insurance Studies, University of Nottingham.

¹⁹ These figures may include policy clusters.

3.6 It appears that consumer interest in with-profits has declined. This may have been for reasons of low returns and low consumer confidence resulting from mis-selling scandals.

3.7 It has not been possible in the time available to determine exactly the type of policies that consumers are favouring over with-profits products, but a minimum it could plausibly include unit-linked policies.

3.8 Nonetheless, we do not consider it necessary to reach a conclusion on the definition of the market in this case. This is because, as we will demonstrate, our competition assessment is similar whether we consider with-profits and non-with-profits to be in same (wide) or separate (narrow) markets.

3.9 As a final point on product market definition, we note that there is a range of different with-profits products available to consumers. Again, we have not considered each sub-market separately as our arguments are likely to be the same for each submarket.

Geographic scope

3.10 As O'Brien (2007) notes the number of consumers purchasing life assurance from overseas insurers is very small and that there are significant differences between national markets. This implies that overseas insurers will find it extremely difficult to sell in the UK without establishing a presence and obtaining the requisite authorisations.

3.11 We agree with this assessment. The geographic scope of the market is therefore likely to be the UK.

Market structure

3.12 Given time constraints, we have been unable to obtain data on the wider definition that includes non-with-profits products and on the supply of non-with-profits products separately. However, we do have limited data on the with-profits only market.

3.13 The FSA estimates that there are 32 million with-profits policies in open and closed funds in the UK, valued at £432 billion.²⁰ They also informed us that there are 20 life insurers open to new with-profits business, but in some cases the with-profits business has very limited guarantees (this number of life insurers does not include small friendly societies). A number of traditional with-profits companies are reported to have stopped accepting new business.

3.14 The FSA has further reported to us that they are unaware of any new entrants in at least the last five years and that the number of new withprofits policyholders in 2006 numbered approximately 340,000 compared with over five million in each of the years 2001 and 1996. Further, as a proportion of total new business, with-profits has fallen considerably – from 73.2 per cent in 1985 to 4.1 per cent in 2005 (O'Brien, 2007).

3.15 We also have seen no evidence to suggest that any single company is dominant in the supply of with-profits products, or that a number of companies hold a collective dominant position.

3.16 In the wider insurance sector, Syn Thesys Life data shows that in recent

²⁰ In its May 2007 paper, *Insurance Sector Briefing: Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholders*.

years, the largest two companies, who between them have 25 per cent of new business (measured as regular and single premiums), were Legal and General Assurance (Pensions Management) and Barclays Pension Management. ²¹Neither of these companies offer with-profits products or have inherited estates. The next largest company on this measure is Legal and General Assurance Society, but less than four per cent of its business was in with-profits.

Theory of harm

3.17 In this section we consider the competition question raised by the Treasury Committee – namely whether allowing life assurance companies to use inherited estates to finance new business, make strategic investments, pay shareholder tax and pay the costs of compensation mis-selling is having an adverse effect on competition.

3.18 In investigating this question the OFT considered the possible effects on competition both in a wide market for with-profits and non-with-profits products and in the supply of with-profits and non-with-profits products separately.

3.19 In carrying out our assessment we started by clarifying what is in fact allowed by FSA rules. We then looked at the combined effect of financing all the activities that can be charged to inherited estates on the supply of new policies by with-profits firms (as opposed to looking at each activity in turn). Our assessment is based on our understanding of how the market operates and of the incentives that exist for with-profits firms to behave in a way that distorts competition. The evidence available to support our arguments is included where appropriate.

²¹ This data was provided to us by the FSA.

FSA rules on the use of the inherited estate

3.20 Regarding the financing of new business, the FSA explained that the acquisition of new business has an impact on the value of assets in the fund. While new premium payments received have a positive impact, transaction related costs and overhead costs incurred in order to acquire the new business (including marketing costs and the payment of commissions to financial advisers) have a negative impact.

3.21 It follows that the net change in assets is unlikely in the short run to be sufficient to cover both the cost of establishing the mathematical reserves as a balance sheet liability and the regulatory capital base that needs to be held in respect to the new business taken on. There is, therefore, a cash flow timing issue.

3.22 FSA rules (COBS 20.2.28) allow the inherited estate to be used to address this cash flow issue provided a with-profits company recovers back into the with-profits fund, out of the premiums and charges of the new business written, the acquisition costs it charged to it.

3.23 Regarding the use of inherited estates to pay shareholder tax, the argument is that in a 90:10 fund, shareholders incur a corporate tax liability on their 10 per cent share of the funds that are distributed. For new entrants, the FSA would require this tax bill to be paid by shareholders, but for existing with-profits firms the FSA permits this tax bill to be charged to the inherited estate.

3.24 The FSA has told us that their rules do not in fact allow this unless it is already an established practice of the firm and which has been disclosed

to policyholders (and, in some cases, might be sanctioned by a scheme of financial management approved by the High Court).

3.25 The Committee is also inquiring whether allowing with-profits companies to use their inherited estates to make strategic investments and for paying the costs of compensation for mis-selling can have an effect on competition. We note that, with respect to compensation costs for mis-selling, the FSA has confirmed that it will be consulting on this. The FSA also confirmed that with-profits firms are allowed to use their inherited estates for making strategic investments that strengthen the capital base of the fund. The returns on these investments must be paid back into the fund, however.

3.26 Essentially, therefore the inherited estates are used as working capital. Only a small part of it appears to be in fact consumed for these purposes, with the remainder being used as a floating fund.

Theory of harm

The use of inherited estates to subsidise corporate activity, including financing of new business, making strategic investments, paying shareholder tax and paying the costs of compensation for mis-selling, is having a distorting effect on competition in a wide market for with-profits and nonwith-profits products or in the supply of with-profits and non-with-profits products separately.

3.27 As discussed above inherited estates are used as a source of working capital. In contrast to incumbent with-profits companies, a potential entrant or a non-with-profits company would need to have access to an alternative source of capital to finance the activities that with-profits

companies are able to finance with their inherited estates. The argument, however, is that an inherited estate is a source of cheap credit for withprofits companies that own one, and hence serves as a subsidy to the activities of these companies. This in turn provides them with a competitive advantage over their rivals and/or creates a barrier to entry. At the extreme more efficient competitors might leave or never enter the market.

3.28 Before we discuss this theory of harm there are a few points of background worth noting.

3.29 First, changes to the UK life and pensions market have meant that fewer firms are offering with-profits policies. The cost of providing guarantees on investment policies has risen considerably. This, coupled with deteriorating financial positions of certain insurers, has led to the closure of a number of with-profits schemes. Many firms, including with-profits firms, have made a strategic decision to focus on non-profit business (mainly unit-linked).²²

3.30 Second, with-profits firms can write non-with-profits policies into a withprofits fund. The FSA confirmed that some with-profits funds contain only with-profits business; others contain additional types of non-profits business.

3.31 It follows that it is important for the assessment of this theory of harm to be clear on whether we are considering that inherited estates are being used to subsidise new with-profits policies or new non-with profits polices. For clarity, therefore, we have considered two separate versions of the theory of harm.

²² The FSA submitted that the most common type of non profits business is unit linked business which represents by far the greatest proportion of new business now being written. Other types of products being sold in material amounts include annuities and term assurances.

Theory of harm: version (a)

3.32 The first version considers that it is the supply of new with-profits policies that is being subsidised by the inherited estates. The effect of this could be that it creates a barrier to entry into the market for withprofits policies, or that with-profit companies with inherited estates would have a competitive advantage over non-with-profits companies in a wider market, which would be expressed in terms of sales of withprofits policies increasing vis-à-vis sales of non-with-profits policies or perhaps, in the supply of with-profits policies not declining as fast as it would without the subsidy.

3.33 The trends in the sales of with-profits policies noted above do not support this version of the theory of harm. If with-profits companies were indeed subsidising new with-profits policies with an aim of gaining market share vis-à-vis the sales of non-with profits policies this is not proving to be a very successful strategy, as sales of with-profits products have declined significantly relative to sales of non-with-profits policies, as mentioned earlier in paragraph 3.4.

3.34 Further, while it is possible that a subsidy could be used to arrest (and reverse) the decline of with-profits policies, we note that it is not entirely obvious why a firm that offers multiple investment products (some of which are experiencing growth) would want to preserve the with-profits market in the face of diminishing customer numbers. The evidence suggests that even if this has been attempted that it has not been successful on the basis that new business in with-profits policies continues to decline (there has been no reversal) and more firms are no longer offering them.

3.35 Moreover, the fact that the with-profits market is declining appears to be a more significant barrier to entry into the supply of with-profit policies than the existence of inherited estates. We stress in particular that withprofits companies themselves are withdrawing from with-profits business.

Theory of harm: version (b)

3.36 The second version of the theory of harm contends that the inherited estates are being used to subsidise the supply of new non-with profits policies. The harm in this case would be that with-profit companies would gain a competitive advantage in the supply of non-with-profits policies (either in a narrow market for these policies only or in a wider market encompassing both types of policies) and prevent other, perhaps more efficient firms from expanding or entering the market. Indicative evidence that this was occurring could be, for example, if with-profits companies were holding persistently high shares of new non-with-profits business in the relevant markets and/or, in the absence of other barriers to entry, we observed little new entry in competition with with-profits companies.

3.37 We were unable in the time available to obtain share of supply data for the main with-profits firms in the non-with-profits sector or in the with and non-with-profits sectors taken together.

3.38 We attempted instead to assess directly whether the cost of capital to with-profits firms of using their inherited estates is lower than the cost of capital from alternative sources to non-with-profits companies and new entrants. We found some evidence to suggest that this is not the

case.

3.39 First, as mentioned above in paragraph 2.10, non-with-profits companies may have also retained surplus assets in excess of the amount of their policy liabilities, which can be used for fund management purposes such as cash flow. We considered therefore whether the opportunity cost for with-profits companies of using the inherited estate was lower than the cost for non-with-profits competitors of using their retained surplus assets.

3.40 The argument is that the opportunity cost for shareholders of using the inherited estate to fund new business is lower when compared to other sources of capital because the alternative use of this capital would be to distribute it to policyholders on a 90:10 basis. We found two reasons for believing that this is not the case, however.

3.41 First, there are FSA rules on the terms on which new business can be written in a with-profits fund, which require that (a) a with-profits company recovers back into the with-profits fund the acquisition costs it charged to it and (b) that new business must only be written on a withprofits fund if it is unlikely to have a material effect on the interests of existing policyholders. These rules suggest that the with-profits firm must aim to pay back into the fund with the new business at least what it would have made if it had, for example, made other strategic investments (which it can do). If policyholders are made worse off by the writing of new business or strategic investments, then this will not be allowed. These rules therefore raise the cost of using the inherited estates and suggest that the cost of capital to with-profits firms from this source is not significantly different from the cost of capital to non with-

profits companies.

3.42 Second, according to the FSA, non-with-profits companies have been able to obtain a large share of the new business being written despite not having an inherited estate.

3.43 As mentioned earlier in 3.17, the two firms that have written the largest amounts of new business in the last few years (by some considerable distance) are not involved in with-profits business and do not have inherited estates.

3.44 The evidence on entry also does not suggest that it is the inherited estates that are inhibiting entry in the relevant markets, which in turn suggests that the cost of capital to potential entrants is not significantly higher than the cost to with-profits companies of using their inherited estates.

3.45 The FSA submitted that there have been very few new market entrants in recent years and none, to their knowledge, offering with-profits products.²³ However, looking back 20 or so years when with-profits business had a much larger market share than it has now, and inherited estates were already substantial, entry did occur. According to the FSA, at that time with-profits funds operated in exactly the same way then as they do now, albeit with less regulatory constraints, in using the fund to support writing new business. This, though, did not prevent a significant number of new firms starting up between the late 1960s and the early

²³ O'Brien (2007) mentions that in fact one firm writing with-profits business did enter the market in 1995: Pensions Annuity Friendly Society. This entry was funded with capital provided by a bank and reinsurer. However, the society demutualised, transferring its business to a proprietary life insurer, Partnership Life, in 2005.

1990s. They included, amongst many others:²⁴

- Abbey Life

- Allied Dunbar (now Zurich)

- Trident Life

- Target Life

- Save and Prosper

- M&G

- Lincoln

- Black Horse Life

- Barclays Life

- Nat West Life

- Halifax Life

- Vanbrugh Life

- Skandia.

3.46 These firms tended not to offer with-profits products to any material

²⁴ Some of these have since merged with other firms.

extent - mainly because the existence of an established track record was perceived to be an essential marketing requirement. However, some of these firms went on to be successful in selling unit-linked products in competition to with-profits products.

3.47 This suggests that the ability of with-profits firms to use their inherited estates to support new business did not create a serious entry barrier for new non-with-profits firms at that time. Nothing material appears to have changed in this respect since, and if anything inherited estates have shrunk.

3.48 The earliest year for which data on inherited estates is readily available is 1986. In that year, the global inherited estates (that is to say all inherited estates in the UK) were £36 billion. According to the FSA, the equivalent figure in 2006 was approximately £30 billion. However, the size of the inherited estate relative to total mathematical reserves has fallen sharply. In 1986, the inherited estate of £36 billion was against reserves of £50 billion (around 70 per cent). By 2006, this ratio had fallen to under eight per cent (realistic liabilities and current liabilities of around £400 billion). Thus, the size of inherited estates has declined sharply in relative terms.

3.49 In our view, therefore, the fact that there has not been new entry in the last 10 -15 years must be due to other factors. Given the decline in with-profits business sales, the fact that there has been entry in this segment is not surprising. With respect to the life market more generally, O'Brien pointed out that an earlier study (O'Brien (2001)) revealed that it is difficult for new entrants to establish distribution outlets, which is one reason why in the UK life market new entrants have had only modest levels of sales. He also found that it is difficult for a new entrant to

establish a reputation that will result in high levels of sales from independent financial advisers.

4 CONCLUSION

4.1 Based on this preliminary analysis it would appear to us that inherited estates and the various uses that with-profits companies make of them are not significantly distorting competition in a wide market for withprofits and non-with-profits products or in the supply of with-profits and non-with-profits products separately.

4.2 This conclusion rests on the arguments that (a) the opportunity cost for with-profits companies of using their inherited estate is not different from the opportunity cost of using the capital set aside by non-withprofits competitors and (b) that the inherited estates have not increased significantly, nor have regulatory restrictions on their use decreased, from 20 or so years ago, when entry in competition with with-profits companies did occur. We have no evidence to suggest that these arguments are incorrect.

8.00 The Office of Fair Trading's Response to the Treasury Committee Report

1. This letter responds to the recommendations made to the Office of Fair Trading (the OFT) by the House of Commons Treasury Committee in its report on inherited estates, published on the 19th of June 2008. These recommendations are contained in paragraph 39 of the report, which urge the OFT to (a) consider performing a more thorough analysis of the aspects of competition of the uses of with-profits funds assets, or (b) as a minimum, to monitor the competition aspects of the funding of new business from inherited estates on an ongoing basis.

2. The OFT has reconsidered whether a fuller investigation of the competition aspects of the uses of inherited estates is warranted, in light of the evidence that was provided to the Committee by the various witnesses. In considering this, we note that no substantially new evidence was provided to the Committee that the OFT had not already considered in its preliminary analysis. In particular, no new evidence was provided which, in our view, contradicts our preliminary conclusions.

3. The witnesses who expressed concerns over the various uses of inherited estates allowed by the FSA are concerned that inherited estates confer an unfair competitive advantage to with-profits companies that possess one and could represent a barrier to entry to firms wishing to start supplying with-profits policies. The evidence discussed in the report revolves around the incentives that might exist on shareholders/with-profits firms to write too many new policies from the point of view of policyholders, or even loss making policies, with the implication that this must be having an effect on competition.

4. In our preliminary assessment we did note that these incentives might exist (see

paragraphs 3.27 and 3.38). For instance, we noted that inherited estates might represent a source of cheap credit for with-profits companies, which would not be available to new entrants and, therefore, could in principle constitute a barrier to entry. However, the evidence on incentives is inconclusive. Therefore, we placed more weight on the evidence of the actual effects the various uses of inherited estates were having on competition than their potential effects.

5. In order to assess the competition effects that the uses of inherited estates might be having it is important to specify the scope of the market in which with-profits firms operate. It was not necessary to reach a definitive conclusion on this, however. In our preliminary assessment we considered both a wide market definition, which would include with-profits and non-with-profits policies, and a narrower market definition, which would encompass with-profits policies only. We found no compelling evidence to suggest that the existence of inherited estates is having a significant distorting effect on competition under either of these market definitions.

6. First, under a wide market definition, the evidence available suggests that with-profits companies do not have a competitive advantage over non-with-profits companies. Even if we assumed that having an inherited estate provided some competitive advantage to the firms that own one, this has not prevented non-with-profits companies from entering in Inherited Estates: FSA and OFT responses 9 competition with with-profits companies, albeit with differentiated products, such as ISAs or unit linked policies.

7. In our written evidence we discussed evidence of entry that occurred some twenty years ago. We believe this is relevant because at the time there were fewer restrictions on how with-profits companies could use their inherited estates and not more (as is the case today). These companies appear to have been very successful at competing with incumbent withprofits companies despite the latter having sizeable inherited estates, which suggests there is no significant competitive advantage faced by with-profits firms with inherited estates. Which?'s

submission to the Committee itself acknowledges the 'continued competition from ISAs and open-ended investment companies'.

8. The evidence available also shows that the firms that have written the largest amounts of new business in recent years are those firms not involved in with-profits business and do not have inherited estates.

9. Second, although we believe that the evidence available supports the wider market definition, we have also considered the possible effects on competition in a narrower market, encompassing with-profits policies only. The assertion here is that inherited estates have acted as a barrier to entry, preventing new firms from offering competing with-profits products. Witnesses have pointed out as evidence of this that there has been no such entry in more than ten years and that the largest with-profits firms have substantial inherited estates.

10. In our view it is possible that inherited estates may have inhibited entry of new with-profits products in the past. However, developments in the market suggest that there are stronger reasons, independent of inherited estates, why there has not been new entry in the with-profits sector in recent years, which are the same reasons that explain the continued decline in sales of with-profits products.

11. As Which? itself states in its written evidence to the Committee, some of the reasons for this decline include:

- The significant number of consumers who have had a negative experience from with-profits products and the associated publicity surrounding cases such as pension mis-selling, endowment mortgage shortfalls, closed with-profits funds and Equitable life
- The opacity of with-profits products has contributed to a lack of confidence amongst consumers. This has led to a mood of suspicion that they are not getting

a fair deal

- Continued competition from ISAs and open-ended investment companies
- Fundamental questions about the low profitability of with-profits products
- Changes to the taxation on investment bonds: the recent changes to Capital Gains Tax in Budget 2008 means that these structures in which many with-profits products are sold are less attractive for some higher tax payers
- A survey by the Association of Financial Advisers in February 2008 found that 87 percent of financial advisers no longer recommend that clients invest in withprofits business

12. Judging from evidence of other witnesses enclosed in the report no one has disputed that that the with-profits sector is in irreversible, long term decline. With-profits companies have been unable to arrest (or reverse) this decline, despite having substantial inherited estates.

13. On the basis of our analysis of the evidence, the OFT does not believe that it would be the best use of its scarce resources to carry out further competition analysis of the effect inherited estates might be having on this sector, nor to monitor the sector on a regular basis.

14. I hope that this letter offers the Committee a better understanding of the rationale behind our position.