

08/11***

Financial Services Authority

With-profits funds –
compensation
and redress

June 2008



Contents

1	Overview	3
2	Proposed change to COBS 20.2.24R and 20.2.25R	6

Annex 1: Compatibility statement

Annex 2: Cost benefit analysis

Annex 3: List of questions

Appendix 1: Draft Handbook text

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 3 September 2008.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/CP/2008/cp08_11_response.shtml).

Alternatively, please send comments in writing to:

Peter Morris
Retail Policy & Themes Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 9572
Fax: 020 7066 9573
E-mail: cp08_11@fsa.gov.uk

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A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

1 Overview

Context

- 1.1 The purpose of this Consultation Paper (CP) is to present for consultation a proposed change to our rules in COBS 20 which relates to the charges that can be made to with-profits funds. It fulfils a commitment we have made both in correspondence to interested parties¹ as well as in our 2008/09 Business Plan.

Background

- 1.2. Our rules² currently allow proprietary firms running with-profits funds to charge payments for compensation and redress in relation to their past and present policies in these funds to their inherited estates. We are persuaded that this may not lead to the intended outcome of COBS 20.2, which is that firms treat with-profits policyholders fairly.
- 1.3. The current rules do not permit proprietary firms to pay financial penalties (fines) from a long-term insurance fund, and we propose to leave this position unchanged³.
- 1.4. We do not believe the rules as they stand provide sufficient incentive for proprietary firms to address failures of systems and controls and, as a result, with-profits policyholders may not be treated fairly. We take the view that shareholders alone should bear the risk of such management failures. This is already the case in relation to non-profit business such as unit-linked business that is not written in a with-profits fund.

1 Letter to Ms Clare Spottiswoode, Policyholder Advocate and Mr Mark Hodges, Norwich Union Life chief executive sent on 6 December 2007.

2 COBS 20.2.24R and 20.2.25R.

3 INSPRU 1.5.33R and 1.5.34G.

Inherited estates

- 1.5. An inherited estate is part of the with-profits fund. It is the part of the fund, over and above what is required to meet its liabilities, that the insurer retains as working capital. It may in future be distributable to with-profits policyholders. 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.
- 1.6. Our rules require firms that have with-profits funds to consider at least once a year whether the funds contain an ‘excess surplus’. This is a surplus over and above the capital the fund needs to meet its liabilities and as working capital. If they do, firms must consider whether retaining the excess surplus 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 that are not required for the purposes of the funds’ business. If firms cannot properly justify retaining the assets then we would expect them to be distributed on a 90:10 (policyholder to shareholder) basis, or other basis applicable to the particular fund.
- 1.7. As noted above, capital held as part of the inherited estate is needed as working capital to protect policyholders against adverse market conditions, to allow smoothing of payouts and to support new business. So it may 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.
- 1.8. A key purpose of our rules in COBS 20 is to constrain the firm so that it cannot unfairly use the assets retained in the inherited estate as working capital in ways that are detrimental to the interests of with-profits policyholders.

More principles-based regulation

- 1.9. Our proposal better aligns COBS 20 with Principle 6, which requires firms to treat their customers fairly. We see the proposed change as a further refinement of the more principles-based thrust of COBS 20 which was introduced on 1 November 2007 and replaced the more prescriptive rules relating to with-profits in COB 6.10 to 6.13.

Scope of the review

- 1.10. This CP confines itself to the specific issue of compensation and redress charged to the inherited estates of with-profits funds. As we stated in the letter of 6 December 2007 referred to in paragraph 1, footnote 1, we have reviewed other rules interested parties have brought to our attention and have concluded there is currently no reason to re-consult on them.

Method of review

- 1.11. Our approach to this issue is informed by our over-arching requirement that firms treat their customers fairly. We question whether it is fair for proprietary firms to be able to charge costs incurred as a result of management actions to inherited estates, so reducing the value of with-profits policyholders' contingent interests.

Who should read this paper?

- 1.12. This CP will be directly relevant to proprietary life insurance firms writing with-profits business or with existing books of with-profits business. It will also be of interest to other life insurance firms and friendly societies with similar interests in with-profits business.

CONSUMERS

- 1.13. This proposal is relevant to consumers and consumer groups as it may affect the level of bonus or compensation they may receive in the event of a distribution or a reattribution.

Next steps

- 1.14. This consultation will close on 3 September 2008. We will then finalise the draft rule in light of responses to this CP and publish a Policy Statement giving feedback before the end of the year.

2 Proposed change to COBS 20.2.24R and 20.2.25R

The issue

- 2.1. Our rules currently require proprietary firms to pay compensation and redress to current and past policyholders from shareholder funds or with-profits funds' inherited estates. Such firms can charge such costs to policyholders' asset shares⁴ only if those two other sources of money have been exhausted. In the case of mutuals there is no other source of money to pay such bills.
- 2.2. These rules were put in place in June 2005 after extensive consultation and essentially maintain the regulatory stance on this matter that has been in place since the mid-1990s. The policy objective of this regulatory stance has been that the payouts to current policyholders should not be affected by compensation or redress payments so long as the firm has other resources from which to meet these costs.
- 2.3. This particular rule has now been challenged. Some have argued that allowing compensation and redress costs to be charged to an inherited estate reduces the total amount of money that would otherwise be available to policyholders in the event of a distribution or a reattribution. We accept there is a case for further consultation on this issue.
- 2.4. One of the things we have considered is the tendency in recent years for with-profits funds to close to new business. Where this is the case the likelihood of an inherited estate being distributed as payments to policyholders may increase, as less of it is likely to be needed as the working capital. So, in this situation, our policy objective of avoiding payouts to current policyholders being affected is put at risk. Those payments would be directly affected by firms' continuing ability to make such charges to inherited estates.
- 2.5. We are, however, aware that there are concerns that the proposed change may be seen as a possible incentive for policyholders to switch from mutually-owned firms to proprietary ones. The argument is that proprietary funds would be more attractive as money earmarked for policyholders could not be used to pay compensation costs. However, policyholders in mutuals may see their money affected as there may be no other source of money available for mutually-owned firms to make compensation and redress payments with.

4 'Asset share' is a term used as a proxy for the amount that will actually be paid to policyholders.

- 2.6. We see this as one of the trade-offs policyholders make when they decide to take out policies in with-profits funds run by mutually-owned firms. Such policyholders will typically also have membership rights as owners of a mutual. As owners of the firm they take on rights and responsibilities similar to those taken on by shareholders in proprietary firms, for example, the power to elect and reject a firm's management. Such rights are not offered to customers by policies taken out with with-profits funds run by proprietary firms.
- 2.7. We do not consider the risk that mutually-owned firms may become relatively less attractive as a reason for not improving the position of policyholders in proprietary firms.
- 2.8. The proposal will not lead to any new costs for the firms directly affected. Rather, its effect will be that costs are reallocated from the inherited estate to assets attributable to shareholders. If a hitherto unidentified and substantial mis-selling arises in the future then it may lead to further costs to shareholders.

Details of the proposed change

- 2.9. In making this change we propose implementing the rule as follows:
- We propose that the change to the rule will take effect for payments for compensation and redress made after 1 November 2008, regardless of when the mis-selling occurred.
 - Where arrangements to the contrary are governed by existing court-approved schemes, such schemes will take precedence. This is consistent with our approach to all other rules in COBS 20.
 - We propose that the rule will apply to all types of compensation whatever the cause. Our initial view is that distinguishing between 'systematic' mis-selling and other events that might give rise to payments of compensation and redress will be difficult to frame and open to abuse.
 - In addition, we do not propose to include 'guarantee' schemes in the definition of compensation and redress. We propose that the cost of these schemes may therefore continue to be met from the inherited estate. These schemes typically promise mortgage endowment maturities will cover the home loans they were taken out to pay off if investment growth achieves a set level. We also note that such schemes are offered by both proprietary and mutually-owned firms.

Q1: Do you agree with our proposal to prevent the use of inherited estates to pay compensation and redress?

Q2: Do you agree with our detailed proposals?

Compatibility statement

Statutory objectives

1. The proposed change will support our statutory objective of securing the appropriate degree of consumer protection.
2. With-profits policyholders in funds run by proprietary firms may be less exposed to the danger of being mis-sold financial products. Shareholders will bear any costs that result from such actions and this should put greater pressure on firms' senior management to ensure such events do not occur. More widely, the proposed change will also have the effect of providing further protection of the interests of with-profits policyholders in a share of any future distribution from the inherited estate.
3. The proposed rule change addresses our requirement to ensure firms treat their customers fairly. It clearly describes our position to firms and has the secondary consequence of simplifying the Handbook.

Principles of good regulation

4. The proposed change will help enhance the principle of good regulation in relation to the role of management. As discussed above, our proposal will put greater focus on the need for management to ensure its actions do not lead to mis-selling which in turn may then lead to the need to make payments for compensation and redress from shareholders' funds.

Cost benefit analysis

Introduction

1. The policy proposal in this CP is to no longer allow proprietary firms to charge costs for compensation or redress for policyholders to with-profits funds' inherited estates. Any such costs would have to come out of shareholders' funds.
2. The with-profits market is currently worth an estimated £400 billion. There are 46 proprietary firms running with-profits funds whose assets amount to £340 billion or 85% of the total market and these have the potential to be affected directly by the proposal in this CP. Mutually-owned firms run the balance of the funds, and are not expressly affected by our proposal.
3. A marked feature of this market in the last decade has been the number of funds that have closed to new business. The closure of a with-profits fund to new business greatly increases the likelihood of a distribution. Since the fund is closed its requirement for working capital correspondingly decreases. When this money is no longer needed as working capital it has to be distributed unless to retain it is not unfair to policyholders. In such circumstances allowing compensation and redress payments to continue to be made from the inherited estate could lead to a material impact on the amount available for distribution to policyholders.
4. If costs for compensation or redress were paid out through shareholders' assets rather than inherited estate, as proposed, this would simply be a transfer from shareholders to policyholders, and not an overall welfare gain or loss. However additional benefits may arise from a reduction in mis-selling. The mechanism for this and potential costs and benefits are described below.

Market failure

5. The with-profits market suffers from a principal-agent problem. The complexity inherent in with-profits makes it hard for policyholders (the principals) to understand elements of their funds' performance – hence there is an information asymmetry problem. This in turn can lead to wide-spread mis-selling, for example of mortgage endowments.

6. Allowing compensation for such mis-selling to be taken from the inherited estate rather than shareholder funds exacerbates the problem. Shareholders have limited incentive to prevent management actions that may lead to mis-selling as they do not directly bear the financial consequence of this. Limiting the use of inherited estates in the way proposed should, in principle, lead to shareholder pressure motivating firms to deal more effectively with this market failure.

Costs

7. If the use of inherited estates to pay out compensation or redress is limited, shareholders' funds would be used to meet these costs. While this represents an extra cost for shareholders, in overall terms it is a reallocation of costs within a with-profits fund and not an imposition of new costs. So it does not translate into an overall loss in welfare.
8. Where shareholders find they bear an increased risk from investing in the with-profits fund as a result of this reallocation of costs they may require a higher return driving up the cost of capital, and/or put pressure on firms to improve their systems and controls in order to reduce mis-selling. Both of these outcomes could increase costs for firms part of which may be passed on to policyholders.
9. The magnitude of costs will depend on two factors:
 - The extent to which firms currently use inherited estates rather than shareholder funds to pay compensation.
 - The probability of large scale mis-selling being identified in the future leading to compensation pay outs.
10. On the first point, information provided by large firms indicates that some are using money from their inherited estates to pay compensation for mortgage endowment mis-selling and have used money from the same source to pay compensation for pension mis-selling. However, the bulk of compensation for pension mis-selling has now been paid. Some payments are still outstanding for mortgage endowment mis-selling. However, in relative terms the outstanding bill for with-profits funds is not estimated to be very large.
11. On the second point, it is difficult to predict the possibility of wide-spread mis-selling, similar for example to mortgage endowments, being identified in the future. It is also difficult to predict the extent of the liability in any such eventuality which may fall to with-profits funds rather than financial advisers. In principle we take the view that it is the responsibility of firms' owners to rectify the consequences of mis-selling.

Benefits

12. Policyholders, whose potential share from inherited estates may otherwise diminish if this is used to pay out compensation or redress, will benefit from increased payments as a result of any distribution funds may undertake. This is simply a transfer from shareholders to policyholders, and not an overall welfare gain.

13. In overall terms, benefits are expected to arise if mis-selling is reduced. To the extent that mis-selling reduces, benefits would occur through the following three mechanisms:
 - a greater proportion of more suitable products being sold with accompanying positive welfare implications for consumers;
 - a reduction in costs that would otherwise arise in the process of claiming compensation and redress; and
 - greater consumer confidence that mis-selling is less likely to occur and where it does, there is less chance that policyholders' interests may be affected by such payments, potentially leading to greater participation in the financial services market.
14. The magnitude of benefits depends on the extent of reduction in mis-selling as a direct result of the proposed policy change. This in turn depends on how effective shareholders are in observing the increased risk to them, and how this translates in practice in incentivising firms to reduce mis-selling.

List of questions

- Q1: Do you agree with our proposal to prevent the use of inherited estates to pay compensation and redress?
- Q2: Do you agree with our detailed proposals?

Draft Handbook text

**THE WITH-PROFITS FUNDS: PAYMENTS OF COMPENSATION AND REDRESS
INSTRUMENT 2008**

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of:
- (1) the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):
 - (a) section 138 (General rule-making power);
 - (b) section 139 (Miscellaneous ancillary matters);
 - (c) section 156 (General supplementary powers);
 - (d) section 157(1) (Guidance); and
 - (2) the other powers referred to in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 1 November 2008.

Amendments to the Handbook

- D. The New Conduct of Business sourcebook (COBS) is amended in accordance with this instrument.

Citation

- E. This instrument may be cited as the With-Profits Funds: Payments of Compensation and Redress Instrument 2008.

By order of the Board
[DATE] 2008

Annex

Amendments to the New Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text.

20.2.24	R	A <u>proprietary firm</u> must not pay compensation or redress from a <i>with-profits fund</i> unless the payment is made to a <i>policyholder</i>, or former <i>policyholder</i>, of that <i>with-profits fund</i>.	
20.2.25	R	A <u>mutual firm</u> may pay compensation or redress due to a <i>policyholder</i> , or former <i>policyholder</i> :	
		(1)	from assets attributable to shareholders, whether or not they are held within a long term insurance fund; or [deleted]
		(2)	from its <i>inherited estate</i> (if any); or
		(3)	from assets that would otherwise be attributable to asset shares, if, in the reasonable opinion of the <i>firm's governing body</i> , that compensation or redress cannot be paid from the assets in (1) or (2) <u><i>inherited estate</i></u> , or from any other source.

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The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: <http://www.fsa.gov.uk>

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