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Your Ref:

Reattribution of inherited estates

In her role as Policyholder Advocate (PA) for the proposed Norwich Union Life reattribution, Clare has asked the FSA to consider and explain our regulatory approach in a number of areas. This letter responds to that request.

The Norwich Union reattribution is the first reattribution to take place since we revised our rules affecting reattributions in 2005. This letter explains further our approach to reattributions now that those rules have come into force. Therefore, it is not specific to the Norwich Union Life reattribution. The contents of this letter are likely to be of interest to firms considering reattributions, to policyholders and to other stakeholders, and we will publish them on the FSA web-site.

I should make clear, however, that this letter is not formal or general guidance. It does not attempt to be comprehensive. Reattributions may raise different issues than those discussed here and circumstances will change. Each with-profits fund will be run in a different way and have issues that are specific to it. For this reason, it would not be appropriate to adopt a 'one size fits all' approach to reattributions. We will respond to issues as they arise and we will remain flexible in our approach so as to achieve the right outcome in each case.

The FSA's regulation of with-profits - roles and practice in a proposed reattribution of inherited estate

A with-profits fund (including the inherited estate) is in law an asset of the insurer. The inherited estate (a term used to refer to the excess of a fund's with-profit assets over its liabilities) provides capital for the fund. One of the uses of this capital is to help protect the fund and its customers against adverse market conditions. The responsibility for deciding

how much capital the fund needs lies with its management, but they must act fairly, and recognise that policyholders have rights and interests in respect of the inherited estate and that the firm is not free to dispose of it without regard to those rights and interests. In a reattribution, the fund is restructured: capital is moved out of the fund and can be used, for example, by the firm as working capital to support other activities or to enable dividend returns to shareholders. In return, the firm in effect provides compensation to the policyholders in exchange for the rights and interests they give up.

The FSA's role

The FSA's role in a proposed reattribution is to oversee the process and to assist in it where that is appropriate. The material on the FSA website sets out the FSA's role at <http://www.fsa.gov.uk/pages/Doing/Regulated/newcob/estates.shtml>.

The FSA is not a party to the negotiation between the PA and the firm. However, in carrying out our role, we look at whether it appears that the PA and the firm are able to conduct a full and fair negotiation.

The FSA also has an independent role to scrutinise the fairness of the reattribution proposals. We have an obligation to consider the proposals in the light of our regulatory objectives under the Financial Services and Markets Act 2000 (FSMA 2000), and measure them against our Handbook rules and guidance, including the Principles for Businesses.

It is not part of the FSA's role in a reattribution process to take any action which would change the nature of the with-profits investments that policyholders have purchased. Policyholders have entered into contracts for investments with the particular characteristics of with-profits business, which include the pooling of funds and a profit-sharing arrangement subject to 'smoothing', where the firm exercises discretion in determining benefits. It is not our role to change these retrospectively.

Once the PA and the firm have completed their negotiations, we form a view of whether the overall proposals are fair to the firm's 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 give careful consideration to 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 Principles for Businesses and our Handbook rules and guidance.

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, 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 to the 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.

If we conclude that the proposals are unfair, we will challenge the firm, using our regulatory powers under FSMA 2000 where necessary. Where the reattribution involves a court process (such as an insurance business transfer under Part VII of FSMA 2000), we inform the court of our views on fairness and we assist the court wherever we are able to in determining issues relating to the reattribution proposals.

The Policyholder Advocate's role

The precise role of the PA will depend upon the type of firm concerned and the nature of the reattribution proposals¹.

The PA role has been developed so that with-profits policyholders have an informed and independent person, properly supported by advisers, who can negotiate on their behalf with the firm. The negotiation centres on the value of the benefits which will be offered to them in exchange for the rights or interests they will be asked to give up². The PA can challenge any part of the operation of the with-profits fund in the course of negotiations with the firm.

A key responsibility of the PA is to explain to policyholders whether, in the PA's view, the firm's proposals are in their interests³. In particular, the PA will compare the firm's proposals for a reattribution with the position as it would be if the reattribution did not go ahead. The PA will take into account the probability that there may be future surpluses generated by the fund that would be distributed to policyholders. If the PA 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. We believe that any firm involved in a reattribution should be strongly motivated to demonstrate to the PA's satisfaction that the firm's proposals are favourable to policyholders' interests.

The firm's role

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.

An important part of our regulatory framework for with-profits is our guidance that firms should maintain with-profits governance arrangements and these should involve independent judgement in assessing compliance with a firm's Principles and Practices of Financial Management ("PPFM"). These governance arrangements, which may include setting up a with-profits committee (WPC) or using an independent person, should address conflicting rights and interests of different groups of policyholders and, where applicable conflicts between the rights and interests of policyholders and shareholders⁴. The arrangements are of

¹ COBS 20.2.43

² COBS 20.2.44G(1)

³ COBS20.2.44(3)

⁴ COBS 20.3.2G

fundamental importance to managing conflicts of interest, both in the ordinary course of business and in the context of a reattribution.

As we made clear in a letter we sent to the Chief Executive Officer of all firms in the with-profits industry in September, this independent judgement should not be limited to assessing compliance with the PPFM. We expect the WPC or independent person to be consulted, on a timely basis, on all significant issues affecting with-profits policyholders' interests (e.g. changes to investment strategy, charges and bonuses). We are challenging firms where we believe the arrangements are not sufficiently strong or effective.

Excess surplus and firm's risk appetite

A firm considering a reattribution may have an excess surplus (i.e. it has more funds than it requires to continue to operate, taking into account the amount of capital the fund needs to protect itself against future risks and uncertainties).

The firm's risk appetite will be an important factor in considering the level of resources which a fund needs to retain to operate effectively. As a minimum, firms are required to meet the capital resource requirements set by the FSA. However, many firms operate with a higher level of capital resources reflecting the firm's risk appetite. It is for senior management to determine the level of the risk appetite for a with-profits fund. We would not normally object to a firm setting and applying a high risk appetite⁵ and therefore having a high requirement for capital: this brings potential advantages to consumers and may be attractive to them in choosing a particular product.

However, the concern has been expressed that there is a conflict of interest in this area. A firm could set and apply a high risk appetite before a reattribution, with the effect that capital is retained in the fund and unavailable for distribution. After the reattribution the firm might then set and apply a lower risk appetite, which would allow it to determine the existence of an excess surplus which could then be distributed direct to shareholders.

We recognise that there are circumstances in which a firm may want (or need) to adjust its risk appetite. However, we seek to prevent mis-use by a firm of the risk appetite to advantage shareholders' interests. To this end, we will normally expect the reattribution proposals (and in particular the terms of the scheme providing the legal mechanism for the reattribution) to limit post reattribution distribution to shareholders to a distribution that would apply had there been a continuation of the level of risk appetite that formed part of the reattribution proposals put to the PA and the FSA. This will allow the firm the flexibility to amend its risk appetite in response to changes in market conditions, whilst helping prevent mis-use of risk appetite to the disadvantage of policyholders' interests.

If it becomes clear during our examination of proposals to carry out a reattribution (or indeed in other circumstances) that an excess surplus exists, we would ordinarily require a

⁵ A firm with a high risk appetite will take on a high level of risk, e.g. investing in riskier assets such as equity and property and will have a higher requirement for capital than a firm with a low risk appetite. Firms may also need to maintain high levels of capital resources in order to achieve a high credit rating (e.g. AAA).

distribution of the surplus. We would expect the firm to make a distribution as part of the reattribution, or to make a distribution in any event if for some reason the reattribution did not go ahead.

FSA policy on uses of inherited estate

Whilst in law, as with the long-term fund generally, the inherited estate is an asset of the firm, policyholders have rights and interests in respect of the inherited estate and the firm is not free to dispose of it without regard to those rights and interests.

The inherited estate has historically been used as a source of support for a with-profits fund. The principal possible uses are:

- to provide investment flexibility by enabling a higher proportion of the fund to be invested in more risky assets (such as equities) which have a greater potential for yielding higher returns over the long term;
- to facilitate the 'smoothing' policy of the fund, particularly when there are sudden changes in investment markets;
- to provide a cushion against unexpected adverse events;
- to develop the firm's business, by investing to improve efficiency or the provision of additional services to customers; and
- to provide capital to support the writing of new business and development of new products.

Our rules require firms to ensure that uses to which the inherited estate is put do not impact unfairly upon the interests of existing customers. In the following sections we set out some of our expectations of firms in managing and using the inherited estate, including in managing the conflicts of interest between policyholder and shareholder in the assets which make up the inherited estate.

Financing new business

In general terms, we are content that the inherited estate can be used to provide capital to back new business in the with-profits fund. 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, and repaying them to the inherited estate, over a reasonable period.

Where there is a reattribution, we will review 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 the new business which the firm expects to undertake, and whether the firm's assumptions are reasonable in the context of the reattribution scheme.

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.

Paying tax on transfers to shareholders

We only permit a firm to charge tax on a transfer to shareholders to the inherited estate if the firm can show that to do so is consistent with its established practice and that established practice is explained in the firm's PPFM⁶. This rule was introduced to avoid policyholders suffering any deductions from their benefits, whilst preserving the shareholders' position following a change in tax law.

We have consulted on our rules on this charge twice, in 2003 and 2004, before introducing this rule.

Financing strategic investments

Our rules also allow firms to make 'strategic investments' using assets in the inherited estate. Strategic investments are investments in businesses in which the firm, or an affiliate of the firm, has an interest.

Our rules allow firms to undertake such investments and to 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. Relevant factors a firm should take into account include the likely returns from the investment compared with other activities which the firm might undertake and the risks associated with the investment.

As part of the reattribution process, we will consider 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 misselling compensation costs

When we consulted on the rules affecting the reattribution process in 2003, we decided to allow firms to charge misselling compensation costs to the inherited estate. In the light of representations received on this and the above three uses of inherited estates, we have reviewed all aspects of our rules in this area recently. Having done so, we think, on balance that, in the light of the strength of views now put to us, it is appropriate to invite further consideration of the issue of charging mis-selling costs, and whether, given the nature of those costs, they should be borne solely by the shareholder.

⁶ COBS 20.2.20R

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