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Treasury Committee

Inherited Estates: Financial Services Authority and Office of Fair Trading Responses to the Committee's Twelfth Report of Session 2007-08

Fifteenth Special Report of Session 2007–08

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All correspondence should be addressed to the Clerks of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk.

Fifteenth Special Report

The Treasury Committee published its Twelfth Report of Session 2007–08, *Inherited Estates*, on 19 June 2008, as House of Commons Paper No. 496. The Financial Services Authority response to this Report was received on 6 October 2008, and is appended below. It is followed by a letter from the Office of Fair Trading received on 27 August 2008.

Appendix 1: Financial Services Authority Response

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 assets.[1] 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 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 website.[2] We have also continued with supervision of the sector and have discussed the application of our rules with individual firms.

1 Figures as at end of 2007

2 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. 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.[3] 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.
- 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

3 http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/084.shtml

our considerations, they may not be the only relevant points .[4] 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.

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:

4 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.

Figure 2: Potential improvements to the guidance on reattributions

We believe that there would be benefit in the FSA:

- 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 fund[5] 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.

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

5 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.

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.

Appendix 2: Letter from the Office of Fair Trading

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

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 with-profits 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 lead 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 per cent of financial advisers no longer recommend that clients invest in with-profits 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.