House of Commons

Treasury Committee

Inherited Estates

Twelfth Report of Session 2007–08

Report, together with formal minutes, oral and written evidence

Ordered by the House of Commons to be printed 10 June 2008

HC 496
Published on 19 June 2008
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

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Summary

Regulating the with-profits sector

Over recent decades, the with-profits sector has suffered from conflicts of interest on the part of the management of life funds by proprietary companies, leading to concern among some holders of with-profits policies that their interests have not been adequately protected. We are not satisfied that the Financial Services Authority (FSA) has done enough to provide a robust framework within which these conflicts of interest can be managed. Rather than developing clear principles for the regulation of inherited estate, the FSA has become embroiled in making judgements "in the round" and micro-regulation of particular firms' situations. This approach seems a long way from the philosophy of 'principles-based regulation' to which the FSA 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. We would welcome a reopening of the debate about the fundamental design of the regulatory system for with-profits funds and will continue to monitor the FSA's progress in its regulation of the with-profits sector.

Smoothing

The use of inherited estate in smoothing returns to policyholders between good and bad years is clearly appropriate, but more should be done by the industry to improve the transparency of their application of smoothing techniques. If the industry fails to do so, the FSA should enforce such transparency.

Funding of new business

The funding of new business from the inherited estate represents an intergenerational transfer from current policyholders to the future beneficiaries of the inherited estate. This recycling causes particular problems during reattributions 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. It is vitally important for the FSA 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.

Mis-selling compensation costs

We view the charging of mis-selling compensation costs to the inherited estate as inappropriate. The vast bulk of mis-selling costs must be borne by shareholders, because 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.

Shareholder tax

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. It seems unfair that policyholders should pay anything towards this charge. The FSA allows shareholder tax to be paid from inherited estates only if that is the established practice of the firm concerned. We urge the FSA to consult on the charging of shareholder tax to inherited estates by the end of 2008.

Phasing of special distribution payouts

We were not convinced by the arguments put forward for the phasing of special distribution payouts and the FSA must put forward a very strong case indeed if such phasing should be allowed to continue.

With-Profits Committees

We are concerned that With-Profits Committees lack adequate resources, remit and visibility for them to protect policyholders' interests in with-profits funds. We recommend that the FSA consider granting With-Profits Committees an explicit role to ensure that a fund is run in accordance with the FSA's principle of treating customers fairly, rather than merely considering the firm's compliance with its own internal rulebook.

1 Introduction

1. Over recent decades, the with-profits sector has suffered from a perceived conflict of interest on the part of the management of life funds, leading to concern among some holders of with-profits policies that their interests have not been adequately protected. The public policy interest in the with-profits sector is reflected in the recent active involvement of the Financial Services Authority (FSA), holding consultations and making judgments on various aspects of with-profits funds, with the aim of clarifying its rules regarding with-profits funds and ensuring that life firms treat policyholders fairly. Certain life firms have recently contemplated making significant changes to a portion of their with-profits funds called "inherited estate", which has required the FSA to provide further clarification and guidance. Our inquiry's main purpose was to scrutinise the performance of the FSA in its regulation of the treatment of inherited estate.

2. The genesis of our inquiry into inherited estates lay in our ongoing scrutiny of the FSA and we signalled our interest in this area when hearing oral evidence from the FSA on both 9 October 2007 and 22 January 2008. On 26 February 2008, we announced our inquiry into Inherited estates and invited written evidence. The written evidence we received is published with this Report or has been reported to the House and made available for public inspection. In April we held two oral evidence sessions, taking evidence from Which?, the Policyholder Advocate on behalf of Norwich Union for the CULAC and CGNU funds,[1] the FSA, Norwich Union and Prudential. We are most grateful to all those who assisted us in the course of our inquiry.

1 CGNU is an insurance company that is part of the Norwich Union Life group of companies. This company has previously been know as both General Accident Life and CGU Life. CULAC, Commercial Union Life Assurance Company, is another insurance company that is part of the Norwich Union Life group of companies.

2 Understanding inherited estate

With-profits funds and their regulation

3. With-profits funds offer long-term investment products and are managed by life insurance companies, both proprietary and mutual. Whereas in mutual companies the policyholders own the fund, in proprietary companies the policyholders contribute to the fund, which the shareholders own. With-profits products enjoy potentially high returns via exposure to, for example, equity shares, whilst guaranteeing a minimum level of return. Policyholder premiums are held in a pooled fund that is invested in a range of assets, with a significant proportion in equities and property. The risk borne by the investor in such asset classes is limited by guarantees, which usually increase over the lifetime of the policy. Firms will often "smooth" out returns to policyholders in order to cushion policyholders from the extremes of fluctuations in the property and equity markets. Prudential told us that "a with-profits product offers investors a valuable investment option, providing the prospect of competitive long-term rates of return while smoothing the peaks and troughs of volatile market movements and providing valuable guarantees".[2]

4. The FSA noted that the with-profits sector attracted particular scrutiny in the early part of this decade, prompted by concerns about the high degree of discretion given to life companies over the management of with-profits funds; the complexity and opacity of the products; poor early surrender values; and a lack of consumer understanding of the nature of the risks involved.[3] In March 2004, our predecessors reported on *Restoring confidence in long-term savings: Endowment mortgages,*[4] identifying several areas where the FSA could improve the market for with-profits products, including transparency and financial advice to customers. The then Committee concluded that the FSA should have been much more rigorous in ensuring that its policies and strategies were being effectively implemented by the financial services industry. In response to such concerns, in 2005 the FSA implemented a new regulatory regime for the with-profits sector, with the overall objective of achieving greater protection of policyholders. The FSA argued that the new regime had delivered rules and guidance to firms on the management of with-profits funds, provided clarity on how management should exercise discretion, set limits to that discretion in key areas, and improved assessments of the true extent of firms' liabilities and of their resulting capital requirement.[5] This Report considers the FSA's approach with regard to one aspect of with-profits funds—inherited estates—but in doing so considers wider issues such as the role and effectiveness of with-profits committees.

2 Ev 90

3 Ev 76

4 Treasury Committee, Fifth Report of Session 2003-04, *Restoring confidence in long-term savings: Endowment mortgages,* HC 394

5 Ev 76

Introduction to inherited estate

5. The term 'inherited estate' is not a statutory concept and it does not have a universally agreed definition. The FSA defined inherited estate as "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."[6] Norwich Union gave a similar definition—"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".[7]

6. Norwich Union explained that its with-profits funds were composed of several elements: money needed to back policy liabilities; money needed to back guarantees attached to policies; and money needed to mitigate risks to the with-profits funds' ability to meet its liabilities and guarantees (such as a potential stockmarket fall). From time to time, the with-profits fund might contain "excess surplus", which they defined as money in excess of what was forecasted to be needed for the three purposes cited above. Broadly speaking, according to Norwich Union, the inherited estate comprised the aggregate value of the money needed to mitigate risks to the fund, and any excess surplus.[8] Norwich Union argued that the size of the inherited estate was "by no means fixed", and was best described as the difference between two very large amounts—the assets and liabilities of the with-profits company—both of which were highly volatile and susceptible to external influences such as interest rates, equity movements and property markets.[9] Mr John Lister, Norwich Union's Chief Actuary, explained that, at the end of 2007, the inherited estate held within the CULAC and CGNU funds was some £2.6 billion, out of total funds under management amounting to £26 billion.[10] Prudential's inherited estate of £8.7 billion supported an overall fund of £74 billion.[11]

7. Legally, the pooled assets of the with-profits fund (including the inherited estate) are assets of the insurer, rather than the policyholder.[12] In a mutual society providing with-profits investment products, policyholders themselves own the with-profits fund, so the fund would be run solely in the interests of policyholders and conflicts of interest would not arise. However, in a proprietary life insurance firm, owned by shareholders, managers of the fund face competing demands—to run the fund in the interests of the shareholders and to ensure that policyholders are treated fairly. This inherent conflict of interest requires a regulator, the FSA, to ensure that the interests of both shareholders and policyholders are protected.

6 Ev 76

7 Ev 83

8 Ev 86

9 Ev 83

10 Q 170

11 Ev 90

12 Ev 76, Q 69

Origins of inherited estate

8. According to the FSA, in most with-profits funds 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".[13] Norwich Union explained the historical background of their with-profits funds:

> 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.[14]

Mr Mark Hodges, the Chief Executive of Norwich Union, argued that, as a result of their with-profits funds' 200-year history, it was very difficult now to trace the origins of the inherited estate and be absolutely explicit about where it came from. He did say, however, that the company had established that "none of the current generation of policyholders has contributed to the inherited estate".[15]

9. Mr Lister had identified certain contributions from shareholders in 1945 and 1950, but did not suggest that these contributions were a major source of the inherited estate. Instead, the estate arose from the way that the fund was run.[16] Mr Nick Prettejohn, the Chief Executive of Prudential, identified a similar origin for his firm's inherited estate, saying that "a very considerable proportion … of the estate—and it is difficult to put a precise number on it—has been contributed by shareholders over the course of the century of the operation of the fund".[17] Prudential stated that the generation of policyholders whose policies had paid out since 1990 were net beneficiaries from the inherited estate rather than contributors to it. Prudential also stated that it did not expect the current generation of policyholders to be net contributors to the inherited estate either. Therefore, in Prudential's view, "any payment to the current generation of policyholders in respect of the inherited estate would be a pure windfall".[18]

10. **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**

13 Ev 76

14 Ev 85

15 Q 149

16 Q 150

17 Q 156

18 Ev 92

the most significant contribution to inherited estates has resulted from the way that inherited estates have been managed over time.

Special distributions

11. From time to time the assets of a with-profits fund might exceed the liabilities of that fund to such an extent, and the inherited estate has grown so large, that the life firm is in a position to pass this surplus to the two groups of stakeholders in the fund, the shareholders and the policyholders. The division of this surplus between the two stakeholder groups in such a "special distribution" is dependent on the specific nature of the with-profits fund concerned. Many with-profits funds operate on a "90:10" basis, where policyholders receive 90% of any surplus distributed, and the firm receives the remaining 10% on behalf of its shareholders. The FSA requires firms to assess whether or not they have an "excess surplus" in their with-profits fund on an annual basis. If an excess surplus is identified, the FSA expects that a special distribution of these assets will be made by the firm to the stakeholders in the fund. Therefore, whilst policyholders do not own the inherited estate of a fund, they do have a contingent interest in that estate arising from potential special distributions. The impact of a special distribution is that the size of the inherited estate in the fund concerned is reduced. We discuss special distributions in more detail in Chapter 4.

Reattribution

What is a reattribution?

12. We have just noted that policyholders have a contingent interest in possible future special distributions from the inherited estate. If a firm chooses to, it can enter into a transaction called a "reattribution", where it buys this contingent interest from policyholders. Policyholders choose whether to accept the offer or not. If they reject the offer, they retain their contingent interest in the with-profits fund and are not allowed to be disadvantaged by the reattribution process.[19] In a reattribution, the fund itself retains its inherited estate. The only change to the fund following a reattribution is that possible future special distributions would accrue to shareholders rather than policyholders.[20] There are several stages in the approval process of a reattribution scheme: the firm must decide that it is in the shareholders' interest, then the FSA assesses whether the offer made to policyholders is fair, and then individual policyholders choose whether to accept the offer. Finally, once policyholders have made their choice, the reattribution scheme would go to the High Court for final sanction.[21]

19 Qq 80, 218

20 Qq 173–174

21 Q 218

The AXA reattribution

13. In 2000, AXA brought forward proposals for reattributing the £1.7 billion inherited estate in its with-profits fund. The transaction was approved by the FSA and accepted by policyholders. The offer made to policyholders by AXA was considered by Which? to have been unreasonably low. According to Which?, AXA made various deductions from the inherited estate prior to the reattribution, all of which reduced the likelihood of potential special distributions, so reducing the value of the offer that AXA needed to make to purchase the contingent interest of policyholders in the inherited estate.[22] In response to concerns raised by the AXA reattribution, the FSA introduced changes to its regulation of inherited estate, including the advent of the role of "policyholder advocate", who, in future reattribution cases, would be appointed to negotiate on behalf of policyholders a fair reattribution offer.

The role of the policyholder advocate

14. The first life firm to commence reattribution negotiations since the AXA transaction was Norwich Union, which announced in November 2006 the start of a reattribution process which has still not yet been concluded. At that time Norwich Union also announced that Clare Spottiswoode would be appointed policyholder advocate. Ms Spottiswoode, who is the first person to occupy such a position, told us that her "absolutely key role is to represent policyholders in this really complex transaction" and, if the reattribution negotiations resulted in an offer being made to policyholders, her role would entail explaining to policyholders what the deal meant, putting it in context and trying to ensure that each individual policyholder was sufficiently well-informed in their personal decision as to whether or not to accept Norwich Union's offer.

15. At the present time, reattribution negotiations between Norwich Union and Ms Spottiswoode are ongoing. On 30 April 2008, Mr Hodges told us that his sincere hope was that the negotiations would conclude "in weeks rather than months".[23] Following the conclusion of these negotiations, the FSA will consider whether the firm's proposal was fair. If the FSA approve the terms of the reattribution, Norwich Union will put their offer to the relevant funds' policyholders.

16. The Prudential have announced that they are exploring the possibility of reattributing the inherited estate held within their with-profits funds, and would make a decision by the middle of 2008.[24] They have nominated a policyholder advocate, Peter Bloxham, to negotiate on behalf of Prudential policyholders, if a decision were taken by Prudential to proceed with a reattribution. Mr Bloxham's appointment is contingent on such a decision being made, but he is already familiarising himself with Prudential's with-profits funds and the issues at stake.[25]

22 Ev 50

23 Q 145

24 Q 147; "Prudential considering a reattribution", Prudential press release, 15 March 2007

25 Ev 139

The role of the FSA in regulating inherited estates

17. We have already noted the inherent conflict of interest facing managers of proprietary life firms. Managers have a fiduciary duty to look after the interests of shareholders, but also have obligations to treat policyholders fairly. Decisions made by the life firm regarding how the inherited estate is used, for example, affect the size of the inherited estate, and consequently the prospect that policyholders have of receiving a potential special distribution. Policyholders have no power in relation to how managers of a with-profits fund exercise their discretion in operating that fund, so their interests must be protected by the regulator, the FSA. Mr Sants explained that the FSA had an obligation, which it took very seriously, to make sure that policyholders receive a fair deal and that their interests were looked after. He added that "we have a clear mandate to do that and therefore I think that it is right and proper … that our mandate is properly adhered to".[26]

26 Q 90

3 Uses of the inherited estate

Why does this matter?

18. In Chapter 2 we observed that a critical determinant of the size of an inherited estate was the uses to which that estate was put. Any use of an inherited estate that reduces that estate's size reduces the prospect of special distributions to stakeholders in the with-profits fund concerned. There are undoubtedly other factors, such as the performance of investments, but it is the uses of the inherited estate over which the firm has most control. With-profits funds are managed by life firms on behalf of policyholders, and the firms enjoy wide discretion over the use of the estate. This discretion is limited in certain instances by FSA rules, and firms have an overall commitment to treat customers fairly, but Clare Spottiswoode expressed her "surprise" at the "unusually large amount" of discretion that firms still enjoyed.[27] In this Chapter, we examine various uses of the inherited estate.

Supporting a strong with-profits fund

19. Many life companies argue that an inherited estate is an important source of security for policyholders' investments. Prudential told us that life companies had a "regulatory requirement to continuously hold sufficient capital to withstand adverse conditions, including, in particular, large market falls … and a failure to meet this requirement would destroy consumer confidence".[28] Beyond this regulatory requirement, argued Prudential, "a strong inherited estate provides a real benefit for policyholders and helps ensure policyholders get the benefits they are expecting, even in volatile market conditions. Weaker with-profits funds, which do not have a large inherited estate, cannot offer the same levels of security and smoothing".[29] Norwich Union stated that it held more capital in its with-profits funds than the minimum FSA required, in order to "maintain a high level of confidence in our funds and ensure that they will remain strong for the long term".[30]

20. Prudential argued that it was "not possible to run a with-profits fund prudently for the benefit of current and future policyholders without a sufficiently strong inherited estate".[31] The firm described how its inherited estate had protected policyholders in adverse market conditions:

> Even in 2002, when markets crashed, provided that a policyholder's investment had been held for at least 5 years, the policyholder had access to funds up to £10,000 with no exit penalties, and those relying on regular income withdrawals were also not affected. Since 2004, the exit penalty free limit has been £25,000, again provided that the investment has been held for at least 5 years. This protection for policyholders

27 Ev 55

28 Ev 93

29 *Ibid.*

30 Ev 86

31 Ev 93

> was funded from the inherited estate, which was reduced by nearly 30 % of its value during 2002 alone.[32]

21. The existence of an inherited estate may enable a with-profits fund to offer superior investment returns, by allowing for greater flexibility in investments, and allowing a greater exposure to higher risk, higher return, assets. Prudential argued that a weaker inherited estate would necessitate the adoption of a more conservative investment strategy, which would be expected to lead to lower returns to customers.[33] Norwich Union similarly said that their inherited estate was "required for the day-to-day running of the fund", providing protection for policyholders and that the estate enabled Norwich Union to have a higher ratio of equities and property in the funds' investment portfolios than would otherwise be the case.[34]

22. **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.**

Smoothing

23. Policyholder returns from with-profits funds are generally "smoothed" to protect against market volatility. Smoothing occurs when a proportion of the investment return during good performance years is held back to ensure that a reasonable return can be paid to policyholders during years of poorer performance, insulating policyholders from potentially volatile movements in the prices of equities and property. The Actuaries' Profession described the inherited estate as a "buffer" to protect policyholders from harm in the bad times. They explained that

> Over a long period there will be … bad times, and the philosophy of the with-profits funds has been that those who enjoy the years of comparative plenty will tend to contribute to the estate, whilst those who experience leaner years may benefit from its protection.[35]

Prudential noted that the smoothing of returns was "fundamental to how with-profits works as it reduces peaks and troughs in payouts and therefore helps protect the policyholder against market volatility". A strong inherited estate, in the view of Prudential, was needed to provide this protection.[36]

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32 Ev 93

33 *Ibid*.

34 Q 172

35 Ev 93 and 131

36 Ev 93

24. Which? agreed that smoothing could be an appropriate use of inherited estate, but they doubted whether smoothing was actually being used to the benefit of policyholders:

> We think that actually in many with-profit funds smoothing has turned out to be an illusion for many policyholders, and actually, when the markets fell slightly, policyholders ended up with large transfer penalties if they wanted to cash in their policies. So, smoothing clearly has not been delivered as many policyholders would expect. We think it is a legitimate use of the estate, but it is important to note that over the long-term the cost of smoothing will be neutral because it will be balanced by taking money out in the good years and then putting it back in in the bad years. The long-term cost to the company and to the inherited estate should be neutral.[37]

Prudential stated that their "intention is that any smoothing profits or losses should balance out over time, so that in the long run with-profits policyholders as a whole neither gain nor lose".[38]

25. The use of inherited estate in smoothing returns to policyholders between good and bad years is clearly appropriate. An element of smoothing is one of the most attractive features of with-profits investments, and the existence of the inherited estate facilitates this. It is important that the net impact of smoothing over time should be neutral to policyholders. **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.**

Underwriting new business

26. The FSA allows firms to use their inherited estate to provide capital to back new business in a with-profits fund where "this does not have a material adverse effect on the interests of existing policyholders".[39] This underwriting of new business can be used to defray some of the administrative, commission and set-up costs over the initial period of the policy. The FSA considers such underwriting as acceptable provided the business is managed with a view to recovering those costs over a "reasonable period", understood as "at most the lifetime of the product that is being sold".[40]

27. The underwriting of new business affects the distribution of benefits from the inherited estate between generations of policyholders. Mr Hodges stated that the underwriting of new business was "about the recycling of capital between generations of policyholders. That is something that all policyholders during the fund benefited from and future policyholders may well benefit from as well." He confirmed that Norwich Union's

37 Q 7

38 Ev 100

39 Ev 80

40 Ev 80; Qq 99–101

intention was always to make sure that any capital put up to back new business was repaid over the term of the policy.[41] Mr Prettejohn also thought it an important feature of Prudential's life fund that it was "dynamic",[42] and the FSA agreed that "capital recycling" was an intrinsic feature of with-profits business.[43]

Loss leaders

28. Ms Spottiswoode viewed the "subsidisation of an insurance company's new with-profits business" as one of the most controversial uses of inherited estate, because it had "the potential to reduce greatly the amount that current policyholders can expect to be distributed from an inherited estate".[44] She accepted that new business should be funded if it was expected to be profitable but disapproved of life firms writing business using policyholder capital "as a subsidy" for future policyholders.[45] Which? argued that life firms would have an incentive to write subsidised or loss-making new business from the inherited estate, if allowed, because shareholders would not bear any of the cost of this new business, which would be borne instead by the inherited estate. Shareholders would therefore be insulated from any losses incurred. Those shareholders would, however, see the benefits from this new business in the form of their 10% share (in the case of a 90:10 fund) of the bonuses applied to these new policies.[46] The FSA told us that the volume and pricing of the new business was important, and that their rules did not permit the marketing of loss leaders or a firm to persist in marketing products where actual volumes experienced were insufficient to justify costs.[47] Mr Vicary-Smith, the Chief Executive of Which? argued that because life firms were not allowed to fund loss-making business, there was an incentive for firms to overestimate the returns that they might get from such new business in order to justify its underwriting from the inherited estate.[48]

The context of a reattribution

29. Ms Spottiswoode was particularly concerned about the impact of the funding of new business from an inherited estate in the context of a reattribution.[49] She argued that if a firm retained a large amount of capital for the funding of new business, thus "gifting" that portion of the estate to future beneficiaries of the inherited estate, policyholders' expectations of receiving distributions before their policies matured would be reduced significantly. In a reattribution, the firm would then only need to offer policyholders a reduced payment, to compensate them for their reduced expectations of distributions. Following a reattribution, the future beneficiaries of any distributions following the

41 Q 165; Ev 132

42 Q 167

43 Ev 80

44 Ev 57

45 Q 50

46 Ev 45

47 Ev 61 and 80

48 Q 8

49 Ev 55

reattribution would be shareholders. Ms Spottiswoode argued that shareholders would obtain the future policyholders' estate "for free".[50] A firm undertaking a reattribution process would have an incentive to maximise the funds set aside for new business, and to forecast "over-ambitious" levels of new business. This element of discretion on the part of the firm, argued Ms Spottiswoode, made the question of future new business a contentious issue which complicated negotiations between the policyholder advocate and the company.[51]

30. Which? shared the concerns of Ms Spottiswoode that the incentive to subsidise unprofitable new business was maximised in firms considering a reattribution of their inherited estate.[52] Which? referred to the AXA reattribution in 2000 as a case in point:

> Eight years ago in the AXA case, AXA projected that levels of new business in their with-profits fund would grow at 4.5% a year up to 2050. Which? believed this was far too optimistic. At the time of the AXA case, our expert witness forecast that a middle scenario would be for AXA's new with-profits business to fall by two-thirds in real terms. Despite our objections, the FSA concluded that AXA's "assumption is not unreasonable". The actual outcome was that with-profits sales by AXA are now just a small fraction of what the company had projected. According to our calculations based on AXA's FSA returns they are 85% below where AXA had predicted.[53]

Mr Vicary-Smith said that the result of AXA's over-optimistic forecast for new business recruitment was that "a lot of business was written out of the inherited estate, paid for by those policyholders, which actually turned out to, in effect, be loss-leading business".[54]

31. The Financial Services Consumer Panel (FSCP) argued that after a reattribution the FSA should check that a company follows the strategy for new business under which reattribution negotiations were conducted.[55] According to the FSCP, the FSA had said that it expected firms to limit post-reattribution distributions to shareholders, although the FSCP did not know how that might be achieved.[56] If the proposed Norwich Union reattribution goes ahead, shareholders would be unable to benefit from a distribution from the inherited estate for six years, which Mr Hodges said was "to try and ensure that we are incentivised to write new business".[57]

32. When considering a firm's assumptions surrounding its ability to recruit new business, an important factor would be the prospects for the with-profits industry as a whole. The Office of Fair Trading (OFT) reported data from the FSA which showed that the number of new with-profits policyholders in 2006 numbered approximately 340,000 compared

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50 Ev 56 and 57

51 Q 46

52 Ev 46

53 *Ibid.*

54 Q 8

55 Ev 144

56 Ev 145

57 Q 245

with over five million in each of the years 1996 and 2001. The OFT attributed this declining popularity to low returns and low consumer confidence resulting from mis-selling scandals.[58] Which? gave a number of reasons for the continued decline of the market for with-profits products:

- "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 leads 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 of investment bonds: The recent changes to Capital Gains Tax in Budget 2008 mean that these structures in which many with-profits products are sold are less attractive for some higher rate taxpayers; and
- A survey by the Association of Financial Advisers in February 2008 found that 87% of financial advisers no longer recommend that clients invest in with-profits business."[59]

33. Ms Spottiswoode had asked industry experts for advice on likely trends in the with-profits market in the future. That analysis suggested that with-profits policies would continue to appear unattractive to potential purchasers compared with other financial products, and that a continuing fall in with-profits sales was more likely than a recovery.[60] Mr Hodges was more upbeat about the industry's prospects, saying that Norwich Union believed that the with-profits investment product "has a good future".[61]

34. **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 reattributions 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**

58 Ev 111

59 Ev 50

60 Ev 57

61 Q 243

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.

Impact on competition

35. Which? believed that the FSA's policy of allowing the use of the inherited estate to underwrite new business distorted competition and deterred innovation.[62] Which? referred to the Sandler Review of long-term savings which found that:

> The existence of inherited estates distorts competition, since certain providers, not necessarily the most efficient ones, have pools of capital which have arisen for a variety of historical reasons and can be used to subsidise various activities.[63]

Ms Spottiswoode agreed with Which?:

> It is no surprise that most businesses do not choose to write with-profits business, because if you do not have an estate why would you write with-profits business when you have got a competitive disadvantage from doing so? You will write other products. I think there is clear evidence that there is anti-competitiveness in the with-profits business and it is there because of the way the estate can be used to subsidise new business.[64]

36. Norwich Union disputed the suggestion that the presence of an inherited estate represented an unfair competitive advantage, reasoning that, if the ownership of inherited estate was 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".[65]

37. The FSA stated that it had "seen no evidence that the uses of assets of with-profits funds that we permit give rise to any adverse competition issues", and highlighted the fact that the fastest growing areas of life assurance firms' business was non-with-profits (funds which do not have inherited estates). In 2006, according to the FSA, only 5% of all new life and pensions business was in with-profits.[66] The FSA and Which? had both asked the Office of Fair Trading (OFT) to investigate the competition implications of inherited estate.[67] The OFT told us that it had conducted preliminary analysis which had found that:

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62 Ev 46

63 HM Treasury, *Sandler Review of Medium and Long term savings in the UK*, July 2002, paras 10.113–10.114

64 Q 51

65 Ev 86

66 Ev 81

67 Q 10; Ev 81

> 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 both types of products.[68]

The OFT's conclusion rested on two arguments. First, the opportunity cost for with-profits companies of using their inherited estate was no different from the opportunity cost of using the working capital set aside by non-with-profits competitors. Second, inherited estates had not increased significantly, nor had regulatory restrictions on their use decreased, from 20 or so years ago, when entry into the with-profits market by new competitors did occur.[69] The OFT commented that "even if new with-profits policies were being subsidised by inherited estates … this strategy is not being successful",[70] citing the declining popularity of with-profits policies in recent years, which had been mirrored by a rise in popularity of other similar products. In the OFT's view, the declining popularity of with-profits products was likely to be a greater barrier to entry of new firms than the presence of inherited estates in incumbent firms.[71]

38. Mr Christopher O'Brien, one of Ms Spottiswoode's expert advisers, suggested that the OFT's analysis had "understated a number of issues". Amongst these issues was the ability of with-profits firms to use an inherited estate to fund new business, mis-selling compensation claims and shareholder tax. Non with-profits firms would not have a similar source of funding for these costs. He argued that the ability of firms to charge such costs to inherited estate therefore distorted the market.[72] Which? raised similar points in relation to the OFT's evidence, leading them to conclude that "as a result we do not think that it has conducted a fair and reliable assessment of the competition impacts of inherited estates".[73]

39. **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.**

Mis-selling compensation costs

40. Where life firms have been involved in mis-selling with-profits products to policyholders, the firm is likely to be punished by the FSA with a fine and ordered to pay compensation to the policyholders affected. The FSA's rules do not allow firms to charge

68 Ev 108

69 *Ibid.*

70 Ev 107

71 Ev 114

72 Ev 168

73 Ev 163

the costs of mis-selling fines to their inherited estate, but do currently permit the charging of compensation costs arising from mis-selling 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.

41. Nikki Maynard, Prudential's Director of Strategic Projects, argued that policyholders should bear 90% of the losses arising from the business of a 90:10 with-profits fund, just as they would share in 90% of the profits. For shareholders to bear 100% of the cost on a business where they only received 10% of the profits, she argued, would seem unfair.[74] Mr Vicary-Smith said that the argument put forward by Prudential made him "very angry",

> because mis-selling costs are not normal costs, they are not the price of doing business, they are a fine imposed, if you like, for a corporate failure, and to enable them to be paid out of the inherited estate and not borne by shareholders is, to my mind, equivalent to allowing people to commit a crime and avoid a fine. It is actually not reasonable and not fair that people can engage in mis-selling and then avoid the consequences of that by paying it out of a different pot.[75]

Which? argued that mis-selling was caused by corporate failure, and allowing shareholders to avoid responsibility for the costs of mis-selling by charging the inherited estate went against all principles of good corporate governance.[76] In Mr Vicary-Smith's view, "the only way that firms will be discouraged from mis-selling is if the costs associated with mis-selling are borne by shareholders, and then shareholders will force them to take action not to mis-sell".[77]

42. Mr Prettejohn said that, in Prudential's case, the firm had made an undertaking that mis-selling costs "would not affect the future bonus payouts and the investment policy of the fund" for the relevant generation of policyholders. Therefore, continued Mr Prettejohn, the expectations of policyholders would not change as a result of mis-selling costs.[78] Prudential had taken £1.6 billion from their inherited estate to pay compensation (and associated administration) costs relating to mis-selling.[79] We suggested to Prudential that reducing the inherited estate by £1.6 billion to pay compensation costs would mean that policyholders would have less prospect of a distribution from the inherited estate. As Which? pointed out, every pound taken out of the inherited estate reduces the amount available for potential distribution.[80] Ms Maynard denied that policyholders had any such expectations:

> With-profits business is in and of itself an intergenerational play, because what we are doing with smoothing is smoothing out the volatility of the markets over time so

74 Q 184

75 Q 12

76 Ev 47

77 Q 13

78 Qq 179–180

79 Qq 181–182, 184

80 Ev 45

> that you will have transfers in and of themselves from people who have been in the fund in good years to people who have been in the fund in less good years, and therefore no one generation of policyholders would have any particular expectation on the estate of getting any pay-outs from the estate because the estate is there for the long-term use of the fund. In no way have we charged current policyholders with anything; indeed, we have maintained their expectations by saying that we would do nothing different in the management of the fund, notwithstanding the fact that these costs have been borne.[81]

Nevertheless, one might argue that, if the inherited estate were £1.6 billion larger than it currently is, a special distribution of some magnitude might have been possible. Under the FSA's rules, firms have to assess whether there is an excess surplus in the inherited estate on an annual basis. Current policyholders would stand to gain from such a distribution, if one were made. Mr Prettejohn said that the position was not so clear cut: "I think it would depend on all of the other factors surrounding our assessment of the financial condition of the fund. It is difficult to take one isolated element of the calculation of the size of the fund to make that judgment."[82] He insisted that policyholder expectations were instead "centred on whether or not they are getting the investment performance that they were being led to believe they would get and whether they will get the protection against volatility in the equity and capital markets that with-profits products provide".[83]

43. Norwich Union told us that it had so far paid £183 million from the inherited estate for mis-selling compensation claims, with a further £80 million reserved for future claims.[84] Mr Hodges denied that those funds would otherwise have been available for distribution to policyholders:

> It goes back to the issues of looking at the other factors to do with the fund performance and looking at where in a range we feel it is appropriate for the inherited estate that we require as working capital to sit. So I think it is too simplistic to assume that that money would have gone into the distribution … I think you have to be absolutely clear that no policyholder has paid; the policyholders' expectations around their individual policies have been protected. This has come from the inherited estate. The argument assumes that the amount of money that we need in the inherited estate in terms of working capital is so precise that any additional mis-selling would automatically flow through, and that is just not true.[85]

44. Ms Spottiswoode offered a nuanced view of charging mis-selling compensation costs to the inherited estate:

> I think there is some mis-selling that [is] part of running the business, and so I think some mis-selling … is kind of okay to charge to the estate because this … is supposed

81 Q 185

82 Q 246

83 Q 248

84 Q 251

85 Qq 252, 254

> to be the mutual running of the business, profitable or not, and there … will be some mis-selling that happens just in the nature of the beast. If, however, it is systemic mis-selling where shareholders have got a moral hazard, where they have got a conflict of interest, where they think that they can charge the estate and not [charge] shareholders, there was clearly an issue there, and so I think it all depends. I think there is a real case for looking at mis-selling, but it is not quite as black and white as sometimes it is portrayed.[86]

Norwich Union's view was that the mis-selling did not represent systemic failure; it was not a fine and therefore it was appropriate that the inherited estate should be used.[87]

45. In the light of the strength of views against the charging of mis-selling compensation costs to inherited estates, the FSA issued a consultation paper in June 2008 proposing to disallow such charges.[88] This paper stated that the FSA did not believe that the existing rules provided sufficient incentive for proprietary firms to address failures of systems and controls, and, as a result "with-profits policyholders may not be treated fairly". The FSA now takes the view that shareholders alone should bear the risk of such management failures.[89]

46. **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.**

Shareholder tax

47. When a special distribution is made from a with-profits fund, the firm incurs a corporation tax liability (at a rate of 28%) on the share of profits attributable to shareholders.[90] Some, but not all, life firms are permitted to charge this tax liability to their inherited estate, prior to the distribution, thus reducing the size of the distribution to policyholders, or, alternatively, the size of the residual inherited estate.

86 Q 55

87 Q 186

88 Ev 81

89 FSA, *With-profits funds—compensation and redress*, Consultation Paper CP08/11, June 2008, para 1.4

90 No such liability arises in mutual with-profits funds

48. Which? said that "effectively, they [life firms] are using money which would have gone to policyholders to pay the shareholders' tax bill".[91] Which? reported that policyholders gained less than 90% of the special distribution announced by Norwich Union in February 2008 as a result of the shareholder tax rule: "In addition to the £230 million payment to shareholders, an additional shareholder tax bill of £40 million will be charged to the inherited estate. The equivalent gross split between policyholders and shareholders might be equivalent to 88:12, rather than the 90:10, which is required by the policyholder's contract".[92] Norwich Union disputed that the effect of charging shareholder tax to the inherited estate was to subsidise the insurer's corporate activity or the shareholder's return. Instead, they argued, it was "to ensure that the insurance company's shareholders actually receive their 10% share of distributions".[93]

49. The FSA prohibits companies from charging shareholder tax to the inherited estate, unless it was the firm's established practice to do so, and the practice was disclosed in the firm's Principles and Practices of Financial Management (PPFM) document.[94] In explaining why the FSA had different rules for different companies, Mr Sants, the FSA's Chief Executive, acknowledged that this was a "tricky question", but defended the FSA's position as the right judgement "in the round". He argued that it would be wrong to disallow the charging of shareholder tax for those firms that currently do so, because this would constitute retrospective regulation:

> We absolutely acknowledge here we have an approach for those who have already declared it is custom and practice and for those who do not have it as custom and practice. This is clearly a difficult judgment. I absolutely respect that there are different views that could be taken on this. We tried to make a judgment in the round. I would come back to the general comments I have made about the fact that we are trying to make judgments in the round. We are also recognising that as a regulator we try not to make retrospective judgments. That is another good principle of regulation, you do not act retrospectively unreasonably. It is in that context we have reached the view that we have reached on tax.[95]

The FSA described its decision to permit those firms already charging shareholder tax to the estate to continue doing so as a "concession" in a 2004 consultation paper.[96] Which? argued that the FSA's position was "utterly illogical":

> If something is wrong, and they [the FSA] believe now, it seems, that it is wrong because they are not allowing people to do it, then [allowing] people to do it because they have done it in the past strikes me as a curious twist of logic. If it is wrong, it

91 Ev 47

92 *Ibid.*

93 Ev 86

94 See paras 88-91 for discussion of PPFM documents.

95 Q 108

96 FSA, *Treating with-profits policyholders fairly*, Consultation Paper CP 04/14, August 2005, Annex 4, p 4

> should not be allowed. If it is right, it should be allowed and it should be allowed for everybody; some people should not be treated differently from others.[97]

Ms Spottiswoode supported the view that the charging of shareholder tax was either appropriate, or it was not—it could not be both.[98] She was opposed to the use of inherited estate to pay shareholder tax and urged the FSA to consult on the issue.[99]

50. **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.**

97 Q 15

98 Q 58

99 Qq 54, 57

4 Special distributions

Excess surplus

51. Chapter 2 briefly explained how a firm may identify that a with-profits fund is in a sufficiently strong position to conduct a special distribution, when excess surplus in the inherited estate can be distributed to the fund's stakeholders in line with the normal basis of profit distribution in that fund. An excess surplus is defined by the FSA as an amount in the inherited estate which is "over and above the value of the assets required to match the fund's liabilities and the amount required as working capital".[100] The FSA laid out its rules regarding excess surplus in inherited estates:

> Our rules require firms with with-profits funds to consider at least once a year whether the fund(s) contain an 'excess surplus' ... 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 …, or other basis applicable to the particular fund.[101]

The Ministerial Statement referred to by the FSA was issued on 24 February 1995 by Jonathan Evans, the then Minister for Corporate and Consumer Affairs, who stated that:

> A life office may make distributions from surplus in the long-term fund as shown by the statutory annual actuarial valuation. It is common practice to make distributions to policyholders and shareholders in the proportion 90:10. In assessing policyholders' reasonable expectations, the Department [the then Department of Trade and Industry] would expect this ratio to be used as the basis of attribution between policyholders and shareholders.[102]

52. The senior management of the life firm are responsible for deciding whether an excess surplus exists, and deciding what to do with it. The FSA said that, "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".[103]

53. Mr Lister explained that Norwich Union, on an annual basis, looked at the capital contained within its fund and assessed whether or not there was an excess.[104] In 2007,

100 Ev 77

101 *Ibid.*

102 HC Deb, 24 February 1995, col 360

103 Ev 79

104 Q 201

Norwich Union had identified that £2.4 billion of the inherited estate was excess and had distributed this money on a 90:10 basis in February 2008.[105] This was Norwich Union's first such distribution since "the late 1980s".[106] Norwich Union's distribution was possible because the firm had decided to shift some of its assets backing guarantees out of equities and into (lower risk) fixed-income securities, so that less capital was required in the inherited estate to mitigate against the risk of investments under-performing.[107]

54. Mr Hodges said that the special distribution was linked to the firm's reattribution negotiations. In undertaking the reattribution process, Norwich Union had "sharpened [its] ability to look at the inherited estate and what may or may not be surplus". According to Mr Hodges, it was through the reattribution process that the firm came to the conclusion that, if Norwich Union were to change its investment appetite, they would be able to identify an excess surplus and make a special distribution.[108] Mr Hodges did not say that, if a reattribution had not been pursued, a special distribution would not have been made, but that when Norwich Union commenced its reattribution process, "the idea that a special distribution may be part of that process was something we had in mind".[109] Mr Lister clarified these comments by saying the distribution did not occur because of the reattribution as such, but because the reattribution led the firm to look in more detail at the with-profits fund.[110]

55. Mr Vicary-Smith argued that "the very fact there has not been a distribution up to now suggests either that the firms have been woefully incompetent in how they have assessed the level of that capital or that the FSA has not been sufficiently robust in challenging the numbers".[111] Sir Alan Budd and Sir Bryan Carsberg, two of Ms Spottiswoode's expert advisers, argued that the FSA should prevent firms from building up undistributed excess surpluses by setting actuarial limits on the assets that could be accumulated in a with-profits fund.[112]

56. **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 reattributions 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**

105 Q 172; Ev 83

106 Q 202

107 Q 208; Ev 86

108 Q 205

109 Qq 206–207

110 Q 211

111 Q 27

112 Ev 56

should give due consideration to the suggestion that actuarial limits be placed on the accumulation of assets in with-profits funds.

Policyholders' reasonable expectations

57. The obligation placed on firms by the FSA to assess annually whether their with-profits funds contain excess surplus means that some policyholders will wait with interest for the results of that assessment to see whether they can expect a special distribution. Whether such policyholders would be acting reasonably in doing so was a contentious topic during our inquiry. Placing a value on the policyholder's expectation of special distributions is particularly important in the context of a reattribution, because the firm would need to offer policyholders a sum at least equal to the benefit they would stand to gain from special distributions if they were to retain their contingent interest in the fund.

58. Prudential said that policyholders had a contractual relationship with the firm, their expectations were to receive their contractual benefits and no expectation had been created that they would receive any distribution from the inherited estate.[113] Prudential also warned that the current public debate on inherited estates "had the potential to create unfounded expectations in relation to ownership".[114] Norwich Union stated that their policyholders had no right to expect any special distributions during the lifetime of their policy.[115] Consequently, argued Norwich Union, any special distribution "should be considered a windfall".[116]

59. However, in his January 2008 oral evidence to us, Mr Sants said that policyholders did have a reasonable expectation of receiving some money from the inherited estate.[117] The FSA position was expanded on in its written evidence:

> 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.[118]

113 Ev 90

114 Ev 95

115 Ev 82; See Chapter 5 on special distributions

116 Ev 85

117 Oral evidence taken before the Treasury Committee on 22 January 2008, HC 258-i, Q 2

118 Ev 81

60. Ms Spottiswoode welcomed the FSA's declaration that policyholders' interests in an inherited estate were not zero:

> When I came into this job all the industry was claiming that policyholders could have no reasonable expectations of any payout and therefore any payment was going to be good for them … It is really important we know that the FSA does support that expectations are not zero. It means the industry can no longer make that argument.[119]

She stated that the FSA's clarification meant that firms would be unable to present a reattribution offer as a "windfall", because policyholders, if they accepted, would be surrendering something of tangible value.[120] Mr Peter Bloxham, Prudential's nominee policyholder advocate, argued that "in a reattribution, the starting point is that policyholders do have expectations of a future distribution from the inherited estate. If a company announces its intention to explore or propose reattribution, it is implicitly acknowledging these expectations as, otherwise, there is no transaction to negotiate".[121]

61. In response to these points, Mr Lister gave a slightly confusing explanation of what he thought policyholders should expect to receive from the inherited estate via special distributions:

> What we have tried to set out for policyholders is that they should have no expectations of such a distribution. So I would agree with the FSA that policyholders' reasonable expectation is not zero, but I am not sure what it is.[122]

Norwich Union argued that *policyholders as a group* should expect that, if and when an excess surplus arose, they would be eligible for a distribution on a 90:10 basis.[123] On an aggregate basis therefore, policyholders could have "some reasonable collective expectation of a distribution of an uncertain amount at an uncertain future time".[124] However, 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".[125] Mr Hodges said that policyholders' expectations did have a value in the ongoing reattribution negotiations,[126] but his firm's written evidence appeared to downplay this value, warning that it was "extremely unlikely" that distributions would be made from its with-profits funds in the near future:

119 Q 72

120 Ev 60

121 Ev 137

122 Q 235

123 Ev 85

124 *Ibid.*

125 Although new FSA rules do require firms to distribute excess surplus as soon as it has been identified.

126 Qq 236, 238

> Now this [recent £2.4 billion] 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.[127]

62. The Policyholders' Action Group, a group of Norwich Union with-profits policyholders concerned by that firm's reattribution, characterised the announcements by firms, including Norwich Union and Prudential, that current policyholders should not expect any distributions, as "unreasonable", "unfair" and "a crude attempt to create a 'bird in the hand' mentality amongst policyholders, and bully them into voting for reattribution".[128]

63. Mr Dominic Lindley, Principal Policy Adviser at Which? expressed surprise and disappointment that Norwich Union was advising its policyholders that they should have no expectation of payout from the inherited estate by referring to documentation issued to policyholders at the start of their policies. Norwich Union argued that it had "always made it clear in policy literature and communications with customers that they should not expect a distribution from the inherited estate".[129] Which?'s examination of Norwich Union's 1990s marketing material and policy documentation had found no reference to the inherited estate or any clear indication that people should not expect distributions.[130] Mr Lister admitted that in the 1990s the whole topic of the inherited estate was not discussed at all, and no reference was made to the inherited estate in policyholder documentation. He explained that reference was now made to the inherited estate in the firm's Principles and Practices of Financial Management document.[131]

Phasing of special distributions

64. Firms are permitted to phase payments from a special distribution if they deem it appropriate. Norwich Union decided to phase their recent distribution of £2.4 billion across three annual payments. With-profits policies eligible for the special distribution must be invested in the CGNU or CULAC with-profits funds on 1 January 2008 to receive the first payment, and then on 1 January 2009 and 1 January 2010 to receive the subsequent instalments. The impact of this phasing is that approximately 4% (or 40,000) of policyholders, those whose policies mature before 1 January 2010, will not receive all three payments. Norwich Union argued that the decision to phase the distribution over three years was fair because:

- "It rewards loyalty - and policyholders have indicated that they support this;
- It rewards the vast majority of existing policyholders (around 96%);

127 Ev 83

128 Ev 104

129 Ev 85

130 Q 23

131 Qq 230–232

- It does not disproportionately reward a policy which has just been taken out, especially substantial, single premium policy types; and
- There were also real concerns … 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”.[132]

Mr Hodges explained that Norwich Union “was trying to balance various interest groups within the fund, various groups of policyholders”.

> In terms of the profile of payments, obviously 100% of people will receive the first payment; something like 98% will receive two payments; and 96% will receive three. Even though it is three accounting periods that those payments are made over, in elapsed time it is 24 months, so that does allow, we felt, a reasonable balance between rewarding loyalty, keeping the funds stable—there are something like 120,000 people in the fund who are not eligible for a distribution because of the nature of their individual policy, and they benefit from the strength of the fund, so we had to balance their interests.[133]

65. Norwich Union has a With-Profits Committee, whose role is “to ensure that, inasmuch as their actual and prospective benefits and security are concerned, with-profits policyholders are treated fairly”.[134] Sir Nicholas Montagu, the Chairman of that committee explained why his committee had supported Norwich Union’s proposals to phase its special distribution:

> In reaching that view, we recognised that the surplus had built up over a long period of time and that, as a whole, the current generation of policyholders had not contributed to it. We felt that it was desirable to benefit long-term investors more than short-term ones; and also that it was important, in the interests of the generality of policyholders, not to put the funds at risk. Under this head, we were anxious not to encourage a run-off of business—which would have a detrimental effect on remaining policyholders.[135]

66. Mr Vicary-Smith described the phasing of payouts as “utterly outrageous”. His first complaint was that the phasing would “penalise some of the loyalist customers” of Norwich Union:

> There are people who have paid in for 20, 25 years and their policies maturing within the next three are not going to get the full pay-out. This is their money as much as it is anybody’s but they are going to be denied it.[136]

132 Ev 83

133 Q 215

134 Ev 151

135 Ev 154; See Chapter 6, paras 93–94 for more information about Norwich Union’s With-Profits Committee

136 Q 20

He also decried the argument that, in phasing the special distribution, Norwich Union would prevent opportunism as "quite ludicrous":

> Once the special distribution has happened people will only take their money out of the fund if they believe that the returns that they are going to get from those investments will be worse than the returns they are going to get from other investments. If the returns are going to be good, they will stay in the fund … What, effectively, is happening is that, because the returns are not going to be great, people are being locked in unreasonably, which we believe to be contrary to the FSA's own requirements that people do not face unreasonable barriers to exiting; so they are going to be locked in, in order to not take their money out and go to a better investment because they have got the hope of a distribution coming further on[137]

67. Ms Spottiswoode admitted that, because her role specifically concerned Norwich Union's reattribution, she had no particular locus on arrangements for the firm's special distribution.[138] Notwithstanding this, she said that the decision to phase the special distribution was "a shame".[139] In particular, she was unsympathetic to the argument that a single payment would have caused a problem for the stability of the fund.[140] Ms Spottiswoode also felt that phasing breached 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."[141]

68. Mr Sants admitted that the issue of phasing payments fell into the "category of difficult judgments" for the FSA. The reason for the FSA's approval of Norwich Union's phasing plan was to maintain the Fund's "sustainability".[142] The FSA's written evidence explained this point;

> Receipt of a single lump sum could create an incentive for some policyholders to cash in their policies … 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.[143]

137 Q 20

138 Q 63

139 Q 46

140 Q 62

141 FSA, *Business Plan 2008-09*, p 24, box 3; Ev 60

142 Q 120

143 Ev 79

The FSA also mentioned that the Norwich Union With-Profits Committee had granted their approval to the plan and that the FSA considered that phasing was "not an unreasonable barrier" to exit.[144]

69. We disagree with the argument that the phasing of a special distribution rewards loyalty. One could argue that such a scheme incentivises loyalty, encouraging people not to leave the fund within the 24-month distribution period, but it is hard to see how it rewards loyalty, when some of the longest-running policyholders of a fund stand to receive only a fraction of the distribution awarded to policyholders who had joined more recently. If a firm did wish to incentivise loyalty through a special distribution, we do not see why it could not phase its payments, but make all payments to all qualifying policyholders, including those whose policies had matured within the phasing period. **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.**

144 Q 141

5 Reattribution

Introduction

70. Chapter 2 introduced the concept of a reattribution as a transaction in which the with-profits policyholders of a firm are offered a one-off payment by the firm, in exchange for giving up their contingent rights to participate in possible future distributions from their funds' inherited estate.[145] The decision whether to accept the offer is not based on a majority vote: each individual policyholder makes a choice based on their own circumstances.[146] Those who reject the offer retain their interest in the fund and are not allowed to be disadvantaged by the reattribution process.[147] The fund itself retains its entire inherited estate, as the payment to policyholders is made out of separate shareholder funds.[148] There are several stages in the approval process of a reattribution scheme: shareholders, then the FSA and then individual policyholders. Subsequent to policyholders making their choice, the entire reattribution scheme is put forward to the High Court for final sanction.[149]

71. Mr Hodges said there were benefits for both shareholders and policyholders in a reattribution:

> In the policyholder case they can receive certain cash now, paid for by the shareholder, and that is against an uncertain future in terms of distributions. For the shareholder, it means that the capital can be used to write business where the shareholder, instead of taking a 10% stake, can take 100% stake, and that is really, again, at the heart of the commercial negotiation.[150]

Norwich Union described the decision to proceed with a reattribution as a commercial and economic decision. From the shareholder perspective the question to be asked was whether a reattribution would be the best use of scarce resources vis-à-vis other investment opportunities. For policyholders the question was whether reattribution represented a better deal than waiting for potential distributions on a 90:10 basis in the future.[151]

72. Mr Sants said that, in a 90:10 fund, the 90:10 ratio was the "starting point" for reattribution negotiations, but not necessarily the end point. The FSA's judgement was that if the FSA only permitted reattribution offers that were equivalent to 90% of the value of the inherited estate, such reattributions "would not take place".[152] Norwich Union gave two reasons why it was "not economic" for the firm to make such an offer to policyholders:

145 Ev 56

146 Q 49

147 Qq 80, 218

148 Qq 173–174

149 Q 218

150 Q 175

151 Ev 82

152 Q 93

> 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.[153]

Ms Spottiswoode acknowledged that there were risks that the company would take on following a reattribution, so that it would be legitimate for a firm to offer policyholders a sum less than 90% of the value of the inherited estate.[154]

Intergenerational transfers

73. Chapter 3 discussed how the setting aside of capital from the inherited estate for the acquisition of new business to the fund represented an intergenerational transfer from current policyholders to future policyholders, or in the case of a reattribution, future shareholders. Ms Spottiswoode had sought specific guidance from the FSA regarding the question of how this transfer should be treated in a reattribution. The FSA's subsequent guidance accepted that this tranche of capital did have a value attached to it and so should be included in the negotiated payment made by the shareholder.[155] Mr Sants similarly confirmed that, in negotiating with the firm, Ms Spottiswoode should take into account the value shareholders would unlock from the whole of the inherited estate, rather than just the value of potential special distributions foregone by existing policyholders in the reattribution.[156] If such value is reflected in a reattribution payment offered to policyholders, then policyholders would stand to receive a sum greater than the benefits they might reasonably expect from special distributions. Obtaining such a payment might prove difficult for policyholders though, because a life firm undertaking a reattribution would know that most policyholders would be willing to accept just enough to compensate them for their likely foregone distributions. Mr Bill Knight, one of Ms Spottiswoode's expert advisers, explained that a policyholder advocate could find themselves having to conclude that a firm's reattribution offer was in the interests of a significant percentage of policyholders, but overall was at a level that was unfairly beneficial to the firm. In those circumstances it would be difficult for a policyholder advocate to oppose the scheme.[157] Ms Spottiswoode recognised that this situation was a real possibility:

> So I have to say, "Given that the FSA says that you have to share your capital with future policyholders, if you are offered a billion in those circumstances, I have to say

153 Ev 82

154 Q 50

155 Letter from Sir Callum McCarthy to Clare Spottiswoode, 1 February 2008, available at www.fsa.gov.uk

156 Ev 58

157 Ev 73

> to you, that is a good deal." It does not mean it is a fair deal, but I have to say it is a good deal.[158]

Miss Spottiswoode said that it fell to the FSA to ensure that they watched the fairness criterion because she could not: "all I can do is comment on it, I cannot change it. I do hope the FSA will do that properly".[159]

74. **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.**

Policyholder advocate's role

75. The FSA introduced the role of policyholder advocate to represent the interests of policyholders who were eligible to participate in reattributions of with-profits funds. Ms Spottiswoode was appointed Norwich Union's policyholder advocate in November 2006, and she has since established a team of advisers, including legal, economic, actuarial, tax, communications and other experts to assist her.[160] She said that her "absolutely key role is to represent policyholders in this really complex transaction" and that, if the reattribution negotiations resulted in an offer being made to policyholders, her role would entail explaining to policyholders what the deal meant, putting it in context and trying to ensure that each individual policyholder was given the information required by him or her to make a personal decision as to whether or not to accept. She also saw her role as explaining context, "and some of that will be around how much is it that the policyholders are being charged, in effect, for the way in which the FSA regulates these estates". Finally, she said her role was about transparency:

> It is the FSA that creates the rules under which the transaction is done and it is the company that makes the offer, and so my role is very much to debate, discuss and to

158 Q 48

159 Q 71

160 Ev 56

> illuminate what is going on, but I do not have any specific powers other than those of illumination.[161]

76. One area in which Ms Spottiswoode thought her role could be improved was communication with policyholders. She wanted to be able to perform more direct communication, if "done with care and good judgment". She commented that better communication was important because most policyholders were quite distant from the issues involved in a reattribution and that a reattribution was very complicated.[162] The Policyholders' Action Group agreed that there had been inadequate communication from Ms Spottiswoode:

> under the Terms of Reference under which Clare Spottiswoode was appointed as policyholder advocate, she has been effectively "gagged" and has been totally prevented from disclosing any information to policyholders throughout.[163]

77. The Policyholders' Action Group were also very critical of the lack of powers of a policyholder advocate, characterising the role as "The Muggers' Advocate":

> 'The Muggers' Advocate' will warn you of the impending mugging; explain how the mugger intends to assault you, then tell you how much you are likely to lose and how injured you are likely to be. He/she may call the police (FSA) but they will probably sympathise with the mugger, give you a crime number and leave.[164]

78. Ms Spottiswoode explained that Norwich Union had been responsible for providing her with the resources she required, including paying salary costs of her and her team.[165] She added that she had been "very pleased" with the provision of resources, and she thought that, despite receiving a salary from Norwich Union, it was "clear that I am independent".[166] Mr Lindley argued that the appointment of a policyholder advocate should not be made by the firm concerned, but by "some other institution". Although he did not doubt Ms Spottiswoode's independence, he was concerned that another firm would be able to appoint a weak policyholder advocate if they so wished.[167]

79. **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.**

161 Q 85

162 Q 73

163 Ev 104

164 *Ibid.*

165 Q 41

166 *Ibid.*

167 Q 33

Role of the FSA in a reattribution

80. Once a policyholder advocate and a firm completed their reattribution negotiations, the FSA considers whether the overall proposals are fair to policyholders. In doing so, the FSA must 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. Information considered by the FSA in forming their view comes from the firm itself, the firms' with-profits actuary, the independent expert or reattribution expert (who is required to undertake an objective assessment of the proposals and to report on this) and the policyholder advocate. The FSA asks the firm to demonstrate that the proposals are fair and that they are consistent with all other relevant FSA requirements.[168]

81. As discussed in Chapter 4, in a reattribution of a 90:10 fund, the FSA's assessment of fairness starts with the principle 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, the FSA looks at the basis for that proposed division and decides whether it is fair.[169] The FSA also considers the offer's fairness to policyholders vis-à-vis the overall benefit to the shareholders.[170] This fairness assessment is made before the reattribution proposals are put to policyholders by the firm. If the FSA concludes that the proposals are unfair to policyholders, it would "take steps to prevent the firm from putting the deal to policyholders".[171] Where the firm and policyholder advocate agree that a reattribution deal should be put to policyholders, the reattribution scheme is presented to the High Court. The High Court's role in a reattribution is to give final approval to the scheme.[172] The FSA's assessment of fairness would form part of its submission to the High Court and so would be made public at this point.[173]

82. In oral evidence, Mr Sants explained the FSA's role:

> It is to ensure that it is fair for policyholders, for the customers. This is a complex and difficult process … We need to take into account not just the fact that it provides immediate fairness, but we need to ensure that the fund is sustainable. We have a long-term perspective on this and we have a complicated and difficult judgment to make. Clearly we are seeking to deliver fairness to the policyholders.[174]

Speed of negotiations

83. Norwich Union proposed a reattribution of its CGNU and CULAC funds in November 2006, and negotiations are still ongoing. Ms Spottiswoode explained that there were two

168 Ev 78

169 *Ibid.*

170 *Ibid.*

171 *Ibid.*

172 Q 218; Ev 84 and 142

173 Ev 78

174 Q 92

reasons, running in tandem, for the process taking so long: problems with the data, and the need to seek clarification from the FSA about policyholders' rights. She explained that:

> It took until December to get the data and the modelling to a position that we could all have confidence in. We thought we were there a lot earlier, but actually we found very big mistakes in the data because we had our own model. We were running different data and we were trying to work out why our data was showing different things and again and again we found really big problems in the Norwich Union models and their data. A lot of time has been spent having to sort out that. It was not until December that both Norwich Union and we felt we had data that we could rely on for this deal.[175]

Mr Hodges agreed that the Norwich Union reattribution negotiation had been a very complex issue, saying that there had been an "enormous amount of information" flowing between Norwich Union and Ms Spottiswoode's office.[176] Mr Hodges also referred to data issues which had prolonged the negotiations:

> We have been delivering data literally by the truckload most of the way through 2007. In those truckloads of data there was no doubt that there were one or two elements that we were then subsequently able to spot that were inaccurate, but that was really in the minority. The other issue that has been going on is Clare has been building her own modelling capability and her ability to assess the offers that we have made her, and all of those things together have just taken longer than we expected.[177]

84. Ms Spottiswoode also explained that at various stages in the negotiations, she had had to seek clarification from the FSA about the rights of policyholders. The seeking of clarification had run in tandem with the data problems:

> Alongside that, clearly we have been trying to clarify what policyholders' rights are and that has taken time. In some senses the two were going along in parallel and neither stopped the other because they both come together at the same time.

She said that a reattribution "is a long process because it is complicated and detailed" and that policyholders should not be surprised if it took a long time. She admitted to her frustration that it had not been done faster, but said "you have to do the job right. This is too important not to do right."[178]

85. Norwich Union made the following suggestions for improving the negotiation process for future reattributions:

- A timetable must be agreed and stuck to by both parties to avoid negotiations becoming open ended and unnecessarily protracted.

175 Q 74

176 Q 282

177 Q 283

178 Q 74

- 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.[179]

Ms Spottiswoode disagreed with the idea of having a fixed timetable for the negotiations. She argued that if negotiations had had to proceed based on the data as it was in August 2007, those negotiations would have resulted in a deal that would have been "very, very substantially wrong, by many hundreds of millions". Taking time to make sure that the data and modelling was accurate was an essential element of fair negotiations.[180] Mr Sants thought that there would be "some lessons to be learned about data availability and issues around that which the companies will have to take on board" from the experience of the Norwich Union reattribution, and suggested that the FSA would "try to facilitate a lessons learned exercise".[181]

86. **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.**

179 Ev 84

180 Q 76

181 Qq 122–123, 125–127, 132

6 Protecting policyholders' interests

A conflict of interests

87. We observed in Chapter 1 that directors of proprietary life firms have fiduciary responsibilities to look after the interests of their firm's shareholders, but also have obligations placed on them by the FSA to treat their customers fairly. Mr Hodges said that he had a duty to shareholders, but he also had a duty to policyholders and other stakeholders: "We look, as I think any successful company would do, to balance the interests of all stakeholder groups".[182] Mr Vicary-Smith said this conflict of interest was "inherently large", particularly where company directors received bonuses based upon the returns to shareholders. In such a situation, he argued, it was important that the FSA "holds the ring in a firm and robust way, and we feel in the case of the inherited estate that that is not happening sufficiently".[183] Given that managers of life funds faced significant conflicts of interest, Ms Spottiswoode was surprised at the level of discretion granted to firms in deciding how the inherited estate should be used. In this context she argued that the FSA therefore had a particular responsibility to protect with-profits policyholders, but she was not confident that the FSA's current rules did afford such protection. In fact, she said, the rules, particularly about the permitted uses of inherited estates, seemed to favour shareholders over policyholders.[184]

Principles and Practices of Financial Management

88. One safeguard for protecting policyholders' interests lies in the requirement for each life firm to publish the framework by which the firm's management will run the with-profits fund. The FSA requires each firm to produce such a document, called Principles and Practices of Financial Management (PPFM). 'Principles' are statements of the overarching standards which a firm adopts in managing its with-profits business, and must describe the business model used by the firm in meeting its duties to with-profits policyholders and in responding to longer-term changes in the business and the economic environment. 'Practices' describe a firm's approach to managing its with-profits business and responding to changes in the business and economic environment in the shorter term. The PPFM is required to cover the main areas where a firm has discretion in relation to its with-profits business, such as investment and bonus policy, smoothing, charges and expenses, volumes of new business and the management of any inherited estate.[185]

89. In the case of Norwich Union, the PPFM is published on the firm's website. Mr Lister explained that the PPFM "is not something that we give to policyholders; it is really there to enable the running of the fund and a check by the FSA and our with-profit committee on

182 Qq 154–155

183 Q 5

184 Ev 55

185 Ev 99

the running of the fund".[186] A "consumer-friendly" version of the PPFM is made available to all policyholders.[187]

90. Which? argued that a reliance on a PPFM left a firm with significant discretion as to how the inherited estate might be used. Firms are allowed to draft their own PPFM, stating how the inherited estate will be used, and must then report on their compliance with this document. Which? said this was "equivalent to letting firms set and mark their own exam papers".[188] For example, Mr Lindley claimed that Norwich Union had simply amended their own PPFM in order to allow themselves to charge the inherited estate a contribution towards the firm's pension deficit. The CGNU/CULAC PPFM document was amended on 1 January 2006 to clarify "how certain parts of the Staff Pension Scheme deficit can be credited or charged to the inherited estate".[189] Mr Lindley said this "really illustrates the massive freedom that companies have to use the inherited estate in ways which are detrimental to policyholders and, if they do not like the rules, the company are able to change them".[190] He argued that the FSA should actively be preventing such changes from being made, and should specify exactly what the inherited estate could be used for to minimise discretion.[191] Mr Lister denied that Norwich Union's PPFM had been changed in relation to the funding of the pensions deficit.[192]

91. The Financial Services Consumer Panel argued that the FSA's Treating Customers Fairly regime could be strengthened by introducing a requirement for a firm's management to produce a simplified annual financial statement setting out how it had used policyholder capital, including the inherited estate, over the past year and why it expected this use would provide a good return to the fund for the policyholders' benefit. The FSCP argued that:

> Although in theory this information can be gleaned from the PPFM, with-profits experts interviewed for the [FSCP's] research said, of PPFMs, that the management could 'tick all the right boxes' but may still not provide a clear picture of how capital has been used. The simplified statement could set out how the fund is invested, including its asset allocation and information about the asset management team. In addition it could include all other uses of capital, for example for new business purposes, to buy closed funds, to pay shareholder tax, to pay mis-selling claims, and to pay comparatively high levels of commission (relative to similar products) to advisers for the sale of new products.[193]

186 Q 196

187 Q 199

188 Ev 45

189 Norwich Union, *CGNU/CULAC PPF: Summary of Change*, Norwich Union product literature, April 2004, available at http://www.adviser.norwichunion.com/

190 Ev 48

191 Q 17

192 Q 195

193 Ev 146

With-Profits Committees

92. In 2005, the FSA introduced guidance requiring firms to put in place governance arrangements which “involve some independent judgement in the assessment of compliance with the PPFM”. The independent judgement can be provided in different ways including, but not confined to, establishing a With-Profits Committee (WPC) which includes some non-executive directors and external non-directors, or using an independent person with appropriate skills to perform the role.[194] Firms are expected “to ensure that they consult their with-profits governance arrangements on all significant issues affecting with-profits policyholders' interest”. 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.[195]

93. Sir Nicholas Montagu, the Chairman of Norwich Union’s WPC, provided us with an extensive insight into the role, responsibilities and operation of his Committee. According to Sir Nicholas, the Norwich Union WPC’s role was to “advise the [Norwich Union] 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”.[196] The WPC had an independent majority, with three independent members (including Sir Nicholas), and two officers of Norwich Union, the Marketing Director and the Director of Risk and Governance. The WPC met eight times between its inauguration in July 2007 and March 2008. In total, the time commitment for Sir Nicholas amounted to 35-40 days over 10 months. The other independent members had a time commitment of around 20 days over 10 months. The WPC was assisted by internal staff support (amounting to 25% of the time of one actuary, who acted as the WPC’s secretariat, and a member of the firm’s legal staff who took minutes at meetings of the WPC) and a group of independent advisers. The Norwich Union With-Profits Actuary was “heavily involved, both at and in between meetings, providing the main technical link to the committee and, with the head of the secretariat taking the lead in pre-meeting briefings”.[197]

94. The Norwich Union WPC reports to the board, who ultimately make all decisions.[198] Mr Hodges, said the WPC did not make “recommendations” to the board, but “express views which we [the Board] would be well advised to take strongly into account”.[199] Mr Lister added that “if the board chooses not to take the advice of the With-Profits Committee then the With-Profits Committee can go to the FSA”.[200]

95. Mr Prettejohn believed that Prudential’s WPC managed the potential conflict of interest between shareholders and policyholders “very well”. Contributing to this stated

194 Ev 81

195 *Ibid.*

196 Ev 84

197 Ev 151

198 Qq 161–162, 291

199 Q 163

200 Q 266

success of this WPC was the fact that all three members of Prudential's WPC were independent, with two of the members being qualified actuaries. Mr Prettejohn said that his firm's WPC provided "a very robust and detailed critique of the decisions that potentially affect the interests of policyholders versus shareholders".[201]

96. Mr Vicary-Smith did not share the industry's praise for the performance of WPCs. He wanted to see WPCs "turned from poodles into rottweilers", but in order for them to have teeth, they would need to be appointed by policyholders rather than the company; they would need to have a responsibility to act in the interests of the policyholders; and companies would have to be obliged to listen to, and act upon, the WPC's challenges.[202] Ms Spottiswoode added to Which?'s wish list the need for transparency, "because it is the only way in which you can be shown to be undertaking your duties on behalf of policyholders". She supported Which?'s suggestion of giving a WPC a very clear duty to look after the interests of policyholders and no other.[203] She noted that when her role as policyholder advocate came to an end (once reattribution negotiations had concluded), there would be "nobody who is looking after [Norwich Union's] policyholders' interests directly".[204] If the Norwich Union WPC were to take on her mantle, she argued, it would need greater support from independent advisers:

> We [the Office of the Policyholder Advocate] have been working on [the reattribution] solidly for over two years … nearly full time. It is difficult for us to get to grips with it. How you do it on a part-time basis, on monthly or quarterly visits to the company, I just do not know. They have to be well supported.[205]

97. The Financial Services Consumer Panel (FSCP) voiced several concerns about WPCs in a recent report, including a perceived lack of independence from the boards of their companies in the case of many WPCs. The FSCP's research found that, while some companies had moved towards a genuinely independent model, 60% of funds had a WPC that was not independent. In some cases the WPC was a sub-committee of the main board, while in others WPC members consisted of current directors, former directors and non-executive directors.[206] The FSCP believed that the independence of the WPCs should be strengthened to enable them to provide a public and regulatory 'window' on the firm's use of policyholder capital. The primary purpose of a WPC, in the FSCP's view, would be to ensure that the financial management of the fund, including the inherited estate, was in the best interests of policyholders and to achieve this clear objective the WPC would require independence from the firm's board.[207] Such a revised role for WPCs could be strengthened, in the FSCP's view, by an FSA-established 'knowledge and guidance centre'

201 Q 276

202 Q 34

203 Qq 66, 86

204 Q 86

205 *Ibid.*

206 Ev 145

207 *Ibid.*

for WPC members, and increased visibility of WPCs through, for example, a dedicated website linked to the company's website.[208]

98. The FSCP suggested further that the remit of WPCs be expanded to include a specific requirement to explicitly consider the FSA's principle of treating customers fairly.[209] At present, WPCs assess management decisions against the firm's PPFM. Whether or not such assessments alone would satisfy the firm's requirement to treat customers fairly would depend on the extent to which the PPFM itself complied. The FSCP's proposals might mean that the WPC could report on the company's use of capital in relation to its opinion of both the PPFM and the explicit requirement to treat customers fairly, setting out any discrepancies between the two.[210]

99. Ms Wilson said that the FSA had put in place a robust system "if operated properly". Whilst disputing the figures produced by the FSCP on the proportion of WPCs that were independent, she conceded that the FSA's own research had found examples of firms that lacked adequate independent input, as well as examples where WPCs were insufficiently consulted by management in a timely way. The FSA had "made it abundantly clear that that is unacceptable and we have seen some changes as a result".[211] The FSA's view was that independence of WPCs was critical, and they were "very much looking" for the development of effective WPCs that could provide appropriate advice, input and challenge.[212] Mr Sants agreed that improvements needed to be made.[213]

100. We welcome the advent of With-Profits Committees and believe that they have the potential to fulfil a very important role in protecting policyholder interests in with-profits funds. In too many firms though, With-Profits Committees are insufficiently independent of the firm's board to provide any reassurance that they are vigorously protecting and promoting the interests of policyholders. We expect the Financial Services Authority to accelerate its work in enforcing its requirements for independence of such committees. We are also concerned that With-Profits Committees are inadequately resourced. Norwich Union's policyholder advocate and her team have spent two years analysing just one part of with-profits funds on an almost full-time basis. In the context of strong potential conflicts of interest on the part of a firm's management, policyholders' interests need defending at all times, not just in the run-up to a potential reattribution. But we do not see how a part-time With-Profits Committee with staff support of one or two individuals can truly master the complexities of with-profits funds. **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.**

101. **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**

208 Ev 146

209 *Ibid.*

210 *Ibid.*

211 Q 136

212 Q 137

213 Q 138

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.

The Financial Services Authority

102. Mr Sants said that the FSA had an obligation, which it took very seriously, to make sure that policyholders were given a fair deal and their interests looked after.[214] Mr Sants thought that "It seems to me we have a good framework to which we are now seeking to deliver specifics to enable a balanced judgment in the round which is fair to be reached".[215]

103. The uses of inherited estate discussed in Chapter 3 have highlighted the large degree of disagreement over those uses that are appropriate. Inappropriate use of inherited estate is important because, by reducing the size of the inherited estate, policyholders' expectations of special distributions fall. A common refrain from policyholders, policyholder advocates and Which? is that the management of life firms enjoy too much discretion over the day-to-day running of with-profits funds. Where a firm is opposed by a vocal policyholder representative, common ground on the uses of the inherited estate seems hard to find. At this point, the FSA is obliged to step in and provide guidance.

104. Ms Spottiswoode suggested that the issues surrounding the inherited estate would be greatly simplified if the FSA were to adopt two general principles. The first would require that an inherited estate was subject to the same discipline as the rest of the with-profits fund. The second would require the firm to treat policyholder capital the same as shareholder capital. Such a general principle would preclude, she contended, the use of inherited estates in ways that favoured shareholders' interests over the interests of policyholders:[216]

> The whole thing would be transformed if we just had those general principle-based regulations because what that would do is change the nature of the negotiation. I had no idea that all this quite weird and wonderful regulation existed in with-profits.[217]

She struggled to see any logic in permitting uses of the inherited estate which were disallowed with other parts of with-profits funds:

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214 Q 90

215 Q 95

216 Ev 57; Qq 44, 53, 56, 64

217 Q 85

> 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.[218]

105. Ms Spottiswoode argued that, if these two basic principle were in place, "you would have a very clear litmus test for every decision that was made and, because it would be so clear, the companies would be clear, the FSA would be clear, [and] the policyholders would have more confidence that actually their interests were being looked after".[219]

106. Sir Alan Budd and Sir Bryan Carsberg were keen proponents of such a system. Such principles, they argued, would prevent undue discrimination both between groups of policyholders and between policyholders and shareholders:

> 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.[220]

The Financial Services Consumer Panel suggested that, in light of the concerns encountered in its research, firms' use of policyholder capital be reviewed more widely in an open debate.[221]

107. When we put Ms Spottiswoode's suggestion to the FSA, Ms Wilson answered:

> There is a very clear framework within our rules now about the handling of the funds within an inherited estate and they are either the working capital or they are an excess, … Whatever they are, it is absolutely clear within our framework that policyholders have an interest in that, they have a contingent claim over it and there are big restrictions on what the shareholders may use those funds for and generally

218 Ev 59

219 Q 61

220 Ev 63

221 Ev 144

> they may only be used in the interests of policyholders. It is quite clear the way our framework works and I think going forward we have a basis based on the consulted new approach which gives that.[222]

108. Mr Sants summed up the FSA's objectives regarding with-profits investment products:

> We are trying to deliver a fair deal for the policyholders but we also have a principle of saying that this is a credible and worthwhile investment product that should remain in the savings market. We do not think it is a good result for the marketplace, for the consumers as a whole, the UK, if this product disappears.[223]

109. **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.**

222 Q 131

223 Q 95

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 reattributions 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 reattributions 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)

Formal minutes

The following Declaration of Interest was made:

30 April 2008

Mr Philip Dunne declared an interest as a Norwich Union policyholder.

Tuesday 10 June 2008

Members present:

John McFall, in the Chair

Nick Ainger	Mr Michael Fallon
Mr Graham Brady	Mr Andrew Love
Mr Philip Dunne	John Thurso

Inherited Estates

Draft Report (*Inherited Estates*), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 and 2 read and agreed to.

Paragraph 3 read, amended and agreed to.

Paragraphs 4 to 9 read and agreed to.

Paragraph 10 read, amended and agreed to.

Paragraphs 11 to 21 read and agreed to.

Paragraph 22 read, amended and agreed to.

Paragraphs 23 and 24 read and agreed to.

Paragraph 25 read, amended and agreed to.

Paragraphs 26 to 38 read and agreed to.

Paragraph 39 and 40 read, amended and agreed to.

Paragraphs 41 to 45 read and agreed to.

Paragraph 46 read, amended and agreed to.

Paragraph 47 to 49 read and agreed to.

Paragraph 50 read, amended and agreed to.

Paragraphs 51 to 56 read and agreed to.

Paragraph 57 read, amended and agreed to.

Paragraphs 58 to 78 read and agreed to.

Paragraph 79 read, amended and agreed to.

Paragraphs 80 to 108 read and agreed to.

Paragraph 109 read, amended and agreed to.

Summary amended and agreed to.

Resolved, That the Report, as amended, be the Twelfth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Written evidence was ordered to be reported to the House for printing with the Report.

Written evidence was ordered to be reported to the House for placing in the Library and Parliamentary Archives.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

* * * * *

[Adjourned till Tuesday 17 June at 9.30 am.

Witnesses

Tuesday 22 April 2008

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Peter Vicary-Smith, Chief Executive and **Dominic Lindley,** Principal Policy Advisor, Which? Ev 1

Clare Spottiswoode CBE, Policyholder Advocate for Norwich Union, and **Dr Eileen Marshall CBE,** independent consultant, Office of the Policyholder Advocate for Norwich Union Ev 7

Hector Sants, Chief Executive, and **Sarah Wilson,** Director and Insurance Sector Leader, Financial Services Authority Ev 15

Wednesday 30 April 2008

Mark Hodges, Chief Executive, and **John Lister,** Chief Actuary, Norwich Union Life, and **Nick Prettejohn**, Chief Executive, and **Nikki Maynard,** Director of Strategic Projects, Prudential UK Ev 24

List of written evidence

1	Which?	Ev 42,162,163
2	Policyholder Advocate for Norwich Union	Ev 55
3	Financial Services Authority	Ev 75
4	Norwich Union	Ev 82,165
5	Prudential Plc	Ev 90
6	Aviva/Norwich Union With-Profits Policyholder’s Action Group	Ev 101,155
7	Office of Fair Trading	Ev 107
8	Co-operative Financial Services Ltd	Ev 115
9	Association of Friendly Societies	Ev 118
10	Investment and Life Assurance Group	Ev 123
11	Wesleyan Assurance Society	Ev 125
12	Royal British Legion	Ev 127
13	Royal London Group	Ev 128
14	UK Actuarial Profession	Ev 130
15	Steve Dixon Associates	Ev 134
16	Association of Mutual Insurers (AMI)	Ev 135,165
17	Prudential Nominated With-Profits Policyholder Advocate	Ev 136
18	Association of British Insurers	Ev 140
19	Financial Services Consumer Panel	Ev 143
20	Association of Consulting Actuaries	Ev 147
21	Sir Nicholas Montagu KCB	Ev 150
22	Centre for Risk and Insurance Studies, Nottingham University Business School	Ev 167

List of unprinted evidence

The following memoranda have been reported to the House, but to save printing costs they have not been printed and copies have been placed in the House of Commons Library, where they may be inspected by Members. Other copies are in the Parliamentary Archives, and are available to the public for inspection. Requests for inspection should be addressed to The Parliamentary Archives, Houses of Parliament, London SW1A 0PW (tel. 020 7219 3074). Opening hours are from 9.30 am to 5.00 pm on Mondays to Fridays.

Alderton, M
Allely, R
Allwright, D
Attenborough, R
Bednal, M & J
Bendall, R
Britton, L & E
Broadway, E
Brooks, R
Burke, L
Burston, OC
Burwash, G
Bustin, W & D
Butler, G
Cole, JP
Cooke, RW
Dalton, T
Davies, G
Edgington, A
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Fowler, G
Fullick, S
Gott, B
Hague, R & P
Harmar, GM
Hartopp, T
Hillyer, R
Hollis, DJ
Hudson, K
IFA Defence Union
Joffe, Lord
Jones, R
Kendell, D
Llewellyn, R
Mann, C
McCurrie, NM
McKenzie, KI
Meadowcroft, P
Mellor, K
Papps, L
Pett, S
Pilkington, J
Ranken, WM
Reed, P
Rice, M
Rowland, W
Sankey, J
Senior, A
Shann, C
Smith, TR & GP
Taylor, GR
Taylor, R & K
Thompson, M
Townsend, B
Wilson, G
Wise, P
Wright, M

List of Reports from the Treasury Committee during the current Parliament

Session 2007–08

First Report	The 2007 Comprehensive Spending Review	HC 55
Second Report	The 2007 Pre-Budget Report	HC 54
Third Report	The Work of the Committee in 2007	HC 230
Fourth Report	Climate change and the Stern Review: the implications for Treasury policy	HC 231
Fifth Report	The run on the Rock	HC 56
Sixth Report	Financial Stability and Transparency	HC 371
Seventh Report	Administration and expenditure of the Chancellor's departments, 2006–07	HC 57
Eighth Report	Re-appointment of Dr Andrew Sentance to the Monetary Policy Committee	HC 454
Ninth Report	The 2008 Budget	HC 430
Tenth Report	Re-appointment of Mervyn King as the Governor of the Bank of England	HC 524
Eleventh Report	Counting the population	HC 183

Session 2006–07

First Report	Financial inclusion: the roles of the Government and the FSA, and financial capability	HC 53
Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50
Fifth Report	The 2007 Budget	HC 389

Sixth Report	The 2007 Comprehensive Spending Review: prospects and processes	HC 279
Seventh Report	The Monetary Policy of the Bank of England: re-appointment hearing for Ms Kate Barker and Mr Charlie Bean	HC 569
Eighth Report	Progress on the efficiency programme in the Chancellor’s department	HC 483
Ninth Report	Appointment of the Chair of the Statistics Board	HC 934
Tenth Report	Private equity	HC 567
Eleventh Report	Unclaimed assets within the financial system	HC 533
Twelfth Report	The Monetary Policy Committee of the Bank of England: ten years on	HC 299
Thirteenth Report	Financial inclusion follow-up: saving for all and shorter term saving products	HC 504
Fourteenth Report	Globalisation: prospects and policy responses	HC 90

Session 2005–06

First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	HC 525
Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111

Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	“Banking the unbanked”: banking services, the Post Office Card Account, and financial inclusion	HC 1717

Oral evidence

Taken before the Treasury Committee

on Tuesday 22 April 2008

Members present

John McFall, in the Chair

Mr Graham Brady	Mr Andrew Love
Mr Philip Dunne	John Thurso
Ms Sally Keeble	Peter Viggers

Witnesses: **Mr Peter Vicary-Smith**, Chief Executive, and **Mr Dominic Lindley**, Principal Policy Adviser, Which?, gave evidence.

Q1 Chairman: Good morning and welcome to this first inquiry into inherited estates. Mr Lindley, your face looks familiar but could you still introduce yourself for the shorthand writer, please?
Mr Lindley: I am Dominic Lindley, Principal Policy Adviser at Which?.
Mr Vicary-Smith: I am Peter Vicary-Smith, Chief Executive of Which?.

Q2 Chairman: Welcome to this evidence session. Why does the issue of with-profits funds inherited estates matter to you as a consumer organisation?
Mr Vicary-Smith: Could I, firstly, say that we welcome the inquiry by the Committee and are very grateful for the opportunity to give evidence here today. There are two reasons why this matters to us. One is the scale of the issue and the second is the level of detriment which is potentially being suffered by consumers. Between Norwich Union and Prudential alone there is some £14 billion at stake across five million policyholders, and our belief is that unless something changes, unless what we perceive to be a currently inadequate weak regulatory regime changes, then there is going to be potentially some seven billion pounds of money transferred from policyholders to shareholders, and we do not consider that to be fair.

Q3 Chairman: We have half an hour for this evidence session, so we will try and have brief questions and brief answers on that because we have got a lot of points to get through. Mr Lindley, could you briefly explain to us the differences between a special distribution and a reattribution?
Mr Lindley: A distribution is a payment of benefits to policyholders and shareholders and the rules require that any distribution is on the basis of 90% to policyholders and 10% to shareholders. In a reattribution the company offers to buy out policyholders' share of the inherited estate, but we are concerned that it means that the 90:10 principle which was established, the company is able to by-pass that and exploit the regulatory framework to gain far more than 10% for its shareholders, and that means that policyholders are receiving much less than 90% and that policyholders lose out.

Q4 Chairman: You state that the inherited estate has built up mainly due to a process of 'smoothing' out returns to policyholders between good and bad years, yet many life assurance companies seem unable to identify the source of their inherited estate. How can you be so confident about the inherited estate's origins?
Mr Lindley: Many life companies do find it difficult to identify the sources of their inherited estate, but we know that in Norwich Union's case, because it has been confirmed by the Policyholder Advocate who has looked into this in detail, that all of Norwich Union's estate has built up from money they have kept back from policyholders over the course of many years. Part of that might have been almost deliberate short-changing of policyholders who surrendered early, and part of it will be because they have kept too much back for prudential reasons, but in Norwich Union's case it has all come from policyholders, and shareholders have contributed almost nothing to the inherited estate. We have got no problem with shareholders getting their 10% share, but we think 90% should go to policyholders.

Q5 Mr Dunne: Do you recognise the conflicts which are inherent for directors in managing their fiduciary responsibilities to shareholders, in the case of companies which are owned by shareholders as opposed to mutuals, and the obligations which the FSA places on them to treat their customers fairly? How do you see them resolving that potential conflict in relation to the inherited estate?
Mr Vicary-Smith: I think that there is an inherently large conflict between the fiduciary duty of shareholders in the way you have outlined, particularly as in many companies, I believe, including Norwich Union, where the company directors' have a bonus based upon the returns to shareholders, there is a clear incentive placed upon those individuals to actually work in the interests of shareholders. In a situation like this, where the interests of shareholders and policyholders can be perceived to be in conflict at times, given a share out of the limited cake, then we believe it is important that the FSA holds the ring and holds the ring in a

firm and robust way, and we feel in the case of the inherited estate that that is not happening sufficiently.

Q6 Mr Dunne: Can you elaborate on where you think the FSA are not doing their job properly?
Mr Vicary-Smith: Yes, it is in terms of what the inherited estate is allowed to be used for. For example, for the paying of mis-selling costs, for the subsidising of new business, for the paying of shareholder tax, such illustrations of things where there is a lot of discretion on the part of the company to use the inherited estate in ways they want to, and we believe there needs to be firmer rules on what it can be used for to protect the 90% interest of policyholders.

Q7 Mr Dunne: I think we are going to come on to some of those individual issues in subsequent questions, and so I will not pick you up on all of those at the moment, but to talk about the way companies use smoothing, do you think that it is an appropriate use of the inherited estate to allow policyholders to remove the gyrations of the market in the returns that they achieve?
Mr Lindley: We think it is an appropriate use of the inherited estate. We think that actually in many with-profit funds smoothing has turned out to be an illusion for many policyholders, and actually, when the markets fell slightly, policyholders ended up with large transfer penalties if they wanted to cash in their policies. So, smoothing clearly has not been delivered as many policyholders would expect. We think it is a legitimate use of the estate, but it is important to note that over the long-term the cost of smoothing will be neutral because it will be balanced by taking money out in the good years and then putting it back in in the bad years. The long-term cost to the company and to the inherited estate should be neutral.

Q8 Mr Dunne: If we turn to the acquisition costs of new business, I think you used the word "subsidising", Mr Vicary-Smith. Could you elaborate on your views about whether that is an appropriate use of the inherited estate?
Mr Vicary-Smith: Yes. What we effectively see is that where the inherited estate is used to pay for new business, effectively, the substantial initial costs of marketing, administration, and so forth, of writing new business gets paid for by someone other than out of the shareholders fund, they are paid for by policyholders through the inherited estate, and that means that when that business is then done there is a great incentive for more and more business to be written out of the inherited estate because, if you like, the initial costs are not paid for out of the company's assets. The consequence of that is that there is an incentive on firms to overestimate the returns that they would be getting from such new business in order to be allowed to write more of it because they are not allowed to write loss-making business. What we saw in the case of AXA is that AXA, when it was going through its reattribution, was forecasting growth[1], I think, of 4.5% a year up to 2050 in order to be able to write a lot of new business out of the estate. We employed an independent expert, who said it was going to be about two-thirds of that level. In fact, it was 85% less than AXA claimed it would be, as a result of which a lot of business was written out of the inherited estate, paid for by those policyholders, which actually turned out to, in effect, being loss-leading business and we are concerned that the incentive is on companies to overestimate the growth in new business so that could happen again.

Q9 Mr Dunne: You said you employed your own investigator in that case. Are you suggesting that there is lack of transparency in the use of the inherited estate more generally? How can you make the assertion that the new business is being written in this way for other companies?
Mr Lindley: There are two pieces of evidence: firstly, the FSA returns that these companies are required to file, which show the impact of new business on the size of the inherited estate, and in 2006 the impact of new business on the size of Norwich Union's inherited estate was to reduce it by £105 million. In the Prudential's case it was £94 million. Secondly, there is what the company has been using the inherited estate for in terms of guarantees. In 2006 Norwich Union launched a with-profits bond which had an inflation-linked guarantee. The press-release actually says that the guarantee is available at no extra charge to new investors, and we believe that is because it was using the inherited estate to almost subsidise this guarantee. We can also find that the amount of commission Norwich Union is paying on an investment bond is particularly high, certainly compared to the market average. They are then paying an average of 6.8% commission on a lump sum investment, and that is very high and will take a long time to get back from the charges. If they are applying policyholder capital to meet these up-front charges but that capital is not earning a proper rate of return, then that is a subsidy and it also distorts incentives for the company.

Q10 Mr Dunne: I think this gets to the heart of my interest or one of my interests in this inquiry. Is the inherited estate providing, effectively, an historic competitive advantage to the with-profits fund providers which is not available to other new entrants to the market? Is there any evidence to suggest that new entrants are prevented from entering the investment market as a result of this pot of money helping to provide competitive returns, as you have just suggested?
Mr Lindley: This is one aspect that we asked the Office of Fair Trading to investigate because we did not feel it had been covered sufficiently by the FSA, despite the fact that they have got a statutory duty under the Financial Services Markets Act to have regard for the almost anti-competitive nature of their rules. We have asked the OFT to investigate this and we wait to see what the results of their

[1] *Note by witness:* Growth of new with-profits business

investigation come to, but we think it does provide a very large advantage to the existing companies who have built up this money by short-changing policyholders and now they have got an advantage and have got pools of essentially free capital that they can use in a variety of ways. These concerns are not new, they were raised by Sandler in 2002, but the FSA has really failed to address them.

Q11 Mr Dunne: Is not the FSA conducting regulations on a principles-based basis rather than trying to micro-manage the activities, the decisions of every board in the insurance sector? Are you arguing for a much more penetrative style of regulation?
Mr Vicary-Smith: What we are saying is that the overwhelming requirement is for companies to treat their customers fairly. We do not believe the operation of the inherited estate, as it is going at the moment, is treating those customers fairly, and the FSA has a duty to challenge firms about how they are acting and behaving in a way that ensures that fair treatment, and that oversight and challenge is, we believe, not yet sufficiently robust.

Q12 Ms Keeble: I wanted to ask about a couple of the issues which you have already flagged up as being problematic. One was mis-selling and the other is the shareholder tax. On the mis-selling, what would your response be to the counter-argument which you put, which is essentially that, given that the with-profits fund benefits from mis-sold policies, it should also bear any costs associated with mis-selling?
Mr Vicary-Smith: This makes me very angry, because mis-selling costs are not normal costs, they are not the price of doing business, they are a fine imposed, if you like, for a corporate failure, and to enable them to be paid out of the inherited estate and not borne by shareholders is, to my mind, equivalent to allowing people to commit a crime and avoid a fine. It is actually not reasonable and not fair that people can engage in mis-selling and then avoid the consequences of that by paying it out of a different pot.
Mr Lindley: I think the FSA almost set down in 2003 that its key objective was that pay-outs to individual policyholders would not be reduced by the costs arising from a failure by a firm to meet their regulatory obligations. Every pound taken out of the inherited estate to meet these mis-selling costs reduces the returns to policyholders; so the FSA has set down an objective and then failed to meet it.

Q13 Ms Keeble: Would you argue then, Peter, that by adopting this approach the perverse incentive is that it can lead to continued mis-selling?
Mr Vicary-Smith: There is certainly no incentive on firms not to do so if they can pay it out of a different pot. To my mind the only way that firms will be discouraged from mis-selling is if the costs associated with mis-selling are borne by shareholders, and then shareholders will force them to take action not to mis-sell.

Q14 Ms Keeble: What do you think it is either about the strength of your campaign or changing circumstances which has led to the current consultation which the FSA is engaging in on this issue?
Mr Vicary-Smith: I would like to say it is the inherent rightness of our case. In a sense it is a shame it has taken so long for this. This is not a new issue, this has been going on for a while, and it is a shame it has taken so long to be reviewed. We welcome the review, or the consultation, and we hope it will reach the conclusion we hope it will and expect it to. The difficulty is, of course, that most of the mis-selling cost and most mis-selling has already taken place, so if you like the horse is out of the stable already, there are not going to be vast swathes in respect of costs in the future, and, therefore, people have done this and have got away with it.

Q15 Ms Keeble: You also flagged up the issue of using the inherited estate to pay shareholder tax. I wonder if you could set out your objections on that, in particular the fact that the FSA has two different rules for two different groups of funds? Albeit there are arguments that can be made for those, I wonder if you could set out your views on those?
Mr Vicary-Smith: Certainly. We consider it completely unreasonable that the inherited estate should be used to pay shareholder tax because, of course, if the inherited estate is reduced, then the pay-out to policyholders is reduced, and although you can look at it as a relatively small element in each year, taken in total it can give some big sums. For example, in the AXA case some £400 million was put aside as a provision against the payment of shareholder tax, but it all adds up. We consider the FSA's position to be utterly illogical. If something is wrong, and they believe now, it seems, that it is wrong because they are not allowing new people to do it, then why you allow people to do it because they have done it in the past strikes me as a curious twist of logic. If it is wrong, it should not be allowed. If it is right, it should be allowed and it should be allowed for everybody; some people should not be treated differently from others.

Q16 Ms Keeble: There is a third area as well, which is the possibility that Norwich Union intend to fund the deficit in the staff pension scheme from the inherited estate. What evidence do you have for that claim?
Mr Lindley: That is evidence stated in the Norwich Union Annual Report, in which they stated they were going to use part of the inherited estate to plug a deficit in their staff pension scheme, despite the fact they have never done this in the past; so they negotiated presumably with themselves to decide how much policyholders' money they were going to take to plug the deficit in the staff pension scheme, came up with a figure of £120 million and have stated in the Annual Report they were able to then change the rules in how they used the inherited estate to plug that deficit; and it really illustrates the massive freedom that companies have to use the inherited

estate in ways which are detrimental to policyholders and, if they do not like the rules, the company are able to change them.

Q17 Ms Keeble: Do you think that the FSA should intervene?
Mr Lindley: We think the FSA should prevent those kind of changes being made, they should specify if exactly what directors are supposed to use the inherited estate for so they have got less discretion, and they should not have discretion to just change the rules to deprive policyholders of money when they feel like it and when they see this cost coming and they do not want it to be borne by shareholders because it will impact on their bonuses and they have got a fiduciary duty to get the maximum return.

Q18 Ms Keeble: You have mentioned £400 million, roughly, as a cost of the shareholder tax issue and £83 million for the pension fund deficit issue. Have you totted up the amount which you would estimate that what you would regard as unfair use of the inherited estate has actually cost?
Mr Lindley: In the AXA case I think the unfair uses of the inherited estate accounted for over 50% of the inherited estate. We do not know exactly how much will be accounted for in Norwich Union because we are not as close to the negotiations and we have not seen any numbers yet, but we are aware of some reserves that they are making, like £180 million for mis-selling costs, around £83 million for the pension deficit and then there will be a further provision for shareholder tax. We are not aware of how much it will be yet, but it probably is going to be substantial.

Q19 Ms Keeble: What: hundreds of millions?
Mr Lindley: Hundreds of millions.

Q20 Peter Viggers: The Norwich Union is proposing a special distribution of £2.4 billion and, rather than distribute this to one static group of policyholders or shareholders, it is proposing that the payment should be phased over three years. Do you think this is a sensible and fair way ahead?
Mr Vicary-Smith: We think this is utterly outrageous. There are two elements to the special distribution we would like to draw to your attention. One is the issue of it being distributed at all, if you like. Firms are not allowed to keep excess surplus working capital, they have to return that to policyholders largely on a 90:10 basis, and the FSA is meant to challenge that every year, how much excess surplus capital. The firm decides how much it thinks it has and the FSA is meant to challenge it. On the basis there has now been a distribution, presumably one year ago the FSA accepted that there was no excess surplus working capital; otherwise it would have had to have been distributed, so suddenly it has developed from nothing to £2.3 billion in one year. Similarly, we have not seen any distribution from Prudential to its policyholders. My assumption is, therefore, that the FSA has accepted there is no excess there at the moment either, and I think if they move to a reattribution it will be interesting to see how much comes out of the woodwork. First of all, there is to my mind a complete failure to adequately challenge the assumptions the company is making on that surplus capital because they have to be distributed 90:10 to policyholders, and that has not happened in the past. As regards the actual phasing of the deficit, the effect of this is to penalise some of the loyalist customers Norwich Union have. There are people who have paid in for 20, 25 years and their policies maturing within the next three are not going to get the full pay-out. This is their money as much as it is anybody's but they are going to be denied it. The argument that in making this distribution you avoid opportunists I think is quite a ludicrous one. Once the special distribution has happened people will only take their money out of that fund if they believe that the returns that they are going to get from those investments will be worse than the returns they are going to get from other investments. If the returns are going to be good, they will stay in the fund. Why would they not? It would be a good investment. What, effectively, is happening is that, because the returns are not going to be great, people are being locked in unreasonably, which we believe to be contrary to the FSA's own requirements that people do not face unreasonable barriers to switching; so they are going to be locked in in order to not take their money out and go to a better investment because they have got the hope of a distribution coming further on. This money belongs 90:10 to policyholders, to policyholders now, and it should be distributed now on that basis.

Q21 Peter Viggers: There is one group of people who have a responsibility to ensure fairness on behalf of shareholders and policyholders, and that is the directors of the relevant insurance companies. You are speaking with a great deal of confidence and certainty in an area where there is very little confidence and certainty. Whose job do you think it is to ensure that fairness is achieved?
Mr Vicary-Smith: Ultimately it is the responsibility of individual firms to act in a fair way and it is the responsibility of the regulator to ensure they are doing so. Of course, yes, we are all feeling our way on what is fair, but, if you like, we apply very much a man in the street test. We talk to policyholders, we get their emails, 500 in the last few weeks alone, talking about how outrageous they feel about this, but fairness is going to be a perception issue, is going to be what seems reasonable to ordinary people, and at the moment this is not seeming reasonable to ordinary people.

Q22 Peter Viggers: But you are happy enough about the overall 90:10 breakdown?
Mr Vicary-Smith: We are happy on the 90:10 breakdown. We would like that to be applied to the inherited estate in general, not just to the special distribution.

Q23 Mr Love: If the inherited estate is legally owned by the company, if the policyholders, as we are told in some circumstances, have not contributed in any way to that inherited estate, why should the policyholders receive something from it?
Mr Lindley: The inherited estate was built up from the profits of the company, if you like, almost the past profits of the fund, and Norwich Union has confirmed that the inherited estate has built up from past profits. Policyholders' contractual entitlement is to 90% of the profits of the fund, so they have an expectation of receiving 90% of the profits of the fund over time. We have been quite disappointed in Norwich Union that it was trying to say to policyholders that, "When your policies were sold we told you not to expect anything from this inherited estate." We looked at some marketing material and some policy documentation provided back in the mid-nineties and we could not find any reference to the inherited estate or any clear indication that people should not expect distributions. The policy said that profits arise from various sources and that 90% of the profits from the fund will be returned to policyholders.

Q24 Mr Love: Let me press you a little bit on that. Norwich Union, as I understand it, are suggesting that current policyholders have not contributed in any way to their inherited estate, and this lies back somewhere in the dim and distant past. Does that not give you cause at least to question whether it is appropriate that the 90:10 split be given in that way?
Mr Lindley: We do not think so, because shareholders have not contributed to the estate either at all. In that case it would be normal to divide the profits as the rest of the profits are divided, and that basis is 90% to policyholders, 10% to shareholders.

Q25 Mr Love: Can I move you on to policyholders' reasonable expectations. At the time of the AXA distribution they suggested, and it seemed to be accepted, that they did not have any reasonable expectations. When the FSA came before us earlier in the year they rather reversed that and said that there was an expectation. How important is that as a consideration in this whole issue?
Mr Lindley: I think we welcomed the clarification from Hector Sants at the Committee in January that policyholders do have a reasonable expectation of receiving some money from the inherited estate. We think that was an important clarification because companies, as AXA argued, one of their main arguments was that because policyholders should never expect anything from this estate, then even the derisory, as we saw it, offer of 30 pence in the pound is a good offer because you would never have expected anything anyway. So the fact that policyholders do have an expectation of receiving money from the inherited estate is a positive step forward, but we feel that policyholders do have an expectation that 90% of the inherited estate will be ring fenced and then managed for their benefit and will not be used to pay shareholder tax on mis-selling claims or used in other ways which erode the estate and reduce the returns they receive from their policies.

Q26 Mr Love: Do you think that further clarification is required in relation to this issue? I am thinking in particular that, as I understand it, individual policyholders cannot have any expectation but policyholders as a collective can have an expectation and, of course, there is this whole timing issue about when a distribution is made and should it be made. We understand that both Norwich Union and Prudential have been holding an inherited estate for some considered time. Is there any clarification that is required there?
Mr Lindley: We think that could be useful, because at the moment policyholders, almost their rights and their interests to the inherited estate have not been properly protected by the FSA and, therefore, the company, just as AXA did, will be expected to put forward a scheme and it will say to policyholders: "If you do not take this up-front amount"—in AXA's case it was 31%—"then you will not get anything." That does not sound like a effective choice to me, it sounds like an ultimatum, and Norwich Union and the Prudential, as AXA did, will distort the way the fund is run and set the rules of the scheme to mean that for many policyholders, unless they accept the deal, they will get nothing. So they are almost trying to profit by making policyholders an offer that thousands of them will not be able to refuse.

Q27 Mr Love: Mr Vicary-Smith, you were quite trenchant about the FSA in relation to surplus capital and the implication that that should be distributed. Is there a mechanism there to try and at least pressure companies to distribute the inherited estate?
Mr Vicary-Smith: Yes, I think there is. Firms have to tell the FSA each year what they consider to be their excess capital, and the FSA then is meant to challenge that. The very fact there has not been a distribution up to now suggests either that the firms have been woefully incompetent in how they have assessed the level of that capital or that the FSA has not been sufficiently robust in challenging the numbers.

Q28 Mr Love: How do you explain then? Everybody seems to know what the inherited estate is in terms of the amount from Norwich Union—I do not think they have actually tried to hide that—yet the FSA have not said anything about whether or not that should be distributed according to their rules.
Mr Vicary-Smith: What should be distributed now is the surplus capital, because that is the only thing that has to be distributed immediately. If then there is agreement between the Policyholder Advocate and Norwich Union blessed by the FSA and the courts that enables a reattribution of the inherited estate, if there is a deal done, but until that deal is concluded there is no requirement to distribute other than the excess surplus capital.

Q29 Mr Brady: How concerned are you about the amount of time this process has taken? Do you have views about how the process and the regulatory system might be changed to expedite things?
Mr Vicary-Smith: I think a lot of the time has come about because the Policyholder Advocate has had to seek clarification on a number of issues like what the inherited estate can be used for, to understand the negotiating position she holds. I think it is unfortunate that those things were sufficiently unclear for clarity to have to be injected. The fact that clarity is injected does not necessarily mean that there will be a quick deal, because, of course, clarity does not mean to say there is any form of agreement. I think the most important thing here is that policyholders should not be bounced into a bad deal because of the issues of timing. They need a good deal and they need a robust defender of their interests.
Mr Lindley: I think it has built up and it has taken probably longer than expected. We have been warning the FSA for the past seven years, almost since the AXA case, that the process it was putting in place would not be sufficient to protect policyholder interest. So they have been warned about this; they have chosen to ignore those warnings. We think that is why the process has taken so long.

Q30 John Thurso: In your submission at one point, in paragraph 1.9, you urge us to ensure that the FSA conducts and publishes a full cost-benefit analysis showing how much money policyholders lose out due to this policy. Could you tell me what we should look to achieve with that exercise?
Mr Lindley: A cost-benefit analysis is important because it lays out all the options available to the FSA in terms of regulation. If the FSA was taking decisions like allowing shareholder tax to be charged to the estate, we would have expected a clear cost-benefit analysis showing exactly how much policyholders are losing out because of the FSA's decision. The FSA has not done that yet, and by designating the letter that they sent to Norwich Union[2] in correspondence as generic guidance rather than rules, it meant they have avoided the requirement to do a cost-benefit analysis. We think it would lay out the options for people; it would enable people to see exactly how much detriment the FSA's current regulatory framework is causing to policyholders.

Q31 John Thurso: It is pretty obvious from your submission that you think the FSA have been totally lax on this matter and what you are really saying is that they have got to get their act together and actually start doing some sharp work.
Mr Lindley: Yes.

Q32 John Thurso: Is that a fair summation?
Mr Lindley: I think it is.

Q33 John Thurso: The second question: following the concerns on the AXA reattribution, the role of the Policyholder Advocate came in. I do not want to ask you a question about that because we have the benefit of seeing her in a moment. I want to ask this specific question. Would you support a greater role for direct policyholder involvement? It seems to me that there are quite a lot of fairly intelligent and streetwise investors in these policies. Would it not be possible to have them involved in this process?
Mr Vicary-Smith: The Policyholder Advocate should be able to be in a position of negotiating on behalf of all the policyholders. It becomes very difficult, given the constraints this places upon them, and, indeed, one of the issues we believe is important is that the Policyholder Advocate is appointed by the company, they are not appointed by some other institution, they are then blessed by the FSA. Now, in fact, Norwich Union has appointed a policyholder advocate they are finding it difficult to negotiate with, I bet they would not appoint her again. That is, if you like, a mistake. What we do not want to see is a weak policyholder advocate appointed by a company because they can do so. What we then need to ensure is that in the communications between policyholder advocates and the With-Profits Committee, for example, they get a direct reply. At the moment if the policyholders write to Norwich Union's With-Profits Committee, they get a reply from the customer service centre, and that does not suggest independence.

Q34 John Thurso: Which brings me to my third and last question. You are perfectly scathing in your submission regarding the role of With-Profits Committees and, basically, say it is extremely poor corporate governance and very little in the way of independence. What would you like to see as a remedy, or is the committee so weak that it should not exist, or should it be beefed up to be an effective, properly governed body, truly independent?
Mr Vicary-Smith: I think if the With-Profits Committees are going to have any kind of teeth, firstly they should not be appointed by the company, they should, if you like, come out of the policyholder interest, they should have a responsibility to act in the interests of the policyholders and companies should have a responsibility to listen to them and to act upon challenges that are coming from them. All of those things are currently lacking. If you like, we would like to see them turned from poodles into rottweilers. They are there to represent the interests of policyholders and to negotiate and argue with companies. At the moment they do not have the remit to do that.

Q35 Chairman: I notice Sir Nicholas Montagu is the Chairman of the Norwich Union With-Profits Committee. Have you had any discussions with him?
Mr Vicary-Smith: We have written to him about some issues, I think the special distribution was one of them, and he has offered a discussion with us but it has not taken place at this stage.

[2] Letter from the FSA to Norwich Union and the Policyholder Advocate dated 6 December

Q36 Chairman: I note he has not submitted any evidence to this Committee. Does that surprise you?
Mr Vicary-Smith: It does surprise us, because, after all, he is there as the champion of the policyholders. I would have thought their views should be expressed to this Committee.

Q37 Chairman: Maybe word will get to him between now and next week. We could get a letter from him. That would be good, would it?
Mr Vicary-Smith: I think it would be good, but, as I say, it is largely in the hands of Norwich Union as to what happens, so you might want to ask them as well.
Chairman: With that, can I thank you very much for your evidence. It is very helpful to us.

Witnesses: **Ms Clare Spottiswoode CBE**, Policyholder Advocate for Norwich Union, and **Dr Eileen Marshall CBE**, independent consultant, Office of the Policyholder Advocate for Norwich Union, gave evidence.

Q38 Chairman: Ms Spottiswoode, welcome to you and your colleague. Can you introduce yourselves for the shorthand writer, please?
Ms Spottiswoode: Good morning. My name is Clare Spottiswoode; I am the Policyholder Advocate on behalf of Norwich Union for the CULAC and CGNU funds.
Dr Marshall: I am Eileen Marshall, and I am the main economic adviser to Clare on this particular transaction.

Q39 Chairman: Your role as Policyholder Advocate and the powers you enjoy: can you elaborate on that for us, please?
Ms Spottiswoode: Obviously, my absolutely key role is to represent policyholders in this really complex transaction and, because this is the first time there has ever been a policyholder advocate in some ways we have been blazing a trail to work out what it is exactly that we are negotiating, and one of the key issues there has been is what are the interests of policyholders, what are their rights and how do we value them? I do hope there is a deal, and I do hope that policyholders will be pleased with that deal. If there is one, then, clearly, absolutely crucially, the role will entail explaining to policyholders what the deal means, putting it in context and trying to ensure that each individual policyholder is given the information they need to make their personal decision as to whether to take up the offer, whatever the offer is, or whether to decide to stay with the fund, and it is very important in this particular transaction that policyholders do have that choice. I also think my role is to explain the context, and some of that will be around how much is it that the policyholders are being charged, in effect, for the way in which the FSA regulates these estates and, if it is the case that the company we believe is getting excessive returns, then how much is that? This role is about transparency. It is the FSA that creates the rules under which the transaction is done and it is the company that makes the offer, and so my role is very much to debate, discuss and to illuminate what is going on, but I do not have any specific powers other than those of illumination.

Q40 Chairman: This evidence session and the next one, what benefit can this provide? Are we not too late getting here? It is been going on for years.
Ms Spottiswoode: Certainly I really welcome this Committee's investigation, but we are very near the end of this process, so I think it is, in many ways, a great pity that it did not happen earlier. However, I do think you could help because, again, it is part of the transparency, it is part of the illumination of what is happening, and I think it is important that these things are debated in a wider framework, so I am delighted that you are looking at this.

Q41 Chairman: We will maybe come back to some of those points. What is the nature of your contractual relationship with Norwich Union? How independent are you and are there any areas of your work which you are unable to discuss with us?
Ms Spottiswoode: Clearly, all aspects of the deal are confidential. They are price sensitive and they are commercially confidential, so we would not want to discuss any aspects of the specific deal at this point. Once a deal is made, or, indeed, if it is withdrawn, we would hope that all those aspects would be in the public domain, because they should be, and policyholders deserve an explanation of what has been happening. In terms of my pay and rations in my office, they are paid for by the company, and the FSA has been very good about ensuring that we do have the right amount of resources to do our job properly, and it is complex. I cannot emphasise enough just how complex this process is. I am very pleased with the way in which we are provided the resources to do the job properly on behalf of policyholders and I think it is clear that I am independent. I think it is for you to decide whether there are any conflicts that I have, but I do not feel any.

Q42 Chairman: You have been negotiating with Norwich Union for many months now. Can you give us an insight into what potential conflicts of interest arise within a proprietary life company managing a with-profits fund?
Ms Spottiswoode: Clearly there is lot of discretion in the way in which a with-profits fund is run, and that does not matter as long as policyholder interests and shareholder interests are aligned, but there is a real problem in the way in which with-profits regulation is regulated because there are inherent conflicts of interest in the way in which the FSA chooses to regulate with-profits. We are advised by Sir Bryan Carsberg and also Sir Alan Budd, who are clearly

very experienced in this area, Eileen and I are pretty experienced in regulation, and we were all surprised by the way in which the FSA does regulate this business, because it is their regulation which introduces quite a lot of the conflicts that we see. I think if they had introduced a general principle, which kind of would be second nature to the way I am used to regulation happening, a general principle by which the capital in the with-profits fund was treated identically whether it was assigned to the estate or whether it was assigned to the rest of the with-profits fund, if we had that simple principle in place, then we would not have the distortions that we see today, we would not have the unfairnesses that we see between the participants, we would not see the anti-competitive behaviour that exists in these funds and the company's interest would be aligned with policyholders. It is an obvious regulatory rule to put in place. I also think there is a real issue about the way in which the regulator allows a company to treat policyholder capital differently to the way it treats shareholder capital. Again, if the regulator insisted that the company were to treat policyholder capital identically to the way it treats its own capital, we would not see these conflicts.

Q43 Chairman: So do you think that the FSA has not been doing its job as it should have done?
Ms Spottiswoode: I absolutely do disagree fundamentally with the fact that the FSA does not have those two protections in place for policyholders, and I will explain as we go on where that comes in.

Q44 Chairman: Do you share Which?'s concerns that Norwich Union is permitted by the FSA to use inherited estates for purposes which appear to be of little, if any, immediate benefit to existing policyholders in particular?
Ms Spottiswoode: Go back to the general principle. If there was a general principle that forced the estate to be used in the same way as the rest of the fund, then we would not see capital being used in ways that could not be charged to the general fund but, if there is an estate, then it is allowed to be charged to the estate. In a reattribution that causes a particular problem because, in effect, the company is getting a benefit out of that estate outside the 90:10 rules; so after reattribution the estate will be wholly owned by company, they will not any longer be able to charge that shareholder tax to anybody else but themselves and so, in effect, they are getting the benefit today outside the 90:10 principles and, therefore, what we have to do is work out how much the benefit is worth to shareholders. Clearly, shareholders will be giving up that benefit in a reattribution, so we have to work out what that benefit is worth and then take it off the value of the estate before we talk about fairness in a reattribution between policyholders and shareholders. The absolutely big issue is with new business: because what happens is that if the company says that it wants to write a lot of new business, the way that the FSA regulates with-profits, because it does not treat shareholder capital the same as policyholder capital, it allows policyholder capital to be used to subsidise new business going forward. So, in effect, you get a transfer of capital between the generations and, clearly, that is a value to shareholders because they are able to use that capital for free, they get their 10% and so they are effectively getting money when they have not actually paid for any of the capital used to buy that money; but in a reattribution policyholders, because they are sharing that estate with future voters, effectively the company only has to offer whatever it is that the current policyholder would have expected to receive. I think it is probably worthwhile just giving an example. This is no reflection at all on the numbers we are dealing with, but just say there is an estate of £15 billion and just say that shareholders value the stuff they are getting out of the estate from being able to use the new business, the free capital in the estate, from the shareholder tax, from various other benefits that they are able to use outside the 90:10 environment, just say that it is worth £5 billion. We then have to take off that £5 billion before we start the reattribution exercise, because that is the value to shareholders today of their interest in the estate outside the 90:10. After the event shareholders will clearly be writing profitable with-profits new business, and clearly the FSA thinks that with-profits business will still be written. But in that event the company will be charging fully for the cost of capital that it needs to fund strain. It will clearly be charging fully for the cost of capital that needs to be locked in to back that fund, so at that point shareholders are buying new business and they are getting a full return on the capital which they are spending. But today policyholders are expected to give their capital to new business, so shareholders are treating the capital in a totally different way now from the way that they will treat the capital once there is a reattribution. If you just got rid of those two problems: treat the estate fund in exactly the same way as you treat the rest of the fund, treat policyholder capital in the way you treat shareholder capital. It seems to me that it is a duty of the FSA under its duties to policyholders to protect the interests of policyholders, and the least you would expect is that they would insist that the companies treated policyholder capital in the same way as it would treat shareholder capital; so just a really basic regulatory framework.

Q45 Chairman: You and Norwich Union appear to fundamentally disagree over the origin of the inherited estate.
Ms Spottiswoode: No, not at all. The company has never claimed that the shareholders contributed to this estate. We are all agreed that it is a policyholder asset from the past. We can debate, there are nuances and dancing on pins as to whether current policyholders contributed, but, frankly, this is a policyholder asset and if there were not leakages from the estate it would be a 90:10 asset in policyholders' hands, and we do not disagree with that.

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Q46 Mr Dunne: Were you surprised when Norwich Union announced the significant distribution that they did so shortly after their year end, which presumably would have assessed whether there was sufficient excess capital and whether there was any excess capital or not?
Ms Spottiswoode: I think this goes back to---. It is quite clear that after the reattribution the capital will belong to shareholders. Do they have the same appetite for risk that they are prepared to have when the policyholders are, in effect, owning 90% of that capital? If it is the case that after a reattribution they believe that they will change and de-risk the funds, then that immediately releases a huge amount of surplus capital for distribution, and that is what is going on. The company decided to de-risk its capital, as a result of that £2.4 billion was released for distribution and that goes out 90:10—it is a shame it is going out over three years—so it is as part of this exercise that that capital has been revealed, but I think you have to ask the basic question: why is the company not expected to treat the capital in the same way if it belongs to shareholders as if it belongs to policyholders?

Q47 Mr Dunne: Do you see it as part of your role, and, if you do, how do you go about doing this, to assess the benefits for policyholders of a one-off purchase of their future potential income stream from distributions through a reattribution process? Essentially, if I understand it correctly, reattribution means that their rights to future distributions are being bought out now?
Ms Spottiswoode: Yes.

Q48 Mr Dunne: To what extent do you get involved in that pricing decision? Presumably you will be recommending to policyholders or providing them with the means to assess, on an individual basis, whether they should accept this offer or not?
Ms Spottiswoode: Yes, and it has been very important that we have had our own independent model so that we can model our own view of what policyholders will be getting, and that has been really important in this exercise: to ensure that we keep and understand what the Norwich Union models are saying so that we can create our own independent view. Also, when it comes to advising policyholders, we can advise them on the basis of our intimate knowledge of what is going on. I did not actually finish off my example. If we go back to the £15 billion and you take off £5 billion for all the uses of the estate, what we then have is—because of the way the FSA regulates the with-profits business, because it allows policyholder money to be used differently from shareholder money and, therefore, it allows the policyholder capital to be transferred to future generations—then if the company says it is going to write lots of new business (and it has a big interest in writing lots of new business because what that does is mean that current policyholders will get less), so just say they say they are going to write lots of new business and it looks like current policyholders will only get £1 billion of that £10 billion of the estate that they would have had under the 90:10 basis, if there was no new business being written. Then, in effect, the company only has to offer £1 billion to buy out all those policyholders' interests: they get 100% of people to vote for the deal, even though, if the FSA was regulating the way I think they should be (that is treating policyholder money the same as they would shareholder money), actually policyholders would get the full £10 billion. My job is to work under the current regulations. So I have to say, "Given that the FSA says that you have to share your capital with future policyholders, if you are offered a billion in those circumstances, I have to say to you, that is a good deal." It does not mean it is a fair deal, but I have to say it is a good deal. Now, I have been very critical of the FSA, but they have done a number of things to help us. In particular, they have helped us to make sure that we get the distribution out, but also they have helped by saying that they will look at the fairness of this deal to make sure that shareholders do not gain too much. If they were to offer a deal that did have those kind of proportions, I presume that shareholder returns would just look far too excessive and the FSA would step in to make sure that that deal did not go ahead on that basis. I cannot step in. I do not have those powers. All I have is the power to analyse and to illuminate what is going on.

Q49 Mr Dunne: Without getting into the details of your negotiation, is this an all-or-nothing deal? If a sufficient majority of policyholders approve it, does it then go through for all policyholders, or will there be a residual inherited estate from those who reject the offer?
Ms Spottiswoode: No, actually this is particularly good, this particular deal, because every individual policyholder has their own individual decision as to whether to take the offer or not, so they can decide whether to stay with the fund or not, and we will be giving them advice to try and help them analyse whether they should take up the offer or not.

Q50 Mr Dunne: Picking up on your point about new business, you said it is very important for the company to continue to write new business. Can you explain why? Apart from the obvious commercial interest of a company in growing its business, why is it so particularly important that they write new business?
Ms Spottiswoode: I do not think it is particularly important; I think new business should be written if it is profitable. What I have struggled with is a situation where the FSA does not stop the company from writing business using policyholder capital and using that as a subsidy. It seems to me that a healthy, profitable with-profits business requires them to write profitable new business and, as long as customers want to buy with-profits business and it is profitable, I have no problem with that. What I have a problem with is when policyholders' money is taken in the process and they do not have any choice in that and their money is taken away from them, so their rights and entitlements go down from 90:10 in the estate to something quite a lot less, and we know in AXA it was about 30p in the pound. We do not

know yet what this deal will bring, but it is going to be a lot less than 90:10. There are reasons why it should be less than 90:10. The surplus capital goes out at 90:10, but the rest of the estate is there to back the policies. There are risks that the company will take on in taking on the whole estate, and that is worth something. So you would never expect a 90:10 deal out of this, but it would be nice if we were doing the negotiations on a level playing field where it was clear that we started off with the estate belonging 90:10 to policyholders and then we dealt off that basis.

Q51 Mr Dunne: Is that what you mean by the anti-competitive behaviour that you referred to earlier?
Ms Spottiswoode: Yes. If you do not have an estate, you obviously cannot use the capital in the estate to subsidise your new business. And so it is not a surprise that Aviva and the Pru and Legal and General who are the only ones, with substantial estates write well over 50% of the new business in with-profits. It is no surprise that most businesses do not choose to write with-profits business, because if you do not have an estate why would you write with-profits business when you have got a competitive disadvantage from doing so? You will write other products. So I think there is clear evidence that there is anti-competitiveness in the with-profits business and it is there because of the way the estate can be used to subsidise new business. But maybe it is enough for the OFT to get involved, maybe not. I do not know. It is quite clear that, as soon as you get a distortion like that, you have got a problem and it ought to be sorted.

Q52 Mr Dunne: If it is sorted for the proprietary companies, which you are involved in, where does that leave the mutuals?
Ms Spottiswoode: In a healthier position. If you are forced to write profitable new business, then the mutuals should be delighted because it means they are more likely to survive into the future. It is never good for businesses to write unprofitable business; it is not a way to be healthy and strong. I know a number of mutual companies who say to me they absolutely want us to get the FSA to change these rules because they want to write profitable new business. They do not think it is fair to their policyholders, who are also their shareholders, to write unprofitable business.

Q53 Mr Dunne: What would you be asking the FSA to do in changing their rules specifically?
Ms Spottiswoode: Very simply, I would put in an over-arching principle that says treat the estate capital the same as you treat all other capital and, by the way, as you do it, make sure you protect policyholders by making sure that the company treats their capital in the same way as it treats shareholder capital. It is very simple.

Q54 Ms Keeble: I wanted to ask about the use of the inherited estate for other purposes, first off for the payment of shareholder tax. Do you think that is right?
Ms Spottiswoode: No. Clearly, if you do not allow shareholder tax to be paid by the rest of the fund, why should you allow the estate to suddenly pick up the bill. It kind of goes against my basic principle. You just look at everything like that. Would you be prepared to charge it to the basic fund? If you would not, you should not charge it to the estate. If you allow it to be charged to the estate, then it goes outside the 90:10. That breaks the principle of 90:10. It is very simple.

Q55 Ms Keeble: How about the mis-selling?
Ms Spottiswoode: I think on the mis-selling I would have a slightly more nuanced approach, because I think there is some mis-selling that goes along with being part of running the business, and so I think some mis-selling, as long as it is genuinely part of running a business, is okay to charge to the estate because this is the 90:10, it is supposed to be for the mutual running of the business, profitable or not, and there will be some costs that are charged to new policyholders on the basis that there will be some mis-selling that happens just in the nature of the beast. If, however, it is systemic mis-selling where shareholders have got a moral hazard, where they have got a conflict of interest, where they think that they can charge the estate and not shareholders, there was clearly an issue there, and so I think it all depends. I think there is a real case for looking at mis-selling, but it is not quite as black and white as sometimes it is portrayed.

Q56 Ms Keeble: If you are giving advice—it follows on a bit from what Philip asked—if you are then saying to the FSA what they should be doing about regulation, what do you say then about the principles and how they apply? You said very clearly in the case of the shareholder tax and then you have diluted it with the mis-selling. I just wondered how you arrived at that?
Ms Spottiswoode: I would ask the question of the FSA: would they feel comfortable with this cost being charged to the fund? If they would feel comfortable with it being charged to the fund—I do not mind where it is charged, whatever part of the fund it is called it does not matter, what matters is it a fundamental cost that is appropriate to charge to the fund? If it is not, do not allow it and certainly do not allow it as a special exception in the estate, because that just causes conflicts of interest and all the problems that we have talked about.

Q57 Ms Keeble: You are presumably talking to the FSA about the consultation which they are doing, are you?
Ms Spottiswoode: No. I think we are the main prompt of that because it has been part of the outcome of our request for guidance that has been going on now for some time. That is the one thing that they said they would reconsult on. I think they should reconsult on shareholder tax, because I cannot see how it can possibly be fair.

Q58 Ms Keeble: How about the split advice on the shareholder tax or the different approaches that are taken. Do you think that is helpful or not?
Ms Spottiswoode: No. Either it is appropriate to be charged to the fund or it is not. If it is a shareholder tax that is not appropriate and you are not prepared to charge to the normal fund, then do not charge it to the estate.

Q59 Ms Keeble: You heard what the people from Which? said about the use of the inherited estate to plug the hole in the staff pension fund. Have you found any evidence of that?
Ms Spottiswoode: Certainly the numbers, obviously, that we have got are correct, but again it goes back to: is this an appropriate charge, and is it correct and is it appropriate to charge this as part of the costs of running the fund, or are they charging too much? It is, again, a question of nuance. Is it an appropriate charge or is it not? If it is not an appropriate charge, do not allow it to be charged to the estate, shareholders should absorb the cost.

Q60 Ms Keeble: What is your view? Do you think it is appropriate or not, that one?
Ms Spottiswoode: I suspect I probably would allow it actually, and I am sure Which? would disagree with me, but I think it is a legitimate expense, clearly pensions are a legitimate expense, and as long as all those pensions are for this particular fund, then I think it is appropriate to charge it to this particular fund.

Q61 Ms Keeble: So your criticism of the FSA is actually not to be clear enough in the series of issues arising from the inherited estate. It is not just one principle, is it, it is a series of working through?
Ms Spottiswoode: It is about applying that basic principle. First of all, the basic principle is not there. If the basic principle was there, I think you would have a very clear litmus test for every decision that was made and, because it would be so clear, the companies would be clear, the FSA would be clear, the policyholders would have more confidence that their interests were being looked after and I just cannot understand why it is not being done.

Q62 Peter Viggers: What will be the impact of Norwich Union's decision to phase its payments over three years?
Ms Spottiswoode: First of all, the excess capital is there, as Which? says. It is excess capital today, so I do not understand why it is not being paid out today. We have also had quite a lot of people complaining to us, saying that their maturity is coming up before all the three payments have been made, they have been in the fund for a long time, it simply is not fair, they are not getting all three payments, and I agree with them. I have yet to hear any arguments about why this would cause a problem for the stability of the fund that makes any sense to me, and we have asked Sir Nicholas Montagu to tell us why he has made this decision within the With-Profits Committee. He has not responded. We have asked him to make transparent what the rationale was for supporting the three-year deal. He has not responded. So, I have to say, it is not a very good start for the With-Profits Committee.

Q63 Peter Viggers: I was going to ask you if you have any influence over of the terms of the special distribution, including the phasing, but I think you have answered my question.
Ms Spottiswoode: Yes.

Q64 Peter Viggers: In your memorandum to us you said that you were surprised to discover that insurance company managements enjoy an unusually large amount of discretion in determining what part of the return should go to policyholders and what part to shareholders. There is, indeed, an enormous amount of uncertainty in this general area. Do you think that your specific proposal that the FSA should exercise its decision and ensure that policyholders are treated fairly, as you say in your memorandum, do you think that one point is sufficient to bring clarity to this whole area?
Ms Spottiswoode: Absolutely. If you made it clear that you could not use the estate in a different way from the rest of the capital, you would ensure that the 90:10 principles were upheld throughout the fund; if you upheld that shareholder capital had to be used in the same way as policyholder capital, you would do the same. Actually you do not need the second one, you only need the first one, because the second one follows naturally from the first principle. You would then ensure that the company did not have an incentive to write new business using policyholders' money that was not profitable, or that was using policyholder money and subsidising new business, and everything just falls into place.

Q65 Peter Viggers: But the FSA is a regulator, not a rule maker.
Ms Spottiswoode: This is a principle and it is supposed to act by principles. What I am proposing is a very simple principle. You could get rid of a lot of regulation if you had that very simple principle.

Q66 Chairman: Sir Nicholas Montagu seems to have taken a vow of silence. I am thinking after we see the transcript to write to him. What should I be asking him that would help our session here?
Ms Spottiswoode: I think you should ask him, first of all, why he did not see fit to explain to us why he had made the decision to ask the company to phase the payment over three years; it would be nice of him to explain to you, if he is not prepared to explain to us, why he has done it; but I also think policyholders have a right to know why he made that decision. So I think transparency, and that is one of the things. There are two things I want to see out of a WPC. One is transparency, because it is the only way in which you can be shown to be undertaking your duties on behalf of policyholders, and the second thing I would do is to make it very clearly a duty of the WPC that it looked after the interests of policyholders and no other.
Chairman: Good. We will do that then. Andy.

Q67 Mr Love: Can I clarify a question that you answered earlier on when you said that the origins of the inherited estate were agreed between you and Norwich Union, and I think you went on to say that the agreement was that shareholders had not contributed to that estate?
Ms Spottiswoode: Correct.

Q68 Mr Love: Is that the official position?
Ms Spottiswoode: It is. Can I say that, even if they had contributed, the mere fact that they have been able to take money outside of the estate, outside the 90:10 rules, means they are paid over and above whatever they put in, so you should put that on the other side of the credit note, but, as it happens, Norwich Union have had the grace and the honesty never to claim that they put any money into this inherited estate.

Q69 Mr Love: Clearly they have made a special distribution and they are unlikely to make a further special distribution in the future, but what they claim—and I think it is upheld—is that the inherited estate is legally in the ownership of the company.
Ms Spottiswoode: Yes.

Q70 Mr Love: They also claim that current policyholders have not made any contribution to the inherited estate. This dates back quite some time. In those circumstances is there not some validity to their argument that perhaps policyholders do not deserve the 90:10 split that you have been talking about and that they should settle for something else?
Ms Spottiswoode: First of all, as Hector Sants said in his evidence to the Committee in January, the FSA does agree that policyholders have realistic expectations of payouts from the estate and that is because there will be future distributions over time. What our work is doing is estimating what those future distributions will be in various different scenarios. We can put numbers to what policyholders can expect to receive. Of course, it all depends on one's assumptions. We can do a series of scenarios that says "In this scenario this is what you would expect to receive" and, "In that scenario that is what you would expect to receive". The key driver comes back to new business. If you got rid of the new business anti-competitive behaviour and you got rid of the ability of the company to use policyholders' money differently from the way they use shareholders' money we would not have a problem because new business would no longer be an issue; the policyholders would get the same; either way it would be 90:10.

Q71 Mr Love: Do you think there is any prospect that if we back Norwich Union into a corner they might threaten to withdraw from the whole process of a reattribution?
Ms Spottiswoode: They might, but what would be the purpose of that? We are saying that we think the offer should be made. Under the current FSA rules there is an offer to be made, that is compliant with its rules. I doubt very much if the rules are going to go more in Norwich Union's favour from here on in. The more relevant question is how long it would take the FSA to put rules in place that do protect policyholders properly in this scenario and that would mean that they would lose out on all that money that they are currently getting and it is quite significant. Norwich Union has to worry that if they do not do a deal soon it is possible that the rules will change against them. Also, I think they ought to do a deal which is fair to shareholders and is not overly generous to shareholders. The FSA should ensure that they do watch that fairness criterion because I cannot; all I can do is comment on it, I cannot change it. I do hope the FSA will do that properly. It would not be good for us to come out and say, "We think this deal is far too generous to shareholders." I am not quite sure what they are afraid of. Why would they threaten to pull out? If the deal is fair, if it is not overly generous to shareholders, they are going to get a better deal today than they will tomorrow.

Q72 Mr Love: I want to come on to some of the frustrations that I read between the lines in your current role. Let me just go back to the comment you made about the FSA saying that a policyholder's reasonable expectations were greater than zero. How important is that to you in being able to make the judgments that you have to make to inform policyholders?
Ms Spottiswoode: When I came into this job all the industry was claiming that policyholders could have no reasonable expectations of any payout and therefore any payment was going to be good for them. Frankly, £100 would be good for a policyholder and if they paid £100 that would be £100 million out of an estate worth £6 billion at the time. Who was kidding whom? We have tried to put facts against all of this. We have tried to work out exactly what it is that policyholders can expect to receive under various scenarios. The biggest driver is new business, unfortunately something we cannot predict, so we are going to end up with very unclear advice to policyholders that says, "Well, you know as well as we do what the outturn is going to be. None of us can predict it. If it happens to be this, this is a good deal; if it happens to be that, it would not be, but that is the way we have to advise you. So you take your choice." It is really important we know that the FSA does support that expectations are not zero. It means the industry can no longer make that argument.

Q73 Mr Love: I want to ask you about the frustrations that seem to be coming through. Should you have a role in relation to policyholders themselves? You are the first and we hope to improve with experience. What would you say were the principal changes to be made to your role that would improve the effectiveness of what you are trying to do on behalf of policyholders?
Ms Spottiswoode: I think this is a really complicated deal and it is very important that we have had the resources. This is the first time out for Norwich Union. It has taken a long time to get the data straight. It has been using these brand new models

for a short time and making them work properly is not easy. One has to manage expectations. Whatever company it is, it is going to have problems in making sure that all the data and all the models are up to speed and give the information you need. We are talking about the difference between two large numbers so it does matter. A small change in one of those large numbers can make a major difference to what we are negotiating. In terms of what I would like to see improved, we would like to have direct access to be able to communicate with policyholders because we have had two letters to policyholders. Clearly that has to be done with care and good judgment because the last thing one would want to do is to confuse policyholders with different messages and one has to treat all messages to policyholders very carefully for that reason. Most people are a long way from this. This is very complicated. I think the Policyholder Advocate should have the ability to communicate with policyholders directly, with proper constraints to make sure there is proper communication and checks and balances between us and the company to make sure that we do not confuse policyholders.

Q74 Mr Brady: Can I ask why the reattribution process has taken so long?
Ms Spottiswoode: It took until December to get the data and the modelling to a position that we could all have confidence in. We thought we were there a lot earlier, but actually we found very big mistakes in the data because we had our own model. We were running different data and we were trying to work out why our data was showing different things and again and again we found really big problems in the Norwich Union models and their data. A lot of time has been spent having to sort out that. It was not until December that both Norwich Union and ourselves felt we had data that we could rely on for this deal. Alongside that, clearly we have been trying to clarify what policyholders' rights are and that has taken time. In some senses the two were going along in parallel and neither stopped the other because they both come together at the same time. It is a long process because it is complicated and detailed. Whatever company it is, they will never have done the reattribution before. Although we have used the data for this purpose before, they will have to rework their models in a different way and these are complex things. They cannot do it overnight. I do not think people should be surprised it took a long time. I found it quite frustrating because I would have loved it to have been done faster, but you have to do the job right. This is too important not to do right.

Q75 Mr Brady: How much of that timetable has been dictated by the fact that there has been a new process and how much is dictated by the structure of the process itself?
Ms Spottiswoode: If another company had gone first we would still have had all those data and modeling problems. I do not think we would have got to the position we were in in December any quicker. We might have done but I doubt it.

Q76 Mr Brady: Do you see any attraction in the proposals that have been put forward by Norwich Union to speed up future reattributions, fixing a timetable, giving the FSA a role to intercede as an arbiter on disputes and so on?
Ms Spottiswoode: If we had taken the data in August last year, which is when we thought we were going to be in a fit state to do the deal, it would have been very, very substantially wrong, by many hundreds of millions and I do not think you can do negotiations on that basis. You have got to get the data right. We are now talking about estates of £2.5 billion, whatever the number is after the markets of today and when you are talking about many hundreds of millions of a problem in the data that is too big a difference to be able to negotiate a proper conclusion.

Q77 Mr Brady: So essentially you agree with the comments from Which? earlier that it is more important to get it right than it is to do it quickly?
Ms Spottiswoode: Yes, because this is too important. We are talking about a million policyholders here. We are talking about four million for the Pru. This is one in five households in the UK. This is a significant sum for them personally. I just do not think we can do these deals lightly.

Q78 Mr Brady: Let me move on to the question of how you differentiate between the interests of current policyholders and future policyholders and look at the point where you make your recommendation. To what extent are you going to take those two categories into account in putting forward a recommendation?
Ms Spottiswoode: I have no remit for future policyholders, they have no rights and they have no votes. My only remit is for current policyholders who do have rights and do have votes. Future policyholders will be buying policies on whatever the basis they are buying them and clearly after reattribution they will be buying them on the basis they are paying the full cost of their capital, so they are going to be buying a different product. Today my duty to policyholders is to explain to them that unfortunately the amount that they are being offered will depend on the amount of new business that is predicted to be written and that is a very unpredictable thing. It is a very odd dependent variable on the size of the deal. Effectively what we will probably say is, "If this amount of new business is written then for you this is a good deal. However, if this amount of new business is written then it is not a good deal for you. We cannot help you much more than putting a pin in a dartboard to say which of those is going to be the outturn."

Q79 Mr Brady: In this process it is not your role to look after the interests of future policyholders. Is it anybody's business to look after future policyholders?
Ms Spottiswoode: On the assumption they understand what they are buying, it is kind of their own and the IFA's role to look after the rights of future policyholders. These are complex products.

They do need intermediaries or the companies to help them because somebody has got to explain to them what it is they are buying.

Q80 Mr Brady: What will happen to current policyholders who turn down a proposed reattribution offer?
Ms Spottiswoode: They will stay in what was called the old with-profits sub-fund, which means that effectively they stay in the fund. What we are trying to ensure is that they will be in the same position as they would have been if there had not been a reattribution. We are trying to ensure that they have a real choice, so people can decide to stay as they are and they are not disadvantaged by that or they decide to take the offer because they want the cash for whatever reason. That will try and help them decide whether it is a good idea for them to take the cash or not.

Q81 John Thurso: Which? has made it pretty clear that in their view the FSA has not done enough to ensure that customers are treated fairly under the principle. Do you share that assessment?
Ms Spottiswoode: Clearly policyholders are not being treated fairly because the estate is allowed to be used outside the 90:10 gate and this is a 90:10 fund. It is clear that policyholders' money is treated differently from the way it would be treated if it was shareholder money and that does not seem to be fair. I cannot understand why the FSA does not introduce a general principle that protects both of those circumstances.

Q82 John Thurso: How satisfied have you been with their engagement with the question of inherited estate and, in particular, the assistance they have given to you when you have sought help or guidance?
Ms Spottiswoode: I have nothing but praise for the teams that we have been involved with. The team on the ground is courteous, they engage with us fully and they make sure that they understand what is going on, but they are not the people who make the central decisions about how the with-profits is regulated, that is senior management and they do not have any say in that. I have nothing but praise for the general team that we work with. The FSA has helped us in all sorts of ways. I have been very negative about the FSA but it is more to do with the fact there is not that general overarching principle. In other ways they have been very helpful.

Q83 John Thurso: That was precisely the distinction that I wanted to get onto the record. You are appointed by the company albeit at the instigation of what has happened in the past. Would it be helpful in the future for a policyholder advocate to be appointed by the FSA and for that not to be a permanent appointment but a more permanent office so that the corporate knowledge that you are building up is not lost and vanishes with each different transaction?
Ms Spottiswoode: We are certainly intending to write a full report so that everything we have done and all our background papers are in the public domain, subject to the company trying to ensure that their confidential information does not reach the public domain. We intend to pretty much write this as you would regulatory papers, where everything is out there and then we blank out the stuff that Norwich Union really feels is confidential. We will challenge that and we might even ask for the FSA's support in asking if something really is confidential. We think it is very important that it is all on the record because other people should benefit from all this work and it is complicated. It is part of transparency, they should see what made us take the decisions we did and why we thought the way we did. It is not only for future potential policyholder advocates, it is also so people can hold us to account.

Q84 John Thurso: I have had quite a lot of constituency correspondence with people who are policyholders and one of the first things they will come up with is that as you are appointed by the company you are their stooge; "the mugger's advocate" was the description. As we heard in evidence earlier, there is a view that if the company thought that is what they were appointing they made a serious mistake.
Ms Spottiswoode: And I know that my referee has told them that too! I think they were warned.

Q85 John Thurso: Although it has worked out in this case, do you think it would be helpful if you started from the gamekeeper side rather than the poacher side in this process?
Ms Spottiswoode: The whole thing would be transformed if we just had those general principle-based regulations because what that would do is change the nature of the negotiation. If we were negotiating off a 90:10 basis and we were not negotiating off the old PRE equals zero basis they would have a clear remit for policyholders and we would have clearly in our minds and in Norwich Union's mind, or whichever company that you are negotiating with, that this is a 90:10 asset and that clearly the outturn will not be 90:10. It is about how much below 90 you should go to make this deal work for shareholders. You just change the whole basis of the negotiation. I have to say, that is what I thought I was taking on when I took on the job. I had no idea that all this quite weird and wonderful regulation existed in with-profits.

Q86 John Thurso: I want to ask about the With-Profits Committee. In your memorandum to us you said you considered that a truly independent With-Profits Committee "can in theory play a useful role" and then you go on to be quite sceptical in later paragraphs about that taking place. Do you think there is a role for a With-Profits Committee? Can it be effective? If so, what should be done to make it effective?
Ms Spottiswoode: I think it is absolutely essential to have it effective and that it has a very clear remit to policyholders because no-one else has and once I

have gone there will be nobody who is looking after policyholders' interests directly. It is a complex process and therefore it is very important that the Committee is supported properly with advisers and with people who are also independent who can look at what the company gives them and critique it properly. Sir Nicholas Montagu, for all his talents, is not an actuary and he is not involved in the life business, so it must be quite difficult for him to pick up this complex business. We have been working on it solidly for over two years; it is a long time. We are nearly full time. It is difficult for us to get to grips with it. How you do it on a part-time basis, on monthly or quarterly visits to the company, I just do not know. They have to be well supported. I think it is very important that they are transparent because otherwise who knows why they are taking their decisions and how can they be accountable to the policyholders who at least they are in part supposed to represent.

Q87 John Thurso: Presumably it would be to the company's benefit to have a stronger committee because they would then be able to negotiate negotiating with much more of an equal and therefore would not feel quite the same responsibility. It would be better for everybody.
Ms Spottiswoode: I think it is better for the industry generally if it is seen that policyholders' interests are being protected. That is why I would like to see the FSA with a very clear policy because then policyholders would know that their interests were being protected. It is the same with the WPC, if it had a very clear remit for policyholders, their policyholders would know there was somebody who was very close to the company at least who was telling them whether they thought the decisions, whatever they were, were fair, so they could relax a bit. They do not read the small print anyway. They possibly should.
Chairman: Ms Spottiswoode, thank you for your very helpful evidence to us. We will be putting a few of your questions to the FSA immediately.

Witnesses: **Mr Hector Sants**, Chief Executive, and **Ms Sarah Wilson**, Director and Insurance Sector Leader, Financial Services Authority, gave evidence.

Q88 Chairman: Mr Sants, welcome to the Committee. Can you introduce yourself and your colleague for the shorthand writer, please?
Mr Sants: Good morning. I am Hector Sants. I am the Chief Executive of the Financial Services Authority.
Ms Wilson: Sarah Wilson. I am a Director and the Insurance Sector Leader at the FSA.

Q89 Chairman: Does it not look as though John Tiner is the Steve McQueen of the financial services industry in that he has performed *The Great Escape* and you are left with the baby?
Mr Sants: You could certainly observe that his timing seems to be very good!

Q90 Chairman: Why has the FSA got involved in the issue of inherited estate when many might consider you to be meddling in commercial decisions?
Mr Sants: We have an obligation, which we take very seriously, to make sure that policyholders, customers, the man in the street, are given a fair deal and their interests are looked after. We have a clear mandate to do that and therefore I think it is right and proper in these set of circumstances we ensure that our mandate is properly adhered to.

Q91 Chairman: Is the level of detail involved in the negotiations compatible with the FSA's overarching commitments to principles-based regulation?
Mr Sants: We believe so.

Q92 Chairman: What is the FSA's role in a reattribution proposal?
Mr Sants: As I think we have made clear in our submission, it is to ensure that it is fair for policyholders, for the customers. This is a complex and difficult process, as indeed a number of the other speakers have referred to. We need to take into account not just the fact that it provides immediate fairness, but we need to ensure that the fund is sustainable. We have a long-term perspective on this and we have a complicated and difficult judgment to make. Clearly we are seeking to deliver fairness to the policyholders.

Q93 Chairman: In your letter to Clare Spottiswoode in December you wrote that, if a reattribution were to deviate from the 90:10 starting point, you would look at the basis for that proposed division and decide whether it was fair. Does this 90:10 split apply to the inherited estate which would be distributed to all future policyholders and not just the present generation?
Mr Sants: The 90:10 rule obviously is clear with regard to distributions. With regard to reattribution, it maybe is just worth making a point here, that this is only the starting point, as we have already indicated and is well accepted. This then is one of the key issues in the complexity of the issue. I do think some of the comments made earlier necessarily always focus on this. Here, it is our judgment—and I accept it is a judgment, all this is about judgments—that if you ended up with a situation where reattributions actually were 90:10 they would not take place. One of the problems in this debate so far is people are maybe not taking this into consideration and thus looking at the issue in the round. We have to look at the issue in the round. We have to look at the issue over the long term. We have to think about the sustainability of the fund. We

have to think about whether this is a viable product we want in the marketplace over the longer term for the best interests of consumers. I think it is our judgment that if you ended up with a 90:10 distribution requirement for reattributions they just would not happen. You may or may not say that is a good thing. We have to recognise that that is a possible outcome to the framework, as one or two of the earlier comments have alluded to.

Q94 Chairman: When a fund is 'closed' to future policyholders the estate is distributed over time on a 90:10 basis to current policyholders. A reattribution closes off an estate to future policyholders, it is just like closing the fund completely. Do you think that fairness requires that current policyholders should be compensated for the fact that shareholders are purchasing the whole of the inherited estates, not merely the part that current policyholders might hope to receive through distributions?
Mr Sants: Yes, but we also have to take into account the sustainability point that I made earlier. If you are thinking about the phasing issue, we do have to be sure that we have sustainability in the process.
Ms Wilson: There are two things that happen, there is phasing and you are also referring to a position where in order to look at the fairness of the reattribution, so this is the money that is not available for distribution now, there is, on the one hand, the money that the current policyholders could expect to get in future distributions themselves and also money that otherwise would be available to future policyholders. In answer to your question, there is a value to that second amount of money which is part of the negotiation in our view between the policyholder advocate and the firm.

Q95 Mr Dunne: Hector, you have had nearly 20 minutes now since hearing the Policyholder Advocate's criticisms of the FSA's approach to principles-based regulation in relation to the inherited estate. How do you respond to her charge that you are not treating shareholders' capital and policyholders' capital equally?
Mr Sants: I should just say as a general point, which I have mentioned here before, that obviously we really support a vigorous advocacy by the Policyholder Advocate and that was in our minds when we came up with the proposal. I was not party to generating that proposal, but it seems to me to have been an admirable outturn that we do have a strong advocate here and we are very comfortable with that. On the particular with regard to principles, it seems to me that we do have principles here. As I have already articulated, we are absolutely clear and would completely reject any idea that we are not determined to deliver a fair deal for the policyholders. We are trying to deliver a fair deal for the policyholders but we also have a principle of saying that this is a credible and worthwhile investment product that should remain in the savings market. We do not think it is a good result for the marketplace, for the consumers as a whole, the UK, if this product disappears and therefore we want to make sure that this product is a credible, sustainable, long-term product. Those are the two principles and they feed back into our 11 principles which we have. It seems to me we have a good framework to which we are now seeking to deliver specifics to enable a balanced judgment in the round, which is fair, to be reached.

Q96 Mr Dunne: We have just heard the Policyholder Advocate describe the regulatory regime as "weird and wonderful". Do you anticipate, as a result of this exercise, looking again at the rules for reattribution or do you think that they work?
Mr Sants: I have been here before, as you well know, in this debate and I am a strong believer that we should always be learning. We should always look back at every set of events and see what we can learn, that is part of a successful organisation. This is particularly for a regulator in a dynamic marketplace that is changing all the time. It has been observed by Clare that it has proved to be a complicated, difficult and challenging process. We are learning things, and no doubt there will be lessons to be learned and we should take them on board, that is the nature of regulation.

Q97 Mr Dunne: We have heard this morning from one side of this debate and we will be talking to the companies next week. You made the point earlier that if this is pushed too far the companies may choose not to take the offer for reattribution to buy out the policyholders' interests. As we have heard this morning, a company may decide that as a result of going down a reattribution offer process it will apply a different approach to the investment criteria for the fund and therefore it establishes that there is excess capital which can allow distribution to take place. In the event that the reattribution offer is rejected by a large number of policyholders, where does that leave the company that has gone down this process in relation to its capital and how will you as a regulator look at whether it has now got sufficient capital if its reattribution offer has been rejected?
Mr Sants: We have to ensure it does have sufficient capital, that is part of the supervisory process and we obviously have to take that question very seriously.
Ms Wilson: An excess surplus is only declared and paid out if at the time it is clear that it should happen and the fund remains secure. Insofar as in the particular case there has been a distribution, it is as a result of de-risking that has happened, it is not in anticipation of something that may happen in the future.

Q98 Mr Dunne: I am a bit confused because every year when you sign off the accounts you assess whether there is scope for a distribution or not. You did not do that in the context of Norwich Union in last year's accounts. Norwich Union announced in February that they would be making a substantial distribution, but that, as we have just heard from the Policyholder Advocate, is on the basis that the de-risking is going to take place in order to allow reattribution. Are you saying that these things are not linked, that the distribution will not happen if the reattribution does not go ahead?

Ms Wilson: No. Let us distinguish the general case and then the specific. The general case is that where there is an excess surplus that means there is money in the inherited estate over and above what is required for the working capital of the firm now and if it is declared that that is the case and that is what the senior management determine then our rules say that they must justify keeping it and if they cannot they must distribute it. In the particular case that we are dealing with here and it would be normal for this to be the case, a distribution does not happen in anticipation of events yet to come. You can take it that the firm has already taken action to make it possible for them to make the distribution and the distribution happens and will continue to happen regardless of whether the reattribution goes ahead.
Mr Sants: And not linked to events.

Q99 Mr Dunne: Let us look at this issue of new business which we have heard a lot about today. In your submission to us you have made the statement that the inherited estate can be used to support new business provided it is managed with a view to recovering costs over a reasonable period. How do you determine what period is reasonable in the context of funds that have been running for decades?
Ms Wilson: It is at most the lifetime of the product that is being sold and would often be less than that.

Q100 Mr Dunne: Many products are whole life.
Ms Wilson: They can be quite long-term products, absolutely, but the costs must be recovered in no less than that time.

Q101 Mr Dunne: So you are talking about decades in many cases then? I do not know what the average life of with-profits funds are but it is probably 25 years or something of that nature, is it?
Ms Wilson: I would have to look separately for data for you. What our framework allows for—we have a principle-based regime—is we use the phrase 'reasonable time' and there is a maximum on that and clearly funds may choose to do it over a shorter period and we often expect that that is the case.

Q102 Mr Dunne: You also indicated that you are anticipating that post a reattribution, distributions will be reduced going forward. I think Clare Spottiswoode said a moment ago that she anticipates that distributions will continue post a reattribution. Is there a difference of view there? If you think there will be fewer distributions or smaller distributions, how will that be regulated?
Ms Wilson: In a reattribution the policyholder receives a payment now in return for which they give up their interest in distributions from the inherited estate. One of the things the Policyholder Advocate is looking at in the context of a reattribution is the likelihood of distributions were there not to be a reattribution so that he or she can understand what value should be paid to policyholders now to compensate them and that will vary from reattribution to reattribution and fund to fund depending on the circumstances of that fund.

Q103 Ms Keeble: I wanted to ask a bit more about the regulatory framework and the uses to which the inherited estate can be put. You agree with both Clare Spottiswoode and Which? on the over-arching principle but then you seem to disagree on the way those work through in practice, in particular looking at the mis-selling issues and the shareholder tax issues. Can you explain why you take the particular positions that you do on those?
Mr Sants: I do not think it necessarily is the case that we are disagreeing on mis-selling. I should just say as an aside with regard to the Which? comment, that the fines are not actually part of that process, so the terminology they were using there was misleading because the fines are not chargeable even under the current regulations. I think that is a small point. As to the point in the round, we have said that we will reconsult on that matter. Obviously we cannot predetermine that consultation process. We should take views from others in addition to those in the room today. However, clearly we think it is a subject that is worth reconsulting on.

Q104 Ms Keeble: But you have allowed it previously.
Mr Sants: We have indeed, yes. At the time a reasonable judgment was made and I think that does reflect the point I made in my opening comments, that we are trying to make a judgment in the round for what is a reasonable overall proposition that allows this whole process to work. We are trying to come up with workable solutions that work for the consumer, for the policyholder, for the shareholders and produce a sustainable business environment that works for everybody over the longer term. It is a judgment in the round. Since the time the Board of the FSA made the original judgment circumstances have changed. Accordingly, I sat here, and indicated, taking on the new role as Chief Executive in the summer, it was right to look again at that framework. We then reached the conclusion we reached that we should reconsult and we are so doing.

Q105 Ms Keeble: So this was particularly your decision that you should have the consultation, was it? What factors particularly influenced you in making that?
Mr Sants: It is absolutely the case given the importance of the issue we are facing. Clare Spottiswoode has quite rightly said that this is an important issue that affects a lot of people and it should be properly considered and done well. It seemed right and proper, given I was coming into a new role with an important issue on the table, in fact the Committee highlighted this important issue at that point, that we should make sure we were comfortable with the framework we were using. Obviously it is not possible in the timeframe to have a complete consultation process, but we did take a look at the framework internally and reached the conclusion we should consult on mis-selling.

Q106 Mr Dunne: What is the timeline for the consultation?

Mr Sants: We have made a commitment to put the consultation paper out by the summer. I think we normally define that as the end of the second quarter, so it should appear very shortly and then we will go through a normal consultation process.

Q107 Mr Dunne: It looks as though you are looking to change the regime.
Mr Sants: Obviously the presumption, if we are consulting, is that we think there is a case that has been discussed. I think you are clear about my meaning here, but you are also aware that we do have to recognise the consultation is precisely that, it is designed to allow everybody who has a legitimate interest here to express their opinion and it is right and proper we do not anticipate the conclusion of that consultation process. I am sure you would not want me to do that. Obviously we think it is something that is worth looking at again or we would not go through the process.

Q108 Mr Dunne: On the issue of the charging of shareholder tax, can you just confirm that there are two different rules, one for existing firms and one for entrants? Can you explain a bit about the rationale for that?
Mr Sants: We absolutely acknowledge here we have an approach for those who have already declared it is custom and practice and for those who do not have it as custom and practice. This is clearly a difficult judgment. I absolutely respect that there are different views that could be taken on this. We tried to make a judgment in the round. I would come back to the general comments I have made about the fact that we are trying to make judgments in the round. We are also recognising that as a regulator we try not to make retrospective judgments. That is another good principle of regulation, you do not act retrospectively unreasonably. It is in that context we have reached the view that we have reached on tax. I do not disagree, it is a tricky question.

Q109 Mr Dunne: What would you say to what seems to have come out of the earlier two witnesses' evidence, that perhaps the FSA has been a bit too ready to make concessions to the industry and has not acted firmly enough to protect the interests of policyholders?
Mr Sants: I completely reject that. As I said earlier, I think we really are trying to come up with the right answer for policyholders that works.

Q110 Mr Dunne: Your suggestion that you are changing the regime now for the mis-selling would suggest there is some awareness that perhaps things could have been a bit tighter in protecting the interests of policyholders.
Mr Sants: I think what I am saying is that I am making a judgment now as to what looks reasonable. No doubt in the past others made judgments about what looked reasonable at the time. These are all judgments.

Q111 Mr Dunne: On the issue of the staff pension fund deficits in Norwich Union, you heard the evidence that Which? gave. First of all, what is your view of this happening? Secondly, would the FSA permit this?
Mr Sants: I heard Clare's comments as well. Obviously reasonable costs are allowed.
Ms Wilson: Clearly the pension costs associated with staff who are working within the with-profits fund are costs of that fund and are potentially entirely rightly attributed to that fund.

Q112 Mr Dunne: And so you would allow it?
Ms Wilson: There may be some details here, but it is legitimate as a general point that the pension costs of staff can be charged to a with-profits fund, absolutely.
Mr Sants: I am sure you would agree that pension costs are part of staff costs and reasonable staff costs that are genuinely related to the fund are allowed. It would be wrong for us to comment on the particular detail because we do not have the particular detail of that calculation, but the staff costs related to running a fund are allowable.

Q113 Mr Love: You mentioned earlier on the importance of the sustainability of the fund. Is there any merit in going back to the ministerial guidance of 1994 in relation to those issues?
Mr Sants: My point was, with regard particularly to the reattribution, that we do need to be clear that if we are looking for a workable regime we cannot move the dial so far to one side that nothing ever happens just because in the individual particular point or argument that is being advanced it seems a reasonable thing to do to move it there. I think we do have to look at the aggregate result of what we are doing. However, we are in no way challenging the 90:10 principle with regard to genuine surpluses. We are very supportive of it.

Q114 Mr Love: We heard earlier on from the Policyholder Advocate that it would have been a significant improvement in the way that she would operate if she had had a relationship with policyholders. Do you agree with that? Is that something that you might advocate or give guidance on in the future?
Mr Sants: I think that very much falls into the category of some of the observations I made earlier, there will be some procedural and process lessons to be learned. I think that was an interesting observation that we will take on board.

Q115 Mr Love: There has been a lot of concentration throughout this morning, although with many different interpretations, about what is fair in reattribution. You have heard what Which? and the Policyholder Advocate said. How would you characterise how you would decide in principle what is fair in a reattribution?
Ms Wilson: We have set up a process within which we believe that a fair negotiation can happen between two parties who are empowered with appropriate advice and resources to conduct that.

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They do so within a framework which has been entirely consulted on and which we believe is consistent with our principles, including the requirement to treat customers fairly. There are some particular questions about those rules which obviously have been discussed this morning, but that is really the wider context in which we think a reattribution can be fairly conducted.

Q116 Mr Love: Everybody would assume that the optimum turnout for this process would be that the Policyholder Advocate and the company reached a similar, if not the same, conclusion about what that reattribution should be. We do not have that, on almost all points they disagree. It looks likely that they will come up with very different conclusions. If the FSA is not to hold the ring in terms of how we move towards greater consensus, how do we ensure that the interpretation of fair is reasonably uniform between all the different parties?
Mr Sants: You are absolutely right, we are seeking to achieve an environment and framework in which a conclusion could be reached. In the event that that is proving difficult, we have made clear that, if all parties agree, we are willing to give more precise guidance around what we think is fair in a numerical sense, ie potentially give a range, but we recognise that we should do it, in the current framework, as part of allowing that commercial negotiation to be facilitated rather than in a way which runs the risk of us effectively holding that negotiation.

Q117 Mr Love: In the previous reattribution in relation to Axa the policyholders were eventually offered something round about the 30% mark. A lot of people made the assumption—I do not know whether it is true—that a very strong reason why that happened was that a bird in the hand is worth two in the bush. Is there anything that we can do that would equalise that? I heard the Policyholder Advocate saying earlier on that she was feeling her way to what would happen to those policyholders who rejected the offer that was made to them, but it does seem to many of us that they are placed in a position of limbo. They have rejected the offer and they may well get an offer in the future, but they may well end up with nothing. Is there any way that the FSA believes we can ensure that a negative response from a policyholder does not leave them completely out on a limb?
Mr Sants: We clearly would not want them completely out on a limb.
Ms Wilson: When we assess the fairness of the deal one of the things we look at is whether those who vote no are in as good a position both in terms of the security of their benefit and what contingent claim they might have in future as they would have been if the reattribution had not happened. That is one of the criteria that we would look at in establishing whether we could agree that the negotiation had arrived at a fair outcome.

Q118 Mr Love: When would you consider it to be reasonable so that they are not out on a limb? Does that not require that at some point in the future further consideration is given for those policyholders that have rejected the offer in relation to a further reattribution? I do not know. I am feeling my way as much as anyone else.
Ms Wilson: In the particular circumstances here policyholders have a choice as to whether they elect to join the reattribution or not and the reattribution is typically initiated by the firm and if you choose not to participate in it you remain in the position that you had previously been in. The firm could clearly, as time evolves, conclude that it would like to enter into a further negotiation with that group of people and it would be a separate transaction that it could do that.

Q119 Mr Love: Is not the point that the message that goes out, whether it is completely underlined by the company, to policyholders is this is probably the only offer you are likely to receive while you are a policyholder? Therefore, is there not some pressure to say that if there is a significant number of policyholders who do reject it there is then a pressure on the company to make a further offer within a reasonable timescale?
Ms Wilson: It is obviously hugely important and the Policyholder Advocate has already said that they would have a very major role in setting out clearly to all parties the choices that they face and what is and is not fair for them or to their advantage in particular circumstances. When a firm initiates a reattribution it initiates a process and it is hugely important that people have clarity about the choices they make. It is very important to us, as part of that, that those who vote no are in the same position as they would have been.
Mr Sants: There should not be any suggestion by the company that those who choose to vote no are in any way going to be unreasonably treated in the future. Any suggestion that this is a choice which would have implications for the way they were treated would obviously be unacceptable to us.

Q120 Peter Viggers: What is your view of Norwich Union phasing its special distribution over three years?
Mr Sants: This is in this category of difficult judgments. We absolutely recognise the fact that others may have a different view here. The fact that we are taking it into account is the sustainability point. Also, we should bear in mind here that the With-Profits Committee did indicate that they considered this approach to be the right one; they have been quite clear about that. It is not quite the case to say that everybody who has a view about policyholder interests are sitting on this side with one view and somehow or other the FSA is sitting over here with a view which aligns with the shareholders' view. As usual, we are trying to make a difficult judgment and there are a number of views on the table. I would make the point that the With-Profits Committee does believe that phasing is reasonable.

Ms Wilson: Phasing is a legitimate decision and a legitimate conclusion to reach in the interests of the stability of the fund and in the interests of all the policyholders in it, including those who might be left behind if a large number of people chose to leave.
Mr Sants: You would be unhappy if there was not a sustainable fund and those who chose not to leave then found themselves in a non-sustainable fund. That is a difficult judgment to work out how we get into that space and I recognise the points. It is not that we are doing something which we believe to be anything other than in the interests of all policyholders.

Q121 Peter Viggers: Your normal rules require that each year firms must distribute any excess surplus that has arisen. Can you just comment on that point?
Mr Sants: We do expect distribution to be made in 90:10. We engage the firms through the supervisory process, to make sure they are carrying them out if there is a genuine surplus identified.
Ms Wilson: That is the position, and we have ongoing discussions with firms.

Q122 Peter Viggers: There a great lack of clarity and certainty in the whole of this area and it is extremely difficult to reach objective judgments. You have heard the criticism from witnesses earlier today that the rules should be clarified and the FSA should make a much more determined statement and stand in defence of policyholders. Currently you allow inherited estate to finance new business, pay tax on transfers to shareholders, financing strategic developments, paying mis-selling compensation costs and so on. The view has been expressed by witnesses earlier that decisions need to be taken in this and you should move beyond the stage of being a regulator and become a decision-maker. What is your reaction to that?
Mr Sants: We are a regulator that aims to deliver results through a principles-based approach and by definition we are not going to have answered every question you can think of. I have to say, we also believe that however large we made our rule book it would not answer every question. The idea that somehow or other when you go into a highly complicated—and Clare's comments about the issues around modelling here is an example of that—and very difficult situation the FSA will have delivered a guide that answers what you do at every step in the process in relation to a specific reattribution I think is not realistic. I think any reasonable person realises it is not realistic. As to the point that we have not been clear enough, it seems to me we have been completely crystal clear that our job is to deliver a fair deal for policyholders. We can debate whether every judgment we have made is one that they choose to agree with or not to agree with, but we reject any suggestion that we have not been crystal clear that our job is to look after the policyholders, the customers who have purchased these products and to ensure that they are getting a fair deal --- We have said repeatedly and I will say it any time anybody likes to ask me, our policy approach is clear. We should of course, nevertheless, learn from a complicated situation such as we have just been through, review and see if we can improve. A number of helpful suggestions have been made. The idea, however, that we are not looking after policyholders I reject completely.

Q123 Peter Viggers: Do you agree that there is a high level of uncertainty in this general area on the treatment of inherited estate, and whose duty do you think it is to bring clarity to this area?
Mr Sants: I certainly agree that it is a very difficult and complex problem. We have been working away on this difficult and complex problem for a number of years. It was absolutely recognised by Clare that if you go back into the past the perception here was generally that policyholders had no particular rights and we have addressed that issue to the benefit of policyholders through all the actions we have taken. In any difficult and complex situation there are always lessons to be learned. I do think people are confusing a bit here the general with the particular. An individual reattribution discussion is always going to be complicated and will always throw up questions. The idea that somehow we can pre-answer the questions about any specific set of circumstances I just think is not realistic and shows a lack of understanding of the complex nature of the problem on the table. To be fair, I think the Policyholder Advocate absolutely understands the complex nature of the problem on the table and rightly observed that what matters here is getting the right result rather than necessarily doing it in any particular time-frame. We are certainly listening and we will take on board a number of the comments made and no doubt see if there are improvements that can be made to the framework going forward.

Q124 Mr Brady: Are you frustrated at the length of time it has taken to get to where we are now?
Mr Sants: I think if you are one of the customers here it probably does feel a bit frustrating. Once people have heard something might be in the offing they obviously would like a result. I think we have got a lot of sympathy with the point that if you are a customer here you may feel it has gone on for a long time. I completely agree however with the earlier observation that what does matter here is the right result. It is a very complicated product and, as was observed, you do need to have the right data to make the decision. At the end of the day, however, it is a commercial matter, it is the company's decision, so we do need to be careful here. We can observe the points I have just made but we do have to recognise that this is a process which lies primarily with the company.

Q125 Mr Brady: Could anything be done in your view to expedite the process for future reattributions?
Mr Sants: From the regulatory point of view, I do not think we heard any comments suggesting our process was what was slowing it up. I think Clare very kindly observed the efficiency of our team, which I was grateful for, and made the point that it was collecting data that had created the deadline.

Clearly there will be some lessons to be learned about data availability and issues around that which the companies will have to take on board. I am sure we can try to facilitate a lessons learned exercise.

Q126 Mr Brady: Would you be open to any specific proposals to change the role of the FSA in this process? For instance, what about the suggestion that you might have an arbitration role in the event of disputes?
Mr Sants: We are always open to suggestions. It is a difficult problem. This is the first time that we have been tackling a large event within this framework of rules that was primarily put together back in 2005. It would be completely remiss of us not to say we should take on board observations about how the process can be improved going forward. I think it would be a very odd thing for me to suggest otherwise.

Q127 Mr Brady: Do you think that kind of arbitration role would be a good thing?
Mr Sants: I think we need to look at it in the round. I am hesitant to make a commitment to a particular element of the suggestions that have been tabled. I am indicating that we will look at all the suggestions in the round.

Q128 Mr Brady: You have stressed that you are keen to ensure fairness in the interests of all policyholders. Was that a reference to all current policyholders or do you feel that you have a responsibility to future policyholders as well?
Mr Sants: We need to differentiate between the specific mandate with regard to the determination of a reattribution where we are talking about current policyholders and those who may opt to stay in the fund and those who may opt to come out. I was observing in my opening comments that as the FSA, with our wider objectives, when we are framing those frameworks in which those decisions are made we need to give consideration to whether this is a product which works well, delivers a result for consumers, is part of a good framework and part of the overall savings framework and is a product we would like to see in the marketplace over the longer term. I think the general view is that this is a worthwhile product to be offered to consumers. There is still some 350,000 or so of them being sold each year. I do not think people are looking for this product to be abolished. We do have to be very careful that we do not frame a set of rules which effectively deals with people's short-term judgments but end up with a long-term detriment to the economy and savers.

Q129 John Thurso: I want to follow up on some of the questions that I have been asking to get your side of the story as it were. I do not doubt your intentions in the slightest; I just have doubts about the application. I have heard a lot of people say in evidence how complex this whole business is. Surely the principle is remarkably simple, which is one bunch of people have paid money into a fund and another bunch of people are trying to take it. What is complicated is the process and the fact that everybody wants to talk in oxymorons because we keep talking about excess surpluses and it is either a surplus or it is not, it cannot be excess. Whilst I understand what the language is attempting to do, we have actually got a position where it seems to me that the core of it is the lack of regulation of the surplus, which historically grew up from way back in the days before computers. It is much more open today than it used to be. Really it is up to the FSA to regulate that and if it cannot then it is up to us to legislate. Is it something you can properly regulate or is it something we should legislate on?
Mr Sants: On the first part of your question, I think that is pretty straightforward, ie where you do have a genuine surplus that there is now a very clear framework, the 90:10 framework and it is clearly the role of the regulator to ensure that if it is determined there is a surplus then the surplus should be distributed on a 90:10 basis. Clearly the boards and the directors of the companies have an obligation to adhere to our rules, but that is a straightforward enough regulatory process.

Q130 John Thurso: My first proposition is that if you prosecuted those rules firmly at that stage the likelihood of surpluses being less understood and possibly in excess would be far less likely.
Mr Sants: Absolutely. To some degree we are an inheritor of a past position. We are not in any way suggesting that the historic regulatory framework for this process was adequate, that is why it was changed. It follows if we changed it we thought there could be a better one. If you go back in the past, as has been reflected on by a number of others, we did not have a regulatory framework that we would now consider reasonable in the way that we currently look at it and that has led to a number of effects, some of which we now have to deal with.

Q131 John Thurso: On the basis that you are much closer to a point where these super-surpluses are not going to arise in the future because of good regulation we are into slightly historic territory. Is that not something where we should simply grab the bull by the horns and legislate and just say, "You nasty shareholders, you can't have any of it. We'll give it all to the policyholders. Yaboo sucks"?
Ms Wilson: Two things. We have a framework now which means that large inherited estates should not as a general case develop because of the changed approach to smoothing and the rules that we have on that. There is a very clear framework within our rules now about the handling of the funds within an inherited estate and they are either the working capital or they are an excess, and I take your point about oxymorons. Whatever they are, it is absolutely clear within our framework that policyholders have an interest in that, they have a contingent claim over it and there are big restrictions on what the shareholders may use those funds for and generally they may only be used in the interests of policyholders. It is quite clear the way our

framework works and I think going forward we have a basis based on the consulted new approach which gives that.
Mr Sants: It strikes me that the area of judgment is primarily in respect of the determination of what is the right specific distribution for a specific fund or specific reattribution in a specific case. It strikes me that that is rather a tricky area to legislate in. I think we are all agreed it is reasonable to support a level of new business. The issue of debate is how that is calculated and determined. Although I am superficially attracted by your offer to take us out of the hot seat, I am not absolutely convinced that necessarily this is the right space for regulation because I suspect that we will always be left with a requirement for somebody to make a reasonable judgment.

Q132 John Thurso: I am not going to take up your invitation to debate the new business part with you, I think somebody else can do that. In her evidence Ms Spottiswoode made the point about the great cooperation that she has had with the junior staff from the FSA which is very welcome, but she also made the point that at the senior staff level better decisions need to be made, which sort of slightly takes us back to a report we have done earlier this year but we will leave that out of it. Are you guilty as charged? Do you want to mitigate or do you want to enter a plea of not guilty?
Mr Sants: First of all, as far as I know, I have not heard it suggested otherwise, all the senior staff have been cordial and attentive to her requests. I have had meetings with her as has the Chairman and I am not aware of any requests that we have not addressed in the period I can speak to. It is not clear to me that we could have made any policy decisions which would help her in regard to the specific set of questions she has in front of her. We have a policy framework and as we have just demonstrated with mis-selling, if you wish to change part of our policy framework you have to go through a full consultation process. We do genuinely also adhere to the point of not carrying out retrospective judgments, changing the rules on firms retrospectively or unreasonably. I am a little mystified as to her comments that there is something we could have done in the last few months other than that which we have done, which is painstakingly and carefully sought to answer all her questions and if there are any unanswered questions I will happily answer them and try to give her as much guidance and help as we can to make the current framework understandable for use in the current set of circumstances. I have already indicated that going forward you should always have a learning process. I repeat, if there are unanswered questions currently we will happily answer them.

Q133 John Thurso: I think what she said in her evidence was that she had had great cooperation from the FSA on all of those matters and extreme cordiality, but the way in which the FSA chose to look at the principles of the regulation, which is the senior staff level, was what she found wanting. Rather than you answer that, perhaps you could both speak to each other and come up with a view of where you disagree.
Mr Sants: I am not sure if we do.

Q134 John Thurso: You heard the evidence from Which? in which they requested a full cost-benefit analysis of the impact of your decision to allow insurance companies to use the inherited estate to pay shareholder tax and subsidise new business. Is that something you will consider?
Mr Sants: I am not sure if it is calculable. Furthermore, we are where we are in respect of those past processes. We are looking to make a fair judgment in the round and that is what we have done. I am not sure where doing a retrospective calculation as to what may have happened in the past takes us.

Q135 John Thurso: Presumably, on the one hand, the money is going to be used by the company to subsidise new business and to pay tax or whatever, therefore it is less cost to the company and, on the other hand, because it has gone there it is less potential profit for the people who benefit from the funds and so that is the costs. The benefit must be something to do with keeping the fund liquid and keeping it in capital or some benefit and the two must be calculable. You must be able to come up with a decision as to why you have done it because it costs more to do it one way than the other way.
Mr Sants: Absolutely. In the right circumstances we will be happy to publish a range of what we think fairness is. A range expressed in numbers for a particular set of circumstances will of course have to have been calculated by us. We are happy to do that if both parties agree.

Q136 John Thurso: With-Profits Committees, there has been pretty unanimous evidence to say that these are hopeless and weak. 60% of companies are still not independent; 40% are independent. The independent ones are still appointed from within, under-resourced, et cetera. This is a clear and major failure. What are you going to do about it?
Ms Wilson: Perhaps I could comment as I wrote to companies and you will be aware of that. We believe we put in place an important and robust system if operated properly. I do not recognise the numbers that you have just quoted, but we did do our own work and we published the results of it in a letter that we sent to the CEOs of life companies last autumn. There were indeed some examples of firms that did not have adequate independent input, not on a scale that you have just quoted and also examples where those committees were insufficiently consulted by management in a timely way. We made it abundantly clear that that is unacceptable and we have seen some changes as a result.

Q137 John Thurso: Those quotes I gave you on numbers come from the memorandum from the Financial Services Consumer Panel, which actually states: "The Panel's research found that while some companies have moved towards a genuinely

independent model, 60% of funds had a WPC that was not independent. In some cases the WPC was a sub-committee of the main board, while in others WPC members consisted of current directors, former directors and non-executive directors." This seems to me to be an area of utter weakness.
Ms Wilson: We did do some work and we have fed back to the industry our own findings on the scale of independence or otherwise. Independence is critical, it is required in our rules and, most importantly, in many ways is the effective working of the committee so that they provide appropriate advice, input and challenge and we are very much looking for that.
Mr Sants: We agree with you.

Q138 John Thurso: The core point surely should be that the company should not appoint these people. There must be some way of appointing them so that they are not company appointees.
Mr Sants: I think it falls into the category we mentioned earlier, ie a number of helpful observations have been made. We agree with your comments that improvements need to be made.

Q139 Chairman: Since we announced this inquiry we have had quite a lot of correspondence from policyholders and a number of them have complained about the FSA's regulation of inherited estates, the fact that that has been rejected, "with the sole aim of preventing any consideration of reasonable complaints". Why is the FSA rejecting so many policyholders' complaints?
Mr Sants: I am a little mystified.

Q140 Chairman: Policyholders have written to us to notify us that complaints about the FSA's regulation of inherited estate have been rejected, "with the sole aim of preventing any consideration of reasonable complaints". Why is the FSA rejecting so many policyholders' complaints?
Mr Sants: The complaints about treatment as policyholders go to the FOS, not to the FSA. The FSA receives complaints with regard to an FSA process. If you feel the FSA has not been handling the process well. We are not particularly aware of receiving any volume of complaints with regard to the latter point. With regard to the former point, I think that is primarily a question to be addressed to the FOS, but if you have information you would like to draw to our attention we will be happy to take a look at it, but they would not come to us directly is the answer to your question.

Q141 Chairman: Does your acceptance of the stability argument for the three-year phasing of the special distribution imply that three-year phasing constitutes a barrier to policyholders leaving?
Mr Sants: I am not sure I would quite use that phrase.
Ms Wilson: We have accepted that it is legitimate to conclude that phasing is in the interests of all policyholders in the fund and because we have concluded that we do take the view that that is not an unreasonable barrier.

Q142 Chairman: It is not our primary duty to act as an introduction agency, but given the policyholders' concerns about relations with senior management and the time elapsed on this issue, can you give us an assurance that you will look at that relationship with urgency so that you can have a common agenda and we can try and move this on?
Mr Sants: We are more than happy to do that. We are always happy to talk to the Policyholder Advocate and we will take that forward forthwith.

Q143 Chairman: That is a novel issue for us, but we may be developing our skills in that area!
Mr Sants: We are always happy to have help with our difficult tasks.
Chairman: Mr Sants, thank you very much for your time and your very helpful evidence to us.

Wednesday 30 April 2008

Members present

John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Mr Colin Breed
Jim Cousins
Mr Philip Dunne
Mr Michael Fallon
John Thurso
Mr Mark Todd
Peter Viggers

Witnesses: **Mr Mark Hodges,** Chief Executive, and **Mr John Lister,** Chief Actuary, Norwich Union Life, and **Mr Nick Prettejohn,** Chief Executive, and **Ms Nikki Maynard,** Director of Strategic Projects, Prudential UK, gave evidence.

Q144 Chairman: Welcome to this session on inherited estate. Perhaps you could introduce yourselves, please.
Mr Lister: I am John Lister. I am the Chief Actuary of Norwich Union Life.
Mr Hodges: I am Mark Hodges, I am the Chief Executive of Norwich Union Life.
Mr Prettejohn: I am Nick Prettejohn, Chief Executive of Prudential UK and Europe.
Ms Maynard: I am Nikki Maynard, Director of Strategic Projects, Prudential plc.

Q145 Chairman: Good afternoon. Mark Hodges, how confident are you that Norwich Union's ongoing reattribution negotiations will come to a successful conclusion? When might this be?
Mr Hodges: Thank you, Chairman. I remain confident that we can do a deal. However, I think we have to accept that it is by no means certain, so we are working as hard as we possibly can. The Committee is aware that we have been engaged in this process for two years now, working with the Norwich Union Policyholder Advocate and with the FSA. We are all committed to trying to bring a deal to a conclusion as swiftly as we can so that we can give certainty to the policyholders, but the reality is at the moment, as we stand, that there are still some significant gaps between our position and the position of the policyholder advocate. We meet on a very regular basis and are meeting this week, for instance, to try to close those gaps, so my sincere hope is that we can close the negotiation phase of the project down in weeks rather than months and bring some certainty to our policyholders. But I do have to stress it is not certain, because if we cannot get to a conclusion that all parties feel is reasonable then the process has to allow for the unfortunate eventuality, and not one that we want, that has to allow for the fact that we may not be able to do a deal.

Q146 Chairman: Can you understand the public interest in this issue?
Mr Hodges: Absolutely we can understand the public interest in this issue. Our firm commitment and desire—and it has been throughout—is to try to resolve this issue, to bring what we think would be a very attractive offer into the public domain, put it to the policyholders and then give them the free choice to make their minds up.

Q147 Chairman: Nick Prettejohn, you have nominated Peter Bloxham as Policyholder Advocate for your own potential reattribution. When will you be starting that process in earnest?
Mr Prettejohn: We have been working on looking at the possibility of a reattribution since our nomination of Peter Bloxham last March. We have not appointed him but we have said that we will reach a decision as to whether we pursue a reattribution by mid-year this year.

Q148 Chairman: Why have you not already commenced these negotiations? What are you waiting for, given the public interest—and you can probably understand the public interest in this.
Mr Prettejohn: We understand the public interest acutely well. We have over four million policyholders who would be affected by this. We are keen to make sure we examine the possibility of a reattribution from every angle, to make sure that it would be in the best interests of our policyholders now and in the future and of our shareholders, and to make sure that we are treating our policyholders fairly.

Q149 Chairman: Where have your two firms' inherited estates come from? What contributions have derived from both shareholders and policyholders?
Mr Hodges: Perhaps I could start, Chairman. The reality is that our funds—and I can only talk about our funds—are between 150 and 200 years old. We are talking about two funds under Norwich Union's reattribution proposals. The reality is that, over that time and through prudential management, surpluses have arisen and it is very difficult now to trace those back and be absolutely explicit about where they come from. We have done an awful lot of work throughout the process on establishing that none of the current generation of policyholders has contributed to the inherited estate and over the years there have been contributions by the shareholders. We do have one or two examples. They are slightly historic but maybe we could give you some colour on those.

Q150 Chairman: Clare Spottiswoode said here last week that the company has never claimed its shareholders contributed to this estate.

Mr Lister: It is very difficult to know exactly where the money came from but when these companies were set up many years ago shareholders would have contributed. I also know from our records that contributions were made in 1945 and 1950. I do not think, fundamentally, the inherited estate came from those contributions; it came from the running of the fund.

Q151 Chairman: Therefore, would you disagree with Clare Spottiswoode?
Mr Hodges: I think Clare, in the round, is right, but there are specific elements where we know shareholders have contributed.

Q152 Chairman: If you will forgive me, do not mention that phrase "in the round" again.
Mr Hodges: Okay.
Chairman: Because Hector Sants came last week and it was "in the round" all the time!

Q153 Mr Fallon: Mr Hodges, your primary duty is to your shareholders, is it not?
Mr Hodges: I think we have a duty to a number of stakeholders.

Q154 Mr Fallon: That is why I asked you what your primary duty was.
Mr Hodges: From my perspective, I have a duty to our shareholders. I also believe we have a duty to our employees and a duty to our policyholders. We look, as I think any successful company would do, to balance the interests of all stakeholder groups.

Q155 Mr Fallon: You do not have a primary duty to your shareholders.
Mr Hodges: We have a duty to our shareholders but we have a responsibility to our policyholders and to other stakeholders in running the company.

Q156 Mr Fallon: Mr Prettejohn, it is presumably for each board to consider its position quite separately and independently of the decision reached by any other company?
Mr Prettejohn: It is the duty, indeed, of the Directors of the company to look at its own specific situation. It is the case that all inherited estates, all life funds, are different. In our case, for instance, as far as the source of the estate is concerned a very considerable proportion we believe of the estate—and it is difficult to put a precise number on it—has been contributed by shareholders over the course of the century of the operation of the fund, but we have to look at the particular situation of our estate, look at its financial condition, look at how much money is required for the regulatory solvency and the working capital of the fund that provides the benefits to policyholders over the long term.

Q157 Mr Fallon: It would be perfectly possible and indeed perfectly proper for you simply to decide in the event not to have a reattribution at all.
Mr Prettejohn: It would be a perfectly proper decision for us to do that, yes.

Q158 Mr Fallon: I understand the policyholder interest you both referred to but I am a little bit confused about the public interest here. Why is there a public interest in this? I see the policyholder interest. Why should it be a matter for this Committee, indeed, to interfere in what are commercial negotiations? What is the public interest here outside the policyholder interest?
Mr Prettejohn: It is a perfectly reasonable question. Obviously large numbers of people are potentially affected by it and we are clearly concerned to make sure in responding to the Committee that people understand exactly where we are and that our policyholder interests are properly being taken account of.

Q159 Mr Fallon: Mr Hodges, one of the uses of inherited estate is to smooth out returns over good and bad years. Is it the position that those who happen to be policyholders at the moment have in fact seen those returns smoothed out reasonably over the period?
Mr Hodges: Yes. Our belief is that the smoothing process works well. From our perspective, part of the wider public interest is that a with-profits investment vehicle is something that is a useful investment vehicle. I think the volatility we are seeing in the investment market at the moment shows that something that does smooth returns over time can be useful. Investors are interested in the product and I think that is where some of the public interest comes from, because if we can clear up some of the misunderstanding and misconception about inherited estate through a reattribution process, our view is that we then have a product that can be sustainable and useful in the longer term. Certainly we believe the smoothing does work and has worked.

Q160 Mr Fallon: If it has worked, does it follow from that that it would have benefited the longer-term policyholders more than those who have just joined up in the more recent years?
Mr Hodges: That really does depend on individual investor circumstances. Each investor, ultimately, has their own investment appetite, their own investment preference. They may be able to call the market right in terms of when they join the fund and when they leave but, frankly, it is a very difficult question to answer in generic terms—I nearly said "in the round" apologies—because it does depend on individual circumstances.

Q161 Mr Brady: Could I ask both of you what procedures or checks you have in place to ensure that the underwriting of new business from the inherited estate is done in a way that protects policyholders' interests?
Mr Hodges: We have a very strong governance process in place over the running of our with-profit funds. As the Committee is aware, we have a With-Profit Committee that has an independent majority. They report to the board. We also have a with-profit actuary, and we have independent advisers to the With-Profits Committee. So there is a whole series of

checks and balances in place to make sure that the actions that we take or the actions that are taken on behalf of the fund are appropriate.

Q162 Mr Brady: But they make those recommendations to the board and it is the board who makes the decision.
Mr Hodges: Ultimately the board makes the final decisions, yes.
Mr Prettejohn: Similarly, in our case, we have a With-Profits Committee that is entirely independent of our Board. There are no non-executive members of our Board on it. We have two qualified eminent actuaries on the committee and it is their job to review the proper balance between policyholder and shareholder interests. Ultimately it is of course the Directors' decision, but in that we have a very stringent regulatory regime which requires us to treat customers fairly. That is a very important part of the considerations that our Board has to go through.

Q163 Mr Brady: Have you always accepted the recommendations of the With-Profits Committee or have you ever disregarded them?
Mr Prettejohn: Normally we have a good and strong debate. It is not a case of them making recommendations, but they will express views which we would be well advised to take strongly into account.

Q164 Mr Brady: Is it similar for the Norwich Union?
Mr Hodges: In the nine months that we have had our independent majority, we have accepted the recommendations that are usually put forward to us.

Q165 Mr Brady: After a reattribution takes place, would you use shareholders' funds to subsidise the writing of new business in exactly the same way as you do now?
Mr Hodges: We would take issue with the word "subsidy" as an organisation because this is about the recycling of capital between generations of policyholders. That is something that all policyholders during the fund benefited from and future policyholders may well benefit from as well. Our attention is always to make sure that any capital is put up to back new business is repaid over the term of the policy. We do not use the word "subsidy" internally, but certainly after reattribution we would see the fund continuing to operate in the way it has now, just backed by money that the shareholder would have a claim to in the future.

Q166 Mr Brady: You would expect the same kind of rate of return on the money that you have used.
Mr Hodges: Yes.

Q167 Mr Brady: And that would be the same for Prudential?
Mr Prettejohn: In our case, clearly we have not decided whether or not to do a reattribution. I would agree with the disagreement with the term "subsidy". I think it is an important feature of our life fund that it is a dynamic fund. It is there to provide existing products and new products to the current generation of policyholders and future generations of policyholders. Inevitably, as part of the function of the inherited estate is providing working capital for the fund, it funds the initial set-up costs of new business for policyholders.

Q168 John Thurso: Mr Lister, in answer to the Chairman's question about whether or not shareholders had ever put in any money, gave some instances from the long past, and the 1940s I think was the last one. Can you give me an idea of the value of that? In other words, would it be fair to say that 99% of the fund came from the policyholder contributions and the activities of the fund and less than 1% from shareholders? Would that be accurate?
Mr Lister: To be perfectly honest with you, I cannot tell you whether that is accurate or not. You will appreciate that these funds have been run for a very long time, as Mark outlined, and I am afraid that the history simply is not there for me to go back into and quantify that.

Q169 John Thurso: When you found that 1945 example.
Mr Lister: I found out that the contributions were made in 1945 and 1950, less than the full amount was taken, but the records do not tell me how much was contributed.

Q170 John Thurso: I probably should have researched this before I came in, but could you tell me what the sort of ratio is between what is considered inherited estate and the value of the fund?
Mr Lister: The estate at the end of 2007 was some £2.6 billion after we distributed £2.4 billion to policyholders and shareholders. The total funds under management was £26 billion.

Q171 John Thurso: It is about 10%.
Mr Lister: It is about 10%. To follow up on that a bit, the 10%, the £2.6 billion that we have got left, is the amount of money we need to retain within the fund to provide smoothing, investment freedom, capital for future new business, et cetera.

Q172 John Thurso: Presumably the reason you are looking at a reattribution is because under the new rules from the FSA the surplus has to be paid back and, therefore, you have identified some funds which are surplus to requirements. You would not be doing a reattribution if you needed them.
Mr Hodges: The words distribution and reattribution tend to get used interchangeably. From our perspective, the distribution that we undertook earlier this year of some £2.4 billion was clearly identified as excess, money that was not required in the fund, and therefore was distributed quite rightly on a 90:10 basis. The £2.6 billion that is left is required for the day-to-day running of the fund. It provides, as John just outlined, protection for policyholders. It means we can have a higher ratio of equities in our investment portfolio and a

higher ratio of properties and ride out some of the market volatility, so that we can hopefully give a better return to policyholders over time—the concept of smoothing. The reattribution part really is then—I think Mr Fallon picked up earlier—a commercial negotiation between the current group of policyholders in the company to say, "Is there a value that the company could pay to those policyholders to give up rights to future potential distributions." I think the key word there is "potential" because there is no certainty that distributions will be made in the future: it will depend on investment conditions and what happens to the fund in terms of consumer behaviour, for instance.

Q173 John Thurso: I suppose what I am having a little difficulty with is why at the end of last year there was a clear surplus available for distribution—that is dead simple—but between then and now there is another sum that is identified as being available for reattribution. Because at that point it is lost to the fund, and, therefore, if it is needed to operate the fund, how can it be reattributed when it was not a surplus?
Mr Hodges: One of the key features of the reattribution is that no money leaves the fund. This is potentially an area that I know it is not necessarily easy to understand.

Q174 John Thurso: Presumably the shareholders' bit leaves the fund, does it not?
Mr Hodges: No. New money is provided by the shareholder to pay an incentive to the policyholders to give up these future rights, but the £2.6 billion that is currently in the inherited estate and identified as required working capital stays in the fund and the shareholder is effectively buying the right to use that capital and to have the excesses if they arise in the future. That is why it goes to the heart of how much do you pay for an asset today that in our case it just happens to be the way that the deal is potentially being structured with the Policyholder Advocate. In our case it is locked in for a minimum of six years and then is subject to investment volatility and changes in regulation, changes in legislation and changes in consumer behaviour. That is at the heart of the reattribution but no money leaves the fund; it is new money that goes to policyholders.

Q175 John Thurso: No money leaves the fund. You are putting forward that shareholders are not seeing a particular advantage, so why are you doing it?
Mr Hodges: There are advantages, we think, for policyholders and shareholders. In the policyholder case they can receive certain cash now, paid for by the shareholder, and that is against an uncertain future in terms of distributions. For the shareholder, it means that the capital can be used to write business where the shareholder, instead of taking a 10% stake, can take 100% stake, and that is really, again, at the heart of the commercial negotiation.
John Thurso: Thank you.

Q176 Nick Ainger: Mr Prettejohn, what criteria do you use as a company to decide when there has been mis-selling of a product?
Mr Prettejohn: The criteria that we would use would revolve around the principles of treating customers fairly that are laid out in the FSA Regulations. There are a number of outcomes that the FSA are looking for and that we would also use to judge: Are we targeting the right group of customers with the right product? Are we meeting clear expectations? Does the product do what we said it would do? Where advice is being given, is that advice appropriate? Are we explaining ourselves in clear language? Are we offering the anticipated and appropriate level of service? You need to weigh up all those different factors in order to decide whether a product could be mis-sold.

Q177 Nick Ainger: You have clear guidance of what you should be doing and where that clear guidance is not followed mis-selling has taken place.
Mr Prettejohn: Could have taken place.

Q178 Nick Ainger: You have set aside £503 million for mis-selling costs. Presumably that is because of mistakes and misdemeanours made by your members of your staff but rather than shareholders bearing the burden of those costs—which, in effect, some would call a fine—you are asking the policyholders to pay that £503 million, or certainly on a 90:10 per cent basis. Do you think that is fair?
Mr Prettejohn: The first point I would make is that as far as mis-selling costs are concerned, fines are not paid by asset shares. It is compensation that is paid out of the inherited estate.

Q179 Nick Ainger: It is a penalty, though.
Mr Prettejohn: Yes. It is important to understand that, in some cases, clearly, the people who were performing the sales task were effectively employees of the life fund. I think the most important point that I would make is that, in recognising what was a very regrettable episode in the life industry's history, the Directors of the Prudential quite properly said at that time that as far as mis-selling costs were concerned they would not affect the future bonus payouts and the investment policy of the fund as it related to those policyholders. For that generation of policyholders we gave an undertaking that we would not change the investment policy, and therefore the expectations of policyholders, as a result of mis-selling costs. That was an important undertaking that was given at that time.

Q180 Nick Ainger: All policyholders stand to lose by your using £503 million for future mis-selling costs. The shareholders are only taking a tiny hit. They have the corporate governance responsibility to ensure that your staff and your agents follow the clear guidance which you have described and yet the policyholders are expected to bear the burden of the penalty if mis-selling takes place. Is that fair?
Mr Prettejohn: As I said, in terms of the undertaking that we gave, we are intending and have maintained that policyholder expectations in terms of their

policies with the Prudential will not be affected by mis-selling costs. The second point I would make is that the inherited estate has been contributed to very significantly by shareholders as well. If we go back to where the questioning started, the shareholders over the course of the operation of the fund have made very substantial contributions indeed to the inherited estate as it stands today.

Q181 Nick Ainger: How much in total have you taken out of the inherited estate to pay for mis-selling costs?
Mr Prettejohn: Over the course of the last few years, we have used about £1.1 billion in order to pay compensation, and the cost of administration of those payments of compensation has been a further £500 million. About £1.6 billion in total.

Q182 Nick Ainger: £1.6 billion. Did all of that come out of the inherited estate?
Mr Prettejohn: Out of the inherited estate, yes.

Q183 Nick Ainger: Clare Spottiswoode argued that it is not as clear as perhaps I have been putting it over; that you should bear, as a company, all the costs of mis-selling. She said that where there are mistakes, that could be understood, but there might be systemic failure. When we have a cost of £1.6 billion what are the mistakes which occur in the nature of business and at what point do you say, "No, this is a systemic failure and therefore the shareholder should be bearing the burden of these costs?"
Mr Prettejohn: I am not entirely sure of precisely her definition of systemic and I am not sure I would necessarily hazard one of my own, but I think the reaction of the Directors of Prudential at the time was to say that this was an unusual set of circumstances and therefore they gave the undertaking that I have referred to in order to reflect the abnormal nature of those circumstances. If that is a recognition that it was systemic or verging on systemic, then so be it.

Q184 Nick Ainger: In that case, any systemic failure should be the responsibility of the shareholders, not the policyholders. Do you think they would have been quite so generous if they themselves as shareholders were expected to pay £1.6 billion rather than the policyholders?
Ms Maynard: Harking back to the comment you said Clare Spottiswoode made on this, I think what she said was a very good point. The with-profits business is the business of a with-profits sub-fund and the policyholders of the fund share 90:10 in the profits and losses of that business. Therefore, it seems appropriate, where you have losses, that those would be shared 90:10 in the same way as profits are shared 90:10—which I think is why Clare accepted that it was not a clear point. For shareholders to bear 100% of the cost on a business where they only get 10% of the profits, would probably seem equally unfair to them. As Nick said, we have always made an undertaking that in no way would we charge policyholders for these mis-selling costs, so the current generation of policyholders have not in any way borne the mis-selling costs, rather we have stood behind the fund and said we will not change our investment policy, we will not change our bonus policy on the basis of the money that has been used for mis-selling and, *in extremis,* we the shareholders, would be there to offer support.

Q185 Nick Ainger: I would just make the point that there is less money to be distributed from the inherited estate to policyholders as a result of the policy that you have followed. If the shareholders were expected to bear a far fairer burden, because, after all, it was their responsibility to ensure that the guidance that was provided by the FSA was abided by, they have failed in that responsibility and that is why mis-selling occurred and therefore the shareholders should bear a significant proportion of that responsibility.
Ms Maynard: I think it comes back to the comment Nick made earlier about the reasonable expectations of policyholders. With-profits business is in and of itself an intergenerational play, because what we are doing with smoothing is smoothing out the volatility of the markets over time so that you will have transfers in and of themselves from people who have been in the fund in good years to people who have been in the fund in less good years, and therefore no one generation of policyholders would have any particular expectation on the estate of getting any pay-outs from the estate because the estate is there for the long-term use of the fund. In no way have we charged current policyholders with anything; indeed, we have maintained their expectations by saying that we would do nothing different in the management of the fund, notwithstanding the fact that these costs have been borne.

Q186 Chairman: Mark, given you are further down the road on this, what is your response to the question that Nick Ainger put?
Mr Hodges: Just to echo the point that Nick Prettejohn made, any mis-selling is regrettable and our prime concern at that stage and since has been to remediate to customers any loss that they suffered. In terms of the fairness, our view is very much in the space that it was not systemic failure, it was not a fine which would be charged to shareholders and therefore it was appropriate that the inherited estate should be used. In the context of reattribution, though—and this is where the reattribution offers an opportunity to resolve some of these issues once and for all—it is a value item in the negotiation. Our Policyholder Advocate will have a view on how much value should be attributed to that particular item and it is part of a negotiation we are having with her about what is a fair amount for the shareholder to pay for the inherited estate. That is the advantage of pursuing a reattribution, that some of these issues can be closed off once and for all.

Q187 Mr Breed: We have had other parts of the finance industry before us fairly recently. You are doing pretty well really. The banks have managed to

lose a load of money, and even they have not charged the depositors but they have managed to offload it on to the taxpayer. Your costs of the failure to do your business properly you think should be paid by your policyholders. Most reasonably fair-minded people would say, I think, that the shareholders should be bearing the full costs of the inability for you to do your business properly. It is not for policyholders, who perhaps somewhat mistakenly decided to put their money with you. Anyway, we will move on to these other questions. Mr Hodges, your annual report stated that pension costs would be charged to the inherited estate. Can you confirm that the use of the inherited estate to support your staff pension fund is a new development?
Mr Hodges: It is not a new development. It is consistent with the Principles and Practices of Financial Management that we produce for our customers. Around the pension scheme deficit funding there are some very important facts and figures of which the Committee were not made aware in the first part of the inquiry. At the end of 2006, the pension scheme for Norwich Union in the UK had a deficit of some £900 million and at that stage the shareholder committed to make a contribution of £700 million. As part of the process, because a number of the employees over the years have been employed directly by the funds, the with-profit committee was asked to consider whether a contribution would be sensible and viable from the funds and from the inherited estate. After a long debate and lots of challenge, it was agreed that the with-profit funds should make a contribution of 12% of the deficit, so 88% came from the shareholder and 12% from the with-profit funds, which seemed like an appropriate split based on the work that we had done around the numbers of staff who were employed directly by the funds. There are a few other important facts in here as well. This was not a one-way bet. The With-Profits Committee insisted that if the deficit were to reduce and the company's contributions were to reduce, the with-profit fund contributions should reduce as well. Equally, it was agreed at the time that if pension holidays were taken in the past, because obviously the deficit can move into surplus depending on investment and returns and circumstances, the with-profit fund would benefit from those pension holidays in the future, as it had done in the past. There was an enormous alignment between what was happening around funding the deficit from a shareholder perspective, and funding it from the with-profit fund perspective.

Q188 Mr Breed: From that I can take it, first of all, that only those staff who were directly employed in respect of the with-profit funds are being contributed to by the inherited estate.
Mr Hodges: People move in and out.

Q189 Mr Brady: Yes, some will move in and out, but, essentially, you have tried to identify as far as you possibly can—and it is by a percentage basis—that it relates to those members of staff directly employed in terms of the with-profits fund.
Mr Hodges: Yes. We have tried to align that. At the time, the number for the with-profit fund was £120 million. This was the number that was quoted last week. At the end of last year, that had been reduced down to £64 million in line with the deficit shrinking.

Q190 Mr Breed: You have said it was not a new development but did the inherited estate contribute to the pension fund whilst it was in surplus?
Mr Lister: When the staff are employed by the with-profit fund, all of the expenses would be charged to that fund; therefore their pension contribution, when a pension contribution was being required, was taken from the fund as an expense. When no contribution was made then no contribution would have been charged to the fund.

Q191 Mr Breed: During the pension holiday there is no charge.
Mr Lister: During a pension holiday no charge will have been made to the fund.

Q192 Mr Breed: Of course not. When it was not considered to be actuarially in surplus, there were contributions made from the inherited estate in previous years at some stage in the past.
Mr Lister: In the past. When contributions were necessary, as an allowable expense associated with those policyholders, that would have been charged to the fund. When no contribution was necessary, nothing was charged to the fund.

Q193 Mr Breed: Mr Prettejohn, could I pose the same question to you. Is that roughly what you do as well?
Mr Prettejohn: We go through a similar process, by the sound of it, to establish rigorously, in so far as we can, what proportion of our total costs, including the costs of our people, are attributable to the life fund and those that are not. That is a process we go through very regularly. Only those costs that are attributable to the operations of the life fund go to the life fund.

Q194 Mr Breed: Is your fund in deficit at the moment?
Mr Prettejohn: Our pension fund at the moment on an actuarial basis is in deficit, although in an accounting sense it is in surplus.

Q195 Mr Breed: It is quite interesting that those who provide pensions for millions of people find their own pension fund in deficit. Still, we will proceed. Which? have highlighted the issue of pension costs as an example of how easy it is for a firm like you to change its own Principles and Practices of Financial Management just to suit your needs from time to time. How do you go about amending or changing your PPFM? Who in that process is looking after the policyholders interests?
Mr Lister: To start with we did not change our PPFM. I am not quite sure where Which? got that from, the existing PPFM—

Q196 Mr Breed: Is that published by the way?
Mr Lister: The PPFM is published on our website. It is not something that we give to policyholders; it is really there to enable the running of the fund and a check by the FSA and our With-Profits Committee on the running of the fund.

Q197 Mr Breed: When was the current thing on the website agreed?
Mr Lister: It is updated on an annual basis.

Q198 Mr Breed: Is it changed on an annual basis, then?
Mr Lister: Yes, if I could bring you to how we would do that. On an annual basis we would look at how the fund has complied with both the principles and the practices set out. A report is produced by the with-profit actuary to the funds and that is considered by the With-Profits Committee. If there are changes required to the PPFM for any elements, if it is a change in principle then that would be considered by the With-Profits Committee and the Board, and will be notified to policyholders; if it is a change in our practice, then we would need both our With-Profits Committee and our Board to approve it and we would also need the FSA to approve such a change. In both a change in the principle or a practice, we would notify our policyholders. As you will appreciate, anything that would damage the interests of policyholders would be looked at very, very carefully from the TCF perspective and treated very seriously. It has not happened.

Q199 Mr Breed: I have not seen it but might it be two or three pages of minute script that you send out with a vast amount of other bumph so that the vast majority of policyholders would have to go to Specsavers in order to read it?
Mr Lister: Just to be absolutely clear, there are two documents that are produced in the management of the with-profits fund. One is a consumer-friendly version that everybody can ask for, every policyholder receives. There is also the more detailed Principles and Practices. That runs to something like ten pages and gives much more granularity on the running of the fund. As I said earlier, it is there so that the With-Profits Committee and the Board can be held to account relative to the exercise of discretion. It is also there so that the FSA can have oversight of how we run the fund.
Mr Prettejohn: We have a very similar process. In principle, change has to be approved by the FSA. There is a requirement for us to keep the PPFM continuously up-to-date. Any changes that are made would be reviewed by our actuarial function holder, by our with-profits actuary, either by the With-Profits Committee that I referred to earlier on, and by the Board. We have a customer-friendly PPFM and a longer, more detailed version of the same. The process we have is a very rigorous one and, indeed, the process itself is part of our actuarial control procedures manuals, so the process itself is controlled.

Q200 Mr Breed: You have made no substantive changes to Principles and Practices in advance of any particular decisions of the board in respect of inherited estates.
Mr Prettejohn: No, we have not made any that would prejudice or in any way influence the course of those negotiations or the interests of our policyholders, which we are required to bear very strongly in mind at all times.

Q201 Mr Dunne: I would like to ask a few questions about distributions and reattribution. This is perhaps a question for Mr Lister. Is it the case that every year your actuaries have to determine whether or not there is any excess surplus over and above working capital needed to maintain the business within the inherited estate and that that has to be agreed by the FSA?
Mr Lister: Yes. On an annual basis, as part of the process of managing our funds, we look at the capital we have within the fund and assess whether we have got an excess. If we had an excess, then there would be a presumption of distribution on a 90:10 basis.

Q202 Mr Dunne: Apart from this year, when was the last year that you decided that there was an excess?
Mr Lister: That would have been in the late 1980s, when there were some special bonuses added to policies.

Q203 Mr Dunne: Not for well over 20 years.
Mr Lister: But the point I would make is today actuaries have much better tools for assessing the level of capital that we need to run the funds and protect policyholder interests than we had in the 1980s.

Q204 Mr Dunne: Those evolved over time. They did not suddenly arrive.
Mr Lister: Those evolved over time.

Q205 Mr Dunne: What was it that drew your view as the actuary and your board to the conclusion that this was an appropriate year in which to compare and that there was excess capital?
Mr Hodges: This is where the reattribution process and the distribution processes are joined. We have been working intensively over the last couple of years with the FSA and the policyholder advocate, looking into things that we have already talked about—the source of the funds and some of the uses of the funds—and trying to work out what the future might look like under a number of scenarios. Through that process there is no doubt that we have, with the FSA, sharpened our ability to look at the inherited estate and what may or may not be surplus, depending on different investment scenarios and different investment appetites that we may have. It was really through the process in 2007 that we came to the conclusion that, if we were to change our investment appetite on the actual investments, backing some of the guarantees we had given to policyholders, that we could free up an excess surplus and we could make that distribution to

customers this year. As we went through the second half of 2007, we were able to go through a process of investigating that in more detail, taking it through the FSA processes and then, as soon as we were able to, of course, we made the declaration and made a special distribution of £2.4 billion.

Q206 Mr Dunne: Had you not had it in mind to consider reattribution, are you telling us that you would not have gone through that process of looking at your policies and determining that you could in fact afford a distribution.
Mr Hodges: I am not saying that we would not have done it. We already had undertaken voluntarily the process of looking at a reattribution, so it is a part of the process. It is hard to say now, but I could not say that we would not have done it.

Q207 Mr Dunne: You are presenting this as though it is part of a package and that, in order to do a reattribution, a conclusion was that it was appropriate to do a distribution. Is that a correct assumption that I am making?
Mr Hodges: I do not think I would characterise it quite like that. I think when we started out on the reattribution process—which obviously we entered into voluntarily and we were keen, as we said earlier, to bring some clarity to the situation—the idea that a special distribution may be part of that process was something we had in mind, and if we cannot agree with the Policyholder Advocate on a deal that we think is balanced and fair to all stakeholders then we will have achieved as a minimum the paying out of £2.4 billion in special distribution to qualifying policyholders and shareholders.

Q208 Mr Dunne: You referred to the fact that you had looked at the returns applicable to the guaranteed product. Does the fact that you are going ahead with a distribution—whatever happens to reattribution, if I understand it correctly—means that your investment parameters for your inherited estate have now changed, now that you have determined that there is excess capital available?
Mr Lister: Effectively that is what we have done. We have moved some of the assets backing the guarantees out of equities into fixed interest securities. The effect of that has not been to damage policyholder returns, because the investment strategy for assets backing the policyholders has remained the same, but it does enable us to create a surplus that we could give to policyholders without damaging their expected returns or the fund as a whole.

Q209 Mr Dunne: Because it only applies to guaranteed product.
Mr Lister: No, it is the guarantees that policyholders have. The with-profit policyholders receive what we term an asset share, which is their pot of money accumulated, subject to smoothing, and a minimum return, and the minimum return is the guarantee.

Q210 Mr Dunne: You have just said that the policyholders expectations have not changed as a result of this process. If the reattribution goes ahead, does it mean there has been a change in the expectation of shareholders as to what either shareholders or policyholders going forward are meant to earn on the residual inherited estate?
Mr Lister: Again that is something we have been talking to Clare about, but there are still quite a number of risks, both economic and tax regulatory risks within the fund, which drive uncertainty, and therefore the shareholders and the policyholders are faced with the same level of uncertainty regarding future distributions. We have not closed down all risk, if that was your question.

Q211 Mr Dunne: I think I am trying to get to why it is that suddenly you have managed to make this enormous distribution, having not done so for 20-something years. I am trying to clear up whether this is driven by the fact that reattribution is in prospect or whether it is driven by something else. You are trying to suggest that it is something else. It seems an extraordinary coincidence.
Mr Lister: It is the mere fact that we are looking in detail at a reattribution process. As part of those discussions with the FSA and the policyholder advocate, we thought it sensible to take a different investment strategy and distribute the money on a 90:10 basis rather than push it into the reattribution process itself. The effect of our distribution is that we have paid out something like 40% or 45% of the fund or the estate to our existing policyholders.

Q212 Mr Dunne: Mr Prettejohn, has the Prudential, having seen what has happened with one or your main competitors, also taken another look at your working capital requirements in the inherited estate? Is there a prospect of a distribution with or without a reattribution?
Mr Prettejohn: We are obliged to look at the financial condition of the life fund each year. It is not a process we go through because our competitors have initiated a particular process; it is something we have to do as Directors. It is a process we go through each year. We look at the way in which we run the fund, we look at the investment policy that we have, the benefits that we want to provide to our policyholders, and look to see whether there is a surplus or not. Our current judgment is that, given the way we run the fund and the estate, we have no excess surplus. We have an inherited estate of £8.7 billion on a fund of £74 billion. Just to put the £8.7 billion in context, our annual bonuses to policyholders that we paid in respect of last year are £2.7 billion. The total size of the estate is only just over three times the size of our annual bonus declaration. In our view, at the moment we have no excess surplus in the fund.

Q213 Mr Dunne: I know you have not decided whether to go down a reattribution route, but, if you did, would you anticipate that that would throw up an opportunity for a distribution alongside it or are you not in a position to tell?

Mr Prettejohn: I think we are still going through the process of deciding whether or not a reattribution could make sense. But our judgment at the moment is, given the way in which we run the fund and the estate, there is no excess surplus at this point.

Q214 Mr Dunne: Thank you. Going back to the current distribution that you have proposed at Norwich Union, Mr Hodges, you have decided to phase this over three years.
Mr Hodges: Yes.

Q215 Mr Dunne: Recognising that some of your policyholders will have policies maturing during that period and therefore may lose out from the whole thing. Obviously the issue of individuals losing out from things is quite topical at the moment in this Place and I understand that the calculation is that approximately 4% of your policyholders would not get the full distribution. Why have you decided to phase it in that way, recognising that there will be some policyholders current who will lose out, even if that is for the benefit of some who are not yet policyholders?
Mr Hodges: The issue here for us was trying to balance various interest groups within the fund, various groups of policyholders. The things that influenced our decision were wanting the fund to remain strong and open, which is in the interests, we believe, of all policyholders; wanting to reward loyalty; and not to unduly reward anybody who could and did join the fund within just the last year. We get some very large, single premium investments and somebody could join the fund, receive special distribution if it had been made in a one-off way and then leave the fund. We thought that was less fair than a phased payment that rewarded some loyalty. The reality from our perspective is when we balanced all the interests up we considered a phasing of between one year and ten years we felt three years was the best option open to us. In terms of the profile of payments, obviously 100% of people will receive the first payment; something like 98% will receive two payments; and 96% will receive three. Even though it is three accounting periods that those payments are made over, in elapsed time it is 24 moths, so that does allow, we felt a reasonable balance between rewarding loyalty, keeping the funds stable—there are something like 120,000 people in the fund who are not eligible for a distribution because of the nature of their individual policy, and they benefit from the strength of the fund, so we had to balance their interests, but we felt that the three-year phasing in accounting periods over what is effectively 24 months was the fairest way to do this on balance.

Q216 Mr Dunne: You are familiar with the concerns of the policyholder advocate over this phasing. How have you responded to her? I notice we have had a reply from the chairman of the With-Profits Committee since last week, which is helpful, and he has endorsed your decision. Can you explain how you dealt with her specific concerns about this.
Mr Hodges: The issue here is the remit of the Policyholder Advocate, which is to negotiate the reattribution. The distribution is something that falls within the remit of the With-Profits Committee, who made a recommendation to the Board. Whilst we talked to Clare about our intentions, we did not include Clare in our decision-making process. From our perspective, because she is representing a group of policyholders (that is, the group of policyholders who were in the fund on the eligibility date for reattribution, which was November 2006) she herself would be compromised in being part of the decision that affected a broader range of policyholders. She was aware of what we were doing—not the detail but certainly the principles—and I and we were happy with that process.

Q217 Mr Dunne: In the reattribution undertaken by AXA a few years ago, if I understand it correctly AXA paid 31 pence in the pound for every pound of inherited estate they effectively acquired through reattribution. The FSA accept that the 90:10 rule should not apply to reattribution; it should be less than 90% of the policyholders and the Policyholder Advocate accepts that as well. I appreciate you are in the midst of a commercial negotiation now and I am not asking you to make a statement today about where you have got to, but I would ask you to give us some indication of the range which presumably is somewhere between 31% and 90% within which you may think it is appropriate to reward policyholders for buying them out of their interest.
Mr Hodges: I think it is very, very difficult, given that we are at a very delicate stage of what has been a long negotiation to try to give a range, because any range we give can give an implied value and that is something that I do need to be very careful about. The one thing I would point out is that the 31% that you quoted was a distribution and reattribution payment and, taking the figure that John quoted earlier with the distribution we have made already, we have already distributed 40% of the estate that was there at the end of 2007, so from our perspective we are already ahead, if you like, in terms of value, and our intention all along has been and still is to do the deal that we believe is fair to policyholders and provides a sensible return for shareholders based on the risk they have to take.

Q218 Mr Dunne: Will this be a transaction which will require your shareholder approval?
Mr Hodges: It would require shareholder approval because the new cash that is required to pay to policyholders has to come from shareholders' resources. It then has to be approved by the FSA and ultimately in the scheme that we have designed every single person will have effectively a free choice. There is no compulsion in the scheme that we are proposing, so people will have a free choice to vote yes or no. If they vote no, their portion of the inherited estate will be segregated and they will remain exactly as they are today. Finally, once that mailing process and choice process has been completed, it would go to the High Court for final approval.

Q219 Mr Dunne: Did you say it does not go for shareholder approval?
Mr Hodges: It does.

Q220 Mr Dunne: As a board, you have a very delicate balancing act to undertake here. On the one hand, presuming you are going through this tortuous exercise having to persuade as many policyholders as possible to accept this is a good deal for them, and at the same point persuade your shareholders, your other main stakeholder, that it is a good deal for them, and they are on opposite sides of this particular negotiation. What are the factors that you will use to persuade your shareholders that this is a good deal for them?
Mr Hodges: There were a number of factors, and they are not all financial. One of the prime factors will be the return on capital that a shareholder can expect to return over the next few years, if it were to make an incentive payment. But other factors that weigh very heavily in our mind are things like reputational risk. We want and believe we are trying to do the right thing here. We have entered this process voluntarily. We believe it is the right thing to bring clarity to the inherited estate. The way this is perceived and the way that our policyholders feel about this is important to us as well. But I would say those are the two tests.

Q221 Mr Dunne: Essentially it is cheaper capital than is available from other sources from the shareholders' perspective.
Mr Hodges: Not necessarily cheaper but it is the return on the capital we invest upfront. The incentive payment that goes in cash to policyholders is new money that the shareholder could be doing other things with, so it is the relative return on that money that we would be interested in.

Q222 Mr Dunne: The FSA in our submission last week accepted the argument from the Policyholder Advocate that reasonable expectations of policyholders faced with reattribution is for some distributions to follow and not for them to be zero. Therefore, this is not just a question of them accepting an offer because it is there on the table and there is no prospect of getting anything else in future. Obviously they will not if they do accept it, but, going forward, there will be some distribution capacity within the inherited estate because that is why your shareholders are interested in buying it in the first place. Have I understood that correctly?
Mr Lister: In arriving at the value we believe we should pay, as Mark has said, we have tried to put a fair offer on the table, therefore we have been trying to estimate what those future distributions would be to policyholders, should the reattribution not go ahead. Post the reattribution, the money will clearly belong to shareholders but they will not be able to take that money out until it is no longer required to support the policyholders in the fund. That support comes from investment flexibility and bonus policy, et cetera.

Q223 Jim Cousins: I would like to recap on one or two of the things that have been said so far. You have said that the shareholders have made a contribution to the with-profits fund but you were not sure when and it was probably as long ago as 1945.
Mr Lister: Yes. When companies were set up 150/200 years ago, there had to be a contribution from shareholders and I know from records that further contributions have been made but what I do not know is the level of those contributions because I do not have the records going back 150 years. I do know that the analysis that we have done is that the current generation of policyholders have not contributed to the estate.

Q224 Jim Cousins: You see the difficulty, Mr Lister, I am sure, in saying on the one hand the present policyholders may not have contributed to the inherited estate but the shareholders should get this substantial benefit from the reattribution, although many of those shareholders may not have been around in 1945/1950. Do you know how many of the present shareholders were?
Mr Lister: I have absolutely no idea how many of the present shareholders, but, just to be absolutely—

Q225 Jim Cousins: When you are applying these principles, a certain measure of consistency always strengthens the force of the principle.
Mr Hodges: Could I intervene on that point. Because the reattribution is funded by shareholder cash today, it is the shareholder cash today that goes toward the incentive payment, a considerable amount of shareholder cash, and so I think there is consistency there because it is today's shareholders who are, if we can agree a deal with the Policyholder Advocate, making the payment to buy out those future uncertain distributions.

Q226 Jim Cousins: Yes, but let us agree that in terms of the shareholders and policyholders of today, neither would appear *prima facie* to have a particular claim over the inherited estate.
Mr Lister: I would agree with that. In the discussions that we have had with Clare, our Policyholder Advocate, we have not sought to claim that shareholders have put them in.

Q227 Jim Cousins: Mr Hodges, you took us through this rather interesting issue of the pension contribution issue. Just to keep it relatively simple, if you had set up a management company for the with-profits fund in line with the Sandler recommendations, of course that particular issue would never have arisen in that form, would it?
Mr Lister: The period we are talking about, where people were employed by the with-profits funds were before the Sandler recommendations were put forward, so it was prior to 1988 that the pensions' accruals that we have allocated the cost to the fund arose.

Q228 Jim Cousins: Are you considering setting up a management company for the with-profits fund in line with the Sandler recommendations?
Mr Lister: No, we are not.

Q229 Jim Cousins: Why not?
Mr Lister: Because we think the existing structure of the fund benefits our policyholders, as it has done for the past 150 years.

Q230 Jim Cousins: The power of tradition! There is some discrepancy in the evidence we have had to the Committee. Your literature in more recent times—because your with-profits fund is an active one, you are still selling policies and getting people into it—has made it clear that policyholders should not expect any distribution from the inherited estate, but Which? who have looked at this, have said that is really not the case and that your literature has been silent on the issue of the inherited estate. Which is it?
Mr Lister: I think the answer is that both are true. If I go back into the 1990s I do not believe the whole topic of the inherited estate was discussed at all.

Q231 Jim Cousins: When you say the "whole topic" was not discussed at all, do you mean the topic was not discussed at all or the whole topic was not discussed in full? Those are two statements of quite different meanings?
Mr Lister: What I mean is no reference was made to the inherited estate.

Q232 Jim Cousins: So Which? are right in saying that no reference was made to this issue of the inherited estate?
Mr Lister: In the 1990s that would be true; today it is completely referenced in our PPFMs, it is referred to in our bonus statements. But I would accept that historically there was not a great deal of reference to inherited estates.

Q233 Jim Cousins: Can you pinpoint a time at which new policyholders being recruited to be contributors and beneficiaries from the with-profits funds were made aware of these inherited estate issues? It is comparatively recently?
Mr Lister: I would say it was around 2000, but I do not know the precise date.

Q234 Jim Cousins: I think you will see that policyholders in each era may have a very different view of your conduct. Mr Dunne has taken you through the basis for the reattribution in terms of phasing and perhaps not verbally but in writing can you set out for the Committee how your NVAs and your terminal policies have changed over that period?
Mr Lister: Yes, we can set that out for the Committee; if the Committee does not have time to hear an answer now we are very happy to do that.

Q235 Jim Cousins: There is also a dispute about whether it was reasonable for you to say that policyholders' reasonable expectations were zero because the FSA have told us that it is not reasonable to make that claim. How do you deal with that issue?
Mr Lister: I think we would accept that there are situations where an excess surplus arises that we would distribute that on a 90:10 basis, and that is exactly what we have done. What we have tried to set out for policyholders is that they should have no expectations of such a distribution. So I would agree with the FSA that policyholders' reasonable expectation is not zero, but I am not sure what it is.

Q236 Jim Cousins: What would be the process of deciding what it was?
Mr Lister: You would have to do a whole range of modelling, as we have done, to support the negotiations with the Policyholder Advocate.
Mr Hodges: This point does go to the heart of the negotiation we are having with the Policyholder Advocate; these are the sorts of issues that quite rightly Clare Spottiswoode is holding us to task on, and it is a value item in that negotiation. So we are not disputing it, we are actually actively trying to resolve it.

Q237 Jim Cousins: Presumably because it is in active negotiation at the moment it is not something that you particularly want me to pursue?
Mr Lister: It would be very difficult for us to draw that out at this point in time.

Q238 Jim Cousins: At least we have established that you agree with the FSA that it would not be reasonable to say that policyholders' reasonable expectations were zero, and the process of working out what they might be is part of the active negotiations between you and the Policyholders Advocate.
Mr Lister: Yes.

Q239 Jim Cousins: What do policyholders know about that negotiation and what part can they play in it?
Mr Hodges: Clare Spottiswoode was appointed to represent them. She has been through a very full process of consultation in terms of road shows and we both have written to the policyholders involved in this particular transaction a number of times to update them on the progress that we are making. I am sure we would both like to be writing to them to update them that we had actually been able to move the negotiations to a conclusion, but unfortunately we are not quite at that stage yet; but they have been kept aware of the process and the progress that we have been making over the last two years.

Q240 Jim Cousins: Your written submission to the Committee gives us the impression that your view is that existing policyholders are unlikely to benefit from future distributions.
Mr Hodges: I think the reality is that having made a very significant special distribution earlier this year and having considered that distribution very carefully in terms of the size of it and where it falls in our range of the risk appetite for the working capital

that is left, it is unlikely that over the next few years additional surpluses will be built up to such a level that distributions will be made. Into the future that may well change—into the longer term future—and again that goes to the heart of how much cash should a policyholder receive today for what might be a very uncertain distribution some time in the future? So I think the point was more around in the near term future it is very unlikely, given we have just made a bit special distribution.

Q241 Jim Cousins: But that would very much depend on the position of the individual policyholder, would it not? In making a proper judgment about that a lot will depend on the length of their policy.
Mr Hodges: Yes, absolutely.

Q242 Jim Cousins: Not only that, but you would also have to make some assumptions about whether the new recruits, if I can put it like that, who have contributed to the with-profits funds would continue on a substantial scale. So the individual policyholder now would have to make a guess about what your intentions might be to continue to recruit new contributors into the with-profits funds and how successful you might be in doing that.
Mr Hodges: Certainly one of the largest value items that we are in discussion with the Policyholder Advocate around is the levels of new business into the future because that does have a material impact on the incentive payment that it is fair and proper to pay now.

Q243 Jim Cousins: And what is your policy in that respect?
Mr Hodges: Our policy is that we feel that the with-profits investment product has a good future. We started earlier in the Committee proceedings talking about the fact that with investment volatility the concept of smoothing through some of that volatility we think is attractive. We have plans to write new business; we have submitted those plans to the Norwich Union Policyholder Advocate, she is considering them and from there on it becomes a negotiation.

Q244 Jim Cousins: What has your present success been in recruiting new policyholders?
Mr Hodges: I know that we have had a very successful first quarter because the product has seemed very attractive in the current investment climate.

Q245 Jim Cousins: You will see the issue here that we could end up with rather inactive with-profits funds even if they are open in terms of new contributors coming in, and a growing pool of resources that have not been distributed and a policyholder now will have to make a judgment about the fairness of your proposals and whether they wish to remain in the fund around the likelihood of that.
Mr Hodges: That is absolutely right, and the things that we have tried to design into the scheme to make sure that that fairness is transparent is: one, no distribution could be made to shareholders for six years, so effectively to try and ensure that we are incentivised to write new business; and, two, that every individual policyholder does have a free choice. If they do not like the assumptions—and between Clare Spottiswoode and ourselves we will be setting out if we can get to a deal in what we hope will be in sufficient detail but in a clear way the choices and the assumptions that we have made—they will have the right to say no and stay exactly as they are, and then if distributions are made in the future to benefit from them. That is an absolutely key part of the scheme that we have designed because we believe it is fair for the policyholders.

Q246 Nick Ainger: So that the Committee is clear on what I was being told in response to my questions about the mis-selling compensation, Mr Prettejohn you told the Committee that current policies have not lost out as a result of the inherited estate paying £1.6 billion in compensation and costs for mis-selling. You also in subsequent questions referred to the size of the inherited estate that you administer. If the 1.6 billion was still in that inherited estate and not being paid out in compensation, would that have then been deemed excess and been distributed to current policy holders?
Mr Prettejohn: I think it would depend on all of the other factors surrounding our assessment of the financial condition of the fund. It is difficult to take one isolated element of the calculation of the size of the fund to make that judgment.

Q247 Nick Ainger: But the reason you are telling the Committee that current policyholders did not lose out is because you have not distributed anything from the inherited estate; is that correct?
Mr Prettejohn: No, that is not correct. The reason why policyholders have not lost out is that our investment and bonus policy has not been affected by the fact that mis-selling costs have been paid out of the inherited estate, and the shareholders have undertaken that that will be the case.

Q248 Nick Ainger: If the inherited estate was £1.6 billion better off, and if on your annual examination of whether there was an excess there was an excess, then some or all of that £1.6 billion could have been redistributed to current policyholders, could it not?
Mr Prettejohn: I think you have to look at the calculation of excess surplus and look at all of the different factors that determine the financial condition of the fund; and most importantly in looking at a life fund you have to look at the investment performance and bonus performance of the fund, and that is where I think policyholders' expectations centre. They centre on whether or not they are getting the investment performance that they were being led to believe they would get and whether they will get the protection against volatility in the equity and capital markets that with-profits products provide.

Q249 Nick Ainger: But is it not true that you have to look every year at the inherited estate and if there is an excess then you either distribute it or you reattribute it—that is the way the system works?
Mr Prettejohn: We look at the financial condition of the inherited estate and the life fund each year in light of what we think will be the current and future market conditions and all sorts of other factors, yes.

Q250 Nick Ainger: But the fact that you have taken £1.6 billion out of that inherited estate meant that it was very unlikely you were going to be in a position to redistribute anything to policyholders, were you not?
Mr Prettejohn: Our first priority is to make sure that our policyholders' reasonable expectations in terms of the investment performance and the quality of the products that we have promised policyholders are in fact delivered, and the only way in which we can deliver that protection to policyholders, particularly in times of the volatile investment markets, for instance, that we have at the moment, is by having a very strong inherited estate.

Q251 Nick Ainger: Mr Hodges, how much has the Norwich Union paid out in compensation and costs for mis-selling?
Mr Hodges: To date we have paid out I think £183 million and is about £80 million reserved.[1]

Q252 Nick Ainger: So you have done your special distribution, so if that £183 million had not been taken out of the inherited estate that would have gone to current policyholders, would it not?
Mr Hodges: Not necessarily. It goes back to the issues of looking at the other factors to do with the fund performance and looking at where in a range we feel it is appropriate for the inherited estate that we require as working capital to sit. So I think it is too simplistic to assume that that money would have gone into the distribution.

Q253 Nick Ainger: How much did you undertake in the special distribution?
Mr Hodges: £2.4 billion.

Q254 Nick Ainger: £2.4 billion plus 183, you have made that decision that you had that surplus to distribute. What I am saying is you also had another 183 potentially to distribute, to add to that, but you decided that the policyholders would pay the costs of compensation of mis-selling. I do not know how many policyholders there are—I do not know what the figures would be individually—but surely that £183 million would have been part of that excess and therefore would have been part of that distribution?
Mr Hodges: I think you have to be absolutely clear that no policyholder has paid; the policyholders' expectations around their individual policies have been protected. This has come from the inherited estate. The argument assumes that the amount of money that we need in the inherited estate in terms of working capital is so precise that any additional mis-selling would automatically flow through, and that is just not true.

Q255 Mr Todd: It is fair to say that expectations are based on information, are they not? So you have referred repeatedly to the expectations of your policyholders but that assumes an informed environment in which they can make judgments based on the full knowledge of what we would have to say is a complex, technical subject. Is that reasonable?
Mr Hodges: I think we recognise that it is a complex subject. The process, we feel, has been enhanced by the employment of a Policyholder Advocate who is there to represent the policyholders.

Q256 Mr Todd: I am going to come to that, but one of the arguments you presented, both as being that your policyholders' expectations have been met and that therefore there is no particular reason why they should expect substantial benefit from the inherited estate—I think that has been broadly what you put—I think it is fair to say that until others have pointed a torch into this particularly dusty cupboard most policyholders probably did not know anything about the inherited estate, what it was or what their entitlements might be to it or not. I think that is a fair remark, is it not?
Mr Hodges: It is hard for me to assess levels of policyholders' knowledge around inherited estates.

Q257 Mr Todd: You think there may have been some experts out there?
Mr Hodges: I agree with your point that it is a complex subject. From our perspective—this is the Norwich Union perspective—we have entered into the process of reattribution voluntarily to try and resolve an awful lot of the issues about which we have been talking.

Q258 Mr Todd: Let me turn to the process of doing that. You have mentioned reputational damage as one of the risks your business had to bear in mind in this process. Do you think that this exercise has been beneficial to your business's reputation?
Mr Hodges: From our perspective—and again I can only speak on behalf of Norwich Union—we are not yet through the full process. I think we feel that we have done the absolute right thing in terms of a special distribution and we acted as soon as we had the information that we did, we believe swiftly, to get that money back into policyholders' hands through the enhancement to their policies. In terms of the reattribution time will tell. My view is that if a deal can be struck, if it clears up an awful lot of the uncertainty and misunderstandings around inherited estate it will be well worth it because to do a deal it has to be, I think, good for policyholders and obviously beneficial at the same time for the shareholder.

[1] *Note by witness:* This is the correct figure for 2006 and the same figure as quoted by Which? in their evidence. However, there is a 2007 figure which is £202 million plus £64 million in reserve.

Q259 Mr Todd: What do you feel about the role of the Policyholder Advocate, which is a relatively recent innovation and one in which you are a pathfinder, to some extent?
Mr Hodges: Absolutely. We are, we feel, blazing a trail in this regard and I think the role is a very useful role and one that we would say is adding a huge amount of value to the process. We have been very challenged, quite rightly, by the Policyholder Advocate; she has explored all avenues on the group of the policyholders that she is representing, and I think that is as it should be because in terms of reputational issues the one thing I hope everybody will feel, if a deal can be struck, is that the process we have been through has been rigorous, the negotiation we have been through has been rigorous, and at that stage as long we can explain this—which will be a challenge and one that we need to rise to—in terms that people can understand, I do not think anybody will feel that we have not been through a proper process.

Q260 Mr Todd: You referred in your memo to us to firms being preset rigorous terms of reference. Do you think that the terms of reference for your Policyholder Advocate have been less than rigorous?
Mr Hodges: I do not think they have been less than rigorous, no.

Q261 Mr Todd: So you comment is not an implied criticism of the process, it is just a reaffirmation of it?
Mr Hodges: Absolutely. I think one of the things that we have committed to do and we will do is if we can strike a deal—and obviously there is still a lot of the process to go through—of course we will be in a position to reflect on what has happened and reflect on what could be improved and feed that back in to the FSA. But as it stands we think we have been through a very rigorous process, we are still in one and we think that is the right thing to do.

Q262 Mr Todd: You referred at one stage earlier on to what you described as the fairly narrow remit of the Policyholder Advocate and the distinction between that role and that of, say, the With-Profits Committee. Do you think that further thought needs to be given to precisely where the remit is drawn for the Policyholder Advocate's function?
Mr Hodges: My own personal view is that it is quite right that the Policyholder Advocate is there to represent the interests of the group of policyholders. So once you declare eligibility, as I see her role it is to maximise the value for that group of policyholders in a commercial negotiation. So I am not sure at this stage—although this is something we will have to reflect on as we get further through the process—that we would advocate any changes to the remit.

Q263 Mr Todd: There is clearly some overlap, nevertheless, in the representational function of policyholders between the Advocate for the defined group and the With-Profits Committee; is it reasonable to say that?
Mr Hodges: Yes.

Q264 Mr Todd: They obviously have overlapping functions—not identical but overlapping.
Mr Hodges: I think the Policyholder Advocate role is there to do a specific task, which is to look at the reattribution and to negotiate with the company on behalf of the policyholders, whereas with the With-Profits Committee there are other funds that need to be looked at; there are also people in funds who join subsequent to the eligibility cut-off that they need to look after, so it is a much broader role in the With-Profits Committee.

Q265 Mr Todd: Do you think there is an argument for the With-Profits Committee having greater independence from the business?
Mr Hodges: From my perspective we are nine months into having a With-Profits Committee with three independent members. We see that and saw that as a strengthening of a process that we felt was already working because there was already independent actuarial advice being fed into the With-Profits Committee. It is a sub-committee of the Board and ultimately I think it is right and proper that the board of the company has to make the final decision.

Q266 Mr Todd: But in governance terms that produces some difficulties of interest, I would imagine, because the With-Profits Committee, if it is a sub-committee of the board, is in the same way responsible for shareholder value. No? I have a shaking of the head.
Mr Lister: I think the With-Profits Committee is there to oversee the exercise of discretion in the with-profit funds. If the With-Profits Committee does not like what the Board is proposing it will tell the Board that it does not like it; the Board can determine whether it wishes to take the advice of the With-Profits Committee or not. If the Board chooses not to take the advice of the With-Profits Committee then the With-Profits Committee can go to the FSA.

Q267 Mr Todd: That would be clarified by a very clear fiduciary duty being set on the committee; is that likely to happen? Because the fiduciary duty of a director of your business, despite the fact that you were not very clear in responding to Mr Fallon's question, is quite clearly a responsibility to the shareholders. Is there a way of separating that fiduciary duty and the function of the committee so that they do not have a clear responsibility to your shareholders?
Mr Lister: I do not believe the committee sees themselves as having a responsibility to the shareholders. The committee has a responsibility for looking after the rights and interests of the with-profits—

Q268 Mr Todd: Even though they are not a wholly independent membership?
Mr Lister: Even though they are not a wholly independent membership.

Q269 Mr Todd: Just turning briefly to you, Mr Prettejohn. You have been watching your competitor go through this process. Experiences learnt?
Mr Prettejohn: We have been far too busy on our own activities!

Q270 Mr Todd: I am sure you have! But you are of course contemplating some of these issues and you have made steps towards appointing a Policyholder Advocate, although I do not think you have actually appointed one yet?
Mr Prettejohn: That is correct.

Q271 Mr Todd: Have you learnt from the process and felt that there are lessons that you can apply in your own experience, other than—I think I have taken from your answers—seeking to avoid this process as far as you possibly can? Is that what I read your answer to be?
Mr Prettejohn: No, that would not be the case. We have been very busily engaged in looking at the feasibility of a reattribution. I do think it is important—and it is a point that has been made several times before—to stress that each fund is different and each estate is different.

Q272 Mr Todd: Indeed.
Mr Prettejohn: So in looking at the discussions between Norwich Union and their Policyholder Advocate there are only limited parallels that necessarily can be drawn because our funds are different, our situations are different, our business situations are different, and our governance processes are similar in many ways although slightly different in others. I think you need to look at each situation and you need to look at each possible process on its own merits.

Q273 Mr Todd: In terms of the remit given to Mr Bloxham is that a remit which you have seen as being pretty much identical as that of Ms Spottiswoode?
Mr Prettejohn: I am not privy to the detailed remit that Clare Spottiswoode has been given. Our Policyholder Advocate is a nominated Policyholder Advocate. When he is appointed he will have, Nikki, terms of reference at that point?
Ms Maynard: He will have terms of reference that must be approved by the FSA in accordance with their conduct of business rules, so to that extent I am sure there will be similarities.

Q274 Mr Todd: But no negotiation has taken place so far? You have just identified a name and a set of capabilities that you like.
Ms Maynard: He has spent the last ten months or so, since nomination, building his advisory team; so he now has a team of actuarial advisors and lawyers and other support, and he has been spending the time getting up to speed with the intricacies of the with-profits business and with our with-profits fund, which is obviously not something that you can just pick up overnight. So that if we do decide to appoint at the end of June he will be able to hit the ground running, so to speak.

Q275 Mr Todd: Which, just to conclude, goes back to my first question about the likelihood of policyholders having a tremendous grasp of this subject. If you have just appointed Mr Bloxham to look carefully at this area and he has spent ten months learning it and assembling a group of advisors to assist him I think we can safely assume that your typical policyholders would not be au fait with details of these funds and how they relate to the inherited estate, and therefore are rather unequal partners in the process of deciding on its future.
Mr Prettejohn: I think that is why the concept of a Policyholder Advocate is an extremely valuable one and why it was a sensible addition to the regulatory framework, because it enables an intelligent person, with the time to be able to understand all of those issues, to negotiate quite properly on behalf of policyholders and I think that has been a very sensible innovation.

Q276 John Thurso: First of all, just on the With-Profits Committee—and perhaps I can address this to Mr Prettejohn and give Mr Hodges a bit of a rest as he has done most of the batting this afternoon—Which? argued in their submission that the WPC has to be a Rottweiler but it is more like a poodle. I put this to Clare Spottiswoode and she said that a truly independent WPC was a very good thing but she was highly sceptical about the possibility of it really being independent. Is this one of these good ideas that does not work or is it something that can genuinely work to the very opposite requirements of the two stakeholders involved; and should it therefore be something that should be dealt with by the regulator rather than a committee?
Mr Prettejohn: I think the oversight of the management of the potentially different interests between shareholders and policyholders is performed very well by our With-Profits Committee. To reiterate what I said earlier, our With-Profits Committee has three members. None of them are directors of any of the group companies, two of them are highly qualified actuaries and they provide a very robust and detailed critique of the decisions that potentially affect the interests of policyholders versus shareholders. I think that process actually works extremely well.

Q277 John Thurso: I suppose the problem is that in order for that to really work well it has to be demonstrated to those in whose interests it is for it to work well that it requires transparency, but at the same time they have to be privileged to a great deal of information which is clearly commercially confidential, so they can never actually prove that they have done a good job. So you have something that is—and I do not for a moment doubt intention—appointed by the board whose ultimate primary responsibility is to the shareholders, who cannot be transparent by the very nature of the animal, and who therefore are always going to be under suspicion; whereas perhaps the regulator, who could have access to the similar information, would

be trusted by virtue of the fact of being a regulator. Is this something that we watch for a year or two and come back to?

Mr Prettejohn: I think the With-Profits Committee has the option ultimately to communicate directly with policyholders. Our With-Profits Committee has the ability to be able to request technical assistance from outsiders in order to do its job, so I think it is well equipped technically to look at the complicated issues that are put in front of it, and I think the system works very well.

Q278 John Thurso: That leads me neatly into the FSA. I think there is nobody here who would disagree with the concept or the principle of treating customers fairly; the problem is actually to give effect to that because the definition of fairness on one side might be rather different to what it is on the other side. Mr Hodges, perhaps I can ask you how you have found your dealings with the FSA through this process and what, if any, recommendations you might have to make?

Mr Hodges: From our perspective the FSA have been involved every step of the way, so there is a huge amount of work we have been doing with them that runs parallel to the work we have been doing with the Policyholder Advocate in terms of the quality of the information that we are providing, some of the judgments that we are making and ultimately the quality of the communications that we are sending out to customers. So they have been involved in this process every step of the way, and obviously clarifications that they have given around some of the material points of regulation to the Policyholder Advocate. So our view is that we are satisfied with the process.

Q279 John Thurso: Does that imply that they have been too soft?

Mr Hodges: Absolutely not. I would say that we have had numerous meetings—I could not actually give you a number just because there have been so many—and they have been very challenging to us and I think that effectively as we go through the process they have been arming themselves—because they ultimately are also the final arbiter of fairness—so if a deal is struck the Policyholder Advocate and ourselves have to take the deal to the FSA and they do have to opine on its fairness overall. What that means is that they have to stay close to what is going on for both parties so that they can give that opinion if we can get to that stage.

Q280 John Thurso: Can I ask you a specific question about that moment when you arrive at hopefully about to do a deal? We have had a lot of extensive evidence today and before regarding the extent to which the writing of new business influences the amount of money that is gifted to future policyholders and the reattribution to shareholders. It seems to me that in this process the company and the Policyholder Advocate are absolutely bound to come at this from very different positions, otherwise there would not be a negotiation to be had. Is it not necessary for the FSA also to take a view in its fairness review of the company's proposal, and should there be a mechanism to break the logjam? The particular suggestion that has been put to me, and I would like to put to you, is if swing arbitration was involved, both sides being charged to put in their most realistic estimate of what might happen, on the basis that an independent arbitrator would decide on one or other position, is that something that you would consider helpful, unhelpful, irrelevant?

Mr Hodges: Certainly not irrelevant. Given that we have entered this process and it is a new process I am sure there are things that we can learn as we go through. On the issue of new business, for example, we have taken the FSA through all of our assumptions in detail, all of our thinking in detail and they have been able to challenge us on them, so that they are aware of our position, and I am sure they are aware of the Policyholder Advocate's position as well. The only difficulty I see in the proposal as you make it is we feel we have made a very realistic assumption about future new business levels anyway, and that is the basis on which we are negotiating because our intention, as it has been all the way through, is to try and conclude a deal if we possibly can. So there is naturally a tension between the role of the Policyholder Advocate and naturally of course she is looking to do the best deal possible on behalf of the policyholders. We want a good deal for policyholders as well—that is absolutely, we think, in our interests—but I am not sure if an arbitration process would break the logjam because the issue there is that there are a number of valued judgments that need to be considered.

Q281 John Thurso: You said in earlier evidence that you started out on this process with the best intentions and to do the right thing, and of course we all know the road to which place is littered with good intentions. If you had to start again today what advice would you give to perhaps Mr Prettejohn or anybody else, and in particular what advice would you give regarding the way in which a company communicated so that there was more clarity and less confusion as between the clients, the policyholders?

Mr Hodges: One of the issues I perceive that is causing a problem in terms of the clarity and the undertakings is just the time that it is taking to try and bring the negotiations to a conclusion. So from our perspective we are trying to balance a desire to be able to bring a proposition to policyholders as soon as possible so that they can make a decision because that, for me, breaks the logjam of misunderstanding, and breaks the issue around clarity; and of course the need to do things properly. I cannot yet give you a fully formed view on what we would do differently because we have not quite finished, but I think the area of how we can try and make sure that there was an appropriate period to negotiate but it did not become so elongated that it caused confusion.

Q282 Mr Brady: Just picking up on that last answer, why has it taken so long?

Mr Hodges: I think from our perspective it is just a very complex issue, which you have already been through. I think there have been for the Policyholder Advocate a number of enquiries about detailed points of law and regulation, quite properly, so that no stone was left unturned. There has been an enormous amount of information shared between the two teams and there has been a very active negotiation going on. That has just added up to it taking a lot longer than we had expected.

Q283 Mr Brady: Clare Spottiswoode told us that the date that was needed for the negotiation process was not ready until December. What are the reasons for that?
Mr Hodges: I think Clare said that some final parts of data were not delivered. We have been delivering data literally by the truckload most of the way through 2007. In those truckloads of data there was no doubt that there were one or two elements that we were then subsequently able to spot that were inaccurate, but that was really in the minority. The other issue that has been going on is Clare has been building her own modelling capability and her ability to assess the offers that we have made her, and all of those things together have just taken longer than we expected.

Q284 Mr Brady: Looking to the future, would it be better in these circumstances to wait until the data was there and ready and in a fit state before announcing reattribution?
Mr Hodges: No. Personally I think it is part of the process and I think the intention to do the reattribution in itself drives requests for additional data, additional thinking, so I do not think it is possible, necessarily, to wait, have all the data parcelled up and then start the process because some of the negotiation itself drives a need for new data and as those new data requests have come in we have responded to them.

Q285 Mr Brady: Mr Prettejohn, you have been working with your nominees for ten months; are you confident you have the data in more or less the form that you need to proceed if you decided to?
Mr Prettejohn: We have no shortage of data and we have over four million policyholders, as I think I said earlier, and 300 different policy types and we are looking at financial modelling out for the next 40 years with thousands of different scenarios for what happens to financial markets and so on and so forth. It is, I am afraid—and I know sometimes it is a frustrating answer when people say it is a very complicated process of modelling—genuinely a very complicated process of modelling. It is also an extremely important decision. It is an important decision for shareholders and an extremely important decision for policyholders, and it is not one that we want to get wrong; it is one that we want to do a thorough job on because, as I say, it is important to the interests of all parties.

Q286 Mr Brady: So you are as close as being ready to go as you can be?
Mr Prettejohn: We have said to the outside world that we will make a decision as to whether or not to pursue a reattribution by the middle of this year.
Mr Dunne: Chairman, it is actually not a question but an apology to the Committee and to our witnesses that I should have disclosed at the outset that I am actually a Norwich Union policyholder.
Chairman: I could have my car insurance, I am not too sure!

Q287 Jim Cousins: There is just one point, Mr Hodges. You used the term "truckloads of data". I am guessing you used that in a jocular way but I think you would recognise the sums of money we are talking about, which could come into your company's accounts, could also be described as truckloads of money. And when you are talking about who gets their hands on truckloads of money maybe truckloads of data are required; would you agree with that?
Mr Hodges: We have striven to provide all the data that the Policyholder Advocate has requested throughout the whole process. In terms of using colloquial language it was merely to highlight that there was a significant amount of data that we were providing, and absolutely the provision of that data is essential to the data, and we feel that we have met every request as quickly as we could every step of the way.

Q288 Chairman: Mark, the Norwich Union website indicates that the executive bonus plan is geared towards "incentivising and rewarding superior performance and returns to shareholders". In what ways is senior management pay linked to the returns received by your policyholders?
Mr Hodges: The executive bonus plans in the company have a weighting for customer service, which includes measures of customer satisfaction around investment performance and also around employee satisfaction, so there are three key measures: the financial performance of the company, employee satisfaction and also customer satisfaction.

Q289 Chairman: Nick?
Mr Prettejohn: Our executive bonus plan for our UK business also includes a customer recommendation measure, so that we think is a very good proxy for whether people are happy with the investment performance and the overall product performance and service performance of the fund, and I think academic research suggests that customer recommendation is a good measure.

Q290 Chairman: I noticed as a curtain raiser for this appearance today that AVIVA had a press release yesterday saying that you are going to change your name, so sadly we will have Norwich Union no longer. Is that linked to Mark's question about any reputational risk?
Mr Hodges: Absolutely not, Chairman; it is part of trying to realise a global vision.

Q291 Chairman: Can I say though, that in terms of information, certainly from my point of view, the information I have had, it seems that the cards are stacked in the firm's favour and if we leave aside the reattribution process and just consider what normally happens to the inherited estate in normal circumstances you can do the following. You can underwrite new business, you can pay shareholder tax, you can pay mis-selling costs and indeed you can support the staff pension fund, and the question arises: what safeguards are there for policyholders? It seems to me that the FSA at the moment is sitting back and actually looking at things in the round and maybe are not pushing things as they should. A With-Profits Committee exists to protect the interests of policyholders in general, but certainly the question in my mind is how much of a robust challenge do they offer? For example, Sir Nicholas Montagu sent me a letter but it was only after I had sent him a letter and I would have thought if we had an inquiry such as this that the guardian of the policyholders may have been in contact with us. If I look at that With-Profits Committee they are part-time, you say, and in Norwich Union's case they have staff support consisting of 25% of one actuary's time and somebody to take the minutes. It seems as if the scales are imbalanced there and there is a legitimate question to ask: who is protecting the interests of groups of policyholders, not just the population as a whole? So my question is, all in all why would anybody want to invest in a product where a part of the fund that might be distributed to them could be raided at any time by those also trusted to invest that money for them?

Mr Hodges: From my perspective there are a number of issues that you raise there that if you would allow me I would like to come back on. The policyholders' returns, using the benefits of a strong inherited estate around smoothing I think we have established is an advantage, it is an attractive form of investment. In terms of the With-Profits Committee, it certainly does provide a very robust challenge to the company. We are nine months into the process of having three independent members. The selection process of those three independent members was exactly the same selection process we used for finding the Policyholder Advocate. We specifically targeted people who we thought would provide a challenge in an oversight function to the company's activities. As you have seen from the submission from Nicholas Montagu we have been through strategy days, been through familiarisation days bringing him up to speed, and his submission also makes it very clear that, as well as internal support, at their request and at the company's cost we have continued to provide them with full time independent actuarial resource that they can draw on as and when they need it, and that is the kind of commitment we have made to the robust process. In terms of, if I may, contribution to the inquiry, that potentially falls down to my responsibility because we were responding in the initial submission on behalf of Norwich Union in its entirety and therefore the comments we were making I believe incorporated the With-Profits Committee. However, subsequent obviously to last week's hearing and the request Nicholas Montagu turned something round very, very quickly for the Committee to look at.

Q292 Chairman: Do you have anything to add, Nick?

Mr Prettejohn: I think from our point of view our With-Profits Committee, as I said in answer to a previous question, does indeed offer us a very detailed and robust challenge on all of the key decisions and indeed the minor decisions that might affect the interests of policyholders and I think that committee works extremely well. It is completely independent from the board in terms of its membership. It is well equipped in terms of actuarial expertise and the availability of other support as necessary. In terms of why do consumers buy with-profits policies, they buy with-profits policies because in volatile market conditions in particular, with-profits policies offer the protection against market volatility and the potential for long term return that is extremely attractive to them, and we have about two million policies which are people's pensions, and particularly in volatile markets that protection against the volatility of markets that smoothing provides is an extremely important feature for policyholders.

Q293 Chairman: I presume when Clare Spottiswoode was appointed as Policyholder Advocate on that day everything was sweetness and light; is that still the case?

Mr Hodges: As I have already said, we have been through a very robust process in terms of negotiation. Clare is a formidable negotiator, as she should be on behalf of the policyholders, and we—and I think including her—sincerely hope that we can pull off this negotiation and soon be in a position where we can present all of the hard work that has gone on to our policyholders so that they can make an individual choice.

Chairman: Back to my first question when I asked you about public interest and both of you agreed that there is a public interest here. I think I have received about 100 to 150 letters and emails on this issue, so there is indeed a public interest, and as a Select Committee we will be keeping a watchful eye on this. But I would like to think that there can be negotiation in your case, first of all, Mr Hodges, and then moving on because there are many people depending on this, and given that the public awareness has been heightened I think it serves everyone's interest to ensure that. So I would say from a distance we will be watching you. Thank you very much.

Written evidence

Memorandum from Which?

1. EXECUTIVE SUMMARY

1.1 Over five million policyholders in the UK have a stake in with-profits funds at Norwich Union and Prudential, having used them to save for retirement, pay off an endowment mortgage or invest a lump sum. Around £14 billion has built up in what is known as the "inherited estate" of these funds, mainly due to a process known as "smoothing", where investment returns are held back in good years to pay out more than the return achieved in bad years.

1.2 Which? is concerned that without a change in Financial Services Authority (FSA) policy, 5.5 million Norwich Union and Prudential policyholders stand to lose over £7 billion pounds. We welcome the Treasury Committee's inquiry into this important subject. Given the amount of money at stake and the number of people affected we believe the FSA needs to reconsider its regulatory approach to ensure a fair outcome for policyholders.

1.3 Our submission covers the following issues:

1.4 *The 90:10 principle:* Which? believes that the 1995 Ministerial Statement means that policyholders should have a 90% interest in the inherited estate and this money should be managed for their benefit and to preserve their interest. We are concerned that the FSA has created a process which allows firms to use the inherited estate in ways which erode this principle and enables shareholders to gain substantially more than 10% of the inherited estate.

1.5 *The FSA's approach:* With so much money at stake there is a strong incentive for companies not to treat policyholders fairly. As a result a strong regulatory system is needed to protect policyholders' interests in the inherited estate. Which? notes that the FSA consistently concentrates its efforts on justifying why policyholders should get less than 90%. We believe that the correct approach would be for them to justify why they are pursuing an approach which will allow shareholders to gain more than 10%.

1.6 *Subsidising new business:* Which? is concerned that it is possible for companies to make what we see as unrealistic assumptions about how much money they need to hold back to fund new business, thus reducing the offer that they say they can make to current policyholders. Sales of with-profits policies by AXA are now 85% below the predictions they made, resulting in a large windfall gain to shareholders as money set aside to subsidise new business is not needed for this purpose. We also have concerns about the competition implications of using the inherited estate to subsidise new business.

1.7 *Shareholder tax:* The FSA prohibits any new firm from charging shareholder tax to the inherited estate but allows all firms who have done this in the past to continue doing it. We view this as an extremely unfair practice and believe that the FSA should change the rules to prevent the inherited estate being used for this purpose. We also believe that this practice could be a breach of the terms of policyholders' contracts.

1.8 *Mis-selling claims:* Allowing shareholders to avoid ultimate responsibility for the costs of mis-selling by using money from the inherited estate weakens incentives and goes against all principles of good corporate governance.

1.9 *Cost-benefit analysis:* We urge the Committee to ensure that the FSA conducts and publishes a full cost-benefit analysis, showing how much money policyholders lose out on due to its policy on the inherited estate and evaluating the options put forward to protect consumers.

1.10 *Policyholder choice:* The FSA and Norwich Union place considerable emphasis on the fact that policyholders will be able to vote on whether to accept or reject the proposal made by the company to buy out their rights to the inherited estate. Which? believes that for many this will be a false choice and is not an effective safeguard. The FSA should clarify how this lack of real choice is consistent with their treating customers fairly regime.

1.11 *Excess surpluses:* It seems extraordinary that Norwich Union was able to build up £2.3 billion of excess capital without anyone at the FSA taking action to ensure that this money was paid out to policyholders. We would like to know what steps the FSA has taken to assess whether an excess surplus exists in other with-profits funds.

1.12 *The three year phasing of Norwich Union's "special" distribution:* Which? is deeply opposed to the decision to phase the payment over three years. We believe that this money should be distributed immediately and in full. As the money is an "excess surplus" this can be done without any negative effect on the security of the fund and we do not believe any of the arguments for the phasing stand up to scrutiny.

1.13 *The role of with-profits committees:* We have no confidence that with-profits committees will ensure that customers are treated fairly. The operation of these committees offers little in the way of effective corporate governance and accountability.

1.14 *The future of the with-profits market:* Which? believes that the with-profits market will continue to decline. The actions of individual companies and the regulation of the with-profits industry, typified by the outcome of the AXA case, has damaged consumer confidence in the market. We see nothing in the market to justify projecting long term growth in the sale of with-profits products.

1.15 To ensure the fair treatment of with-profits policyholders the FSA should take the following action:

— Ensure that the 5 million policyholders at Norwich Union and Prudential are treated fairly in the current reattribution negotiations.

— Immediately ring-fence the inherited estate through regulation. The FSA should clarify policyholders 90% interest in the inherited estate and ensure that this money is managed for their benefit. Shareholders should not be able to obtain more than 10% of the inherited estate.

— Ensure that key elements of how the inherited estate can be used are prescribed by FSA regulation. Proprietary firms should not be permitted to use the inherited estate to subsidise new business, pay shareholder tax bills, pay mis-selling claims or prop up the staff final salary pension scheme.

— Introduce controls on directors' discretion to erode the inherited estate to the detriment of policyholders.

— Carry out a full review of all with-profits funds and require them to distribute their "excess surplus" capital immediately.

— Ensure that Norwich Union carries out its special distribution immediately, rather than phasing the payments over three years.

— Introduce reforms to the way with-profits funds are run to ensure that policyholders' interests are protected, as Which? does not believe "with-profits committees" are providing the appropriate degree of policyholder protection. This could take the form of a Permanent Policyholder Advocate who would have real power to champion the policyholder interest and make decisions about how the fund is operated. There would be a clear separation between the duties of directors and the policyholder representative.

2. Introduction

2.1 Which? is an independent, not for profit consumer organisation. Based in the UK, it is the largest consumer organisation in Europe. Entirely independent of government and industry, we are funded through the sale of our range of consumer magazines and books. We have been campaigning on the issues relating to the regulation of inherited estates in with-profit funds for over eight years.

2.2 Over five million policyholders in the UK have a stake in with-profits funds at Norwich Union and Prudential, having used them to save for retirement, pay off an endowment mortgage or invest a lump sum. Due to a process known as "smoothing", where investment returns are held back in good years to pay out more than the return achieved in bad years, around £14 billion has built up in what is known as the "inherited estate" of these funds.

2.3 Government policy and the contractual position of policyholders means that, as a general rule, these assets should be allocated 90% to policyholders and 10% to shareholders. However the FSA's lack of protection for policyholders, when compared to shareholders, means that companies do not have to follow this rule. In 2000, despite objections by Which?, AXA persuaded the FSA and the Court to allow a deal which meant that, according to our calculations, policyholders were allocated just 31% of the inherited estate dealt with under the reattribution negotiations.

2.4 Following the AXA case the FSA reviewed their rules and introduced the role of "Policyholder Advocate" to negotiate with the firm about how the inherited estate is divided between policyholders and shareholders. However, it has failed to change its rules to offer policyholders sufficient protection. We have warned the FSA consistently over the past eight years that its regulatory structure is not sufficient to protect policyholders. It is very disappointing that these warnings have been ignored.

2.5 The FSA rules, which allow companies to use the inherited estates to subsidise new business, pay shareholder tax bills, pay mis-selling claims and prop up staff final salary pension funds, institutionalise the unfair treatment of customers. By failing to protect the rights and interests of policyholders the FSA is undermining the ability of the Policyholder Advocate to secure a fair deal. This is not a fair negotiation and without further changes by the FSA policyholders stand little chance of being treated fairly. If they receive a similar result to AXA policyholders, the 5.5 million Norwich Union and Prudential policyholders stand to lose over £7 billion.

2.6 This is a key test of whether the FSA is serious about ensuring that customers are treated fairly. Which? is focused on the outcome of the deals for policyholders and believes that there is a very real risk that these deals will not be fair. The result will be that shareholders gain substantial assets at the expense of policyholders. If this happens the FSA will have failed in its duty to protect consumers and it will further undermine trust and confidence in the financial services sector and the regulatory system.

2.7 We welcome the Treasury Committee's inquiry into this important subject. Given the amount of money at stake and the number of people affected we believe the FSA needs to reconsider its regulatory approach to ensure a fair outcome for policyholders.

3. 90:10—The Principle that should Govern the Division of Interests in the Inherited Estate Between Policyholders and Shareholders

3.1 The Government policy on the principles that should govern the attribution of inherited estates was first set out in a Ministerial Statement issued on 24 February 1995. Jonathan Evans, the then Minister for Corporate and Consumer Affairs stated that:

> *"A life office may make distributions from surplus in the long-term fund as shown by the statutory annual actuarial valuation. It is common practice to make distributions to policyholders and shareholders in the proportion 90:10. In assessing policyholders' reasonable expectations, the Department would expect this ratio to be used as the basis of attribution between policyholders and shareholders."*[1]

3.2 This position was reaffirmed by the Labour Government in 2002. In a Westminster Hall debate the Economic Secretary to the Treasury Ruth Kelly MP said:

> *"The principles governing the attribution of the inherited estate between policyholders and shareholders were set out in a statement on 25 February 1995 . . . Those principles have been accepted by subsequent Governments . . . The FSA also follows the principles set out in the ministerial statement made in 1995."*[2]

3.3 The 90:10 principle reflects the contractual position of policyholders. Policies typically state that with-profits policies share in the profits generated by the fund in which premiums are invested by the Company, and that at least 90% of profits are allocated to Policyholders, with the remainder being allocated to shareholders.

3.4 Norwich Union has been clear that the inherited estate has built up from profits made by the with-profits fund in the past.

4. The FSA's Failure to Enforce the 90:10 Principle

4.1 The Ministerial Statement set out that the 90:10 principle that applies to distributions should also apply to "attribution" of the inherited estate. Which? believes that the Ministerial Statement means that policyholders should have a 90% interest in the inherited estate and this money should be managed for their benefit and to preserve their interest.

4.2 We are therefore deeply concerned that, instead of enforcing this principle, the FSA has created a process which allows firms to use the inherited estate in ways which erode the principle and enables shareholders to gain more than 10% of the inherited estate.

4.3 The AXA reattribution and the subsequent court case permitted the company to bypass the 90:10 principle and allowed shareholders to gain around 69% of the inherited estate with just 31% going to policyholders. While the FSA has reviewed their approach since the AXA case, Which? has consistently argued that the FSA's rule changes will not result in the protection of policyholders' interests.[3]

4.4 The FSA has created the role of the Policyholder Advocate, but we do not believe the FSA has put in place the regulatory framework to ensure a fair negotiation. Instead the deck remains stacked against policyholders and the Policyholder Advocate. The FSA has, in our view, unrealistically characterised the reattribution process as a "commercial negotiation between those with interests in the inherited estate".[4] However, this process is far removed from a commercial negotiation between two informed parties of equal power. Clare Spottiswoode and her team have done a good job in highlighting some of the inherent unfairness of the FSA's rules and the way the fund is run, but have no real power to enforce changes.

4.5 In a reattribution process, the firm has every incentive to maximise the amount of working capital in the fund and minimise the prospect of future distributions. The FSA's decision to allow firms to subsidise new business, pay the shareholders tax bill and mis-selling costs means that firms are able to claim that a substantial amount of capital needs to be held back for these purposes. By seeking to maximise the amount of working capital needed by the fund, the firm minimises the amount of the inherited estate that goes to current policyholders. As a result, after a reattribution the shareholders gain a substantial share of the inherited estate without having to pay for it: the FSA's approach allows them to get money for nothing.

4.6 The FSA's approach of concentrating on the value of the inherited estate if it is distributed ignores the point that the inherited estate has significant value regardless of whether it is distributed. In any meaningful sense, attribution is synonymous with "ownership" of those assets and any income or gain

[1] http://www.publications.parliament.uk/pa/cm199495/cmhansrd/1995-02-24/Writtens-2.html£Writtens-2_spnew50
[2] http://www.publications.parliament.uk/pa/cm200102/cmhansrd/vo020114/debtext/20114-37.htm£20114-37_spmin0
[3] See Annex B.
[4] FSA, With Profits Review, Issues Paper 1: Process for dealing with attribution of inherited estates, page 9.

derived from those assets—not some undefined right to possible future distributions. Clare Spottiswoode, the Policyholder Advocate has confirmed that in the Norwich Union case "the money in the inherited estate has accumulated purely from policyholders".[5]

4.7 While the FSA has consistently stated that the legal structure of the funds means that the inherited estate, just like all the assets in the with-profits fund, is owned by the firm, it is possible through the regulatory system to protect or ringfence policyholders' 90% interest in the inherited estate.

4.8 Which? notes that the FSA consistently concentrates its efforts on justifying why policyholders should get less than 90%. We believe that the correct approach would be for them to justify why they are pursuing an approach which will allow shareholders to gain more than 10%.

4.9 By failing to protect policyholders rights to the inherited estate and restrict how it is used, the FSA has created a back-door way for shareholders to gain far more than their 10% entitlement. It has also undermined the ability of any Policyholder Advocate to secure a good deal. If shareholders gain more than their 10% entitlement then, by definition, policyholders lose out.

5. Usage of the Inherited Estate—The FSA's Failure to Ensure Customers are Treated Fairly

5.1 Directors have a fiduciary duty to their shareholders. This is supposed to be balanced by the regulatory system to ensure that customers are treated fairly.

5.2 In their with-profits review following the AXA case, the FSA had the chance to introduce rules to ensure effective corporate governance and the protection of policyholder interests. Instead the FSA decided to require firms to describe how the inherited estate is used in long and complex documents called Principles and Practices of Financial Management (PPFMs). This leaves the company with significant discretion as to how the inherited estate is used. The FSA allows firms to draft the PPFM, stating how the inherited estate will be used and then to report on whether they have complied with this document. When it comes to treating customers fairly, in our view, this is equivalent to letting firms set and mark their own exam papers. In research conducted by the FSA's Financial Services Consumer Panel, the PPFM approach has been described as a "charter for abuse".[6]

5.3 The FSA rules go on to institutionalise the unfair treatment of customers by allowing proprietary firms to use the inherited estate to:

— subsidise new business;
— continue to pay shareholder tax bills if they have done this in the past;
— pay the cost of compensation when the company has mis-sold a policy;[7] and
— pay off the deficit in the staff pension scheme.

5.4 FSA rules require companies to distribute the excess surplus in the inherited estate. As a result Which? finds the argument that taking money out of the inherited estate does not affect the bonuses applied to policyholders incomprehensible. Every pound used for these purposes reduces the amount available to distribute to policyholders and Which? urges the Committee to ask the FSA to confirm this fact.

5.5 With so much money at stake there is a strong incentive for companies not to treat policyholders fairly. As a result a strong regulatory system is needed to protect policyholders' interests in the inherited estate. As demonstrated by the AXA case, companies are able to exploit weakness in the regulatory system and gain as much benefit as they can for their shareholders. It is therefore essential that the FSA revises its rules and ensures that, as the regulator, they act to ensure that customers are treated fairly.

5a. *Subsidising new business*

5a.1 The FSA's decision to allow proprietary firms to subsidise new business with money from the inherited estate leads to a large conflict of interest which the FSA has done little to control.

5a.2 Companies will have an incentive to write subsidised new business if they are allowed to use the inherited estate to do so. This is because shareholders do not bear any of the cost of this new business such as spending on administration, set-up costs, high commissions to financial advisers and backing expensive guarantees. These will be borne by the inherited estate—so shareholder capital will not be at risk and will not be affected by any of the losses involved. They only see the benefits from this new business in the form of their 10% share of the bonuses that are applied to these new policies.

5a.3 In a properly regulated market, any new business subsidies would be at the expense of shareholders not policyholders. Which? does not have any principled objection to firms subsidising new business, but only if these new business subsidies are borne by shareholders, not policyholders. It is clear that this is not the case under current regulations.

[5] Policyholder Advocate, Press release, 5 February 2008.
[6] "Are customers in closed life funds being treated fairly?" Report for the FSCP, prepared by The Pensions Institute, Cass Business School and IFF research Ltd, September 2007.
[7] The FSA has said they will review this rule. See page 10.

5a.4 Norwich Union and Prudential have both been using the estate to write loss-making business, which does not cover the cost of capital provided by the inherited estate. This has a detrimental effect on existing policyholders. Evidence from analysis of the FSA returns of companies with with-profits funds shows that in 2006:

- Norwich Union subsidised the acquisition of new business, reducing the inherited estate by £105 million;[8] and
- Prudential subsidised the acquisition of new business, reducing the inherited estate by £94 million.[9]

5a.5 Which? believes that the incentive to subsidise unprofitable new business is maximised if firms are looking to reattribute their inherited estate. Under the FSA rules, companies are allowed to set aside money that they say is needed to fund the cost of new business in the future. Which? is concerned that it would be possible for companies to make what we see as unrealistic assumptions about how much money is needed to fund new business, thus reducing the offer that they say they can make to current policyholders.

5a.6 After a reattribution, when the inherited estate will be owned by shareholders, companies would then be unlikely to continue to use this capital to write loss making business. If this did occur, the eventual outcome may be that new business would be much lower than the company forecast. This would result in a large windfall gain to shareholders as it would mean that money set aside to subsidise new business would not be needed for this purpose.

5a.7 Eight years ago in the AXA case, AXA projected that levels of new business in their with-profits fund would grow at 4.5% a year up to 2050. Which? believed this was far too optimistic. At the time of the AXA case, our expert witness forecast that a middle scenario would be for AXA's new with-profits business to fall by two-thirds in real terms. Despite our objections, the FSA concluded that AXA's "assumption is not unreasonable".[10] The actual outcome was that with-profits sales by AXA are now just a small fraction of what the company had projected. According to our calculations based on AXA's FSA returns they are 85% below where AXA had predicted.

£437 million:
The amount AXA claimed that they needed to hold back to cover the fact that the inherited estate would be locked into the fund, mainly as it would be needed to write new business.

85%:
Actual sales of new business are 85% below AXA's predictions.

5a.8 Which? does not see any way this issue could be re-visited, and policyholders compensated, if the new business predictions in a reattribution prove overly optimistic. We would welcome the FSA's opinion on whether this could be achieved and, if so, how.

5b. *Distorted competition*

5b.1 In addition to causing detriment to existing policyholders, Which? believes that the FSA's policy to allow the use of the inherited estate to subsidise new business distorts competition and deters innovation.

5b.2 The competition concerns arising from the use of the inherited estate to subsidise new business were raised by Ron Sandler in his review of long-term savings in 2002. He concluded that:

> *"The existence of inherited estates distorts competition, since certain providers, not necessarily the most efficient ones, have pools of capital which have arisen for a variety of historical reasons and can be used to subsidise various activities".*[11]

5b.3 We have raised our concerns with the FSA who, under the Financial Services and Markets Act (FSMA), must have regard to "The need to minimise the adverse effects on competition that may arise" from its activities and the "desirability of facilitating competition between the firms" it regulates. We have seen no evidence that the FSA has even considered the anti-competitive nature of its rules. We question whether this could mean that it is in breach of its duties under FSMA. We have also raised our concerns with the Office of Fair Trading.

[8] http://www.aviva.com/files/pdf/regulatory_returns/2007/cgnu.pdf (page 160); and http://www.aviva.com/files/pdf/regulatory_returns/2007/commercial_union.pdf (page 122).
[9] http://www.prudential.co.uk/prudential-plc/investors/financialreports/2007/fsareturns2007/fsareturns2007ind/ (Forms Appendix 9.4 and 9.4a, page 77).
[10] FSA Witness statement in the AXA case, Para 52.
[11] HM Treasury, Sandler Review of Medium and Long term savings in the UK, para 10.113-10.114, July 2002.

5b.4 By allowing large proprietary companies to subsidise new business from the inherited estate we are concerned that the FSA is failing to create a level playing field. This has the potential to damage consumers and damage the market.

5c. *Shareholder tax*

5c.1 In a 90:10 fund, the principle should be that policyholders receive 90% of the profits and shareholders 10%. Shareholders incur an additional corporation tax liability on their 10% share of the profits from with-profits funds. Instead of shareholders bearing this tax liability, Norwich Union and Prudential are allowed to charge this tax liability to the inherited estate. Effectively, they are using money which would have gone to policyholders to pay the shareholders tax bill.

5c.2 Which? believes the FSA should change the rules to prevent the use of the fund to pay shareholders tax bills. We view this as an extremely unfair practice which the FSA has done nothing to control. The FSA prohibits any new firm from charging shareholder tax to the inherited estate but allows all firms who have done this in the past to continue doing it. The FSA described this as a "concession" to the industry, while seemingly acknowledging that it resulted in policyholders receiving less than 90% of the distributed surplus.[12]

£400 million:
The allowance from the inherited estate the FSA allowed AXA to make to cover the shareholders tax bill. This resulted in a loss per policyholder of around £600.

5c.3 The large amount of detriment caused to policyholders by this practice becomes evident during a reattribution as the firm may take out an allowance from the inherited estate to cover the impact of its shareholder tax bill on all future business. In the AXA case, the FSA allowed AXA to make an allowance of £400 million (23%) of their inherited estate to cover the shareholders' tax bill. The FSA even wanted to allow AXA to make a further allowance of £50_£100 million to cover the "contingent risk" that the tax rate applying to shareholders would be "higher than assumed".[13] These decisions resulted in AXA policyholders losing out on around £600 each.

5d. *Shareholder tax—The contractual position*

5d.1 Which? believes that the effect of the FSA's rules on the payment of shareholder tax is that policyholders gain less than 90% of the total money paid out from the fund. For example as part of the Norwich Union special bonus in addition to the £230 million payment to shareholders, an additional shareholder tax bill of £40 million will be charged to the inherited estate. The equivalent gross split between policyholders and shareholders might be equivalent to 88:12, rather than the 90:10, which is required by the policyholder's contract.

5d.2 We instructed a QC to advise on this matter and he concluded the effect of paying the shareholder tax could be a clear breach of the term of the contract that distributions will be on the basis of 90% to policyholders and 10% to shareholders.[14]

5e. *Mis-selling claims*

5e.1 Which? has campaigned for over 10 years against companies being able to use the inherited estate to pay mis-selling claims. Mis-selling is caused by corporate failure. Allowing shareholders to avoid ultimate responsibility for the costs of mis-selling by using money from the inherited estate weakens incentives and goes against all principles of good corporate governance.

£182 million:
the amount Norwich Union has set aside to cover its mis-selling costs.

£503 million:
the amount Prudential set aside to cover its mis-selling costs.

[12] FSA, CP 04/14, Annex 4, page 3-4.
[13] FSA, Witness statement in the AXA case, para 57.
[14] Annex D.

5e.2 We welcome the fact that the FSA is considering changing the rules, but are concerned that they are in effect shutting the stable door after the horse has bolted. Norwich Union has already set aside £182 million[15] from the inherited estate to cover its mis-selling costs while Prudential has set aside £503 million.[16] Unless any change in policy is immediately forthcoming it is unlikely to occur before the Norwich Union and Prudential reattributions have been concluded. As a result, the FSA will have allowed these two companies to take even more out of the inherited estate to finance their mis-selling claims, and the change will come too late for the millions of policyholders who will lose out as a result.

5e.3 We believe insurance companies should reveal how much has been taken out of the inherited estate to pay mis-selling claims. This will enable policyholders to see the benefit shareholders have derived and how much they have lost out as a result of this regulatory failure.

5f. *Paying the deficit on Norwich Union's staff pension fund*

5f.1 Norwich Union's decision to use the inherited estate to pay the deficit on their staff pension fund is a prime example of how companies are able to change the way the inherited estate is used to benefit their shareholders.

5f.2 In 2005, Norwich Union's interim results indicated that all of the costs of funding the deficit in the company staff pension scheme had previously been paid by shareholders.[17] The company said it was hopeful that in the future part of the cost of funding the deficit would be borne by the with-profits funds. On 1 January 2006, a change was therefore made to the PPFM to clarify "how certain parts of the Staff Pension Scheme deficit can be credited or charged to the inherited estate".[18] FSA returns indicate that at the end of 2006 it was anticipated that £83 million of the inherited estate across Norwich Union's with-profit funds would be used to cover the cost of the pension scheme deficit. This directly reduced the amount of money available for policyholders and illustrates the freedom afforded to companies that directly results from the FSA's poor regulation.

£83 million:
The amount from the inherited estate that Norwich Union has set aside to cover the deficit of their staff pension scheme.

6. FSA's Failure to Conduct a Proper Cost-benefit Analysis

6.1 Which? believes that the FSA did not conduct a proper cost-benefit analysis during its with-profits review. The regulator has never disclosed how much policyholders were losing out as a result of their rules on the uses of the inherited estate. This is despite the regulator's commitment to "use CBA as an integral part of the policymaking process to illuminate policy choice".[19]

6.2 In addition, the FSA's 6 December letter to Norwich Union and their Policyholder Advocate explaining their regulatory approach[20] was not accompanied by a cost-benefit analysis. The FSA avoided the statutory requirement of the Financial Services and Markets Act to conduct a cost-benefit analysis by designating that the letter is not formal or generic guidance, despite the impact it will have on policyholders. Even if the FSA is proposing not to change the rules, we believe it should use cost-benefit analysis to evaluate the different options available.

6.3 We urge the Committee to ensure that the FSA conducts and publishes a full cost-benefit analysis, showing how much money policyholders lose out due to its policy on the inherited estate and evaluating the options put forward to protect consumers. If the FSA board is to make an informed decision about the appropriateness of the FSA's regulatory framework then it should have been provided with this information.

[15] FSA returns.
[16] http://www.prudential.co.uk/prudential-plc/investors/financialreports/2007/fsareturns2007/fsareturns2007ind/pacl_fsa07_app9.pdf
[17] http://www.aviva.com/files/reports/2005ar/index.asp?pageid=22
[18] http://adviser.norwichunion.com/product-literature/files/in/in16023.pdf
[19] December 2004, FSA response to the JHC report on embedding Cost-Benefit Analysis within the FSA.
[20] http://www.fsa.gov.uk/pubs/other/reattribution_letter.pdf

7. Policyholders' Reasonable Expectations

7.1 At the time of the AXA case, regulation of the with-profits industry was based on the concept of "Policyholders' Reasonable Expectations" (PRE). This gave the regulator (then the DTI) the power to intervene if Policyholders' Reasonable Expectations were not being met. However, the meaning of PRE was not defined in legislation and was typically based on existing actuarial practice in the industry. This allowed AXA to argue that policyholders did not have a reasonable expectation of receiving anything from the erited estate and therefore even the offer of 31% was a good deal.

7.2 We welcome the clarification by Hector Sants at the Treasury Committee meeting on 22 January 2008 that policyholders have a reasonable expectation of receiving distributions from the inherited estate. Which? has long maintained that this was the case.

7.3 We are concerned by reports from our members that Norwich Union is claiming that policyholders were told not to expect any distributions from the inherited estate. These claims have not been substantiated by the evidence Which? has seen. We instructed a QC to examine two sets of documents for an endowment mortgage and personal pension provided when these policies were sold in the mid-late 1990s. He concluded that the policy documents and any other documentation made no reference to the inherited estate.[21] This is consistent with several other sets of policy documents provided when the policies were sold that we have seen, which also make no reference to the inherited estate.

8. Policyholder Choice

8.1 The FSA and Norwich Union place considerable emphasis on the fact that policyholders will be able to vote on whether to accept or reject the proposal made by the company to buy out their rights to the inherited estate. Which? believes that for many this will be a false choice and is not an effective safeguard to ensure that the principles of treating customers fairly are met.

8.2 We are aware that Norwich Union is already stating that the prospect is slim of a further significant distribution happening within the lifecycle of the majority of their current policyholders.

8.3 If policyholders believe that they are unlikely to benefit from any further payout from the inherited estate during the lifetime of their policy, they will be less likely to take the risk of voting "No" in case they receive little or nothing in the future. In essence, the company has them over a barrel. This is particularly true of those policyholders whose policies will mature over the next few years: they will have little choice but to accept the money. We believe the FSA should clarify how this lack of real choice is consistent with their treating customers fairly regime.

8.4 We also remain to be convinced that the interests of those who vote "No" will be unaffected by the deal. In the absence of a reattribution, they would expect the inherited estate to be available for distribution in the future. By definition if shareholders are able to gain more of the inherited estate than their 10% allocation, then these policyholders may lose out.

9. Norwich Union's "Special" Distribution

9.1 On 5 February 2008, Norwich Union announced that it would distribute £2.3 billion, with £2.1 billion going to policyholders. As Norwich Union has made clear, this payment is "separate from the reattribution proposals".[22] This money is excess surplus and Norwich Union is required under FSA rules to distribute this money to policyholders.

9.2 It seems extraordinary that Norwich Union was able to build up such an amount of excess capital without anyone at the FSA taking action to ensure that this money was paid out to policyholders. We have asked the FSA what steps it has taken to assess whether an excess surplus exists in other with-profits funds and hope the Committee will raise this issue with the FSA and Prudential.

9a. *Three year phasing*

9a.1 Which? welcomes Norwich Union's decision to make this payout but is deeply opposed to the decision to phase the payment over three years. This will mean that those people whose policies mature before 2010 will not benefit from the full payout. Norwich Union has effectively chosen to penalise thousands of their most loyal and long-standing customers.

9a.2 Which? believes that this money should be distributed immediately and in full. As the money is an "excess surplus" this can be done without any negative effect on the security of the fund and we do not believe any of the arguments for the phasing stand up to scrutiny.

[21] See Annex C.
[22] Letter sent out by Norwich Union alongside the declaration of special bonus.

9a.3 Norwich Union has attempted to justify the phasing by stating that a large number of policyholders might surrender their policies if they made one payment. Which? would note that policyholders would have no reason to seek to leave the fund if they are happy with their investment and trust Norwich Union to deliver good returns.

9a.4 Norwich Union could be seen to be saying that it wants to lock people into the fund for another three years. This is in complete conflict with the FSA's stated desire to ensure consumers do not face unreasonable barriers when switching product or provider[23] and we do not see how the regulator can support such a move.

9a.5 In addition, Which? questions whether a three year phasing of the payout can be compatible with the FSA rule which requires firms to "assess at least once a year"[24] whether their with-profits fund contains an excess surplus. Under these rules, if a firm has an excess surplus it is supposed to assess whether retaining that surplus would breach the requirement to treat customers fairly. If so it is required to distribute this surplus or carry out a reattribution. We believe that the FSA is undermining the purpose of this rule if they allow the phasing of the payment.

10. The Role of With-Profits Committees

10.1 Which? has been a long-term critic of the fact that the policyholder interest is not represented effectively in how the with-profits funds are run. The weak corporate governance in these funds is a particular problem because directors have an express fiduciary duty to maximise shareholder interests.

10.2 We have no confidence that the with-profits committee will ensure that customers are treated fairly. The operation of these committees offers little in the way of effective corporate governance and accountability. We believe that the role of the with-profits committee in approving the terms of the special distribution has further undermined the credibility of their role.

10.3 Our concerns about the effectiveness of with-profits committees stem from the fact that:

- Members of the With-Profits Committee have no fiduciary duty to policyholders or the remit to act in policyholders best interests.
- The firm has no obligation to take the views of the With-Profits Committee into account and no requirement to state where it disagrees with the Committee's input.
- The meetings of the with-profits Committee are held behind closed doors and there is no published record of proceedings or decisions.
- The FSA has itself raised concerns about the effectiveness of with-profits committees in a "Dear CEO" letter sent by Sarah Wilson which identified several areas of concern about the operation of With-Profits Committees.[25]

11. The Future of the With-Profits Market

11.1 Which? believes that the with-profits market will continue to decline. The actions of individual companies and the regulation of the with-profits industry, typified by the outcome of the AXA case, has damaged consumer confidence in the market. We see nothing in the market to justify projecting long term growth in the sale of with-profits products.

11.2 Which? believes that the Committee should treat with scepticism any forecasts of long-term growth in with-profits business made by companies during the reattribution process. As noted, AXA's predictions for new business were 85% above their actual levels.

11.3 We see a number of reasons for the continued decline of the market for with-profits products:

- 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 leads 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.

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[23] As part of its work aimed at ensuring that customers are treated fairly, the FSA has set six consumer outcomes which it wants firms to deliver. Outcome number 6 is that "Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint."
[24] FSA Handbook, COBS 2.2.21–22.
[25] http://www.fsa.gov.uk/pubs/ceo/with_profits.pdf

— Changes to the taxation of investment bonds: The recent changes to Capital Gains Tax in Budget 2008 mean that these structures in which many with-profits products are sold are less attractive for some higher rate taxpayers.

— A survey by the Association of Financial Advisers in February 2008 found that 87% of financial advisers no longer recommend that clients invest in with-profits business.[26]

Annex A

THE AXA CASE

In 2000 AXA brought forward proposals for reattributing the £1.7 billion inherited estate in its with-profits fund. Which? intervened in the Court case, expressing serious concern about the unfair treatment of policyholders in the reattribution. Despite our objections, the Court approved the deal, supported by the FSA. Policyholders received just 31% of the inherited estate compared to their 90% entitlement, losing out on close to £1 billion. The amount received by policyholders was so low due to the deductions AXA was allowed to make to use the inherited estate to pay shareholder tax and to fund the costs of new business.

AXA claimed that it needed to make allowances of:

— £400 million to pay its shareholders tax bill on the current business in the fund and all future business written by the with-profits fund; and

— £437 million to cover the fact that they claimed the money was locked-in to the fund and was exposed to risk, mainly because it would be used to write new business.

These deductions allowed AXA to claim that the deal was only worth an extra £150 million to shareholders.

The FSA submitted in their evidence that it thought the proposals were worth around £200 million more to AXA than the figure the company claimed. However, they did not put any pressure on AXA to offer more to policyholders, stating that in the FSA's view the offer fell within a "reasonable range". However, they refused to disclose this "reasonable range" on the grounds of commercial confidentiality.

Which? objected to the deal for a number of reasons, including:

1. The proposal infringed the 90:10 principle and it was clear that Policyholders did have a reasonable expectation of receiving a distribution from the inherited estate. The proposals were worth far more to AXA than its standard 10% share.

2. Which? believed that the value of the deal was unfairly weighted towards shareholders and was greater than stated because:

— new with-profits business was likely to decline;

— the provision for lock-in was overstated; and

— the provision for tax was overstated.

AXA projected that the new business in the with-profits fund would grow at 4.5% a year up to 2050. Which? believed that its projection was too optimistic. The analyst Which? commissioned for the AXA case to evaluate the future of the with-profits market predicted that the outlook for AXA's with-profits business was far gloomier than presented by the company. He forecast that a middle scenario would see AXA's with-profits sales falling by two-thirds in real terms.

Despite our objections the FSA concluded that AXA's projections were not unreasonable. The FSA acknowledged that if the actual level of new business written by AXA was lower than expected there would be some increase in the value of the deal to shareholders. However, the FSA did not place any value on AXA's projections not being fulfilled. The actual outcome has been that levels of new with-profits business are now a small fraction of what AXA had forecast. The collapse of new business meant that money set aside to fund new business and pay shareholder's tax bill was not needed for those purposes but AXA is not required to return this money to policyholders. A City analyst concluded that AXA had created a "massive heads I win, tails I don't lose bet".

Annex B

TIMELINE

1998

Which? objects to Prudential using over £1 billion from its inherited estate to pay for the cost of pension mis-selling.

[26] AIFA member survey, February 2008.

2000

AXA case—Which? intervenes to argue for a better deal for policyholders. Despite our objections, the Court and the FSA support a deal which sees policyholders receive just 31% of AXA's £1.7 billion inherited estate.

2001

February—Which? publishes its policy paper *Profits at the consumers' expense: Life insurance company with-profits funds*. This identified problems and practices in the with-profits industry which gave rise to consumer detriment. We called for immediate action to protect policyholders rights and interests in the inherited estate.

FSA launches with-profits review, stating that the "financial services industry and its regulators need to work together to improve the way with-profits policies are described, managed and sold". The intention was to look at change in four main areas:

— The extent of discretion available to management over the operation of with-profits funds and how that discretion is exercised;

— Improvements in the transparency of the published information in consumer literature and in the regulatory returns about with-profit funds;

— Better information for policyholders about the progress of their investments, including improvements in the language used to describe returns, and greater clarity about investment strategies and the way in which terminal bonuses are determined; and

— The principles which underpin the requirement for firms to have due regard to the interests of customers and to treat them fairly.

October—FSA publishes *With-profits issues paper 1: Process for dealing with reattribution of inherited estates*. Which? responds to the publication stating that:

> *"We are very disappointed and note with increasing concern that the FSA has not yet developed proposals for dealing with the fundamental issue of establishing actual ownership of the Estate, and protecting policyholders interests and rights in the inherited estate. We have little confidence that simply looking at a new process, however transparent, without addressing the ownership question would offer policyholders any real protection against predatory interests."*[27]

2003

January—FSA launches CP167: *With-profits governance, the role of actuaries in life insurers, and certification of insurance returns*. Which? responds that:

> *"We are concerned that these proposals are a retrograde step in terms of corporate governance in that directors will have even more power to exploit policyholder vulnerability and consumer influence will be further weakened. We think these proposals will undermine the statutory objectives of protecting consumers, promoting confidence and raising public awareness."*[28]

Which? also raises the impact of the distorting effect on competition:

> *"There are concerns that with-profits have a detrimental effect on competition through the use of with-profits funds to cross subsidise acquisition of market share at un-commercial terms. This not only directly affects policyholders in those with-profits funds but consumers generally as competition is not conducted on a level playing field".*[29]

December—FSA publishes CP207: 'Treating with-profits policyholders fairly'. Regarding the proposed process for reattribution of inherited estates, Which? comments that:

> *"The process outlined is unlikely to protect consumer interests during a reattribution because of a prior failure to establish policyholders' interests . . . It follows that the FSA's approach to inherited estates will not protect policyholders from an AXA type raid on the estate or some other manipulation in favour of shareholders."*

2004

December—FSA publishes CP04/14: CP04/14: Treating with-profits policyholders fairly Further consultation. Which? responds that:

> *"We are of the view that the FSA's overall with profits review will not lead to any fundamental reform of the legal, corporate, governance and accountability structures in the sector . . . The process outlined is unlikely to protect consumer interests during a reattribution."*

27 Which?, Response to FSA With-Profits Review, Issues Paper 1: Process for dealing with attribution of Inherited Estates.
28 Which?, Response to CP167, page 2.
29 Which?, Response to CP167, page 1.

2006

February—Norwich Union announces that it is considering pursuing a reattribution. Clare Spottiswoode is nominated as Policyholder Advocate.

November—Clare Spottiswoode is formally appointed as Policyholder Advocate at Norwich Union with an intention to commence the negotiations with Norwich Union in Spring 2008.

2007

March—Prudential announces that it is exploring the possibility of a reattribution and nominates Peter Bloxham as Policyholder Advocate. Formal appointment would only be made if Prudential decides to proceed with the reattribution.

October—Which? writes to Hector Sants, Chief Executive of the FSA, expressing concern that:

> *"The FSA's conduct of business rules allow too much leeway to use the inherited estate in ways which benefit shareholders . . . We believe that policyholders are at a significant disadvantage in any reattribution process".*

November—Prudential states that no decision has been taken about whether to proceed with a reattribution. Prudential indicate that they "aim to be in a position to consider whether reattribution is in the interests of policyholders and shareholders in the first half of 2008".

December—FSA releases guidance letter to Norwich Union and Clare Spottiswoode. Which? responds that the FSA's decision mean that 5 million policyholders will lose out and expressing concern about the FSA's decision to allow the inherited estate to be used to subsidise new business and pay shareholder tax bills.

December—Which? calls on Norwich Union to act with integrity and not claim money from policyholders to subsidise new business, pay shareholder tax bills and mis-selling claims.

2008

January—Which? writes to Hector Sants and Kitty Ussher MP, the Economic Secretary to the Treasury, reiterating our concern that the FSA's regulatory framework is not sufficient to protect policyholders rights and interests in the inherited estate.

February—Norwich Union announces £2.3 billion special bonus. Which? welcomes that this payment is being made on a 90:10 basis, but expresses concern that the payment is being phased over three years, penalising thousands of Norwich Union's most loyal and long-standing customers. Which? calls on FSA to make changes to ensure a fair deal on remaining £3 billion inherited estate.

March—Which? welcomes the announcement of the Treasury Select Committee inquiry into inherited estates.

Annex C

LEGAL ANALYSIS OF POLICYHOLDER DOCUMENTATION

SPECIFIC CGNU POLICIES

A "Low Cost Endowment Policy"

1. I have been supplied with copies of documentation relating to two relevant Norwich Union policies, both with CGNU. The first concerns a "Low Cost Endowment" taken out by [Mr and Mrs X] in 1997 with what was then General Accident Life. This includes a "with profit" element. The "Policy" is a document of some 15 pages. The only provision relating to with-profits is Clause 8. This provides that

> "(a) With-Profits policies share in the profits generated by the fund in which Premiums are invested by the Company. At least 90% of profits are allocated to Policyholders, with the remainder being allocated to shareholders".

Clause 8(b) deals with reversionary and terminal bonuses. Clause 8(c) states that "Profits arise from various sources". Clause 8(d) says that a more detailed description of the factors influencing bonus rates and recent bonus policies is available in "the Company's With-Profits Guide".

2. I have not seen the GA Life "With Profits Guide" for 1997. I have, however, seen a later copy of what I assume is the same document (dated 02/2000).[30] This states that

"Your With Profits policy aims to provide a payout that reflects the returns earned on the investment assets held by the CGU Life Fund"

It goes on to say that CGU Life aimed to return 100% of asset share[31] but, because of "smoothing" this could vary between 90% and 110%. It states that "investment returns and profits" are added to the policy in the form of bonuses and, later on, that "Capital Growth in the value of the Fund's investments is paid out to policyholders primarily through final bonus". The "With Profits Guide" does not make any reference to the "inherited estate".

[30] This is the CGU Life Assurance document "What with-profits means to you".

[31] Which is stated to be "a fair share of the assets of the fund".

3. Neither the Policy nor any of the other documentation makes any reference to the "inherited estate". A subsequent "Bonus Notice" refers to the fact that the objective of GA Life in adding a final bonus "is to ensure, that over the term, the maturity payout represents 100% of the policy's share of the Fund wherever possible".

A "Personal Pension Plan"

4. The second set of documentation concerns a Personal Pension Plan taken out by [Mrs X] in 1998 again with GA Life, 100% of which is invested in a "unitised with-profit fund". The "Prospectus" states "With Profit Fund" aims to secure a rate of growth by "participating in the profits of General Accident Life". It goes on to say that

"The calculation of the total profit of General Accident Life and its distribution amongst participating policyholders and shareholders is decided by General Accident Life. The policyholder's proportion cannot be less than 90% of the distributed profit"

The "Policy" is said to be subject to the "Rules of the General Accident Personal Pension Scheme". I have not been provided with a copy of these rules. There are a number of relevant provisions of the Policy:

(1) Clause 2(a) provides that "GA Life will maintain . . . one or a number of With-Profits Funds . . . "

(2) Clause 2(d) provides that "Each With-Profit Fund is a non-identifiable part of GA Life's life assurance fund which is referable to Pension business".

(3) Clause 8 is headed "Unit Prices (With-Profit Funds)". Clause 8(a) provides that

"Each With-Profit Fund participates in the profits of GA Life's life assurance fund. At least 90% of the profits are attributed to policyholders with the remainder being attributed to shareholders"

This clause goes on to say that profits are attributed by means of reversionary and terminal bonuses.

The documentation which I have seen makes no mention of the "inherited estate".

Annex D

Legal Advice in the Matter of Norwich Union With-profits Insurance Contracts and in the Matter of Charging Tax to the Inherited Estate

1. I am asked to advise Which? Limited in relation the contractual position concerning the payment of shareholder tax from the "inherited estate" in the with-profits funds of two Norwich Union companies, CGNU Life Assurance Limited ("CGNU") and Commercial Union Life Assurance Company Limited ("CULAC").

2. A "with-profits policy" is a contract of insurance, the policyholder exchanges money for a contractual promise of benefits. In other words, the policyholder has contractual rights but does not own the fund from which his contractual entitlements are met.[32] The life insurance company must deal with the fund in accordance with the terms of its contracts with the policyholders. Even where that contract grants the directors a broad discretion, that discretion may be constrained by "implied terms" or by the directors' "fiduciary duties. In *Equitable Life v Hyman*[33] the House of Lords found that the policy contained an implied term to the effect that the directors were precluded from overriding or undermining guaranteed annuity rates, This term was found to be "necessary" to give effect to the reasonable expectations of the parties.[34]

3. Special difficulties arise in relation to the "inherited" estate. There is no statutory definition of this term but the FSA has suggested the following:

> "the excess of assets maintained within the long-term fund over and above the amount required to meet liabilities which arise from the regulatory duty to treat customers fairly in making and setting discretionary benefits".[35]

Although such surpluses could be the result of historic injections of capital by shareholders, in practice the inherited estates of life companies are derived from that part of with-profits policyholders' investments which has been retained and accumulated within the long-term business fund and not distributed.[36] According to Norwich Union the current policyholders have not contributed to the inherited estates_because since the late 1980s policyholders have been paid out in accordance with their "asset shares". It seems likely that the bulk of the inherited estate originated during the post war period, up to the early 1970s when the stock market grew consistently over more than two decades.

[32] FSA, With Profits Review: Issues Paper 5 (March 2002), 21-22.
[33] [2002] 1 AC 408. It is noteworthy that although the Equitable Life board were clearly acting in a way which undermined express contractual rights, it won the case at first instance and persuaded Morritt LJ in the Court of Appeal that there was no breach.
[34] See the analysis of Lord Steyn, *ibid*, 459.
[35] FSA "With Profits Review: Issues Paper 1", Oct 2001, 3, p.3. The FSA Handbook, "Glossary" defines it as "an amount representing the fair market value of the with-profits assets less the realistic value of liabilities of a with-profits fund".
[36] FSA "With Profits Review: Issues Paper 1", Oct 2001bid, 5, p 4.

4. It seems to me that there is a strong argument that it is either an express or an implied term of current CGNU and CULAC "with profits" policies that on any "special distribution" from the inherited estate the policyholders will receive at least 90% of the sum distributed. This contractual term arises out of both the express terms of clause 8 of the policies[37] and from the "factual matrix" in which such policies were made over, including the statement of the Corporate Affairs Minister on 24 February 1995.[38]

5. Norwich Union is proposing to make a special distribution from the inherited estate of the order of £2.3 billion. As I understand the position, it is proposed that 90% of this sum, or £2.07 billion will be paid to policyholders and 10%, or £230 million will be paid to shareholders. The payment to shareholders will mean that they are under an additional tax liability which is likely to be of the order of £40 million. I am instructed that Norwich Union is proposing that this additional tax liability will, itself, be paid from the inherited estate. It is difficult to see how a such a payment can be consistent with Norwich Union's contractual obligations.

6. In substance, the effect of paying the "shareholder tax" is that an additional sum of £40 million will be paid out of the inherited estate. In my view, this represents an additional "distribution" to the shareholders. In other words, the shareholders are receiving a total of £270 million, as against the £2.07 billion paid to the policyholders. This means that the shareholders are receiving more than 11.5% of the total sum distributed from the inherited estate. In my view, this is a clear breach of the term of the contract that distributions will be on the basis of 90% to policyholders and 10% to shareholders. I can see no contractual justification for this payment.

7. Finally, I note that, under the FSA rules, a life insurance company can charge tax on a transfer to shareholders to the inherited estate if this is consistent with the company's "established practice". I have seen no evidence as to Norwich Union's established practice in this regard. Unless such a practice was made clear to policyholders at the time at which their policies were taken out, it cannot affect the terms of the contracts which were entered into. As a result, even if the charging of tax to the inherited estate is consistent with current FSA rules it would, on the material which I have seen, constitute a breach of contract by Norwich Union in the circumstances of this case.

Memorandum from Clare Spottiswoode CBE, Policyholder Advocate for Norwich Union

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% 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

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[37] Which says that "At least 90% of profits are allocated to Policyholders, with the remainder being allocated to shareholders".

[38] This is obviously part of the "factual matrix" in which any post 1995 policy was concluded. It was accepted in the AXA case that policyholders had a reasonable expectation to this effect, see Re AXA Equity and Law [2001] 2 BCLC 447, 472 (Second Judgment, 19).

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; and
- the AXA post-reattribution new business levels suggest it is unlikely a company will continue to write the same level of new business after a reattribution as it predicts before a reattribution.

22. However, it remains a fact that it is not possible to forecast new with-profits business with any degree of certainty. Reattribution 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 reattribution 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 reattribution.

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 reattribution. 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 reattribution.

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% in 2003 to 31.5% in 2005. Aviva's market share has grown from 7.6% in 2004 and 13.6% 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".[39]

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 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

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

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.

Annex 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% to policyholders and 10% 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.

Annex 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%for with-profits business) is subject to tax at the usual corporation tax rate (28%).
- On life assurance business:
  - the income and capital gains of companies are subject to tax at a lower policyholder rate of 20%;
  - 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% by policyholders and 10% shareholders;
- deducted from the amount of surplus transferred to shareholders, ie 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; and

— 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.

Annex 3

WITH-PROFITS: COMMENTARY FOR THE POLICYHOLDER ADVOCATE

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.

2. 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

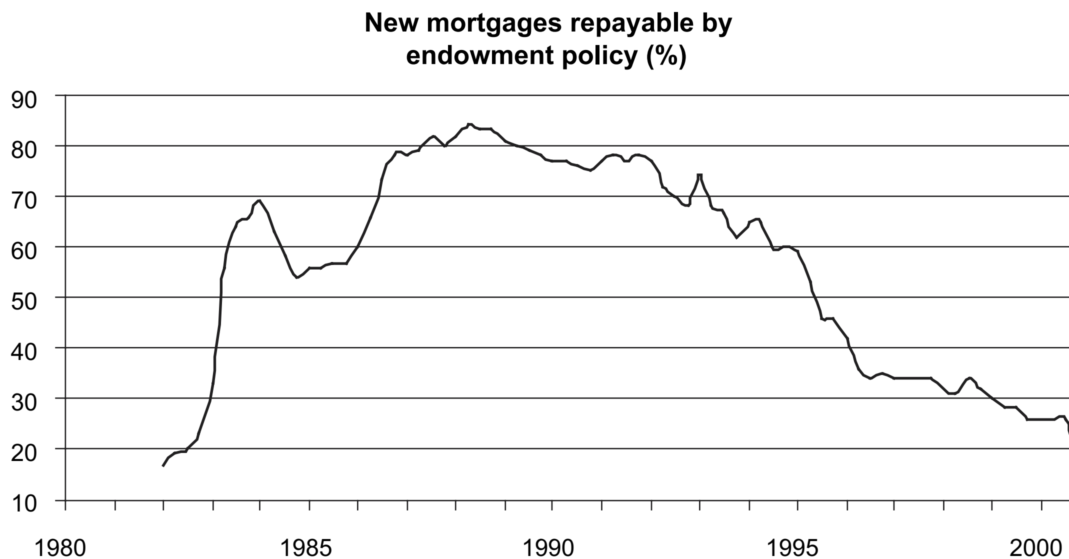
78. For a period in the 1980s and 1990s, the main product line of the UK life industry was the mortgage endowment policy—a regular premium savings plan, most commonly in with-profits format. What appeared a core product line subsequently was almost totally wiped out during the space of a few short years 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.

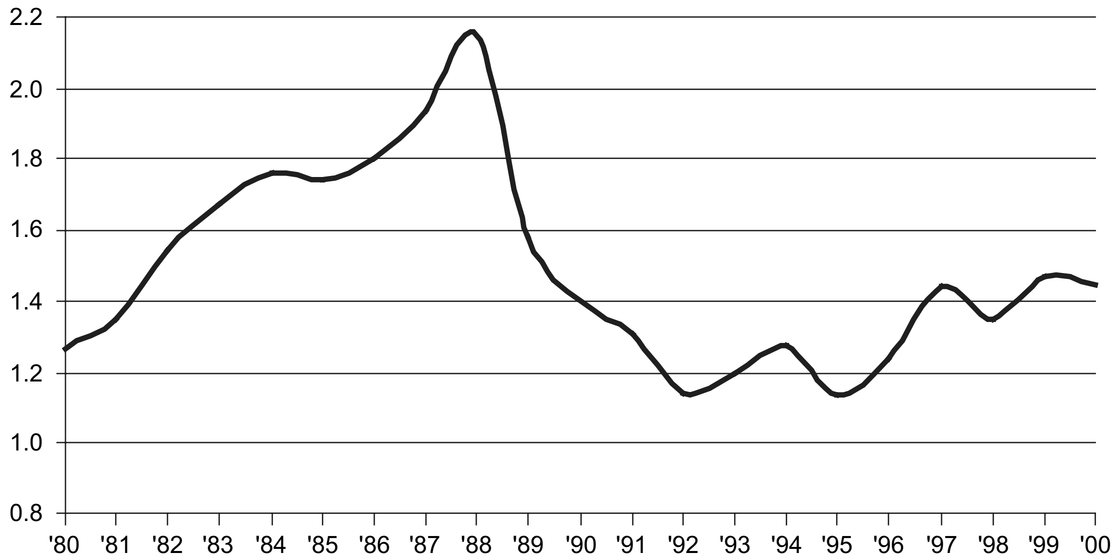
80. We suggest that the almost complete eradication of mortgage endowment new business that took place in the late 1990s/early 2000s (resulting initially from the emergence of evidence that the vast majority of such contracts were not capable of fulfilling their purpose—ie to pay off the associated home 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.

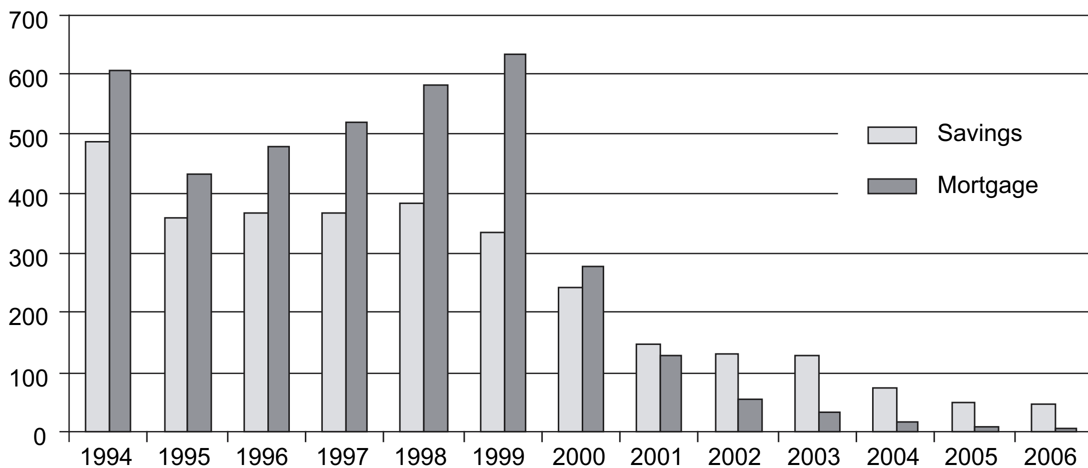
82. The chart below tracks the proportion of new mortgages that were repayable by an endowment. The sudden and massive uptake of the mortgage endowment concept arose not only because of the optical attraction of the monthly outlay comparison and prospects of a lump sum at the end of the period, but was 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.

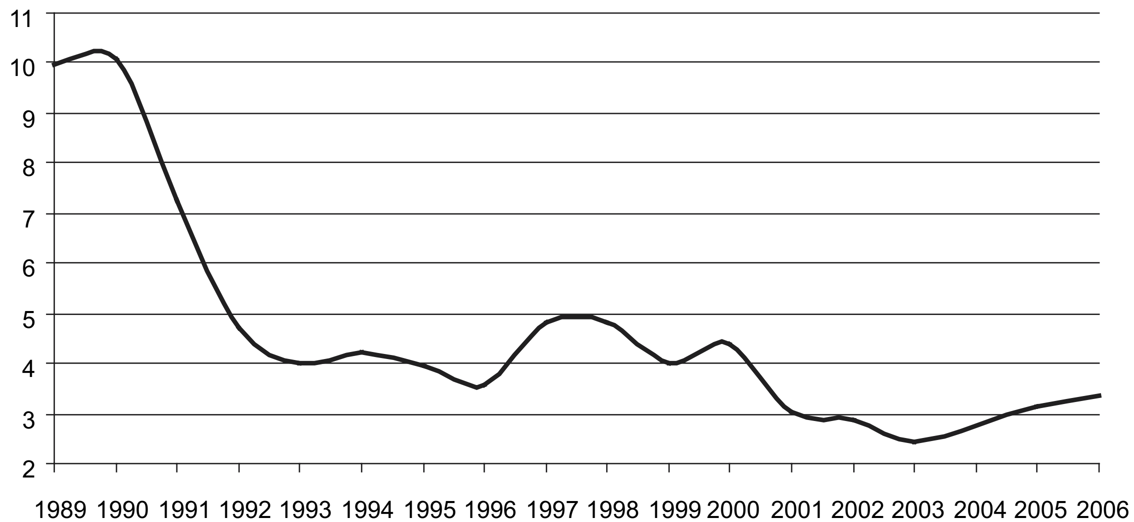


3. With-Profits Bonds

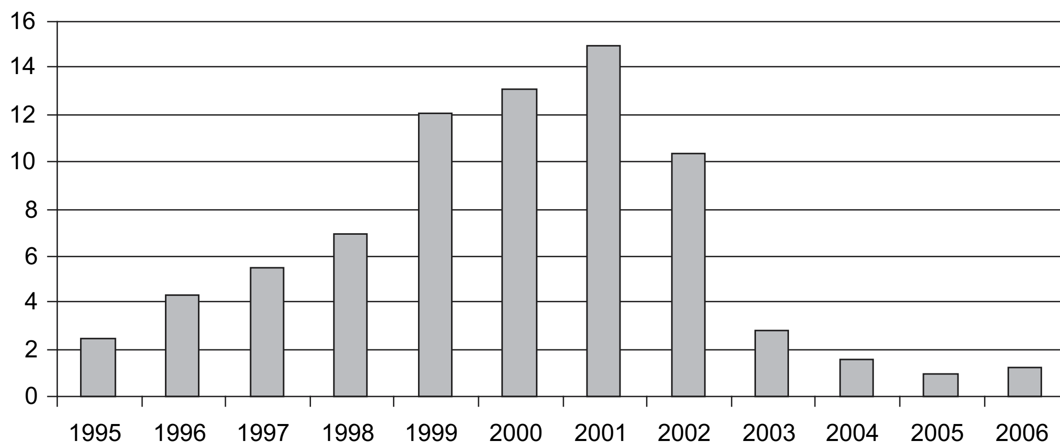
Not a core product

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.



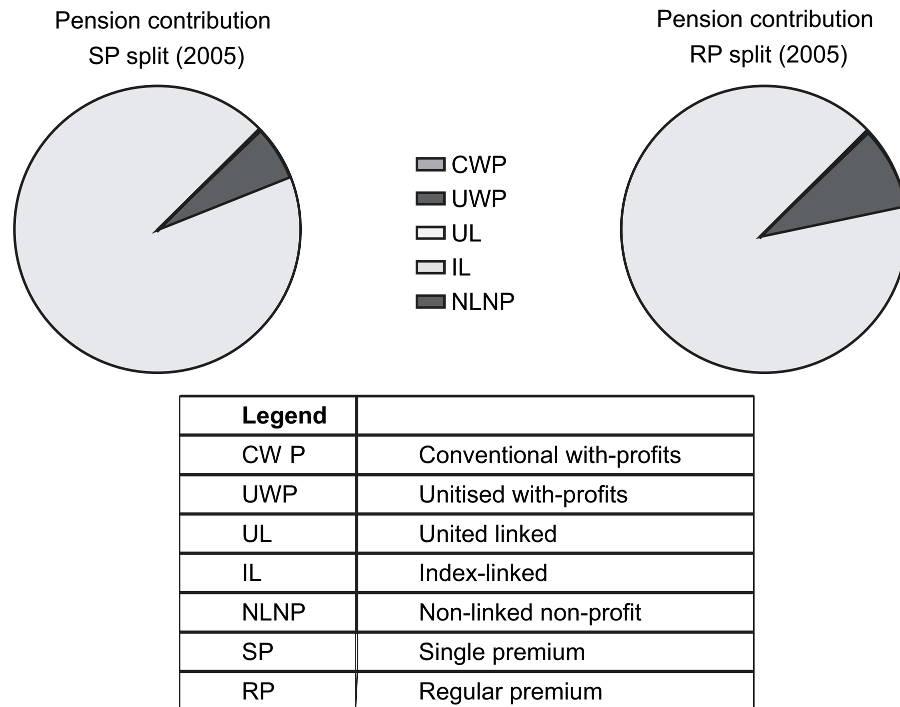
88. The with-profits bond surge and slump that straddled the turn of the decade was characterised by a product development race, as providers competed to offer the highest guarantees, highest bonus rates and highest commissions in order to gain market share and boost sales volumes.

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.

4. Pensions Saving

Contribution split

90. The charts below describe the split according to investment format of pension accumulation (ie 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	
CW P	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 £25 billion of pension new single premium business written, of which only £1.6 billion was in with-profits format (6.4% of the overall new business written).

93. In 2005, there was £2.6 billion of new pension regular premium written, of which only £0.2 billion was in with-profits format (7.7% 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% of new pensions saving single premiums were with-profits, compared to 6% in 2005.

97. As for new pensions saving new regular premiums, 37% of these were with-profits in 1999, compared to only 9% in 2005.

5. "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.

6. 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 £64 million of new with-profits regular premiums and £699 million 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 £46 million of new with-profits regular premiums and £476 million 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 £7 million and new single premiums were £45 million.

104. Stripping out increments and pension rebate business, new regular premiums in 2006 would have been £4 million and new single premiums would have been £22 million, 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 five 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 £50 million as at end 2005, including the following:

- An illustrative £50 million excess capital position as at end 2005 was projected to arise if new with-profits business fell on average by 5.5% 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 £50 million as at end 2005 might be caused, was if actual new with-profits business was c30% less than budgeted levels in 2000 and then increased in line with an assumed annual growth rate of 2% 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 (£64 million of new regular premiums and £699 million of new single premiums), then a 5.5% 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 £48 million of new with-profits regular premiums (compared to an actual outturn of £22 million) and new with-profits single premiums of £527 million (compared to an actual outturn of £82 million).

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 annum for convenience, the resulting 2005 levels of new with-profits business being sufficient to result in the emergence of £50 million of excess capital would have been something like £56 million of new with-profits regular premiums (compared to an actual outturn of £22 million) and £610 million of new with-profits single premiums (compared to an actual outturn of £82 million).

Annex 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%) 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.

Annex 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; and

— 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; and
- — 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 Considerations[40]

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, 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.

[40] 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.

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 make 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; and
- — commitment to explain the result of reattribution negotiation directly and indirectly to policyholders is an essential component of accountability.

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 reattribution. However, if a firm does choose to, then the reattribution needs to be conducted within the regulatory framework described in this Memorandum, including ensuring that policyholders are treated fairly. If there is no reattribution, or if reattribution 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 £420 billion 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.

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 (eg 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

Memorandum from Norwich Union

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 £33 billion 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 fulfill 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 £2.4 billion. 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 it 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 of 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?

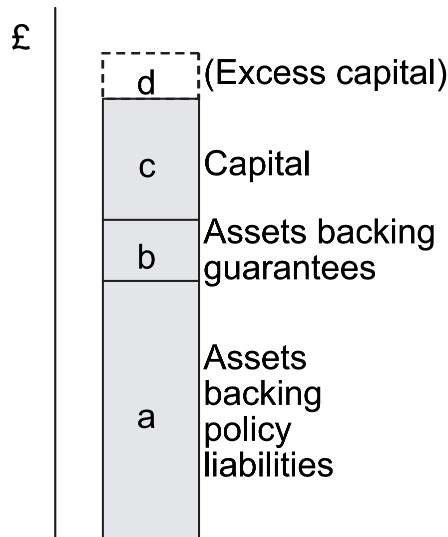
Fund assets comprise money / investments:

(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", eg 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.

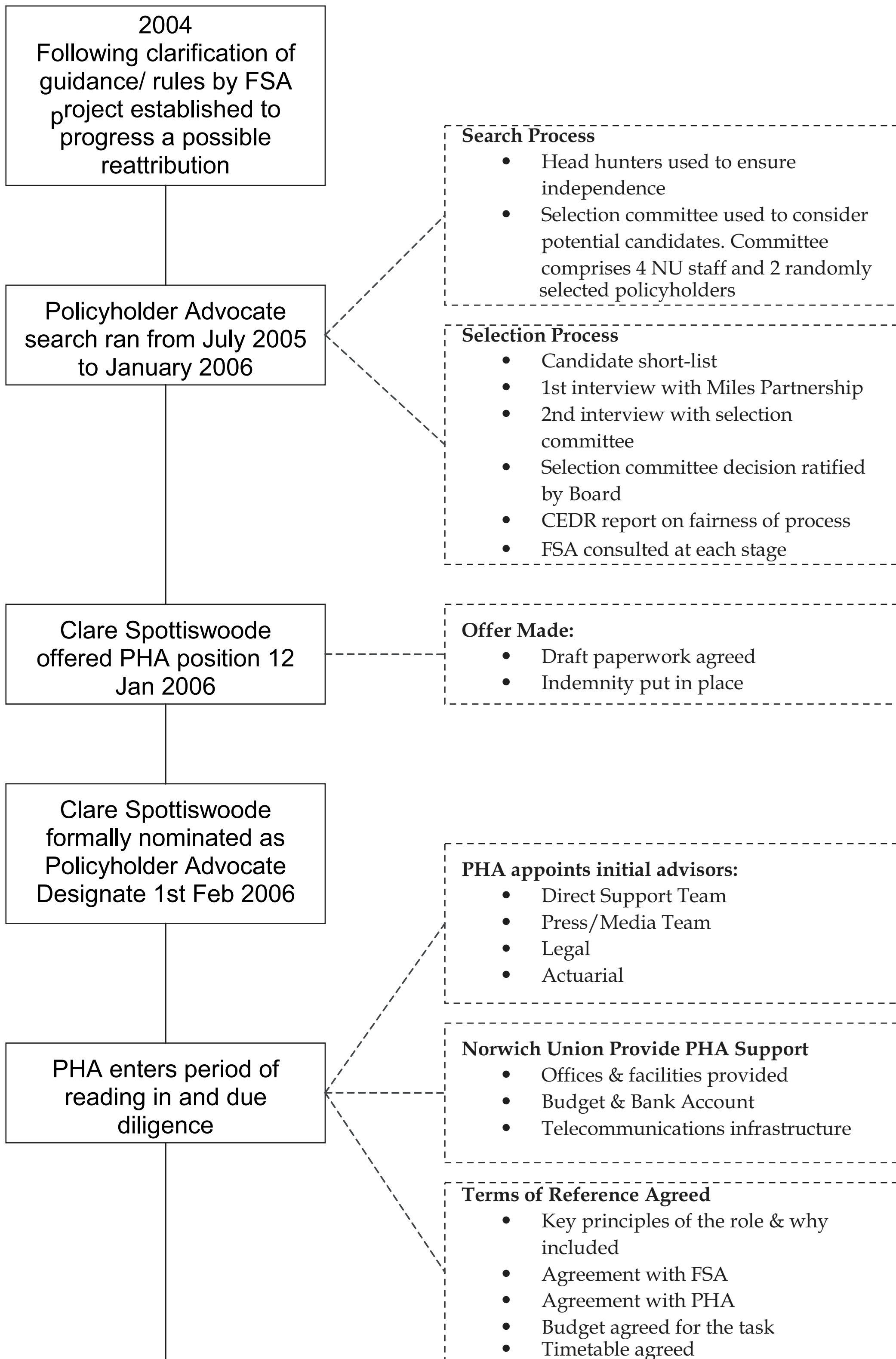
The FSA requires Norwich Union to hold a particular minimum amount of capital but requires Norwich Union's management to determine the appropriate level of capital to be held in respect of its with profits fund. As the largest UK provider Norwich Union wants to maintain a high level of confidence in 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 £2.4 billion 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 £2.6 billion (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 REATTRIBUTION



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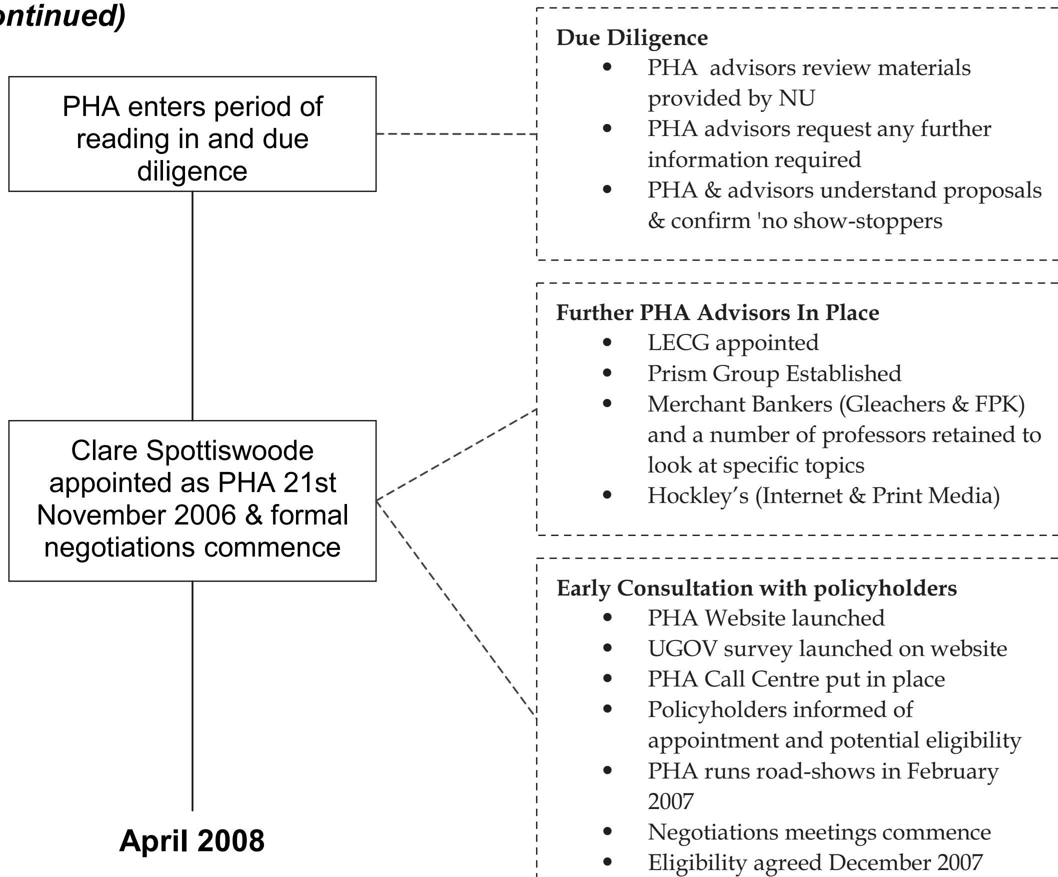
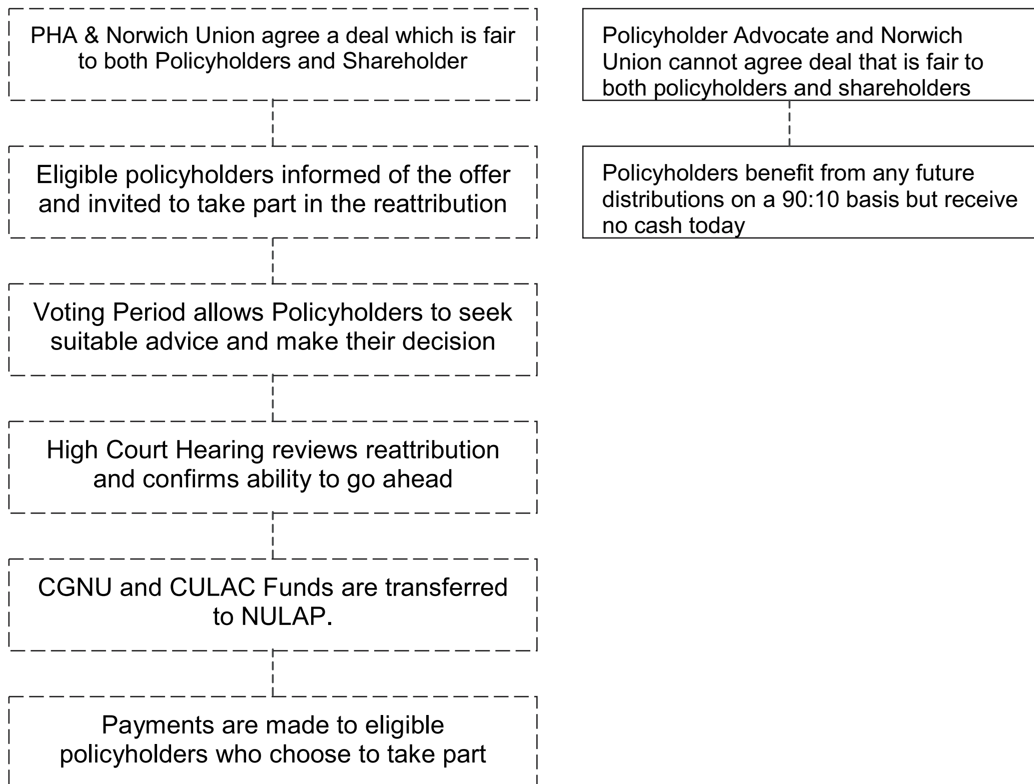




Memorandum from Prudential plc

Prudential plc

Established in 1848, Prudential[41] is a leading international financial services company with more than twenty million customers world-wide and major businesses in the UK, the US and Asia.

In the UK, Prudential provides a range of financial products and services including annuities, corporate and individual pensions, with-profits bonds, savings and investment products and Individual Savings Accounts (ISAs) to around seven million customers. Prudential in the UK also includes the Scottish Amicable business, which was acquired in 1997.

In 1999, Prudential acquired fund manager M&G, which now acts as the Group's UK and European fund manager and is one of the largest active investors in the UK, with nearly 400,000 investors and over £160 billion funds under management.[42]

Executive Summary

A with-profits product offers investors a valuable investment option, providing the prospect of competitive long-term rates of return while smoothing the peaks and troughs of volatile market movements and providing valuable guarantees.

The operation of with-profits funds is subject to rigorous governance which ensures that policyholders are treated fairly.

Prudential's with-profits policies have consistently performed well. Strong with-profits performance relies on having a strong with-profits fund which, in turn, means having a large and strong inherited estate.

The inherited estate plays a vital role in ensuring the financial strength and performance of the Prudential With-Profits Fund. It provides the solvency capital that ensures security as well as enabling smoothing and investment flexibility. The Prudential With-Profits Fund needs to have sufficient working capital to give it the investment freedom to continue to provide policyholders with outstanding investment returns. To put the size of the fund into context, Prudential's inherited estate of £8.7 billion[43] supports an overall fund of £74 billion[44] and is only around three times the size of the annual with-profits bonus declaration in February 2008.

The generation of policyholders whose policies have paid out since 1990 are net beneficiaries from the inherited estate rather than contributors to it. We do not expect the current generation of policyholders to be net contributors to the inherited estate. Prudential's inherited estate has accumulated from a variety of sources including shareholder contributions. Any payment to the current generation of policyholders in respect of the inherited estate would be a pure windfall.

Policyholders have a contractual relationship with Prudential, and expect to receive their contractual benefits. No expectation has been created that they would receive a distribution of the inherited estate and the legal ownership of the estate is clearly with the company.

It is Prudential's view that the whole of the inherited estate is currently required to support the with-profits fund and particularly so in light of present market conditions. Prudential's overriding priorities are policyholders' long-term financial security and providing good investment returns for policyholders. A one-off windfall for the current generation of policyholders would reduce the strength of the fund. Prudential's current assessment is that it would not be prudent to weaken the inherited estate by a distribution.

There is a fundamental difference between reattribution and distribution. These words have been used interchangeably but incorrectly by some commentators. In reality they are two different and quite distinct processes.

Any possible reattribution involves shareholders buying-out the policyholders' contingent interest in any potential future distributions of the estate. Current policyholders would get a definite payment now in exchange for a possible payment in the future. The inherited estate would remain in the long-term fund to support with-profits policyholders. Shareholders would have to fund this payment from their own resources and therefore would need to believe an adequate return was possible on this investment.

We have announced publicly that we are looking at the possibility of reattribution of the inherited estate but we have not yet taken a decision. We will proceed with a reattribution only if it is in the best interests of both policyholders and shareholders.

The Court process and the reattribution process set by the FSA provide many safeguards for policyholders on a reattribution.

[41] This submission is from Prudential plc, the group holding company. The Prudential Assurance Company Ltd is the main UK life assurance operating company. For convenience, both companies are referred to as "Prudential" in this submission.
[42] As at 31st December 2007.
[43] As at 31st December 2007.
[44] As at 31st December 2007.

1. Introduction

1.1 Prudential welcomes the Committee's Inquiry into Inherited Estates. There is a great deal of interest in inherited estates and it will provide a useful opportunity to clarify some important issues and to address a number of misunderstandings, misconceptions and myths about inherited estates.

1.2 Any with-profits fund needs to be financially strong to give policyholders the security that their policies will pay the benefits they are expecting. The near demise of Equitable Life underlines this point. A strong fund can support a higher risk, higher return investment strategy than a weak fund, providing better long-term returns for policyholders without compromising their security.

1.3 There are a significant number of with-profits funds in the UK. It is important to understand that each fund is different; they vary in terms of their history, financial strength, how they are managed (for example, in how they assess what should be paid to policyholders), some are open, others closed to new business, some are in mutual companies (ie companies which are owned by their policyholders) and others in proprietary companies (ie companies which are owned by shareholders). This variety means that a "one size fits all" approach cannot be taken to with-profits funds. The FSA recognises this in its approach to regulation.

1.4 There are, however, strong governance requirements around all with-profits funds, including With-Profits Committees (or other independent review), With-Profits Actuaries[45] and FSA regulation in general. This ensures the fair operation of the fund, maintaining the balance between current and future generations of policyholders and between policyholders and shareholders.

1.5 Some commentators have raised uncertainties about the status and purpose of the inherited estate which risks creating misleading expectations among policyholders. In this submission, we clarify why the maintenance of a strong inherited estate is so important to protect policyholders' interests. Comments on the Committee's specific areas of interest are set out at Annex A. Annex B includes more detail on how with-profits works in general and the Prudential With-Profits Fund in particular.

2. An introduction to with-profits

2.1 A with-profits product offers investors a valuable investment option, providing the prospect of competitive long-term rates of return while smoothing the peaks and troughs of volatile market movements and providing valuable guarantees.

2.2 The main features of with-profits products are set out below:

- With-profits often combines insurance (the protection element) and medium to long-term investments (the savings element);
- Policyholders' premiums are pooled with the existing assets of the fund;
- Investment risk and return is spread by means of investment in a broad-based multi-asset portfolio;
- With-profits policies offer investors the prospect of competitive long-term rates of return while smoothing the peaks and troughs of day-to-day market volatility;
- Smoothing occurs when a proportion of the money gained in good years is kept in the fund to enable a reasonable return to be paid during years of poor performance;
- Bonuses are the way policyholders receive their share of the profits of the fund and smoothed payout values. Prudential decides annually on the amount it is prudent to distribute to policyholders by way of bonuses;
- Annual (or regular) bonuses are added to policies each year and, once added, are guaranteed; final bonuses are added at the end of a policy;
- With-profits products can include other guarantees to provide security and certainty for policyholders;
- In a 90:10 fund, policyholders receive 90 per cent of the distributed profits from the with-profits fund, by way of bonus additions to their policies, and shareholders receive the remaining 10 per cent. Sharing investment returns in this way aligns the interests of policyholders and shareholders because both are interested in securing the best possible outcome;
- Companies are required to provide regulatory capital. The provision of guarantees and smoothing requires capital to absorb the impact of market volatility. The maintenance of a multi-asset portfolio containing equities also requires capital to help protect the value of policyholder investments against market movements.

2.3 With-profits funds need a strong inherited estate to provide the financial stability, solvency and investment flexibility necessary for a successful with-profits fund.

[45] See Annex B for an explanation of the role of With-Profits Committees and With-Profits Actuaries.

2.4 With-profits is used across a broad spectrum of products including annuities, pensions and savings products, such as bonds. The with-profits concept is particularly important for pensions, Prudential has over 2 million pension savers in with-profits, where a falling market just before retirement can have a significant impact on the value of the fund. This would have a lasting impact on income throughout retirement. With-profits is also a valuable option for customers with relatively small amounts to invest who want to mitigate the risk of direct investment in higher risk, higher return assets.

3. Governance of With-Profits Business

3.1 The operation of with-profits funds is subject to rigorous governance which ensures that policyholders are treated fairly.

3.2 With-profits businesses are subject to rigorous governance designed to ensure that:

— policyholders are treated fairly

— conflicting interests between policyholders and shareholders are dealt with fairly.

3.3 Within this governance regime, for Prudential, the With-Profits Actuary and the With-Profits Committee (chaired by Andreas Whittam Smith and other expert members independent of Prudential) act to protect the interests of with-profits policyholders.

3.4 A firm must also explain how it manages its with-profits business in a public document called the Principles and Practices of Financial Management (PPFM). More detail on the governance regime is included at Annex B.

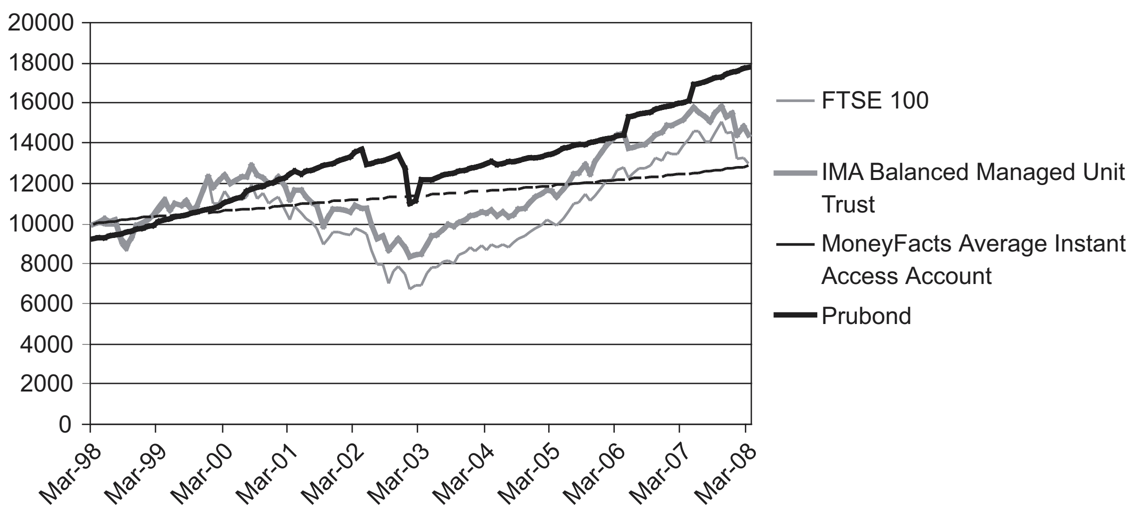
4. The Prudential's With-Profits Fund

4.1 Prudential's with-profits policies have consistently performed well. Strong with-profits performance relies on having a strong with-profits fund which, in turn, means having a large and strong inherited estate.

4.2 The Prudential With-Profits Fund is the largest with-profits fund in the UK, with assets totalling some £74 billion. Prudential has approximately 4.4 million with-profits policies. Of these, 1.3 million are policies with an average value of less than £1,500. Prudential continues to write substantial volumes of new with-profits business—with-profits sales were approximately £2.3 billion in 2007, up 21% on 2006 and sales of Prudential With-Profits Bonds increased 59% in 2007.

4.3 The chart below illustrates how the performance of a Prudential with-profits product compares to a range of other potential products.

Cash-in values for £10,000 investment to 31 March 2008



4.4 The chart clearly shows the benefits of a strong with-profits fund, providing a smoothed return for policyholders and providing protection against market volatility, compared with the performance of other types of funds and products over the same period. For individuals who are reasonably risk averse, and particularly those who do not have large sums to invest, with-profits is a good way of accessing higher risk, higher return investments with the added benefit of protection from the extremes of market volatility.

4.5 The financial strength of the Prudential With-Profits Fund has allowed Prudential to protect policyholders in adverse market conditions. Even in 2002, when markets crashed, provided that a policyholder's investment had been held for at least 5 years, the policyholder had access to funds up to £10,000 with no exit penalties, and those relying on regular income withdrawals were also not affected. Since 2004, the exit penalty free limit has been £25,000, again provided that the investment has been held for at least 5 years. This protection for policyholders was funded from the inherited estate, which was reduced by nearly 30% of its value during 2002 alone.

4.6 The financial strength provided by the inherited estate has also allowed Prudential to follow an investment policy which enabled it to add £2.7 billion in bonuses to with-profits policy values (£1.2 billion in regular bonuses and £1.5 billion in final bonuses) in its February 2008 bonus declaration.

5. The Inherited Estate

5.1 The inherited estate plays a vital role in ensuring the financial strength and performance of the Prudential With-Profits Fund. It provides the solvency capital that ensures security as well as enabling smoothing and investment flexibility. The Prudential With-Profits Fund needs to have sufficient working capital to give it the investment freedom to continue to provide policyholders with outstanding investment returns. To put the size of the fund into context, Prudential's inherited estate of £8.7 billion supports an overall fund of £74 billion and is only around three times the size of the with-profits bonus declaration in February 2008.

5.2 In simple terms, the inherited estate is the capital buffer and working capital for the Prudential With-Profits Fund. More technically, it is the amount of assets in the with-profits fund in excess of what Prudential expects to pay out to meet its obligations to policyholders, based on our assumptions about factors including investment growth, mortality, persistency and new business volumes.

5.3 The inherited estate therefore provides the necessary financial strength for the With-Profits Fund which contributes:

Security

A strong inherited estate provides a real benefit for policyholders and helps ensure policyholders get the benefits they are expecting, even in volatile market conditions. Weaker with-profits funds, which do not have a large inherited estate, cannot offer the same levels of security and smoothing.

Superior Investment Returns

A strong inherited estate allows for greater flexibility in investments. It allows a greater exposure to higher risk, higher return assets and has allowed the Prudential fund to achieve outstanding investment returns for its policyholders over a consistent period. With a weaker inherited estate a more conservative investment strategy would have to be adopted, which would be expected to lead to lower returns to customers.

Smoothing

The ability to smooth returns is fundamental to how with-profits works as it reduces peaks and troughs in payouts and therefore helps protect the policyholder against market volatility. A strong inherited estate is needed to provide this protection.

Solvency

It is a regulatory requirement to continuously hold sufficient capital to withstand adverse conditions, including, in particular, large market falls. Failure to meet this requirement would destroy consumer confidence.

Supporting New Business

A strong inherited estate is needed to ensure we can continue to develop valuable with-profits products to meet the investment needs of current and future generations of policyholders. Weakening the fund could result in reduced consumer choice

5.4 Therefore, contrary to some popular misconceptions, the inherited estate is not surplus to requirements. It is not possible to run a with-profits fund prudently for the benefit of current and future policyholders without a sufficiently strong inherited estate.

5.5 The inherited estate has allowed Prudential to support and protect the interests of policyholders in times of stress and catastrophe, such as the two World Wars, the Spanish flu epidemic and a number of stock market crashes. It is Prudential's view that the whole of the inherited estate is required to support the with-profits fund, particularly in light of current market conditions.

6. Sources of the Inherited Estate

6.1 The generation of policyholders whose policies have paid out since 1990 are net beneficiaries from the inherited estate rather than contributors to it. We do not expect the current generation of policyholders to be net contributors to the inherited estate. Prudential's inherited estate has accumulated from a variety of sources including shareholder contributions. Any payment to the current generation of policyholders in respect of the inherited estate would be a pure windfall.

6.2 A commonly held assumption is that all inherited estates have built up solely from under-payments to policyholders. However, this is not the case for Prudential's inherited estate.

6.3 Overall there has been no contribution to the inherited estate from policyholders whose policies have paid out since 1990 (this includes those who took out policies many years before 1990 which were paid after 1990), as a result of the modern techniques described below. We expect this to continue to be the case for existing policyholders.

6.4 Technological and technical advances in actuarial tools and techniques over the last twenty years have allowed Prudential to be far more confident in calculating what can be paid to policyholders and what should be retained for prudence. Prior to 1990, Prudential did not have access to modern statistical tools which now enable the calculation of multiple scenarios involving changes in equity prices, interest rates, mortality, persistency and new business volumes.

6.5 The main contributors to Prudential's inherited estate:

— The shareholders have made a significant contribution to the inherited estate. They contributed the original working capital to establish the company as Prudential has never been a mutual. Shareholders have also made capital injections over the years. For example, by 1906, accumulated shareholder contributions in the fund were more than £10 million. This becomes more than £6 billion if accumulated to 2007, at the rates of return earned by the fund, after an allowance for tax.

— In addition, from 1951–1988, shareholders took less than their 10% bonus entitlement. During this period of rapid expansion of with-profits sales the working capital, that is the inherited estate, needed to be increased, whilst at the same time preserving policyholder benefits. The shareholders reduced their share of profits over this time to achieve that strengthening.

— Without the benefit of modern actuarial tools and techniques, some past with-profits policyholders (ie those generations whose policies were paid before 1990) received less than they would have using today's methods of calculation. However, at the time it was right that Prudential gave priority to financial security and prudence in deciding what to distribute each year. All Prudential With-Profits policyholders over the years have enjoyed security and competitive returns which has led to Prudential's strong market position.

— In 1990, once Prudential had developed and validated the new "asset share"[46] methodology, it reviewed all in-force policies and enhanced their value to bring them into line with modern asset share methodology.

7. Ownership of the Inherited Estate

7. 1 Policyholders have a contractual relationship with Prudential, and expect to receive their contractual benefits. No expectation has been created that they would receive a distribution of the inherited estate and the legal ownership of the estate is clearly with the company.

7.2 The FSA has confirmed that, it is clear that "A with-profits fund (including the inherited estate) is in law an asset of the insurer".[47] Prudential is not, and has never been, a mutual company and its with-profits fund is not a mutual fund.

7.3 It is Prudential's view that the whole of the inherited estate is currently required to support the with-profits fund and particularly so in light of present market conditions. Prudential's overriding priorities are policyholders' long-term financial security and providing good investment returns for policyholders. A one-off windfall for the current generation of policyholders would reduce the strength of the fund. Prudential's current assessment is that it would not be prudent to weaken the inherited estate by a distribution.

7.4 It is ultimately the Directors' responsibility to determine the risk appetite for the With-Profits Fund. In doing so, they need to take a long-term view of the volatility of markets, the cyclical nature of economic factors and lessons learned from previous bear markets.

[46] See Annex B for a definition of asset shares.
[47] Letter from FSA to Clare Spottiswoode and Mark Hodges on reattribution of inherited estates, 6 December 2007.

8. The Difference Between a Distribution and a Reattribution

8. 1 There is a fundamental difference between reattribution and distribution. These words have been used interchangeably but incorrectly by some commentators. In reality they are two different and quite distinct processes.

Distribution

8.2 A distribution of the inherited estate may follow the emergence of excess surplus. An excess surplus[48] is that part of the inherited estate the Directors have assessed as being additional to the long-term capital needs of the with-profits fund.

8.3 In a distribution:

- the amount distributed is shared on a 90:10 basis (90% to policyholders, 10% to shareholders)
- only current policyholders benefit;
- the Directors are required to decide how much can prudently be distributed;
- the money leaves the estate and is no longer available to support with-profits policyholders.

8.4 Given market conditions and uncertainties about the future, there can be no certainty for current or future policyholders that an excess surplus will develop and hence that a distribution could take place in the future.

Reattribution

8.5 Any possible reattribution involves shareholders buying-out the policyholders' contingent interest in any potential future distributions of the estate. Current policyholders would get a definite payment now in exchange for a possible payment in the future. The inherited estate would remain in the long-term fund to support with-profits policyholders. Shareholders would have to fund this payment from their own resources and therefore would need to believe an adequate return was possible on this investment.

8.6 In a reattribution:

- Policyholders are compensated by shareholders for giving up their potential participation in any possible future distribution(s);
- Reattribution will give current policyholders a certain benefit now rather than a potential benefit in the future;
- The company makes an agreed payment now to current policyholders; and
- All capital remains in the long term fund to support with-profits policyholders.

9. The Current Prudential Position

9.1 We have announced publicly that we are looking at the possibility of reattribution of the inherited estate but we have not yet taken a decision. We will proceed with a reattribution only if it is in the best interests of both policyholders and shareholders.

- Prudential has consistently said over many years that the status of the inherited estate should be clarified. The current debate on inherited estates in general has the potential to create unfounded expectations in relation to ownership. The FSA has now provided detailed guidelines for reattribution.
- Prudential is following this clearly defined FSA process in considering a reattribution to clarify this uncertainty, but we have not yet decided to proceed.

9.2 Deciding whether to proceed is a complex process. It requires complex actuarial calculations, to take account of regulatory capital requirements and to model diverse scenarios over the next 40 years. There are also weighty operational issues to consider. With a large number of small policies it is likely that the average payments to policyholders would be relatively small. The decision about whether to proceed with reattribution will only be taken if it is in the best interests of both policyholders and shareholders taking into account policyholder long-term security and investment returns.

10. Policyholder Protection

10.1 The Court process and the reattribution process set by the FSA provide many safeguards for policyholders on a reattribution:

- The current reattribution process is set, and is overseen, by the FSA and is designed to protect policyholders by ensuring they are treated fairly in the reattribution.

[48] A fuller definition of excess surplus is given at Annex B.

- The FSA requires each company to appoint an independent Policyholder Advocate (PHA) to negotiate on behalf of policyholders—at present Prudential has only nominated a PHA, Peter Bloxham, because we have not yet decided to pursue a reattribution.
- The PHA (and his terms of reference) must be approved by the FSA. This is to ensure his independence and suitability.
- A Reattribution Expert is also appointed by the company[49] to assess the reattribution proposals objectively and prepare a report for the Court on the implications of the proposals for policyholder security and benefit expectations.

14 April 2008

Annex A

RESPONSES TO SPECIFIC AREAS OF COMMITTEE INTEREST

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

The FSA defines an inherited estate as an amount representing the fair market value of with-profits assets, less the realistic value of liabilities of a with-profits fund. This means that an inherited estate:

- is defined as the total assets of a with-profits fund less the amount that the fund expects to pay out to policyholders;
- includes the working capital of a with-profits fund (eg capital required to meet regulatory capital requirements and for investment flexibility, smoothing and security for policyholder benefits).

As a result, it should not be assumed that an inherited estate is surplus to the requirements of the business. Section 5 above explains how an inherited estate provides working capital for a with-profits fund in more detail.

- The FSA has commented that an inherited estate is usually made up of previous and current policyholders' premiums and investment returns, or past injections of capital from shareholders.[50]
- This is not true in the case of Prudential. Overall, the current generation of Prudential policyholders has not contributed to the inherited estate.
- The Prudential inherited estate has arisen from shareholder contributions and the prudent management of the business. Prudent management of a long-term savings business is critical to policyholders.
- Whilst, with the benefit of modern actuarial modelling techniques, it might have been possible to pay more to policyholders maturing before 1990, Prudential believes payouts to its with-profits policyholders have been competitive and that this accounts for the strong market position of Prudential today.

The extent to which life assurance companies should be permitted to diminish the 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.

The Prudential With-Profits Fund is a dynamic entity.

- It requires new products and new customers to continue in business and importantly to continue to provide benefits to existing and future customers.
- The Prudential inherited estate is clearly owned by the company and not by policyholders.
- In addition, Prudential policyholders have no expectation of a distribution from the inherited estate.

As the working capital for the With-Profits Fund, it is appropriate that the inherited estate be used for purposes properly attributable to the business of the With-Profits Fund. This includes:

- financing change in infrastructure;
- product development;
- new business sales;
- mis-selling costs;
- and tax on transfers to shareholders from the Fund.

As the FSA stated in its letter of 6 December 2007[51] it is acceptable for a company to charge shareholder tax to the fund where it is "consistent with its established practice and that established practice is explained in the firm's PPFM". This is the case with Prudential.

[49] The terms of reference and suitability of the Reattribution Expert must also be approved by the FSA.
[50] FSA general information on reattribution of inherited estates available at www.fsa.gov.uk/pages/Doing/Regulated/newcob/estates.shtml
[51] Letter from FSA to Clare Spottiswoode and Mark Hodges on reattribution of inherited estates, 6 December 2007.

In a statement in November 1998, the then Economic Secretary to the Treasury, Patricia Hewitt, made clear that it is acceptable to meet the costs of mis-selling from the inherited estate[52] and, subject to the review indicated in the FSA's letter of 6th December 2007, this position has also been endorsed by the FSA.

Although it is appropriate for the inherited estate to be used for the purposes above, Prudential's policy is that such uses must not have a material adverse effect on the reasonable benefit expectations of existing policyholders.

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

The inherited estate does not "subsidise corporate activity" as the funds belong to the company. It is used only in connection with the company's with-profits business.

- The capital provided by the inherited estate is used by the with-profits business for the benefit of both current and future policyholders and shareholders.
- There are, and have for many years been, strict rules on the uses of an inherited estate, which Prudential is required to follow.
- The with-profits concept meets a consumer need for smoothed products and guarantees and is used across a wide range of savings and retirement products (see Annex B for more detail on this). This provides choice for consumers.
- The existence of an inherited estate is an integral part of any with-profits business.
- The size and strength of its inherited estate may affect the way in which the fund is managed.

There is nothing to prevent new entrants setting up a with-profits fund.

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

- A reattribution is not a division of the inherited estate or a distribution.
- The amount paid to policyholders should be negotiated to reflect all the relevant circumstances.
- The continued provision of security and investment flexibility for policyholders should remain the paramount consideration.
- A payment is made by shareholders from their own funds to compensate policyholders for giving up their 90:10 participation in possible distributions from the inherited estate in future.
- All capital remains in the long-term fund to support with-profits policyholders.
- In the case of Prudential a reattribution payment would effectively be a windfall for the current generation of policyholders.

The FSA letter of 6 December 2007 sets out some of the key issues which firms must consider in the context of a reattribution.

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

The Prudential must have regard to the long-term interests of all policyholders, not just the current generation and needs to balance any conflicting interests that arise between the various groups and generations of policyholders or between policyholders and shareholders.

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

The relationship between the company and the policyholder is one of contract. The contract provides that policyholders receive what is due to them based on asset shares. In Prudential's case, no reasonable expectation of a distribution of the inherited estate has been created.

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

- A distribution of an inherited estate is an unusual event. It should only be made at a level and over a period which the company believes does not impair policyholder security or the ability of the estate to support the fund's investment risk appetite. It should also take account of expected new business and the need to protect against future risks and uncertainties.
- It is always appropriate for the company to take a cautious approach, particularly in a time of volatile markets.

[52] "In many cases, use of the inherited estate to meet personal pensions mis-selling costs is a sensible way to protect policyholders from immediate and severe cuts in their bonuses". Patricia Hewitt, Economic Secretary to the Treasury, 3 November 1998.

— An appropriate level of inherited estate is always required to support policyholder security and to maintain returns to policyholders, as well as for statutory solvency.

— In the normal course of business, policyholders continue to receive "benefits from the inherited estate" in the form of enhanced investment performance and security.

A reattribution by contrast would involve a payment from shareholders to policyholders. The capital represented by the inherited estate remains in the long-term fund to support with-profits policyholders.

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

A Policyholder Advocate is an independent person, appointed to represent policyholders in a specific company throughout a reattribution process. Prudential has nominated a Policyholder Advocate. He will only be appointed if Prudential decides to proceed with a reattribution.

A Policyholder Advocate must be approved by the Financial Services Authority (FSA) who also approve his or her Terms of Reference. Given his or her role, the FSA expects any proposed Policyholder Advocate to be free from any conflicts of interest which may be detrimental to the interests of the policyholders he or she represents. He or she must also have the skills and knowledge required for the role.
The role of a Policyholder Advocate is to look after the interests of affected with-profits policyholders. The Policyholder Advocate negotiates with the company, to ensure that with-profits policyholders receive a fair deal from the process. He or she will be interested in such areas as:

— the size of the inherited estate;

— the current and expected future uses of the estate and the likelihood of future distribution from the inherited estate occurring;

— the size of payments to policyholders;

— the way in which incentive payments (which might be made either as cash or as additional bonuses to policies) are to be calculated and paid; and

— the safeguards to be put in place to protect policyholders in future.

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

The concept of with-profits committees was introduced by the FSA in 2004. The Prudential With-Profits Committee was established in January 2005.
The role of Prudential With-Profits Committee is to provide an independent judgement on:

— The way in which Prudential exercises discretion in relation to with-profits business and how any competing or conflicting rights and interests of policyholders and shareholders have been addressed;

— Compliance with the Principles and Practices of Financial Management.

The Committee may raise concerns with the Company directly or may approach the FSA.
Prudential's With-Profits Committee is made up of individuals who are independent of Prudential. The members of the Committee are:

— Andreas Whittam Smith, First Church Estates Commissioner and the founding Editor of the Independent newspaper;

— Michael Arnold, Head of the Life Practice at Milliman (a major actuarial firm); and

— Paul Thornton, a past President of the Institute of Actuaries.

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

The FSA's letter of 6th December 2007 outlines their views on some of the key issues relating to inherited estates. In general terms, Prudential agrees with that letter. However, it should be noted that it is a generic letter whereas the circumstances relating to each fund will be different.

Annex B

WITH-PROFITS PRODUCTS—FURTHER INFORMATION

The with-profits concept is used across a broad spectrum of products, including annuities, pensions and savings products (including bonds and endowments). Consumers have a choice of a wide range of savings products including:

— bank deposits, generally assumed to be safer, but with a lower return;

— with-profits which typically gives access to higher return investments, often coupled with a life insurance element, while reducing the impact of market volatility by giving a smoothed return to consumers;

— unit-linked products (or direct investment for example in equities) which are fully exposed to the market.

Bonuses

Policyholders share in the profits of the fund via bonuses. There are two main types of bonuses.

Prudential expects to add regular (or reversionary) bonuses to policies each year. Once added, these bonuses cannot be removed and capital is required to support the increased level of liabilities.

Final (or terminal) bonuses are additional bonuses which Prudential would expect to pay when the policy pays out. Final bonuses vary in line with investment performance over the life of a policy.

Sharing Profits

Prudential policyholders receive 90 per cent of any profits distributed from the with-profits funds, through the addition of bonuses to their policies. Shareholders receive the remaining 10%.

Smoothing

Policyholder returns are generally smoothed to protect against market volatility. Smoothing occurs when a proportion of the investment return during good performance years is held back to ensure that a reasonable return can be paid to policyholders during years of poorer performance. This provides smoothed increases in the value of the policy as opposed to the fluctuations that would occur if a policy reflected the volatile movements in the prices of stocks and shares and property. This smoothing is particularly helpful to small investors.

Asset Shares

Benefits under Prudential with-profits policies are set by reference to what are known as "asset shares".

To meet our objectives for fair smoothed pay-out values we target them on the asset shares of a representative set of sample policies.

The asset share of a sample policy is a fair value of the assets that have been accumulated to back the policy, and is calculated by accumulating the premiums paid (less allowance for expenses and charges) at the actual rates of investment return earned on the underlying assets in the fund over the lifetime of the policy.

Prudential aims to pay 100% of asset shares over time.

Smoothing is applied so that the claim values actually paid (which include the accrued annual bonuses and the terminal bonus) change only gradually over time. Prudential's intention is that any smoothing profits or losses should balance out over time, so that in the long run with-profits policyholders as a whole neither gain nor lose as a result of our smoothing policy.

Excess Surplus

An excess surplus is that part of the inherited estate that the company has assessed as being additional to the needs of the with-profits fund. Before deciding there is an excess surplus, the company should be confident that it can maintain policyholder security and still have access to sufficient capital to continue to operate within the fund's risk appetite, to support expected new business and to protect itself against future risks and uncertainties.

With-Profits Actuary

All with-profits funds must appoint a With-Profits Actuary.

The With-Profits Actuary advises the board of directors on the exercise of discretion in relation to its with-profits business, for example in the setting of investment and bonus policy and smoothing. The firm is required to keep the With-Profits Actuary informed and must request his advice on the likely effect of a material change in the firm's business plans on with-profits policyholders. The With-Profits Actuary has the right to speak to the FSA about concerns over the management of the with-profits fund.

The With-Profits Committee

The Prudential With-Profits Committee provides independent judgement on whether the firm has complied with its PPFM and considers conflicting rights and interests of policyholders and shareholders. The Prudential With-Profits Committee is made up of individuals who are independent of the firm's management team.

How a Reattribution Works

A reattribution involves negotiations to determine how much with-profits policyholders should be paid now to compensate them for giving up their 90% interest in any potential future distribution of the inherited estate, if any such distribution were to be made. Examples of issues which must be considered include:

- the company's contractual obligations;
- policyholders' reasonable expectations
- policyholders' security;
- the sources of the Estate; and
- the likelihood of any future distribution.

The amount individual policyholders receive under reattribution would vary: the overall payment should be divided fairly, and may take into account such factors as policy size and term.
Any proposal for reattribution will be put to a vote of policyholders. It will be commented on by the Policyholder Advocate (who may or may not make a recommendation to policyholders) and the range of other governance bodies referred to in this submission.

In addition it needs to be approved by the Court where policyholders will have the opportunity to be heard. The Court will need to be satisfied that the proposal is fair.

To assist the Court, it will receive a report prepared by a Reattribution Expert. The Reattribution Expert assesses objectively the reattribution proposals and prepares a report for the Court on the implications of the proposals for policyholder security and benefit expectations.

Principles and Practices of Financial Management (PPFM)

A firm must also explain how it manages its with-profits business in a public document called the Principles and Practices of Financial Management (PPFM).

A PPFM, as the name suggests, is divided into principles and practices. Principles must be enduring statements of the overarching standards which the firm adopts in managing its with-profits business, and must describe the business model used by the firm in meeting its duties to with-profits policyholders and in responding to longer-term changes in the business and the economic environment. In contrast, practices should describe the firm's approach to managing its with-profits business and responding to changes in the business and economic environment in the shorter term. Practices are expected to change as the firm's circumstances and the business environment change.

The PPFM is required to cover the main areas where a firm has discretion in relation to its with-profits business, such as investment and bonus policy, smoothing, charges and expenses, volumes of new business and the management of any inherited estate.

Management of the Prudential With-Profits Fund

The principles and practices applied in the management of the With-Profits Fund are set out in Prudential's PPFM. The following extracts from the PPFM summarise our approach to the management of the Fund:

Payouts to policyholders: The main objectives of the company's bonus distribution policy are to:

- give each with-profits policyholder a return on the premiums which he or she has paid that reflects the earnings of the underlying investments, whilst smoothing the peaks and troughs of investment performance; and
- ensure that with-profits policyholders receive a fair share of the profits distributed from the with-profits fund by way of bonus additions to their policies.

Smoothing: Our intention is that smoothing profits and losses should balance out over time so that in the long run with-profits policyholders in each sub-fund, or within a product group with a specific smoothing account, neither gain nor lose as a result of our smoothing policy.

We therefore do not expect the Inherited Estate to grow as a result of smoothing.
Investment policy: The company's investment strategy is to seek to secure the highest total return (allowing for the effect of taxation and investment expenses) whilst:

- maintaining an acceptable overall risk level (having regard to the currency, nature and outstanding duration of the liabilities) for the long-term fund; and
- maintaining an appropriate and broad mix of suitable investments, and protecting appropriately the relative interests of all groups of policyholders.

Charges: The overall aim of the expense charging and allocation methodology is to seek to ensure that all expense allocations are fair between different groups of policyholders and shareholders and between different sub-funds.

Memorandum from John Pilkington, Andrew Edgington, and Philip Meadowcroft, Aviva/ Norwich Union With-Profits Policyholders' Action Group

Dr Pilkington, Mr Edgington, and Mr Meadowcroft are with-profits policyholders who qualify for participation in the proposed Reattribution of the CGNU/CULAC Inherited Estate (funds managed by Aviva / Norwich Union). Since 27th January 2007 they have campaigned via their action group's website and in the national press to present policyholders with evidence-based research and opinion together with website discussion to enable them to make an informed assessment of what is being proposed to them by Norwich Union's parent company Aviva. The action group has contributed to a wider awareness and understanding of the key issues for policyholders. This submission has been informed by contributions from group members.

Contents of Submission

1. Background Issues

- Difficulties ensuring that policyholders' views are taken into account
- Problems with Terminology
- Why are such vast surpluses allowed to grow in the with-profit funds?
- What has happened to the Sandler Review?

2. Evidence on Specific Issues posed by the Enquiry

3. Suggested questions which we would like to be put to (a) Aviva (b) FSA (c) Policyholder Advocate.

Background Issues

1. *Difficulties ensuring that policyholders' views are taken into account*

1.a. The reattribution negotiations are taking place between Aviva/Norwich Union and an unrepresentative third party, the Policyholder Advocate, appointed by Aviva. Policyholders have been completely excluded from the reattribution negotiations although their stake in the Inherited Estate is the greatest at 90%, at least. The company has a contract with policyholders, but, under FSA rules, it is not required to negotiate direct with a committee of policyholders, thus excluding them unfairly from the process.

1.b. This unfair exclusion is typified by the company's repeated advice (see December 2006 letter) to policyholders to do nothing. On such an important and complex issue, having a direct bearing on policyholders' finances, its obligation to treat customers fairly should have required it to stimulate discussion; facilitate enquiries; form a panel of policyholders; promote their involvement etc. Aviva's unwillingness to take such action has led many informed policyholders to suspect that the company's aim has been to stifle debate and discourage comment.

1.c. In this context, the authors of this submission have formed—without assistance of any kind—an informal association of affected policyholders, which can be found here:
http://groups.google.co.uk/group/norwich-union-policyholder-reattribution?hl=en

1.d. As far as we are aware, we are the only group of directly affected policyholders. We comment on behalf of all who belong to our group.

Problems with Terminology

2. *"Reattribution" and "Inherited Estate"*

2.a. "Reattribution" and "inherited estate" are unnatural and technical terms that, we believe, serve mainly to conceal what the companies are up to; muddy the water; confuse policyholders, press and media and mislead them to into believing that something legitimate, technical and special is being proposed. The terminology has hampered discussion and debate. The process should be called something simple and accurate, such as:

"Transferring With-Profits Policy surpluses to Shareholders".

2.b. Our view is that companies use this complex jargon to deliberately conceal what the exercise is all about; namely, the acquisition of policyholders' money by directors for the benefit of shareholders.

3. *Why have companies built such vast surpluses in the With-Profits Funds?*

3.a. Concerned policyholders, many of them looking at dismal returns on pensions, bonds and endowment mortgages and having to make new plans, have reacted with bewilderment and dismay at a rapidly growing Inherited Estate within the With-Profits policies. Meanwhile shareholders (including of course many senior Aviva directors with large shareholdings) look on at the prospect of a huge payout in return for no financial contribution. How can such contrasting experiences be justified? Our view is that "smoothing" has been used to justify the transfer of policyholder money into a section of the funds where it can be acquired by shareholders.

4. *What has happened to the Sandler Review?*

4.a. Why has the FSA opposed it? We would support in general the recommendations on With-Profit funds ie:

The "stakeholder with-profits" product should be required to have all of the following features, ...

— explicit "smoothing account with smoothing designed to be neutral over the long run;
— a "100/0" management arrangement, with an explicit management charge to a separate management company and no shareholder participation in with-profits payouts;
— disclosure of the underlying smoothed and unsmoothed asset values; and
— standard rules for the calculation of charges for the product to ensure consistency and comparability.

Extract from Sandler Review 2002

4.b. Implementation of these proposals would have controlled and reduced the accumulation of unjustified sums of money in the Inherited Estate, thus preventing the problem from arising in the first place. It would have defined and clarified the interest of shareholders in the money, and prevented the possibility of shareholders acquiring huge sums of policyholders' money in the Inherited Estates.

Evidence on Specific Issues Posed by the Inquiry

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

> "When I use a word," Humpty Dumpty said, in a rather scornful tone' "it means just what I choose it to mean, neither more nor less."

5.a. Policyholders have found this most confusing. Much time and energy has been wasted on the "ins and outs" of legal ownership. Aviva/Norwich Union has behaved like Humpty Dumpty. Several policyholders have searched through opaque, complex, confusing and poorly written annual reports to try to educate themselves and others about with-profits funds in general and inherited estates in particular. They have written to Aviva seeking information about the size of the CGNU and CULAC inherited estates, flows of money in and out, definitions of "surplus" and "excess". They have been met with a dismissive and confusing set of responses.

5.b. According to the Q&A booklet that comes with the letter announcing the Special Bonus it states:

> "An inherited estate is money that has built up in a with-profits fund over many years, which is above the amount that is expected to be needed to meet current and future policyholder commitments and other obligations such as tax and expenses."

5.c. Elsewhere it states:

> "An 'excess surplus' is an amount in the inherited estate of a with-profits fund that the board of directors considers to be above and beyond the amount needed for the inherited estate to perform its role now and in the future"

5.d. So, the entire Inherited Estate is "above and beyond" the money required to meet the needs of all our policies, including all expenses and taxes. That's simple enough. Aviva goes on to state:
"This distribution is a 'special distribution' because there is an 'excess surplus' in the inherited estate of the with-profits funds."

5.e. According to the Compact Oxford Dictionary, the word "excess" is defined: "an amount that is more than necessary", and the word "surplus" is defined: "an amount left over when requirements have been met". So, Aviva is quite clearly stating that the Inherited Estate is more than necessary to support With-Profits Fund.

5.f. But, and this is where Aviva's "sleight of hand" starts to emerge, Aviva then goes on to put forward a revised definition:

> "A distribution and the resulting special bonuses are paid from an 'excess surplus' of capital in the inherited estate of these with-profits funds. The remaining inherited estate will continue to provide the necessary capital reserves to manage risk, provide guarantees, and allow investment freedom and smoothing."

5.g. Herein lies the sleight of hand, and the smoke and mirrors of Aviva's con trick. Aviva has already defined the ENTIRE Inherited Estate as "EXCESS SURPLUS",

5.h. However, through Aviva's use of "double-speak", it is now attempting to confuse everyone by subsequently claiming that part of the EXCESS SURPLUS is actually required to "provide capital reserves to manage risk, provide guarantees, and allow investment freedom and smoothing".

5.i. It is quite clear to policyholders what Aviva is doing. Aviva is using this revised definition as a pretext for holding the money back and transferring it to shareholders under the "reattribution" con trick. Without the revised definition there is no excuse for failing to carry out a 90:10 distribution. With the revised definition it can confuse everyone and attempt to justify retaining policyholders' money and transferring it to shareholders under "reattribution".

6. 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.

6.a. Policyholders are shocked, dismayed and angered to have discovered that Norwich Union has been using the Inherited Estate to do these things.

6.b. The figures may be relatively small (though not small in absolute terms),but the idea that Aviva Staff Pension Scheme (ASPS) is bolstered by policyholders' money at a time when returns on their investments have been dismal, and with 90%+ mortgage endowments now 'red' fills them with anger. It is bizarre that funding shareholders tax bills; underwriting new business; meeting mis-selling costs and plugging Aviva's staff pension fund deficits are seen as first calls on policyholders' money in the Inherited Estates. At the same time, Aviva is somehow able to pour eye-watering sums into senior executives' salaries and pensions eg:

> "Richard Harvey, head of Britain's largest insurer, Aviva, will leave the company in summer with a pension pot worth at least £12.5m, giving him about £600,000 a year, the company's annual accounts reveal. The revelation is expected to add to the distress of Aviva's 2.8 million Norwich Union customers, who have seen the value of their with-profits policies fall dramatically in recent years.

Mr Harvey, 56, also received pay and bonuses worth £2.7m last year, despite an aborted attempt to merge with the Prudential and a long term failure to raise the company's share price above the FTSE 100 trend and a benchmark of 19 rival firms."

Aviva press statement on retirement of Richard Harvey

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

7.a. This is a highly technical question and we are not really able to comment, except to say that the issue would not arise if companies made 90:10 distributions of Inherited Estates and did not allow huge sums to build up which they then seek to use for their own purposes against the interests of policyholders.

8. The principles that should guide the division of inherited estates in

90:10 funds between policyholders and shareholders upon reattribution of the estate.

8.a. 90:10 should be the firm guide as per the 1995 DTI Ministerial Rule. It has already been established. We consider that under a reattribution Aviva is failing to treat its customers fairly. Aviva identified the entire CGNU/CULAC Inherited Estate, valued at £5 Billion at December 2006, as being in excess of that required to support the With-Profits Fund investments in any conceivable economic climate that may prevail in future. Therefore, Aviva should have no need whatsoever for retaining any part of the Inherited Estate. We therefore consider that the entire reattribution plan, which Aviva is hoping to put in place, is a deliberately complex and elaborate ruse that allows Aviva to devise obscure arguments and artificially created reasons why it should not simply disperse the surplus funds, as per the 90:10 Ministerial Rule, under a straightforward Distribution.

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

9.a. This question only arises in the context of a reattribution. If Inherited Estates were distributed 90:10, the only issue would be about identifying the fairest way of reflecting the allocation of the distribution to the various types of qualifying policyholder. Aviva and the use of a Policyholder Advocate in a reattribution plan, has encouraged a divisive and unnecessary debate about the respective rights of different classes of policyholder. At times this has felt like a diversionary tactic to take attention away from the injustice of the whole concept of reattribution. In conclusion we feel this is a debate, which should take place only in the context of a 90:10 distribution.

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

10.a. It is undeniable that, having paid money into the with-profit funds (unlike shareholders and employees) policyholders have equitable rights to the money in the Inherited Estates. Policyholders have a reasonable expectation of a fair share through a distribution or reattribution following an annual review (Conduct of Business 6.12.57; 6.12.60). It is, incidentally, unreasonable and unfair of companies to announce that they have no intention of arranging future distributions. This is seen by policyholders as a crude attempt to create a "bird in the hand" mentality amongst policyholders and bully them into voting for reattribution.

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

11.a. The Aviva proposals tabled in February 2008 are vindictive, and involve a penny-pinching betrayal of an estimated 40,000 policyholders who will lose out. Aviva announced an eligibility date of 21st November 2006 for the reattribution exercise, therefore the least one might expect of a firm with a reputation would be a degree of honesty. Aviva has conveniently forgotten that it was perfectly free to carry out a 90:10 distribution at any time over the last 2 years.

12. The role and responsibilities of the Policyholder Advocate.

12.a. Many policyholders feel that this highly paid team should not be necessary. There would be no need for the role if we had:

- A proper system based on a With-Profits regime that did not encourage the creation of vast Inherited Estates;
- a compulsory annual review of Inherited Estates that do arise and an immediate 90:10 distribution

12.b. The Policyholder Advocate role is essentially created to compromise. The Policyholder Advocate has no power to stop an unfair reattribution from taking place. The Policyholder Advocate can only explain and warn. It is rather like giving the victims of street crime an advocate. The "Muggers' Advocate" will warn you of the impending mugging; explain how the mugger intends to assault you, then tell you how much you are likely to lose and how injured you are likely to be. He/she may call the police (FSA) but they will probably sympathise with the mugger, give you a crime number and leave.

12.c. The process of consulting policyholders has been weak and frustrating. Admittedly, this was the first reattribution to involve a Policyholder Advocate. From a policyholders' perspective the insurance company, Policyholder Advocate and FSA hold all the cards and information. The timescales allowed to them have been generous but that allowed to policyholders has been very short. The initial consultation was frustrating in the extreme. Only a few (five) Policyholder Advocate "Roadshow" meetings were held in inconvenient locations, at which hurried discussions were held, in the presence of Norwich Union staff collecting copies of policyholders questions and being given the opportunity to filter them. Policyholders were then soon to be told the consultation period was over when even the most concerned and fanatical policyholder was struggling to get a grip on the issues. And there has been the continual repetition of the message 'You do not need to do anything at this stage'. Consulting an IFA is no option since IFA's have invariably told their clients that they had insufficient information from Aviva on which to base any course of recommended action.

12.d. Likewise, under the Terms of Reference under which Clare Spottiswoode was appointed as Policyholder Advocate, she has been effectively "gagged" and has been totally prevented from disclosing any information to policyholders throughout. Such opacity of dealing, which directly affects some 1.1 million policyholders, has created the feeling that Aviva is attempting to steal as much of the Inherited Estate from policyholders as possible.

12.e. Having said that policyholders recognise that we are where we are and wish to pay tribute to the work of Ms. Spottiswoode and her team in battling with Aviva and the FSA.

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

13.a. See above—it is an unfair basis for negotiation

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

14.a. Until the Policyholder Advocate referred to the With-Profits Committee in early 2008 policyholders had not been made aware of its existence. It is totally bizarre that the With-Profits Committee should be called "Independent". Does anyone, repeat anyone, seriously believe that such a committee, remunerated by Aviva, could be independent? This assertion by Aviva simply fuels and reinforces the belief that transparency is not an over-arching principle of Aviva's commercial conduct.

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

15.a. We fully support Clare Spottiswoode's comments about the FSA when she criticised its passivity. The FSA is responsible for regulating companies With-Profits Funds and have set the rules for distributions and reattributions. At the moment the FSA chooses to do so passively, and in a way which favours company shareholders at the expense of policyholders.

In its reply to Clare Spottiswoode in December 2007 the FSA said:

"If the reattribution proposal is to divide value between policy holders 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 policy holders awaiting a potential future 90:10 distribution."

So on one hand we have a ministerial statement that inherited estates should be distributed on a 90:10 basis, and on the other, the FSA saying that companies can choose not to distribute, and bully policyholders into voting for reattribution which would give them much less than 90:10, because that option would be better than nothing.

15.b. The COB rules (para 6.12.57–60) state that an annual review of the Inherited Estate is required, followed by a distribution or a reattribution. Therefore, how can the FSA then imply, quite clearly, that a company can keep policyholders waiting, possibly forever, for a future distribution? How can the FSA allow Aviva to keep saying that it may choose to do nothing, and sit on its hands? How can the FSA allow companies to effectively threaten policyholders with 'Vote for our reattribution offer as it's all you may get'? This is disgraceful arm-twisting and the FSA supports it.

15.c. Several policyholders have complained formally to the FSA in relation to various aspects of its regulation of the reattribution process and the "Special Distribution". For example, for its unreasonable failure to use its discretion to intervene in the unfair decisions surrounding eligibility for the Special Distribution, and the phasing of payments. To date, NONE of the complaints have been accepted. Complaints against the FSA are dealt with administratively, apparently with the sole aim of preventing any consideration of reasonable complaints.

15.d. Policyholders wish to see the FSA providing strong and effective regulation, by using its discretionary powers to intervene vigorously in the interests of policyholders whose money makes up the Inherited Estates.

Suggested Questions we would like to be put to:

(a) AVIVA

(b) FSA

(c) POLICYHOLDER ADVOCATE

Questions to AVIVA

1. *What good reasons prevent you from returning the entire Inherited Estate to policyholders in a 100% distribution paid on a pro-rata basis to all eligible policyholders?*

2. *Why have you recently announced that your Special (Pre-Reattribution) Bonus will only be paid to policyholders who have "live" policies on 1st January 2008 and that to receive the full special bonus, their policies must still be in force at 31st December 2010?*

3. *Why should your shareholders obtain any capital from the release of the Inherited Estate either under reattribution or distribution in a greater proportion than either its pro rata contribution to the Inherited Estate, or 10% as stated in the Ministerial Statement?*

4. *Why do you keep telling policyholders there is no prospect of future distributions when FSA rules require an annual review and a distribution/ reattribution?*

5. *Given the growth of the Inherited Estates and recent dismal returns to with-profits policyholders do you accept your "smoothing" policy has been a failure?*

6. *Given the 90:10 principle do you think it is fair to policyholders that you reportedly plan to offer them just £0.7bn in incentive payments to transfer £2.4 billion to your shareholders who have contributed nothing to the estates?*

7. *Bearing in mind that the Treasury Committee told the FSA at its hearings in January 2008 that with profits insurers were seeking to "diddle" their policyholders over the Inherited Estates, do you accept that Aviva is continuing to "diddle" its policyholders?*

8. *You say that policyholders have not contributed to the Inherited Estate. Who, instead, has contributed, bearing in mind that the Inherited Estates have grown out of the With Profits funds to which policyholders have paid their premiums ?*

9. *If policyholders have not contributed to the Inherited Estate, why does Aviva not simply take the entire Inherited Estate for shareholders without any reference to policyholders at all?*

10. *How does your "With Profits Committee" possess the independence and transparency, which you insist it has, given that its Chairman and members are remunerated by you?*

QUESTIONS TO FSA

1. *Why have you chosen not to direct Aviva to achieve an overall result close to 90:10; and will you use your powers to intervene to direct that the Special Bonus be paid as one lump sum to all eligible policyholders, so that it fulfils the strict criterion of being a 90:10 distribution?*

2. *Will you insist that eligibility for the Special Bonus includes all policyholders whose policies matured between 21st November 2006 and 31st December 2007?*

3. *Do you consider that Aviva is "treating customers fairly" and meeting "policyholders' reasonable expectations" when it has consistently removed more money from the policyholders' With-Profits Fund under its "smoothing" policy and not returned all of the money in annual and terminal bonuses, and retaining some of these "smoothed" funds and placing such funds in the Inherited Estate, for which it now wants to claim more than 10%, even after it already takes management and other charges etc. for handling policyholders' funds within the With-Profits Fund?*

4. *How is it fair of you to allow Aviva to use the Inherited Estate for mis-selling to plug deficits in the Aviva pension scheme; staff pensions; and new business when policyholders' finances are in tatters?*

5. *Will you change your rules to require direct and significant policyholder involvement in future negotiations over inherited estates?*

7. *Your Board says it believes in a "fundamental philosophy of outcomes-focused, more principle-based regulation". In simple English what does this mean and why do you have such a belief when the 1995 DTI Ministerial Rule indicate that the normal attribution of the Inherited Estate should be 90:10 policyholder: shareholder ?*

8. *In what ways have you ensured that Aviva has been "Treating Customers Fairly" in the actual manner in which Aviva has been managing its Reattribution plan thus far, including the unexpected Special Bonus which Aviva's CEO has declared in the recent 2007 Annual Report has "cleared the way" for Aviva to complete its Reattribution plan (despite Aviva's claim that the Special Bonus has nothing to do with Reattribution)?*

9. *Have you considered why the media and respected consumer organizations, such as Which? have all, without exception and from the outset, found Aviva's Reattribution plan both lacking transparency and to be fundamentally flawed?*

Questions to Policyholder Advocate

1. *Do you feel you should have greater power to require an overall result closer to 90:10?*

2. *Do you feel that you should have been appointed by policyholders?*

3. *What 3 changes would you make to the regulatory framework in relation to with-profits industry in general and inherited estates in particular?*

4. *Do you think that your Terms of Reference should permit you to disclose whatever information you think fit to policyholders at any time of your choosing?*

5. *Do you think that the FSA has devised Reattribution rules and guidelines, which are fit for purpose? If not, why not?*

6. *Has Aviva been open and honest with you at all stages during your term as Policyholder Advocate?*

http://groups.google.co.uk/group/norwich-union-policyholder-reattribution

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Memorandum from the Office of Fair Trading

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.[53] 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 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 with-profits 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.

[53] Treasury Select Committee Press Notice No. 26 issued on 26 February 2008.

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 polices) 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: 20 or so year ago, when with-profits 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 with-profits 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)[54] conclude that the typical characteristics of a with-profit product compared to other products are:

- the smoothing of benefits;
- the build up of guarantees over time; and
- the fact that, in many cases, the policyholder participates, through the operation of a bonus pool, in the profits and losses of the company.[55]

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 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.

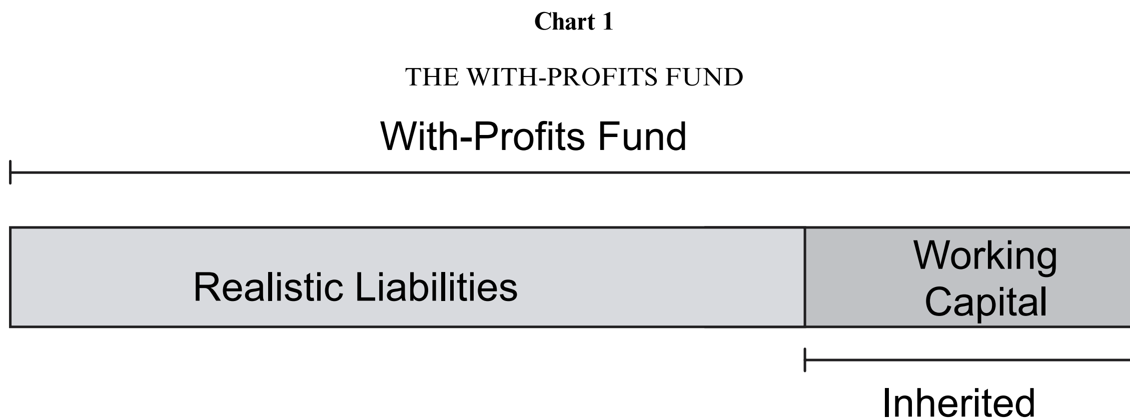
2.6 As stated by the FSA the inherited estate "provides working capital for the with-profits fund in the longer term and supports its operation".[56] The FSA set out the definition of working capital in relation to with-profits products in its Briefing Note BN017/06:

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."

2.8 This is illustrated in Chart 1 below.

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

[54] 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.
[55] These are very similar to the distinguishing features of with-profits pointed out in the 2002 Sandler Review.
[56] FSA, The Process for Reattribution of Inherited Estates

has a strong capital base or so that it can invest in more volatile investments that provide scope for greater long term returns.[57] The FSA has further clarified that such funds in the inherited estate have been used to:[58]

— 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 the provision of additional services to customers; and

— 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.[59]

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.

Chart 2

THE WITH-PROFITS FUND WITH A SURPLUS

With-Profits Fund

Realistic Liabilities | Working Capital | Surplus

Inherited Estate

2.13 Any surplus arising may be distributed between policyholders and shareholders.[60] In a 90:10 fund, policyholders receive 90% of the surplus, and shareholders 10%. 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.[61]

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 company compensate the

[57] FSA Consultation Paper 207 ("CP207"), "Treating with-profits policyholders fairly", at paragraph 5.2.
[58] In its letter to Clare Spottiswoode and Mark Hodges of 6 December 2007.
[59] This opinion is based on information provided by the FSA, but in the time available we have not verified it with industry participants.
[60] 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.
[61] See paragraphs 5.6 and 5.7 of CP207.

policyholders for giving up their claim on distributions that might occur due to a surpluses 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 reattributions 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 with-profits 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 with-profits 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:[62]

- the new with-profits regular premium business has declined in recent years from £4,108 million in 1985 to £295 million in 2005;
- in contrast, non-profit business has risen in the same period from £1,062 million to £3,723 million; and
- 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 with-profits policyholders in 2006 numbered approximately 340,000 compared with over five million in each of the years 2001 and 1996.[63]

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.

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

[63] These figures may include "policy clusters".

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.[64] 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 with-profits 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% in 1985 to 4.1% 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, SynThesys Life data shows that in recent years, the largest two companies, who between them have 25 per of new business (measured as regular and single premiums), were Legal and General Assurance (Pensions Management) and Barclays Pension Management.[65] Neither 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.

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).

[64] 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."
[65] This data was provided to us by the FSA.

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 non-with-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 with-profits 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).[66]

3.30 Second, with-profits firms can write non-with-profits policies into a with-profits 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.

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 with-profits 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 with-profits 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 with-profits companies themselves are withdrawing from with-profits business.

[66] 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 (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 polices) 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 with-profits 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 3.3, 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.[67] 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 1990s. They included, amongst many others:[68]

- Abbey Life
- Allied Dunbar (now Zurich)
- Trident Life
- Target Life
- Save and Prosper
- M&G
- Lincoln
- Black Horse Life
- Barclays Life

[67] 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 a reinsurer. However, the society demutualised, transferring its business to a proprietary life insurer, Partnership Life, in 2005.

[68] Some of these have since merged with other firms.

— Nat West Life
— Halifax Life
— Vanbrugh Life
— Skandia

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

Memorandum from Co-operative Financial Services Ltd

1. Background to Co-operative Financial Services Ltd (CFS)

CFS is the Financial Services part of the Co-operative Group. The principal subsidiary companies of CFS are Co-operative Insurance Society Ltd (CIS), which is the life assurance subsidiary of CFS, CIS General Insurance Ltd (CISGIL) which transacts general insurance, and the Co-operative Bank. CIS Unit Managers Ltd (CISUM), a unit trust company, is a subsidiary of CIS and smile, the internet bank, is a subsidiary of the Co-operative Bank.

CIS and CISGIL are Industrial and Provident Societies, as are CFS and the Co-operative Group; the Co-operative Bank is a public limited company (plc).

2. Background to CIS

CIS is the UK's only Co-operative life assurance company. Its method of operation is unique in that, although it has a shareholder, it operates entirely for the benefit of its policyholders. This distinguishes it both from true mutuals, which have no shareholders and are owned by their customer members, and from proprietary companies which operate for the benefit of their shareholders.

Proprietary life assurance companies usually transact their with-profits business on the basis that profits are split between policyholders and shareholders in the proportion 90:10. Non-profit business is typically transacted on a 0:100 basis, ie all the profits go to the shareholders. Mutual assurers conduct their with-profits business on a 100:0 basis (all profits go to the with-profits policyholders) and typically transact non-profit business for the benefit of with-profits policyholders.

In line with its Co-operative status, CIS transacts its business for the benefit of all its customers, both with-profits and non-profit. In the case of with-profits business, the profits of the business are applied for the sole benefit of the with-profits policyholders, ie the basis is 100:0. In the case of non-profit business, products are generally priced at the lowest possible price consistent with charging appropriately for the risks involved. Any profits (or losses) that emerge from this business are therefore expected to be small and will fall into the Inherited Estate, ie they are not distributed to with-profits policyholders.

This basis of trading is summarised in the statement that has been made repeatedly over many years in sales literature, in advertisements and in the Principles and Practices of Financial Management, and which is stated in the annual returns to the FSA:

> " . . . the whole of the profits of the Society's life assurance and pensions business must be applied for the sole benefit of the life assurance and pensions policyholders, including for this purpose the making of reserves with the aim of preserving the strength of the Society for the benefit of current and future life assurance and pensions policyholders".

3. The Origins of the Inherited Estate at CIS

CIS's inherited Estate is derived from the following sources:

1. direct and indirect contributions made by the shareholder;

2. the excess of the asset shares of with-profits policyholders who have left the fund over the claim values paid;

3. the excess of the amounts paid into the fund by non-profit policyholders over the amounts required to market and administer their policies and to pay claims;

4. investment returns earned on each of the above.

The asset share of a with-profits policy is the accumulated value of the premiums paid allowing for the investment return earned and after deducting amounts required to cover marketing and administration costs, and amounts in respect of risk and guarantee costs. To the extent that the amounts deducted in respect of guarantees are less than the cost of meeting those guarantees, the shortfall is taken from the Inherited Estate.

Because of the difficulty of obtaining detailed individual policy data in respect of past contributions and charges, CIS has not attempted to estimate accurately the precise contributions to the Inherited Estate from each of the four sources above. However, some investigations into the sources of the Inherited Estate have been carried out and these indicate that a substantial part has been derived from the first source, contributions made by the shareholder, together with the investment return earned on those contributions.

Since the capital contributed by the shareholder to CIS has been provided without any expectation of a return to the shareholder, CIS's life assurance fund has always been operated so that the risks to which the fund is exposed are borne by the fund itself, that is, by the Inherited Estate, and not by the shareholder (on the basis that the shareholder should not bear risk unless it is compensated for this by the prospect of potential returns).

4. Use of Inherited Estate

The Treasury Committee has asked for information on "the extent to which life assurance companies should be permitted to diminish the inherited estate in order to subsidise corporate activity . . . ". The word "subsidise" in this context has, potentially, two rather different meanings. It could mean that the subsidy being provided is in the nature of either a gift or a loan.

If the subsidy were essentially a gift, it would mean that money that formed part of the Inherited Estate was being spent with no expectation of return or, more probably, that money derived mainly from policyholders was being used to finance activity that would benefit shareholders disproportionately so that, in effect, a gift of policyholders' money was being made to shareholders.

If, on the other hand, the subsidy were in the nature of a loan, it would mean that the Inherited Estate was being used as working capital for the fund, to provide capital for investment which was expected to benefit the original contributors to that capital broadly in proportion to their contribution.

In general terms, a subsidy in the form of a gift from policyholders to shareholders must be, at best, questionable, whereas one that was essentially an investment would seem to be reasonable.

In the case of a mutual insurer, there are no shareholders and all capital has been derived from policyholders and will be used for the benefit of policyholders, so the use of the Inherited Estate to finance corporate activity is both necessary and reasonable.

In the case of CIS, much of the Inherited Estate has been provided by the shareholder and it is to be used solely for the benefit of policyholders. In this case, to the extent that there is a subsidy being provided from the Inherited Estate, the subsidy is from the shareholder to the policyholders. We therefore believe that the use of the Inherited Estate to finance corporate activity, including financing new business and making strategic investments, is in our case entirely reasonable; it is, in fact, an essential part of our business model

that has operated successfully for over 100 years. Furthermore, as stated in section 3, we believe that it is appropriate that the Inherited Estate should be used to meet risks to which the fund is exposed. These include insurance risks, economic risks and new business sales risks, including mis-selling risks.

5. Distribution of the Inherited Estate

As CIS's fund is not a 90:10 fund, we do not propose to comment on the principles that should guide the division of the Inherited Estate in such funds. It is, however, reasonable for us to comment on two other points raised by the Committee: the appropriate sharing of the Inherited Estate between current and future policyholders, and whether policyholders' reasonable expectations of distributions from the Inherited Estate should be zero or have a positive value.

In a fund that is open to new business, such as ours, we do not believe that policyholders should have an expectation of a distribution from the Inherited Estate. However, FSA Rules require Boards to review regularly the size of the Inherited Estate and, following such a review, the Board could at its discretion decide to distribute part of the Inherited Estate if it believed that the Inherited Estate was larger than was needed to meet the risks inherent in the fund and to support future new business. It is clearly important that current policyholders should be treated fairly, but we believe that fair treatment can be provided by returning to policyholders at the end of the policy term an amount broadly equivalent to their asset share and that policyholders are not entitled to expect more than this amount. This is consistent with representations made to policyholders at the time their policies were taken out.

If a fund is closed to new business, however, it would be reasonable for the Inherited Estate to be distributed over the remaining lifetime of the policies and policyholders might reasonably expect to receive a share of such a distribution. If the fund is mutual, or run exclusively for the benefit of policyholders as is the case with CIS, the distribution of the Inherited Estate following closure would be 100% to policyholders.

The fact that, if a fund were to close to new business, policyholders would expect to receive a share of the Inherited Estate whereas, if it were to remain open, they would not does not mean that life assurers have any obligation to close their funds. If there are two possible outcomes for policyholders, just because one outcome leaves them better off than the other does not mean that they have been treated unfairly if the other outcome is the one preferred by the Board. The decision to remain open to new business or to close should be taken having regard to normal business considerations such as whether new business can be written profitably, not by whether one group of policyholders (the current generation) happens to receive a windfall that they could not reasonably have expected.

6. The approach of the Financial Services Authority

Current rules and guidance of the FSA make it potentially very difficult for mutual insurers, and for CIS, to continue transacting life assurance business unless they continue to sell material volumes of with-profits business. At a time when the value to consumers of with-profits business is increasingly being questioned, this makes it difficult for such companies to diversify away from with-profits business to other forms of long-term savings and protection (eg unit-linked business, term assurance, critical illness cover etc).

This situation has arisen because of FSA guidance COBS 20.2.60, which states

> *"If non-profit insurance business is written in a with-profits fund, a firm should take reasonable steps to ensure that the economic value of any future profits expected to emerge on the non-profit business is available for distribution during the lifetime of the with-profits business."*

This statement effectively prevents non-profit (including unit-linked) business being written over timescales that extend beyond the lifetime of existing with-profits business, and would therefore force mutual insurers to close their funds if they were to stop writing with-profits business. Proprietary companies are largely unaffected by this statement as they typically write non-profit business in separate, shareholder-owned funds.

We believe that COBS 20.2.60 is wholly inappropriate to CIS, which as explained above does not write non-profit business on the basis that future profits are distributed to with-profits policyholders. It is also likely to be inappropriate for mutual insurers, as it prevents them from evolving their business model into a model that is more suitable for the needs of modern consumers.

COBS 20.2.60 does permit insurers to make alternative arrangements for continuing to carry on non-profit business "where it is agreed by its with-profits policyholders". However, CIS's with-profits policyholders are not members and they have no direct interest in the non-profit business within the fund, so it is difficult to see the relevance of this concession in our case, and it may also be unduly restrictive in the case of other mutual insurers.

April 2008

Memorandum from the Association of Friendly Societies

1. I am writing in response to Treasury Committee press release no.26 which announced this inquiry, on behalf of the Association of Friendly Societies.

2. The Association of Friendly Societies (AFS) has around 50 members and represents Friendly Societies in the UK. Between them, these organisations manage the savings and investments of over 5| million people, and have total funds under management of around £16 billion.

3. Friendly Societies are mutual, member-owned organisations, set up originally to encourage self-help and personal responsibility and to enable people with limited financial resources to improve their economic status. They typically provide and promote financial products—including life insurance, income protection insurance, and savings and investment plans—to this sector of the market, although their products and services are generally open to all.

4. The commentary associated with the press release indicates the primary focus is on use of the inherited estate in reattributions for proprietary insurers. However we believe that recommendations emerging from the inquiry might have significant implications for all insurers, and would not wish to see any unintended and unfortunate consequences for friendly societies and other mutuals. It should be helpful therefore to highlight some core aspects of with-profits and the significance of the inherited estate to the mutual model.

5. With profits remains a very attractive product for many consumers. The Tax Exempt Savings Plan (TESP) offered by many friendly societies is mostly built on with profits, and still offered by half of AFS members. At the same time, the largest insurers, such as Norwich Union and Prudential, have reported significant volumes of new with-profit bond sales in 2007. There are a number of reasons for the abiding popularity of with-profits funds, including the median level of investment risk (often mitigated by underlying guarantees), the smoothing of returns, the addition of life cover, the ability to take tax-exempt income (from single-premium bonds), and in mutual organisations the inclusion of membership benefits. Furthermore, with-profits funds run by mutuals are currently attracting a great deal of interest as potential vehicles for offering shariah-compliant "takaful" insurance to the Muslim community in the UK and elsewhere in the EU.

6. The inherited estate is "an amount representing the fair market value of the with-profits assets less the realistic value of liabilities of a with-profit fund" (FSA definition). Most inherited estates have been built up over a considerable period, and as a result there is a collective ownership of the estate, rather than individual policyholders having a specific claim to a part. (This is quite different to unclaimed assets, which with-profits firms provide for separately and where ownership resides with the individual policyholder.) It is therefore appropriate that the inherited estate is put to good use to provide "working capital for the with-profits fund in the longer term and supports its operation" (FSA definition).

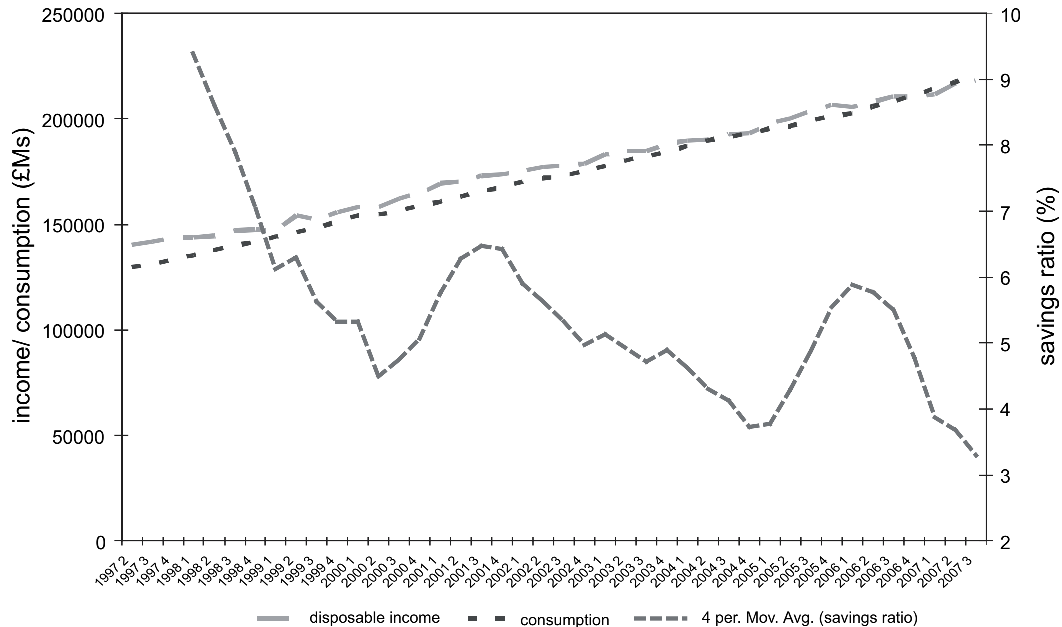
7. For friendly societies (and other mutual insurers) the inherited estate is fundamental to the future viability of the organisation; it is critical to both: a) consistency of returns to policyholders, and b) capital investment to support sustainable new business growth and maintain solvency requirements for the organisation. To illustrate:

a. On returns to policyholders, the inherited estate supports the smoothing process (designed to reduce the impact on customers of variations in the underlying assets). And in combination with low charges and effective investment management, enables friendly societies to offer consistently superior returns. The latest Money Management annual survey of with-profits (April 2008) confirms not only that an investor paying into a PLC with profits fund would be worse off (by 29% after 25 years), but also that investing in other common forms of saving would have produced a shortfall of between 9% and 99% over 25 years, compared to the average friendly society with profits investment:

£50 per month paid into:	*10 years Average return, £s*	*10 years Shortfall to Friendly Society*	*25 years Average Returns, £s*	*25 years Shortfall to Friendly Society*
Balanced Managed Fund	7,634	6%	40,673	34%
UK all Companies fund	7,552	7%	50,018	9%
90 day deposit	6,886	17%	27,393	99%
PLC with profits	6,601	22%	42,168	29%
Freindly Society with Profits	**8,060**		**54,444**	

Source: Money Management/ Morningstar

So despite recent adverse market conditions, with-profits remains an excellent long-term investment, where the money is invested in a friendly society. However despite their suitability for long-term regular saving, lack of effective Government incentive to encourage the less affluent to save (by targeted action such as support to the TESP) coupled with the ill-formed views of many commentators on with-profits, have contributed to the drop in the UK savings rate over the last ten years, which has fallen to an all-time low:



b. With regard to capital investment, the option to raise capital via shareholders or the market is not readily available to a friendly society.[69] The inherited estate is therefore the primary source of working capital for a friendly society, and it is vital that mutual insurers retain freedom to use the estate for a variety of purposes consistent with the best interests of their members/ policyholders. Without this, friendly societies are placed at a competitive disadvantage compared to proprietary firms, and might therefore be faced with stark options, such as having to avoid proper investment in the business, or to consider closing to new business, or to demutualise.

It is also worth emphasising that where the size of the inherited estate in a friendly society is greater than that needed to retain solvency requirements, enable smoothing and fund future projects, a society will consider the best basis on which to distribute returns to its members. Indeed the planning of the level of the estate and how it can be used as working capital is a key part of the financial management for most friendly societies.{ With no other source of capital, careful planning is essential to make sure the estate is neither too big (and in so doing holding too much back from the current members) nor too small (thereby providing an inadequate level of capital for the risks run by the society).

8. Given the above, we believe that the Committee, in making recommendations from this inquiry might devote some of its considerations to supporting the effective use of the inherited estate in friendly societies and other mutuals. Such support might include:

a. The Committee's clear support for the with-profits model, where the provider can demonstrate through, for example, the mutual model, that it has a focus on providing good and sustainable investment returns and is working in the best interests of the policyholders;

b. more discretion, through review of FSA requirements, for mutuals to use the inherited estate as working capital for the organisation;

c. different rules for reattributions for mutuals: the current rules are designed for proprietary companies but apply equally to mutuals (and much of the language is focused on payments to shareholders, including it must be said in the Committee's own press release);

d. Recognition that in a mutual that writes both with-profits and non-participating business, it may be in the long term interests of with-profits policyholders to use the inherited estate to expand the business of the mutual and keep it viable, even if it is not necessarily in their short-term financial interests to do so;

e. For small (unincorporated non-directive) friendly societies the accounting rules make distributions to members more problematic than for larger organisations (for example only actual or realised profits can be distributed.

9. Responses to the specific questions raised are attached as an annex. I would be pleased to discuss further any of the items raised by our response.

April 2008

[69] Technically, there is nothing to prevent a friendly society from issuing tradable debt, although none has ever done so.

ANNEX: RESPONSES TO THE QUESTIONS POSED

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

The definition published by FSA defines the inherited estate as "as amount representing the fair market value of the with-profits assets less the realistic value of liabilities of a with-profit fund".

On its website FSA elaborates further on this definition and on the regulatory restriction on use of the inherited estate.[70] This indicates that FSA has regularly communicated an evolving definition, both of the inherited estate, and also of the way firms might make use of it, particularly during reattributions and distributions. However, there are some potential areas for concern:

— It is not apparent that firms like AXA contravened any FSA rules in paying significant sums to the shareholders, even though the 90:10 rule was meant to discourage this, suggesting that the definitions and commentary leave gaps that firms could legitimately exploit;

— The rules more broadly, particularly for reattributions, have a heavy slant towards proprietary insurers, and largely ignore mutuals: it might be more appropriate to avoid one-size fits all rules;

— the term "inherited estate" is itself a little misleading: before it was possible to computerise asset share techniques there was a great deal more imprecision in modeling, and as a result most with-profits funds showed an excess of assets over that required to match individual asset shares to the total assets of the fund. So the difference, the "inherited estate" has been generated by past generations of policyholders;

— furthermore there are a variety of techniques on apportionment of investment return, expenses and risk charges to asset shares. Decisions on how to calculate each of these will create different transfers between asset shares and the inherited estate.

2. *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.*

As we indicated above, discretion to use the inherited estate for a range of activities that ultimately are designed to strengthen the business should be in the best interests of policyholders in the with-profits fund. For a mutual organisation the inherited estate represents the key source of working capital available to management to invest in the business.

The conduct of business (COBS) requirements for the Principles and Practices of Financial Management (PPFM) stipulate information firms should provide, in the customer-friendly PPFM, including vital information about the *inherited estate* (COBS20.3.8G(5)):

(a) Preferred size or scale of *inherited estate* and implications for the values of the *with profits policies*; and

(b) Any existing division of the *inherited estate* between *with profits funds*; and

(c) Any constraints on the freedom to deal with the *inherited estate* as a result of previous dealings.

(d) How the *inherited estate* is used, for example, in meeting costs;

(e) Whether the investment strategy for the *inherited estate* differs from the rest of the *with-profits fund*; and

(f) Any current guidelines in place as to the size or scale of the *inherited estate* or as to how and over what time period the *inherited estate* would be managed, if it becomes too large or too small.

It is consistent with all the above that the inherited estate will be targeted and controlled by the Board: the PPFM may well state that the inherited estate is targeted at a proportion of total assets, or at a particular level of security, and also that transfers between assets shares and the inherited estate are controlled.

In the simplest model of a mutual insurer, all the assets fall within a single with-profit fund and any use to which the inherited estate might be put will be for the ultimate benefit of the with-profits policyholders. However, all persons to whom a friendly society provides benefits are required by law (s5(2)(b) Friendly Societies Act 1992) to be members of the society (or connected with members) whether they hold with-profits policies or non-participating policies.[71]

[70] The FAQ for "What is an inherited estate?" gives the following, where the words emphasised in bold are ours:
"A with-profits fund contains assets belonging to the firm which it will use to meet its realistic liabilities to with-profits policyholders. To protect policyholders, our rules restrict what the firm can do with the assets in the fund. The "inherited estate" is part of the with-profits fund. Generally, it is **that part of the with-profits fund over and above the part required to meet realistic liabilities that the firm nevertheless retains for commercial reasons.** For example, to ensure it has a strong capital base or to fund future growth plans. The inherited estate **provides working capital for the with-profits fund in the longer term and supports its operation.** In most with-profits firms, the inherited estate has built up over many years. It is usually made up of previous and current policyholders' premiums and investment returns, or past injections of capital from shareholders."

[71] There are some exceptions to this requirement, but the general principle remains true for the bulk of a friendly society's mainstream activities. That said, it is usually very difficult to differentiate between what is with-profits and what is non-profit.

Therefore a society which conducts both with-profits and non-participating business (which many of the larger societies do) faces a dilemma in the use of its inherited estate. It has an obligation to treat all its customers/ members fairly; its inherited estate will have built up over time from contributions made by both with-profits and non-participating members;[72] yet there is an expectation that the inherited estate will be used solely for the benefit of with-profits members. Furthermore it would be difficult for the society to make a reattribution of the inherited estate to the non-participating members as the rules on reattributions are geared towards proprietary companies, even though the inherited estate will have been built up increasingly from contributions by non-participating members and the society has an obligation to treat these members fairly.

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

The inference that the inherited estate "subsidises corporate activity" is largely misleading: funds drawn from the with-profits fund for strategic purposes are subject to clear information to customers, and are generally required to be paid back in a reasonable time period.

Use of the inherited estate may have some effects on competition:

— The inherited estate provides the only accessible working capital for mutual-owned friendly societies. If societies were unable to use the inherited estate to develop corporate strategies they would be severely restricted, and might therefore be forced to underinvest in the business, close to new business, seek a transfer of engagements, or demutualise.

— There have been no new friendly societies created since the mid-1990s. Potential new societies could see the lack of an inherited estate as a barrier to entry, though in reality it is the large capital requirements of FSA that have prevented the creation of new friendly societies.[73]

— Ultimately, transparency and good governance will ensure competition is effective. As well as the requirement for insurance companies to produce the PPFM (with the exception of small non-directives), AFS and its members comply with the requirements of the Combined Code (through the Annotated Combined Code, produced in association with the Association of Mutual Insurers). This ensures the Board is fully accountable to their members for all their actions, including management of the inherited estate.

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

The 90:10 principle was clearly identified as common industry practice as early as a Ministerial statement in 1995, although this also left some scope for latitude.[74]

Needless to say the principle is currently redundant in mutual organisations, where 100% of any surplus is available for the benefit of all policyholders.

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

This should be a matter for management of the company, as well as the with-profits committee (where there is one).

The inherited estate is effectively owned in trust by today's policyholders, in that it has accrued over many years and is not directly attributable to any individual account holding. The inherited estate offers a continuing legacy to future policyholders: significant divestment of the estate to current policyholders may not be in the best long-term interests of the current, or of course future policyholders. And as we describe earlier the inherited estate belongs to all members.

It might be helpful to highlight here that the Policyholder Advocate's role purely relates to current policyholders. Therefore a reattribution exercise in a proprietary insurer, which sees future ownership of the estate pass to shareholders, effectively pays off current policyholders' interest in the inherited estate but is unlikely to take any account of the interests of future policyholders (as there is no-one to speak on their behalf).

[72] (and may in future grow predominantly from contributions by non-participating members because the FSA rules now require insurers to target payouts around asset share even though assets shares themselves may include transfers from the inherited estate)

[73] The last formed society, Pension Annuity Friendly Society, was established in 1995, and illustrates this point very well, as it demutualised in 2005 precisely because of the difficulty in obtaining sufficient capital.

[74] A life office may make distributions from surplus in the long-term fund as shown by the statutory annual actuarial valuation. It is common practice to make distributions to policyholders and shareholders in the proportion 90-10. In assessing policyholders' reasonable expectations, the Department would expect this ratio to be used as the basis of attribution between policyholders and shareholders, unless there was clear evidence, based on a company's circumstances, statements or practice, that a different proportion was appropriate in respect of the surplus arising from some particular part of the business."

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

The last 20 years have seen a growth in speculative investment, from "carpetbaggers" keen to subtract a disproportionate share of the inherited wealth of an organisation. That is particularly true of mutual organisations, such as building societies, mutual insurers and friendly societies. Regulation has always steered professional advisers away from encouraging investment for carpetbagging purposes, as it might conflict with best advice. By the same argument we consider that policyholders that invest in with-profits are making investment decisions framed around potential returns directly proportionate to the sum they invest and therefore there should be no value related to expectation of distributions.

The situation is different for a closed fund, where it is reasonable to presume that the remaining policyholders should have an expectation of deriving a positive value from the inherited estate as the fund runs off.

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

The management of the company, in association with the with-profits committee (where one exists) are best placed to determine their strategy for the inherited estate, and to communicate that through the PPFM. It depends for example where the estate comes from: if for example it has largely been built up in recent times, through the subscriptions of current policyholders, any excess might best be paid in single payments.

By the same token, a friendly society that releases profits from the inherited estate on a phased basis in order to bolster investment returns, retains the option for the future of redirecting the capital, in order to produce more effective returns through alternative use of the inherited estate, such as supporting corporate strategy, including subsidiary businesses designed to produce a positive investment return for the parent fund.

There may be other occasions where, particularly for small with-profits funds, a significant part of the inherited estate might be realised on disposal of one asset (for example the sale of a property). In these circumstances if there is a significant surplus above that needed for long-term corporate strategy or to support the smoothing of returns, a single payment might be more appropriate.

8. *The role and responsibilities of the Policyholder Advocate.*

Under the current regime, the role of Policyholder Advocate is less relevant for mutual organisations, as there is no conflict between interests of policyholders and shareholders.

Even if the reattributions regime were to be adapted for mutuals and applied to distributions to the membership as a whole (as opposed to distributions solely to with-profits policyholders), we believe that the costs of using such an expert should mean that a Policyholder Advocate is not required in a distribution exercise, particularly where the appointed Actuary in conjunction with the with-profits committee makes an assessment of the benefits of the distribution in comparison with the longer term interests that policyholders may be giving up.

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

We have limited knowledge of this and consider the issue is largely one for proprietary organisations. However it is implicit from the continued negotiation around the Norwich Union Life reattribution that the framework is not supporting speedy and effective conclusion of the process.

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

With-profits committees provide a valuable forum for a life company to verify that its actions are helping secure the best interests of the policyholders. It is common practice for the With-profits committee to be a formal sub-committee of the main Board and to ensure that reporting between the two is effective.

In the smallest friendly societies however there is rarely a requirement to have a separate with-profits committee. In such organisations the Committee of Management (or Board) includes a significant number of policyholders, thereby ensuring the interests of policyholders are clearly communicated to management. (Though it must be said that FSA has begun to actively question the governance of small organisations where a significant proportion of a Board's members are policyholders.)

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

FSA has provided an intensity of focus on with-profits for many years. This has lead to significant improvements in communication to members and policyholders, the operating of closed funds, and action in rare circumstances where the long term interests of policyholders are not apparent in the way a with-profits fund is being managed.

That is clearly for the good of customers, though the general tone of FSA communication, and cumbersome nature of regulatory decision-making has not supported confidence in the with-profits product. For example, mutual insurers made proposals to the FSA over 12 months ago, to improve the governance and transparency of mutual with-profits funds, and are yet to receive proper feedback. In the meantime, the FSA approach continues to be focused on the proprietary sector, to the detriment of evolution in mutuals.

Memorandum from the Investment and Life Assurance Group

1. Executive Summary

1.1 The existence of inherited estates as part of with-profits funds is clearly defined and recognised under the FSA's regulatory regime. Equally, the uses to which such estates may be put within the operation of a firm are also well-established and accepted as legitimate by the FSA.

1.2 The process governing the distribution by a firm of any excess capital held in that estate ensures that the rights and interests of both existing and future policyholders are fully taken into account, together with those of shareholders where applicable, and reflect general good practice eg Treating Customers Fairly (TCF).

1.3 ILAG supports recent actions further enhancing the position of policyholders in terms of appointing policyholder advocates and with-profits committees and believes that the FSA's approach to inherited estates and re-attributions in particular is both sensible and pragmatic.

2. Select Committee issues

2.1 *The regulatory definition of an inherited estate in a with-profits fund.*

The FSA definition of an inherited estate is "an amount representing the fair market value of the with-profits assets less the realistic value of liabilities of a with-profits fund". We agree with this definition.

2.2 *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.*

Whilst "underwrite" is a more correct technical term than subsidise", all these uses are regarded and recognised by the FSA as legitimate providing they do not impact unfairly on the interests of a firm's existing customers and policy-holders. We are aware that the FSA is intending to review the practice of firms using the inherited estate to meet previous mis-selling costs (nb: if firms intend to use the inherited estate for such matters it has to disclose this in its PPFM—Principles and Practices of Financial Management). We believe that all the other uses of inherited estate mentioned are capable of enhancing returns to policyholders and thus are valid investments of the policyholders' funds.

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

We are not aware of any evidence which indicates that using inherited estates hinders or undermines market competition. On the contrary within the mutual insurance sector such assets are usually the only form of capital available to such firms to write new business or launch new products. Without the ability to use inherited estates the competitive position of mutual insurers would suffer and consumer choice would be reduced.

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

The 90:10 ratio between policyholders and shareholders has been the conventional norm for the distribution of profits in with-profit funds for many years. It has since become recognised by the FSA as an acceptable basis. There have also been a number of merger and demutualisation schemes where the Court has sanctioned alternative approaches. In whatever decision is reached on the precise allocation, a firm must have regard to the rights and interests of its policyholders and must act fairly at all times, in conformity with its PPFM and Treating Customers Fairly (TCF).

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

We believe that the concept of sharing the inherited estate between existing and future policyholders is valid because both sets of policyholders derive benefit from the establishment and maintenance of an inherited estate in terms of the overall strength and performance of the company. Furthermore it is reasonable to assume that, in the majority of cases, the current generation did not enter the fund with the expectation that the whole or any part of the inherited estate would be distributed to them; rather that it would exist for at least the duration of their policy if not longer and so be able to pass an inherited estate on to future generations.

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

Where a firm determines it does not have an "Excess Surplus" or capital (as defined by FSA Rules) the inherited estate may be used to help fund the running of the overall business; in this case we believe that a policyholder's expectations should be zero. However where there is an identified Excess Surplus (as defined by FSA Rules) it is reasonable for policyholders to assume that this has a positive value for them. As part of its prudential supervision responsibilities, the FSA seeks details of the calculations as to whether an Excess Surplus exists and expects such surpluses to be distributed.

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

In general, it would seem more equitable for the distribution of benefits to be phased over several years—particularly in respect of closed funds—allowing such payments to be made in a fair, orderly and consistent manner. Any calculation of the inherited estate necessarily involves assumptions about the future; if a distribution was made in a single payment it may reduce the security of on-going policyholders to an unacceptable level if the assumptions are not borne out or if a catastrophic risk event occurs.

2.8 *The role and responsibilities of the Policyholder Advocate*

We recognise and support the role of the Policy-holder Advocate (PHA) in representing the interests of policyholders involved in any re-attribution process.

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

Similarly, we uphold the importance of the negotiations between the PHA and firms, and the framework within which the parties operate, in attempting to reach agreed decisions on the size and allocation of any re-attribution.

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

We recognise the independent role exercised by with-profits committees in overseeing the management of with-profits funds in accordance with firms' PPFMs and addressing any conflicts of interests between different groups of policyholders and between policyholders and shareholders. In general, we support the current arrangements that permit firms to establish appropriate governance arrangements to address these issues.

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

We believe that the current approach of the FSA towards inherited estates and re-attributions in particular—as documented in a letter dated 6 December 2007- is both sensible and pragmatic.

3. Technical Background

3.1 With-profits policies are medium to long-term investment contracts, usually offered as endowments, pensions, bonds or annuities by insurance companies. A with-profits policy can be a suitable investment for the customer who wishes to have a significant degree of exposure to equity markets, but who is prepared to forgo the possibility of maximum returns in favour of reduced down-side risk. This can be provided by with-profits policies through, for example, an underlying guarantee (provided by a sum assured and accumulating guaranteed bonuses) or the smoothing of returns.

3.2 Inherited estates will have accumulated over many years as part of the overall with-profits policyholder fund. They have usually arisen as a result of product profit margins, general contributions to surplus, or past injections of capital from shareholders (where applicable); these amounts being increased by investment returns.

3.3 Inherited estates are technically defined as the excess of the value of the assets of a with-profits fund over a realistic assessment of its liabilities. The inherited estate belongs to and may be retained by the firm as working capital or it may be distributed to its with-profits policyholders (and shareholders if applicable) if it is no longer required. The firm may use the working capital for various purposes, such as to allow more investment freedom for the potential benefit of policyholders, to enable it to smooth the returns on its with-profits policies or to fund future new business plans.

3.4 In terms of the beneficiaries of inherited estates, it is necessary to distinguish between the origins and status of mutual and proprietary insurance companies. Mutual companies (which include friendly societies) are created and owned exclusively by its policy-holding members while proprietary companies or plcs have a mix of both policyholders and shareholders. The beneficiaries of the inherited estate in a mutual are therefore the members as the assets belong to them, whilst with proprietary companies there is shared partnership.

3.5 A further distinction should also be drawn between open and closed funds; funds that are closed to new business will seek to distribute the inherited estate over time, often in accordance with a High Court approved Scheme. The aim of a closed fund is to be able to distribute the whole of the inherited estate to policyholders, fairly, by the time the last with-profits policy has gone off the books.

3.6 On the other hand, open funds do not generally seek to distribute their inherited estate, unless they have an Excess Surplus. Instead they use the inherited estate for various purposes as illustrated in 3.2 above. It is important to note that simply because the inherited estate is not being distributed, this does not mean that policyholders in an open fund will suffer worse returns than those in a closed fund. The uses of the inherited estate in an open fund would be expected to generate benefits, and thus enhanced returns for policyholders in such a fund. A closed fund is likely to suffer expense dis-economies of scale as it runs down, which might be a charge on the inherited estate, reducing the amount available for distribution.

3.7 A number of changes and improvements affecting the operation of with-profits funds have been introduced in recent years by the FSA under the general regulatory regime and Conduct of Business (COB) requirements including:

- All firms have to appoint a with-profits actuary who has to report annually to the with-profits policyholders on how the firm has exercised its discretion with regard to with-profits policyholders
- All firms have to produce an Annual Report to policyholders
- All firms have to produce and publish a Principles and Practices of Financial Management (PPFM) together with an abbreviated customer-friendly PPFM (CFPPFM) specifically for its policyholders

3.8 In addition, firms have to establish appropriate governance arrangements that address any potential conflicts of interest between different groups of policyholders and between policyholders and shareholders (as applicable). In many firms, particularly proprietary companies, this is achieved by a with-profits committee composed of persons responsible for overseeing the governance of with-profits funds. Alternatively this function can be vested in an independent person such as a non-executive director or an external actuary.

3.9 As part of the general move towards a principles-based regime within the regulated financial services industry, all firms are also now actively engaged in embracing the Treating Customers Fairly (TCF) culture in which matters of fair treatment of policyholders and open and transparent communication with them are paramount at all times.

14 April 2008

Memorandum from the Wesleyan Assurance Society

1 About Wesleyan

1.1 Wesleyan Assurance Society, founded in 1841, is a mutual life assurance company offering specialist financial advice to hospital doctors, GPs, dentists, teachers and lawyers, through its principal distribution brands Wesleyan Medical Sickness, Wesleyan for Teachers and Wesleyan for Lawyers.

1.2 The Wesleyan Group has in excess of £4 billion of funds under management as at 31 December 2007.

1.3 Wesleyan is one of the strongest with-profits insurers and has a history of good with-profits performance.

2 Executive Summary

2.1 The considerations in relation to the inherited estate are different for proprietary and mutual companies.

2.2 For mutual companies, the inherited estate is the primary source of capital as there is no access to shareholder funds. This "mutual capital" has built up over many generations, maybe even at times when there were no with profits policyholders. Similarly, at some point in the future there may again be no with profits policyholders, but the mutual capital will still be needed to support the ongoing business of the mutual.

2.3 This capital should be regarded as being for the benefit of both current and future policyholders, and as long as the mutual has a viable and sustainable future it should be retained or else used to grow or enhance the business for the benefit of both current and future policyholders.

2.4 It is important that regulators make allowance for the distinctive features of mutual insurers.

3 Responses to Specific Topics Identified by the Treasury Select Committee

3.1 *The regulatory definition of an inherited estate in a with-profits fund.*

We have no issue with the FSA definition of "inherited estate" (an amount representing the fair market value of the with-profits assets less the realistic value of liabilities of a with-profits fund).

3.2 *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.*

For mutual insurers especially, we strongly believe that the inherited estate is the appropriate source of capital for the items listed. Strategic investments need to be carefully assessed to ensure they do not diminish the security of existing policyholders and add value to the with profits fund.
For mutuals, as the inherited estate is the primary source of capital, it should be viewed as available to grow the business.

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

We believe that this ability is highly beneficial to competition within the industry, and indeed essential for companies in the mutual sector.

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

As a mutual insurer we would not wish to comment on this point.

3.5 *The appropriate sharing of inherited estate between current and future policyholders*

In our view, the inherited estate belongs to both current and future policyholders. In normal circumstances the current generation of policyholders should have no expectation of any significant distribution from the inherited estate as they did not take out their policy with any such expectation. They do however benefit from the existence of the inherited estate and should expect to pass it on to future generations.

In certain circumstances, support from the estate may be appropriate to promote the aims of the company and stimulate new business, and (for mutuals) promote the benefits of mutuality, as long it does not diminish policyholders' security or the long term aims of the business.

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

Policyholders' reasonable expectations of distributions from the inherited estate of a company with good prospects for future new business should be zero, unless the company has previously announced that some or all of it will be distributed.

Where a company is closed to all new business (or has seen or is seeing a significant decline in new business so that it is not expected to require all of its inherited estate in the foreseeable future) there should be an expectation of a gradual distribution of the inherited estate.

Otherwise with-profits policyholders' reasonable expectations should be that they will receive an amount based on their asset share, and in line with the firm's published Principles and Practices of Financial Management (PPFM), which sets out how the firm treats these customers fairly.

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

Most with profits funds have been in existence for many years or decades, and, unless they are closed, they may expect to exist for many years in the future as well. In that context, any action to distribute some of their strength can justifiably be seen as a gradual, long term course of action and not as a immediate windfall for the current policyholders. This also allows the fund to ensure the ongoing security of the fund, particularly if favourable conditions are reversed.

For a fund that is closed to all new business, a different approach is needed and it would normally be appropriate to enhance asset shares immediately, to ensure that all current policyholders get a fair share of the distribution of the estate, in a manner which allows this enhancement to be reversed in adverse conditions.

3.8 *The role and responsibilities of the Policyholder Advocate.*

Theframework for negotiation between the Policyholder Advocate and the life assurance companies.

As a mutual insurer we would not wish to comment on these points.

3.9 *The role of the with-profits committees of life assurance companies*

We support the role and purpose of with profits committees as currently defined by FSA rules and the current arrangements for establishing them and operating them, including the ability to establish alternative governance arrangements to fulfil the aims set out by the FSA.

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

We believe that the FSA's approach is broadly appropriate, but that there is scope for a greater recognition of the factors that distinguish mutual insurers from proprietary companies, particularly relating to the need to protect the inherited estate as the firm's primary source of capital, for use by future generations of policyholders and as a source of capital for growth.

April 2008

Memorandum from the Royal British Legion

Executive Summary

1. The Royal British Legion believes that before Inherited Estate is distributed to policyholders or shareholders the unjust and anomalous position regarding the substantial number of mortgage endowment policies mis-sold to UK military forces serving overseas should be properly investigated. Serious consideration should be given to setting aside funds from Inherited Estate and/or Policy Providers to pay compensation for shortfalls on such policies as if they had been sold in the UK by the best regulated institutions.

The Royal British Legion

2. Campaigns to promote the best interests of UK military personnel, past and present. Our team includes a financial consultant who has over 4 years' experience of this subject.

Background

3. A substantial number (possibly tens of thousands) of mortgage endowment policies were sold to UK military personnel and their families whilst serving on our overseas bases.

4. Many of these policies now have projected shortfalls but as they are deemed to be sold outside the UK and/or not by UK authorised agents and/or before the Financial Ombudsman took effect in April 1988, the policyholders have been denied the protection of UK regulations and any meaningful recourse to compensation for mis-selling.

5. The Royal British Legion has corresponded with the Financial Services Authority (FSA), Association of British Insurers (ABI) and three major policy-providers.

(a) We wrote to the FSA on 2 November 2007. In their response dated 23 November 2007 they concluded that this matter was beyond their "scope" and declined to meet us. (both letters are attached here and form a part of this submission)

(b) We have met with the ABI and await further response but to date have been given no grounds to believe that the industry wishes to support our position on this issue.

(c) We have corresponded with three major policy-providers: two have turned the matter aside whilst the third helped us access the ABI and has yet to respond formally.

Request For Action

6. The Royal British Legion would ask the Committee to:

(a) Instigate a thorough investigation of this issue through appropriate channels and

(b) request and/or require relevant policy providers to participate in the investigation and not to further distribute Inherited Estate which might be subsequently directed (either voluntarily or by way of Governmental intervention) to compensate mis-sold policyholders as envisaged above in paragraph 1.

10 April 2008

Memorandum from Royal London Group

Executive Summary

1. Questions of fair treatment between shareholders and policyholders do not arise for mutual insurance companies.

2. Mutual insurers offer the consumer real choice in the market for financial products, and frequently outperform their proprietary counterparts. Mutuals exert a competitive influence on the market leading to a better deal for consumers. But mutuals can only do this because Boards have a degree of discretion in managing the business and the inherited estate for the benefit of members.

3. All mutual insurers need to retain capital in their fund to develop their business for the future, rather than paying it out to the current generation of policyholders.

4. Mutual insurers can use the estate to make strategic investments and to develop their business if this can be shown to be for the benefit of members. Royal London has transformed its business in recent years and is now able to enhance policyholder returns from the value derived from its new operations.

5. Royal London is focussed on writing new business in areas which are likely to add value for its members. Competition for new business is intense and there is evidence that some companies are writing new business on unsustainable terms. Royal London supports FSA's current proposals for a more sustainable form of distributor remuneration.

The Need for an Inherited Estate

6. We are aware that the Committee is primarily concerned with the fairness of distributions of inherited estates between shareholders and policyholders. This is a question that does not arise in mutual insurance companies where there are no shareholder interests to satisfy.

7. Nevertheless, it is necessary for a mutual to retain long-term capital to sustain and develop its business. For a mutual, long-term capital will primarily come from internal sources; in other words, retained profits from business written in the past. It follows that mutuals need to retain capital to fund their business rather than pay it all out to the current generation of policyholders.

8. FSA has formally recognised a number of acceptable uses of the inherited estate.[75] These include use of the inherited estate to finance corporate activity, including making strategic investments and financing new business. This memorandum will deal with these issues from the perspective of a mutual insurance company.

[75] Most recently in a later to the Policyholder Advocate 6 December 2007.

STRATEGIC INVESTMENTS

9. Royal London is the largest mutual insurance company in the UK. In recent years we have transformed our business, adding scale through acquisitions and by developing new business opportunities.

10. For example, in 2000 we acquired United Assurance Group for £1.5bn. This doubled the number of policies administered and delivered £55m p.a. in cost savings to the Group. This cost saving was reflected by a special additional bonus to Royal London members.

11. In 2001 we acquired Scottish Life for £1.1bn. This expanded the range of products we offer expanded the customer base and gave us access to new channels of distribution in the IFA market. The vast majority of new Scottish Life policyholders become members of Royal London.

12. The estate was also used to fund the development of Bright Grey, a specialist protection business launched in 2003. Entry to the UK protection market has created greater diversification in Royal London's business and a source of ongoing profits to the fund.

13. At the time of writing, Royal London is well down the road to acquiring certain businesses which are currently part of Resolution plc. In particular, the acquisition of the Scottish Provident protection business will add greater scale to our operations in this market. We estimate that after the acquisition is complete, Royal London will be one of the top three UK protection providers, just five years after the Group's entry into this market.

14. All the acquisitions and start up were funded out of the open Royal London fund. (The Scottish Life with profits fund closed on acquisition in 2001).

15. In making strategic investments, the Board will consider the potential returns from other asset classes, primarily equities and commercial property. Royal London will not invest in enterprises that we believe are likely to be loss making as this would destroy value for members.

16. Subject to the inherited estate being able to support it, the Royal London Board is committed to paying a discretionary "mutual dividend" representing a share in the profits from Group businesses. In 2007 an additional £39 million was added to participating policies (out of a total of £278 million paid in total bonuses across the group). The mutual dividend is a tangible means by which policyholders benefit directly from the profits of Group businesses.

NEW BUSINESS

17. Royal London has consistently stated that we will not write new business that we believe will be loss-making. Writing new business that has little chance of generating a profit effectively destroys value for members. It follows that we only finance the writing of new business that we believe will realistically generate a positive return to the fund.

18. Evidence[76] indicates that some companies may not be so focussed on avoiding loss making new business. This is particularly true of the pensions market. Charges are effectively capped for many pension products; competition often takes place on the basis of commission paid to intermediaries. Higher commission inevitably leads to greater "new business strain" which, with charges capped, means that new pensions business is effectively receiving a cross-subsidy from the existing business.

19. Royal London has been at the forefront in helping FSA develop alternative, sustainable forms of intermediary remuneration as part of the Retail Distribution Review (RDR). Almost five years ago we launched our own version of what is now being referred to in the RDR as "Customer Agreed Remuneration" (CAR).

20. Under the CAR model, the customer and their adviser agree the cost of the advice and other services being provided. These advice costs are deducted on a "pound for pound" basis from the product. This means that there is no cross-subsidy from the existing book of business to new business. Over 90% of our new individual pensions business is now written on a "fee based" approach ie by a fee or CAR.

ABOUT ROYAL LONDON

Royal London was founded in 1861, initially as a friendly society, and became a mutual life insurance company in 1908.

Royal London Group is a specialist financial service provider. Its businesses focus on those sectors of the market which value premium propositions, operating through a number of brands:

— Scottish Life—UK pensions market.

— Bright Grey—UK protection market.

— Scottish Life International—offshore investment markets.

— Royal London Asset Management—fund management.

[76] Fifth Report of the Treasury Committee (2005–6) and evidence to the Inquiry Polly Put the Kettle On: Pensions Profitability, Cazalet Consulting, January 2006.

— Royal London Administration Services—life and pensions administration.

— Fundsdirect/Ascentric—funds supermarket; Wrap platform.

Royal London is the largest mutual life and pensions company in the UK with Group funds under management of £33.1 billion. Group businesses serve around three million customers and employ 2,620 people. (Figures quoted are as at 31 December 2007).

April 2008

Memorandum from the UK Actuarial Profession

EXECUTIVE SUMMARY

1. This submission contains the following sections:

— *What is an inherited estate?* Broadly this is defined as the excess assets in a with-profits fund not required to pay "reasonable" benefits to current policyholders which reflect the experience of the fund during the time their policies have been in force.

— *How has the inherited estate arisen?* A number of common sources are listed including capital provided by shareholders and profits not distributed to former policyholders. The important point is that there can be many sources, and the source of the estate may have a bearing on the basis of any distribution.

— *Why are inherited estates useful?* The prime use is to meet unexpected and exceptional losses but a number of other uses are listed.

— Distribution of inherited estates. This section identifies the current controls and requirements on the distribution and reattribution of inherited estates in accordance with current Financial Services Authority (FSA) rules.

INTRODUCTION

2. This submission to the Treasury Select Committee is made on behalf of the UK Actuarial Profession.

3. Actuaries provide commercial, financial and prudential advice on the management of a business's assets and liabilities, especially where long term management and planning are critical to the success of any business venture. They also advise individuals, and advise on social and public interest issues.

4. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies, the latter arising from rules made by the FSA under Part XXII of the Financial Services and Markets Act 2000. They also have a statutory role to provide actuarial opinions for managing agents at Lloyd's.

5. The profession is governed jointly by the Faculty of Actuaries in Edinburgh and the Institute of Actuaries in London. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards reflecting the significant role of the profession in society.

6. The aim of this submission is to help the Committee understand what is an inherited estate, together with issues surrounding their provenance, uses and possible distribution. It is not restricted to the question of how a reattribution process should operate and indeed also covers the position of mutual life assurance companies.

7. When considering any issues concerned with the regulation of with-profits business, it is important to place them in the context of current U.K. regulation on governance and controls on treating with-profits policyholders fairly. These matters are now covered in considerable detail in the FSA handbook and place far greater restrictions on the operation of this business than existed prior to 2004. It is understandable that some commentators have not appreciated the impact of these changes which, amongst other things, substantially strengthen the constructive liability for the payment of future bonuses from these policies (which generally must have regard to asset share) and require independent oversight into the way a company complies with its obligations. Asset share represents the accumulation of a policy's premiums less charges at the investment rate of return achieved by the fund. U.K. with-profits business is now subject to a regime which is much tighter than those found in, for example, many continental European markets.

What is an Inherited Estate?

8. The "inherited estate" of a with-profits fund is perhaps best defined as the assets in a fund in excess of those required to make payments to its existing policyholders in accordance with past practice and statements made to those policyholders. Such statements include those contained in the company's Principles and Practices of Financial Management, which is a document prepared in accordance with rules prescribed by the FSA. Payments to with-profits policyholders include not just those guaranteed under a policy but also those in respect of future bonuses. These future bonuses must be in line with commitments made to policyholders and allow for smoothing of payouts. Typically this might involve paying bonuses so that the total payout on each policy on maturity or surrender broadly reflects the profits earned by the fund whilst the policy has been in force, subject, in particular, to smoothing and the cost of providing additional death benefits for those policyholders who claim on their policies.

9. Smoothing of payouts is a common feature of with-profits business and is an attraction of these contracts. Rather than the payout directly following the value of assets, on a day by day basis, payouts on with-profits policies are smoothed in a number of ways. Firstly, typically payouts are set for a group of policies, often by year of commencement, so that precise timing effects, both on exit and entry, are averaged. Secondly, large changes in payouts on policies are phased over time to a greater or lesser degree, so dampening the rate of change. This typically leads to larger payouts than otherwise when market values have fallen sharply, and lower payouts when market values have risen sharply. Falls in the market value of assets have often been sharper than rises, so that the cost of smoothing of payouts up from low values has typically exceeded amounts recovered from smoothing payout down from higher values, even though asset values tend to rise over time.

How has the inherited estate arisen?

10. There is no single answer to this question and it will depend on each fund's individual circumstances. Sources which have occurred fairly commonly are:

- Capital originally provided to the fund by shareholders or a general insurance fund or added subsequently. (For example, sums might have been added as seed capital to fund overseas expansion, or in times of crisis).
- Profits from with-profits business which were not distributed to holders of exiting policies.
- The share, if any, of past profits from any source to which the shareholders were entitled but which, for whatever reason, whether deliberate, accidental, temporarily or permanently, was not removed from the fund. (It is sometimes contentious whether such shares were waived, passed to policyholders, or were deferred; at the time, management may have seen no reason to be explicit on this point).
- Profits from non-profit policies in the fund or other activities which neither the fund's constitution nor the company's statements to its with-profits policyholders require to be distributed to with-profits policies—and which have been left within the fund for whatever reasons in the past.
- Investment return earned on the above amounts since they emerged (though on what exact basis returns are allocated might be the subject of debate).

The significance of the contribution by the last point should not be overlooked. For example, if £1 million of capital was added to a fund on a particular date and the fund had earned an average 5% p.a. investment return net of taxation, the inherited estate from this source alone would be over £131 million one hundred years later. If the average annual return after tax had only been 3% then the same £1 million would have grown to only £19 million, whilst at 7% net the figure rises to an enormous £868 million.

11. Most inherited estates originated many years ago. Given the long history of most with-profits funds, and in particular the lack of historical data, it can be very difficult to determine the sources of the inherited estate with any certainty. Prior to the Second World War, whole life assurances were the most common form of policy and mortality, rather than investment, was the predominant component of surplus.

12. It is also somewhat debateable the extent to which some items necessarily survived. This is particularly true of funds which existed before periods of crisis of one form or another, and which might have been "spent", only to be replaced by inherited estate from other causes. Differing viewpoints can see this as reimbursement of the previous amounts from those who benefited, or as unrelated freshly emerging capital. There is scope for significant debate over the historical development of the fund.

Why are inherited estates useful?

13. The future is never certain, and a with-profits fund can suffer hard times as well as good. The inherited estate is a buffer to protect the current generation of policyholders from harm in those bad times. Over a long period there will be such bad times, and the philosophy of the with-profits funds has been that those who enjoy the years of comparative plenty will tend to contribute to the estate, whilst those who experience

leaner years may benefit from its protection. This does not refer to absolute levels of return seen, but more to the effect of the guarantees, smoothing and other financial structures seen in with-profits business, and with exceptional losses which may occur from time to time.

14. A critical feature usually followed by with-profits funds is that when guarantees cause financial losses to the fund the cost should not fall disproportionally on one generation of policyholders. Without such capital in the estate there is no choice if bad times arrive other than to reduce benefits.

15. It is important to remember the inherited estate was generally never intended to protect policyholders from poor investment returns—other than by means of smoothing. However, it can and often does protect policyholders from losses incurred by the fund on other policies.

16. The main reasons a with-profits fund needs an inherited estate are to support key elements of the with-profits proposition:

— to provide capital to fund losses arising from options, guarantees and other risks, which may include some business risks, including the writing of new business,

— to enable investment strategies to be less constrained by the presence of guarantees, and hence typically to allow a higher proportion of equity-type investments than would otherwise be possible,

— to enable the fund to spread the change in policy payouts over time, so smoothing over shorter term investment fluctuations whilst allowing changes in long-term investment returns to come through, and

— to allow a proportion of bonus payments to be guaranteed in advance (as "reversionary or annual bonus")—before there is certainty about the ultimate proceeds of the underlying investments. This increases the level of guarantees in the fund.

17. These uses of an estate in smoothing and to fund guarantees see it called on when investment markets are weak and contributed to when markets recover. In the absence of an estate it would be necessary to reduce the level of smoothing and/or to invest the fund more cautiously.

18. Another important purpose is to enable a fund to meet unforeseen costs or losses without affecting policyholders' expected benefits.

19. It was argued by some in the 1980s and early 1990s that inherited estates were a consequence of an inappropriate failure to distribute profits in a timely fashion. Much was made of the possibility of running a with-profits fund without such capital, most notably by the management of Equitable Life, but also by commentators outside the industry. Some of the consequences of this strategy were amply demonstrated by the events which befell that company. Whilst Equitable's problems were not related solely to the management of the estate, a major cause, the level of losses arising from the presence of guarantees in the policies, would have been significantly mitigated by the presence of an inherited estate of a reasonable size.

20. Inherited estates have also been used to meet the up-front costs of issuing new policies. This can be seen as a choice of investment for these funds. Provided (and the importance of this proviso is critical) that policies are issued at an adequate price, the estate should receive a return commensurate with the risk it took in providing this capital support. As with any business venture, this is never certain, but this should be the expectation. Investing the estate in this way can defer the opportunities to release estate; such distribution would in most cases benefit the present generation of policyholders, though this may not always be true. However, as their own policies will have received similar support from the previous generation of policyholders, this use of the estate is generally regarded as fair between the different generations of policyholders. Further, these costs are usually fairly short term. The new policyholders supply sufficient money to release this support in a few years in the form of charges to cover the expenses of setting up their policies.

21. It is understood that in the past, before the introduction of relevant FSA rules, there were instances where subsidies to new business from the inherited estate occurred. Whilst the scale and incidence of this may have varied, and indeed in some cases it might have had a legitimate purpose in protecting past investment in infrastructure, such instances raised legitimate concerns over fairness.

22. In accordance with FSA rules introduced earlier this decade, companies may also use the estate to meet compensation payable to with-profits policyholders, for example for poor service or misleading financial advice. FSA has recently announced that it intends to consult on whether this practice should be allowed to continue where a company's shareholders have assets which could meet these costs instead. In principle it seems reasonable for such costs to be allocated in the same way as the corresponding profit opportunities, and that the alternative costs of mitigating the risks that gave rise to compensation would have been allocated. The issues here are not straightforward, and it is tempting to see the proposed consultation in simple terms as a consumer protection measure. There is a counter argument, in that a change in the FSA rules will probably result in increased compliance costs as shareholders will wish to limit their exposure to such compensation payments. These costs will be passed on to consumers through charges, and with the shareholders bearing all the risks and at most 10% of the costs, there will be an incentive to be overly conservative in this area.

23. Finally a common use of the inherited estate in a proprietary company is to meet additional tax which may become payable on the fund because of the existence of shareholders. This is permitted only when it was already established practice to make this charge at the time of the introduction of the FSA rules codifying the fair treatment of with-profits policyholders. Prior to that time some companies deducted this tax from asset shares, but this practice is no longer permitted.

24. When assessing the pros and cons of this FSA rule regarding tax, it needs to be borne in mind that the tax charged to the fund is a unitary assessment on both policyholders and shareholders. The FSA rules in this area reflect a compromise view between those who view the tax on a pure unitary basis and those who would see the marginal additional tax as being effectively an imposition on shareholders. Other arguments relate to the proportion of profits being assessed after all taxes—the tax due on policyholder profits is deducted before the apportionment under the 90:10 rule, and it is arguable that the same principle should apply to the tax arising from being a proprietary company. It is also the basis upon which the 90:10 division was set, and it is arguably unfair to disturb such a fundamental agreement.

Distribution of inherited estates

25. Having an inherited estate enables a fund to withstand unexpected shocks and to smooth over periods of relatively poor investment return. However, if investments prosper and no other shocks occur, it sometimes becomes clear that an inherited estate has become larger than necessary. This is not an easy assessment to make, with many variables and issues to consider, but it can become particularly obvious if the volume of new with-profits policies requiring financial support reduces. FSA now requires the distribution of any inherited estate in excess of that reasonably required, either by distributing it to policyholders and shareholders through the normal mechanisms, or else by a reattribution exercise. Reattribution is a process which has emerged over some fifteen or more years and is now covered by FSA rules.

26. Does the presence of an excess estate mean that past policyholders have been underpaid? Not necessarily. Each year, the fund's management will have had to decide on the profits to be distributed to policyholders as bonuses (and the amounts to be paid on policies which terminated early). When doing so, they will have had to make their best estimate of the estate needed to be built up for all the reasons we described earlier. Whether their judgements were correct or not, only hindsight has been able to tell.

27. FSA rules, based on targeting asset shares for maturity and surrender value payouts, now make it unlikely that policyholders are systematically underpaid. Indeed, since asset share techniques became accepted practice as a means of controlling payouts around the late 1980s it is unlikely that systematic underpayments of claims on death or maturity have been commonplace.

28. When must an inherited estate be distributed? An inherited estate must be distributed in full, or else a reattribution attempted, for a fund which no longer accepts new business (a "closed fund"), over the remaining lifetime of the in-force policies. This is because the fund must be managed so that the assets are fully utilised by the time the last with-profits policy terminates. Complications arise where there is non-profit business in the fund (typically annuities) which are expected to survive the with-profits business. The FSA requires appropriate planning for this, but the solutions may not be straightforward, and could require the sale and transfer of that non-profit business. It is not usually possible to distribute the whole estate at once, as it is still "working", but the company must have a valid reason to postpone the distribution.

29. A fund which is still accepting new business is also required to have reasons for holding an inherited estate. To the extent to which the estate is more than adequate to cover reasonably foreseeable future risks and to finance new business acquisition, then the fund must make plans to distribute the excess, or else risk the FSA considering that it contravenes Principle 6 (which covers the fair treatment of customers).

30. *Who "owns" the inherited estate?* This question, too, has no single answer, certainly not for every company, and not usually a simple answer for any one company. Even in the case of a mutual fund (ie one without shareholders) the surplus may belong to the with-profits policyholders or to those with-profits policyholders who are members of the mutual, or even to all members of the mutual irrespective of their policy types. Governing documents may make this clear, or it may vary with the event causing the ownership to be determined (for example between a winding up and within an on-going entity).

31. Factors which are likely to be taken into account in a shareholder-owned company include the source of the estate (eg does some derive from an original investment by shareholders?) and the determinants of the relative interests of the policyholders and shareholders in future profits. The current in-force with-profits policyholders may only themselves have contributed materially to the estate if some aspect of the financial management involves charging their policies to increase the estate.

32. For a closed fund, if it has operated on the usual 90:10 principles (ie 90% of profits go to policyholders and 10% to shareholders), then it is likely that the estate must be distributed in that same 90:10 ratio, unless any special arrangements exist under which any portion which derived from past shareholder investments can be repaid to them. Similar considerations may also apply to the excess estate of funds still open to new business, though as this results in a windfall for the current generation of policyholders who may have made no, or very little, contribution, some argue that this is an inappropriate interpretation of the situation. To

a degree this is analogous to a demutualisation, whether of an insurer, a building society or even a motoring organisation. The windfall rarely goes to those who financed the build up, but does that alter the rightful recipients?

33. Policyholders would normally expect little or no distribution of that part of the estate of an open fund deemed necessary for prudent management purposes. However, where part of the estate is being invested in the writing of new business so as to preclude its distribution, shareholders may be inclined to offer existing with-profits policyholders an immediate distribution of a proportion of the estate (typically less than 90%), in return for establishing ownership rights{of the balance for the shareholders. This balance would then most likely be transferred out of the with-profits fund and used as capital to support existing business as it runs off as well as future new business, eventually being released to shareholders if and when no longer needed.

34. In the event of such an offer being made, policyholders might be given the option of whether or not to accept. Those not accepting might be permitted to{retain their existing contingent right to a share of 90% of natural future distributions, if any, of the estate. A proportionate amount of the estate would be retained for their benefit and possibly also for the benefit of future policyholders. This was the pattern used in the AXA Equity and Law case but it is not the only possible route.

35. Under the reattribution rules introduced by the FSA at the end of 2004, the company must now appoint and pay for a 'policyholder advocate' to represent and bargain on behalf of the policyholders. This individual will be someone with the skill and authority to negotiate with the company. They will be provided with their own, independent actuarial support and will consult with policyholders. The intention is that at the end of the process a deal ought to have been struck which provides a worthwhile benefit to both parties. This is not, however, guaranteed.

36. Whilst attributions of inherited estates are primarily commercial matters, actuaries can be found working both for the companies concerned and for their policyholders to ensure that the correct information is used and appropriate and relevant analyses carried out to help achieve a fair deal.

April 2008

Memorandum from Steve Dixon Associates

1. We provide actuarial advice to a number of insurers and friendly societies. Many of these have with profit policies. Most of the with profit policies are issued by mutuals.

2. In my opinion, the term "inherited estate" is a misnomer. The expression should be "the estate". The estate is an essential part of the capital of a with profit office and is the only source of capital for mutual organisations. Unless the estate can be treated as a source of capital, all mutuals would be trading as insolvent organisations.

3. The term "inherited estate" only started to gain credence after computerisation has allowed life office actuaries the ability to calculate individual policy "asset shares".

4. Asset shares are a form of retrospective policy valuation designed to show the share that the individual policy has generated within the funds of the life assurer. It is used frequently to give what could be considered a "fair" share of the funds to be paid out on maturity or surrender. It is frequently calculated as the premiums accumulated with some definition of investment return less some definition of expenses less some definition of risk charges for the risk benefits provided plus some item for profits from other business or charges for other sources of loss.

5. The definitions of the investment return credited, the expenses deducted and the risk charges are all fundamental and can have material impacts on the amount of the individual policy asset shares. There are frequently a number of different ways in which these items are set for the calculation of asset shares and, therefore, different asset shares for the same policy in the same life office.

6. When the individual policy asset shares where calculated, the total frequently ended up less than the total assets of the office. This was to be expected as the investment returns, expenses and risk charges (let alone the other profits and losses) could not be accurately calculated from the historic data and had to be estimated. The resulting difference was frequently explained as being the "inherited estate".

7. The estate has long been known of by life actuaries and one of the key functions of life actuaries has long been the planning of the amount of estate to cover the risks that the office runs.

8. Investment return credited to asset shares frequently attempts to reflect the actual performance of the assets held. However, this can be carried out in a number of ways:

a. Assets can be assumed to be one large managed fund and an average level of fund growth calculated. This misses the fact that the policies may be very different in nature and in level of underlying guarantees;

b. Assets can be split into those matching the guaranteed liabilities and those matching the future bonuses that will be credited and those matching the estate. The individual policy's split between guaranteed benefits and values of future bonuses can then be allowed for directly in the calculation of the asset shares.

9. Expenses can be charged on a number of different methods. The extremes are:

a. All of the expenses of the office can be divided between the policies in force. None of the expenses are charged to the estate.

b. The expenses can be charged on "table" or "expected values" to the asset shares with the remaining profit or loss credited to the estate. This is particularly appropriate for friendly societies where the expected values are in tables given to clients as the amount of expenses that will be charged to their policy.

10. Risk charges can again be split on the basis of an expected charge from a mortality or morbidity table or on an actual charge based on actual mortality or morbidity strains in the year. The norm is the former but it does mean that the mortality or morbidity profits (or losses) get credited to the estate rather than the asset shares.

11. Charges may be levied on the asset share on the "costs of guarantees" or the "cost of smoothing". These are normally charged in funds which use a managed fund method of apportioning the investment return (a in 8 above). It frequently has exactly the same impact as using 8 b as the investment apportionment if the assets matching guaranteed benefits are well matched by duration.

12. Whole life assurances tend to have unexpected reactions to asset share calculations. It is well known in actuarial circles that an asset share of a with profit whole of life assurance in high ages (say over 75) can become either several million in positive value or several million in negative value due to extremely small changes in investment returns, expense and risk charges. Mortality starts to have a major impact on the accumulation process.

13. New product development costs have to be financed by the estate for mutuals. A charge may be levied to the asset shares of these new products or the support from the estate may be seen as a "cycle" from one generation to another with the expenses being absorbed by all asset shares.

14. Mis-selling costs for mutuals have to be financed either from asset shares or the estate.

15. The estate must be the first area where profits and losses on non-profit assurances are paid into for mutuals. The mutual will use the estate as a capital pot to take the profits or absorb the losses.

16. The estate generates investment returns that can be used to boost the amount of the estate or to boost the payouts of policies.

17. The amount of estate is frequently planned which means that a large investment return on the estate and any profits from non-profit policies will be returned to with-profit policyholders in some form—frequently additions to the asset shares which are then paid out on maturity or surrender.

April 2008

Memorandum from the Association of Mutual Insurers (AMI)

1 It is important that the Treasury Committee inquiry recognises the fundamental difference between proprietary insurance companies and their mutual counterparts when considering the inherited estates of with profits funds.

2 Typically, in a proprietary insurance company the policyholder has a 90% interest in the profits of the with-profits fund, with shareholders taking a 10% share Theoretically, this should not create tension between policyholders and shareholders during the normal operation of these Funds although it should be noted that the FSA allows certain deductions from with-profits funds such as for shareholder tax and misselling costs which act in favour of shareholders. In previous reattributions of with profits funds much lower proportions of benefits have been given to policyholders as compared to shareholders. While all insurers have a duty to treat customers fairly, proprietary insurers also have a fiduciary duty to manage the company in the interests of shareholders. Given this there is always a real risk that a proprietary insurer will tend to favour the interests of the shareholder and create tensions between the interests of shareholders and policyholders.

3 In a mutual insurance company which has with-profits policyholders, the situation is more complicated because generally mutuals have one Main Mutual Fund which has to provide the assets to support all the activities of the business in the mutual and its subsidiaries both now and into the future as well as containing the assets that are needed to meet the interests and rights of with-profits policyholders. This main mutual fund is managed in a way to optimise the interests of current and future generations of Members as well as meeting the reasonable expectations of with-profit policyholders. Mutuals will have varying degrees of

overlap between members and with-profits policyholders and other Members may well have unit-linked or non-profit policies. Members retain their membership only whilst their policies are part of the active portfolio of the Mutual and that membership ceases when the policy is no longer active.

4 It follows however that mutual insurance companies cannot call on shareholders as a source of capital. Mutual insurers can raise capital in the commercial money market but this may not always be a viable option to secure additional capital. Mutual life insurers are reliant on their Main Mutual Fund as a source of capital. For this reason AMI is very clear that this Main Mutual Fund must be permitted to be used to fund strategic investment and to support the writing of new business (and activities in the interests of current and future members) where these activities are believed to add value to the fund.

5 In recent years we have seen a number of mutual life insurers make strategic investments in their business using the capital of the Main Mutual Fund; some of these have been related to promotion of with-profits business whilst others have been designed to broaden the operations of the Mutual into other areas where value can be added to the overall business.

6 These strategic investments include acquisitions of other companies in similar sectors providing scale and helps reduce costs. Cost savings derived from the resultant economies of scale can be passed directly through to with-profits policyholders in the form of enhanced bonuses and payouts

7 Equally, the sector has seen investment in new product development and new forms of distribution. For example Royal Liver, LV= and Royal London have all developed or acquired new protection businesses offering products that directly compete with more established providers of this type of insurance. These protection products offer a stream of future profits to the Main Mutual Fund which is not directly correlated with alternative investment assets such as equities and property. Profits from the sale of these other products enhance the overall value of the main Mutual Fund and enable it to meet the capital requirements of the Mutual both now and into the future.

8 Although such developments must be subject to a robust business case it is clear that the mutuals may be able to take a longer view than their proprietary competitors, who may be subject to pressure to deliver quick results and significant market share from their institutional shareholders. It is perhaps instructive that the market in Child Trust Funds, a product with low charges but an 18 year investment period, is dominated by mutual providers.

9 Against a background of more active corporate activity, and following the recommendations of the Myners Review, the mutual insurance sector has adapted the Annotated Combined Code for the use of the mutual sector. All members of AMI or bound to comply with the Annotated Combined Code (or at least explain non-compliance) and make a statement in the Annual Report. AMI monitor the compliance of members with the Code and report annually to FSA and HMT.

About the Association of Mutual Insurers

10 The Association of Mutual Insurers (AMI) represents 99% of mutual insurers in the UK. Formed in 2004 by thirteen founder members, its membership comprises 32 mutual insurers representing 15million policyholders and £83bn under assets.

AMI is the voice of the mutual insurance sector and represents members' interests to government, the FSA, the public and the media.

April 2008

Memorandum from Peter Bloxham, Prudential Nominated With-Profits Policyholder Advocate

1 Executive Summary

1.1 In March 2007 Prudential announced that it was considering a possible reattribution of the inherited estate in the with-profits sub-fund of Prudential Assurance Company. As part of this process, I was nominated by the company as the independent Policyholder Advocate (PHA) to represent the interests of policyholders in any reattribution.

1.2 Issues arising in relation to inherited estates and reattributions cannot be separated from the wider framework of how with-profits products operate. With-profits products have features which distinguish them from other investment products. They are characterised by large amounts of discretion conferred on the insurer and by a lack of transparency.

1.3 Insurers commonly use the "asset share" concept as a benchmark to measure policyholder entitlements. The use of standard terminology may give the impression that this is a single uniform industry-wide concept, whereas, in practice, there are various different approaches within the insurance industry to measuring policyholder entitlements.

1.4 The whole with-profits fund, including the inherited estate, belongs to the insurance company.

1.5 In a reattribution, the starting point is that policyholders do have expectations of a future distribution from the inherited estate. If a company announces its intention to explore or propose reattribution, it is implicitly acknowledging these expectations as, otherwise, there is no transaction to negotiate.

1.6 It is important that the inherited estate be available to support existing with-profits business, including after reattribution, to protect the fund against unexpected events. In addition, policyholders' contractual rights and their reasonable expectations must be met.

1.7 I consider that, in the context of an investment product where so much is discretionary and there are many areas where conflicts of interest can arise, there is a particularly strong justification for the FSA insisting that the "treating customers fairly" principle should inform all aspects of an insurer's conduct towards its policyholders.

1.8 A with-profits committee can play a valuable role in monitoring governance and assisting in addressing conflicts of interest which arise in the running of a with-profits fund. These conflicts may increase post-reattribution. As a result, the role of a with-profits committee may need to be reviewed and expanded as part of a reattribution.

2 Introduction

2.1 In March 2007 Prudential announced that it was considering a possible reattribution of the inherited estate in the with-profits sub-fund of Prudential Assurance Company. As part of this process, I was nominated by the company as the independent Policyholder Advocate (PHA) to represent the interests of policyholders in any reattribution. Nomination covers the initial fact-finding stage where I gather information and begin the process of investigation. On this basis I welcome the opportunity to respond to the Committee's call for evidence.

2.2 The Financial Services Authority (FSA) requires any company considering a reattribution of its inherited estate to identify a potential Policyholder Advocate at the earliest opportunity.[77] This requirement has two practical consequences:

- there is, in effect, a two-stage process—nomination of a Policyholder Advocate while the company's investigations are at an exploratory stage, followed by actual appointment once the company has made a firm decision to go ahead.
- at the nomination stage, there is no certainty that the company will proceed with the reattribution and, therefore, there is no certainty that a person nominated as a potential Policyholder Advocate will ever be appointed.

2.3 The decision whether to proceed from nomination to appointment is Prudential's, as is its timing. Even if I am appointed as Policyholder Advocate, Prudential could decide not to go ahead at any stage.

2.4 The Policyholder Advocate is, and must be seen to be, independent of the company and it is important that the Policyholder Advocate should be able to communicate freely with the FSA, with policyholders and with other interested parties.

3 Regulatory definition of the inherited estate

3.1 The "inherited estate" is part of the with-profits fund. The FSA state that it is the excess of a fund's with-profit assets over its liabilities[78]. The inherited estate is used to provide working capital (which is required for the day-to-day running of the fund) and regulatory capital (which protects against adverse market conditions).

3.2 Although there is a general acceptance of what is meant by inherited estate, what is more difficult to agree is how to calculate the two numbers (assets and liabilities including future projections). It is also worth noting that these numbers will fluctuate, notably as the investments and liabilities within the fund change in value.

3.3 One of my areas of focus to date has been the question of what policyholders can expect to receive and how policy benefits are both explained and calculated. The reason why this is particularly important is that the with-profits investment product gives insurers a large amount of discretion in deciding what benefits to award to policyholders. Unlike, for example, a unit trust product, it is not possible to state in advance how a policyholder's benefits will be calculated. There are two factors to mention:

- A common benchmark now used by insurers is the concept of "asset share". This concept is designed to describe the contributions (net of expenses) a policyholder has made and the rolled up investment return, by reference to the overall results of the with-profits fund, attributable to those contributions. However, there are a number of different approaches which are adopted to the exact

[77] FSA rules and guidance on the reattribution of inherited estates can be found in Chapter 20 of the Conduct of Business sourcebook.

[78] FSA letter on 'Reattribution of inherited estates', 6 December 2007 (http://www.fsa.gov.uk/pubs/other/reattribution—letter.pdf)

mechanisms used by insurers for calculating asset shares. It may be difficult for a policyholder to understand some of the details of these differences. As asset share is commonly used as a benchmark for the liability of the company to the policyholder, the methodology used to calculate it will have an impact on computations of the inherited estate.

— The practice of "smoothing", ie withholding part of the returns earned in good years to reduce the swings in overall returns between policies maturing in good and poor times.

4. Using Inherited Estate for Corporate Activity

4.1 My initial thoughts are:-

— there is clearly a conflict of interest for the company if new business (or strategic investment) is carried out on terms which require the with-profits fund to provide a subsidy;

— accordingly, the terms on which new business in the with-profits fund is written should not disadvantage existing policyholders;

— the FSA has established rules dealing both with new business and with strategic investments.

4.2 When a fund closes, policyholders have a much clearer right to distributions, over time, of any inherited estate. A Policyholder Advocate will have to form a view on realistic levels of future new business in the with-profits fund and on the prospect of the with-profits fund closing in the foreseeable future.

5 The Sharing of Inherited Estate

5.1 An inherited estate belongs to the company. The company is not the same as its shareholders. The whole with-profits fund belongs to the company, in the sense that with-profits policyholders are unsecured creditors of the company, not (for example) beneficiaries of a trust. However, policyholders have at least a contingent right to a distribution from the inherited estate.

5.2 Slightly confusingly, there is a concept of "excess surplus", where a company's inherited estate becomes sufficiently large that FSA rules require a company to consider taking specific action to reduce the excess surplus. The existence of this mechanism supports the proposition that an insurer should not consider that policyholders' rights or expectations in relation to distributions from the inherited estate are of no value.

5.3 During reattribution, policyholders are asked to give up their rights to a future distribution from the inherited estate, and are compensated by the company from shareholder funds for doing so. I consider that the launch of a reattribution process by an insurer (and even the nomination of a Policyholder Advocate) constitutes an acknowledgement by the insurer of its policyholders' rights. Otherwise, there is no transaction to negotiate.

5.4 However, a reattribution may allow policyholders to opt in or out (in other words, some policyholders may choose to keep the status quo and not accept any compensation). In such a case, clearly the inherited estate needs to be fairly divided so as to preserve the part attributable to policyholders choosing the status quo.

5.5 For those who give up their future rights, it is very important for the ongoing protection of policyholders' investments, that the inherited estate should continue to be available, where needed, to support the with-profits fund even after reattribution. Accordingly, an important, and complex, part of the negotiations between the company and the appointed Policyholder Advocate will be in relation to the controls over use of the inherited estate post-reattribution (including controls over distributions to shareholders post-reattribution).

6 Policyholders' Reasonable Expectations of Distributions from the Inherited Estate

6.1 The FSA has made its position clear at an appearance before the Treasury Select Committee in January 2008. I share its view that policyholders' reasonable expectations do include a contingent right to a future distribution from the inherited estate. I also believe that this right has a positive value. As previously mentioned, I consider that an insurer which embarks on a reattribution is acknowledging that policyholders' rights to the inherited estate must have a positive value.

7 Phased Distributions of Benefits from the Iinherited Estate

7.1 There are several points to make:-

— the first is that the term "distribution" is a bit of a misnomer, in the sense that most distributions relating to a with-profits policy will not be immediate cash payments, but will be additions of value to a policyholder's policy, which will only actually fall due for payment when the policy matures.

To this extent, distributions of benefits (apart from terminal bonus) are generally deferred. It is, of course, expected that there will be a regular bonus distribution (by way of uplift to policy value) each year;

- it is not clear to what extent promises of future distributions are at risk of withdrawal or reduction;
- distributions, once made, may be eroded if market conditions deteriorate prior to policy maturity.

8 Role and Responsibilities of the Policyholder Advocate

8.1 A Policyholder Advocate exists for the benefit of policyholders, and to seek to achieve the best possible outcome for policyholders.

8.2 The role of the Policyholder Advocate is to ensure that, in a reattribution, the interests of policyholders are protected. To this end, the Policyholder Advocate:-

- acts independently of the company;
- consults with policyholders;
- establishes multiple channels (e-mail, letter, telephone) for policyholders to communicate with the Policyholder Advocate;
- negotiates with the company on behalf of policyholders on the terms of the reattribution and, in particular:
  - the compensation to be offered by the company to policyholders for the rights policyholders are being asked to give up; and
  - the governance rules and protections for the fund and the inherited estate going forward; and
- writes a report containing his recommendations on any offer made by the company to policyholders.

8.3 The role of the Policyholder Advocate is limited to the immediate reattribution and to the with-profits fund in relation to which the Policyholder Advocate is appointed. The Policyholder Advocate should, nevertheless, undertake a thorough analysis of the particular fund in relation to which he has been appointed, including how it has been operated in the past, to help inform the negotiations. This approach was endorsed in the FSA's letter of 6 December 2007.[79]

8.4 It has become apparent to me that a policyholder will only understand reattribution if he understands how with-profits work. As a result, I and my team have put a lot of effort into producing materials which, we hope, will provide simple and clear explanations of these processes to policyholders.

8.5 Since being nominated I have begun to prepare for possible reattribution by:-

- setting up an independent office;
- putting together a small team to work with me;
- dealing with policyholder correspondence;
- commencing due diligence;
- participating in regular meetings with FSA and Prudential;
- making arrangements for policyholder meetings to be held around the country;
- preparing to establish a call centre and fully operational website for communicating with policyholders.

8.6 If appointed, I see my main roles as those of:-

- listening to policyholders;
- ensuring policyholders receive independent, clear and timely communications about the process;
- helping policyholders better understand the nature of the with-profits investment product they have paid into;
- conducting a tough negotiation with Prudential on the terms of the reattribution, so as to produce the best realistic outcome for policyholders;
- engaging with Prudential on "structural" issues such as which policyholders are eligible for any incentive payment;
- ensuring a fair allocation of the overall compensation between different groups of policyholders.
- Another factor I am aware of is the risk that some policyholders may miss out because of the protracted nature of the process. I will do my utmost to avoid unnecessary delays.

[79] FSA letter on 'Reattribution of Inherited Estates', 6 December 2007 (http://www.fsa.gov.uk/pubs/other/reattribution—letter.pdf)

9 The Framework for Negotiation between the Policyholder Advocate and the Life Assurance Companies

9.1 The FSA set the guidelines for the reattribution negotiations between a Policyholder Advocate and the insurance company. I will have to carry out my role (if I am appointed) within the guidelines prevailing at the time of my negotiations.

9.2 The relevant FSA rules[80] recognise that a degree of flexibility is required and that each reattribution will be different.

9.3 If appointed, I would propose to approach this with the aim of getting the best outcome for policyholders. As with any complex negotiation there will be a large number of issues to debate, some of which are very technical. Much of the detail of the negotiations would be confidential and I would be reluctant to publicise my negotiating strategy before appointment.

9.4 Some aspects of the negotiations may relate to the history of the fund and the way it has been managed in the past. I welcome the FSA's clarification, in its 6 December 2007 letter, that the appointed Policyholder Advocate can examine all aspects of past conduct of the fund.

9.5 In my experience, no negotiation produces a perfect solution for either party. An appointed Policyholder Advocate's job is to negotiate the best realistic deal available in all the circumstances for policyholders. Within that, one of the more difficult challenges is to ensure a fair allocation of the compensation between different groups of policyholders.

9.6 As already mentioned, it is important to ensure that the inherited estate is available, if required, to continue to support the with-profits fund. The Policyholder Advocate's responsibilities, as part of the negotiations, include building in suitable protections for the policyholders post-reattribution.

10 The Role of the With-Profits Committees of Life Assurance Companies

10.1 The general "treating customers fairly" principle applies to with-profits products, as it does to all investment products. However, there are good reasons why special rules have been formulated to apply this principle specifically to the with-profits sector. A few examples:-

- the very large measure of discretion afforded to the insurer in a wide range of areas, notably, investment powers and level of benefits to policyholders;
- the relative lack of transparency inherent in a number of core features of the product (for example, smoothing);
- the scope for conflicts between the interests of policyholders on the one hand, and of the company and its shareholders[81] on the other;
- the consequent need for rigorous governance procedures.

10.2 The FSA has, over time, taken a series of steps to reinforce governance, notably, the requirement on insurers to produce and abide by statements of Principles & Practice of Financial Management ("PPFMs") and the requirement to establish independent review of compliance with PPFMs. In large companies, this is generally achieved by establishing a with-profits committee.

10.3 In view of the points made in 10.1, the function of with-profits committees, as well as the with-profits actuary function, is very important as a method of ensuring governance and of monitoring conflicts of interest generally.

10.4 The discretionary nature of the policyholders' entitlements under with-profits products, and the lack of transparency, referred to in 10.1, creates scope for conflicts. Those conflicts of interest could increase post-reattribution and it may well be that a with-profits committee's status and role would need to be reinforced, as part of the enhanced governance arrangements emerging as part of the negotiations over a reattribution.

April 2008

Memorandum from the Association of British Insurers

Introduction

The Association of British Insurers (ABI) represents nearly 400 member companies, which between them provide 94% of the UK's domestic insurance. It works on behalf of the UK insurance industry to keep standards high and to make its voice heard.

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[80] The professional framework is paragraph 20.2 of The FSA's Conduct of Business Rules.
[81] In relation to a proprietary company, not a mutual.

What are Inherited Estates?

1. Inherited estates are a feature of most with-profits funds, long-term investment funds managed by insurance companies. Policyholders pay premiums which are then put together in a pooled fund and invested by the insurance company, with bonuses allocated to policies. With-profits policies also provide policyholders with life assurance and some guarantees.

2. The Financial Services Authority (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-profit fund". It, therefore, represents the assets held by the fund in excess of what the company expects to pay out to meet all obligations to its existing policyholders. These excess amounts can arise from a range of sources, including:

- Money retained in the fund to enable 'smoothing' of returns, so that investors are insulated from short-term variations in the stock market.
- The impact of long-term compound growth.
- In the case of proprietary companies, shareholder contributions; including the original working capital, additional capital injections and those elements of shareholders' profit entitlement retained in the fund.

3. The extent to which various factors contribute to the inherited estate will vary from fund to fund. The inherited estate is not simply made up of profits not paid out to policyholders and shareholders by way of bonuses. The total inherited estate will have been built up over many years.

4. It is worth noting that the insurance company owns the assets of a with-profits fund, including the inherited estate. The smoothed returns received by with-profits policyholders are related to the performance of the with-profit fund but the policyholders do not, and have never, owned the assets. The company is liable for policy payouts and meets these from its with-profits fund. The inherited estate belongs to the company and is not available to either policyholders or shareholders unless by way of a distribution or reattribution.

What are Inherited Estates used for?

5. The inherited estate forms an important element of the capital of with-profits funds, both for overall solvency purposes and to provide the working capital required by the fund. It is particularly important to note that mutual insurers have limited access to other forms of capital and are, therefore, even more reliant on the inherited estate for the continuation of their business model. The main functions of the inherited estate are:

- to provide solvency capital for the with-profits fund to meet the regulatory requirements set by the FSA;
- to provide investment flexibility (mainly to enable investment in equities, which offer higher expected returns than some other investments, but also a higher risk that returns may be insufficient to meet policy guarantees);
- providing for other unforeseen liabilities;
- to smooth bonuses to reduce the impact of sudden sharp changes in investment markets; and
- to help finance the acquisition of new business.

6. There have been a number of episodes in the past that have placed with-profit funds under extreme pressure (such as large market falls)—at such times a company will draw on the inherited estate to support and protect the interests of policyholders. This explains why the inherited estate has been retained: it helps to ensure that policyholders will be protected against any future unexpected events.

7. The letter of 6 December 2007 from the FSA to Clare Spotiswoode and Mark Hodges noted some concerns that have been raised about some of the permitted uses of the inherited estate—financing new business, making strategic investments, paying shareholder tax and paying the cost of compensation for mis-selling. All of these issues have been considered and decided recently by the FSA.

Allowing the inherited estate to help finance the sale of new business and make strategic investments is inherent to the way that with-profits funds operate. In the long-term, charges on the new policies will be expected to exceed costs and so they should generate additional profits for the with-profits fund, which will be to the benefit of policyholders. With-profits governance should operate to ensure that strategic investments are made on no worse than commercial terms. In the case of mutual insurers the inherited estate is the primary source of capital available to the company to finance these activities. The FSA has said that it will consult further on whether the inherited estate can be used to pay mis-selling compensation. We will respond to the FSA's proposals as and when these are published.

Distributions

8. The profits of the fund are distributed to policyholders and shareholders as bonuses (usually in the proportion 90 per cent to policyholders and 10 per cent to shareholders). The amount of bonus, and whether a bonus is added at all, mainly depends on how well the investments in the fund have performed and how the insurer expects them to perform in the future. In deciding the level of bonus insurance companies use a process called smoothing whereby some of the investment returns from good years is retained in the fund and used to top up bonuses in other years. Typically, there are two types of bonus: the annual bonus (which may also be called a regular or reversionary bonus) and the final bonus (which may also be called the terminal bonus).

Annual bonus

Once a year the insurance company will decide the amount of annual bonus it will add to its policies. Once any annual bonuses have been added they add to the policy guarantees and cannot be taken away.

Final bonus

A final bonus is calculated when the policy matures and it is used to top up the value of a policy so that the policyholder receives their fair share of the with-profits fund.

Reattributions

9. A reattribution is a separate process from the normal distributions described above. In a reattribution insurance companies reach an agreement with the current policyholders in their with-profits fund. The company offers a payment to policyholders (which will have to be funded by shareholders) in exchange for the policyholders relinquishing their interest in potential future distributions from the with-profits fund's inherited estate. This is a complex process with many checks and balances to ensure that policyholders are treated fairly. The process is governed by FSA rules and is also subject to approval by the High Court. These issues do not arise for a mutual insurer, as the parallel process would be a demutualisation, a transaction which is already fully safeguarded.

10. A reattribution can only follow negotiations to determine how much with-profits policyholders should receive now to compensate them for giving up their interest in any potential future distribution of the inherited estate. A decision to proceed with a reattribution will only be taken if it is in the best interests of both policyholders and shareholders. It requires complex actuarial calculations, to take account of changes to regulatory requirements and modelling diverse scenarios over a timescale of 25 to 40 years. The amount individual policyholders receive under a reattribution would vary: the overall payment should be divided fairly, and may take into account such factors as policy size and term. This payment represents certain money today rather than the possibility of a potential future distribution that may never happen.

Why have a Reattribution rather than Distribute the Inherited Estate?

11. A number of commentators have suggested that rather than carry out a reattribution firms should simply distribute their inherited estates to policyholders and shareholders. While there may be scope for firms with particularly strong with-profits funds to make such additional distributions, it must be understood that doing so will increase the risk of not being able to meet policyholder liabilities as they fall due.

A distribution of an inherited estate would reduce capital in the with-profits fund and possibly require the insurer to manage it more conservatively, with less equity and commercial property exposure. This may reduce the future returns to policyholders. In the case of mutual funds such a distribution of inherited estate could seriously compromise the viability of the company. A reattribution on the other hand preserves the capital within the long-term fund.

How are Policyholders Protected during a Reattribution?

12. An insurer wishing to undertake a reattribution must initiate a complex process designed to protect the interests of policyholders. These protections include:

- The appointment of an independent policyholder advocate to represent the interests of customers in relation to the reattribution (a separate policyholder advocate is appointed for each proposed reattribution). A policyholder advocate is not an employee of the individual company, although the company will pay reasonable expenses for the policyholder advocate and his/her office. The appointment of a policyholder advocate must either be made by the FSA or, if made by the company, be approved by the FSA. The FSA must also approve the policyholder advocate's published terms of reference to ensure his/her independence;

— An independent reattribution expert will be appointed to examine the proposals in great detail and report to the High Court on how the benefits and security of all customers will be safeguarded;

— The With-Profits Actuary and, where relevant, the firm's With-Profits Committee will also, in practice, help safeguard the interests of policyholders;

— The FSA oversees the whole process (including appointment or approval of a policyholder advocate and independent reattribution expert and ensuring that the with-profits fund continues to meet all regulatory requirements); and

— The High Court must approve the scheme.

13. There is no required timetable laid down for a reattribution process. This is a matter for the company, in consultation with the policyholder advocate and the FSA. Given the complexity of the process and the large sums involved it is inevitable that, while insurers seek to expedite the process, it will take a considerable period of time. Each fund is unique and the reattribution process will need to take account of the particular position and history of the fund.

14. Many of these safeguards, notably the institution of the policyholder advocate, have only recently been put in place following an extensive process of consultation by the FSA. There does not, therefore, appear to be any case for a review of the current process at this time.

Conclusion

15. For many insurers, the inherited estate is a vital resource to enable the management of with-profits funds in the best interests of current and future policyholders. It provides regulatory solvency capital, supports the smoothing and guarantees offered as part of with-profits investments, and allows investment freedom to maximise returns. Without their inherited estate, with-profits funds, particularly mutuals, would be unable to provide policyholders with reasonable returns.

16. The current rules governing the reattribution of inherited estate have only recently been put in place by the FSA. We believe that the checks and balances that now exist will ensure a fair outcome for policyholders and do not believe that there are any grounds for a further review of the regime.

April 2008

Memorandum from the Financial Services Consumer Panel

Executive Summary

The Financial Services Consumer Panel is pleased to have this opportunity to inform the Treasury Committee about issues of concern we have in relation to the inherited estates held by with-profits funds. While we are aware that there are numerous challenges in this area, we have focused this submission on our principal concerns.

The Panel has questioned[82] in the past the permitted uses of the fund, particularly where it seems some companies appear to treat the inherited estate as a free asset. While we recognise that the inherited estate belongs to the firm, as does the with-profits fund, there does not seem to be sufficient recognition that policyholders have contributed to the building of the inherited estate and as a result have a justified interest in how that estate is used and distributed. We welcome the introduction of the role of policyholder advocate and acknowledge the FSA's role in scrutinising the fairness of reattribution proposals.

The Panel's aim is to ensure policyholders are treated fairly in any distribution of inherited estate. In particular, we would like to see

— Greater independence in with profits committees and increased transparency about the reasons for their decisions

— Better, more helpful communication with policyholders during the reattribution process

— Timely, effective and fair distribution of benefits once decisions have been made

— A review of the role, responsibilities and effectiveness of the Policyholder Advocate following the Norwich Union reattribution process to determine whether it is necessary to strengthen the role

— A wider debate about the permitted uses of a fund than currently proposed by the FSA

— A review of the current rules relating to the governance of with profits funds.

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[82] Financial Services Consumer Panel Press Release: FSA must do more to ensure Treating Customers Fairly for reattribution of inherited estates, December 2007.

Principal Concerns

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

1. The Panel has expressed concern[83]in the past about the permitted uses of the inherited estate. The inherited estate can be a substantial asset for proprietary companies and assists with the running of the business. While we are aware that the inherited estate belongs to the firm, as does the with-profits fund, there does not seem to be sufficient recognition that policyholders have contributed to the building of the inherited estate and as a result have a justified interest in how that estate is used and distributed. In addition, there does not seem to be sufficient appreciation of the benefits that shareholders have received through the permitted uses of the inherited estate or appropriate recompense to policyholders for this.

2. The potential for conflicts of interest between shareholders and policyholders in the use of the inherited estate is clear. We believe that the key issue is how to ensure that these conflicts are managed, so that the company's use of the inherited estate reflects the principle of Treating Customers Fairly[84] ('TCF), as well as taking shareholder interests into account, where appropriate.

3. Following the with-profits review undertaken by the FSA in 2001 it decided to require insurers to produce a document called the Principles and Practices of Financial Management (PPFM) explaining how firms ran their with-profits business. The PPFM contains information such as how policy payouts are determined, the operation of smoothing, bonuses and market value reductions. Firms are required to produce a consumer friendly version which summarises the key aspects in a clear and understandable way.

4. Last year the Panel commissioned research[85] into the question of whether customers in closed funds were being treated fairly. This found that there was a strong view amongst consumer representatives and some providers that conflicts of interest between shareholders and policyholders can, in effect be 'written into' the PPFM to the benefit of shareholders. These include the management's right to use policyholder capital to fund new business operations and costs (including comparatively high levels of initial commission), to buy closed funds, to pay shareholder tax and to pay mis-selling claims. We do not suggest that such uses of policyholder capital represent breaches of regulatory rules, nor do we suggest that the conduct of business rules encourage such use, but we are concerned that the present governance arrangements for funds are not sufficiently robust or transparent.

5. We are pleased that the FSA intends to consult[86] during the first half of 2008 on whether it should change its approach and require shareholders to meet mis-selling costs. However, given the concerns we encountered in our research, in the interests of policyholders we suggest that firms' use of policyholder capital is reviewed more widely in an open debate.

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

6. The key principle that should guide any reattribution is to treat policyholders fairly. This is much more complex than it sounds, given that policyholders have been in the fund for different lengths of time and that no one can be certain what the future will hold. The Policyholder Advocate has been examining this problem in detail, but it seems reasonable that money should be paid out as soon as possible and that it should go to all policyholders who were in the fund when a Policyholder Advocate is appointed.

7. An important problem facing those involved in considering the size of the fund available for redistribution is that a decision to stop seeking new business has a considerable impact on the way the fund has to be managed and the risk appetite of the fund. New policyholders joining the fund enable it to take on more investment risk and therefore should lead to higher returns. It is therefore assumed that it is in policyholders' as well as shareholders' interests for a fund to continue to invest in developing new business where this is likely to be profitable. However, a decision to close a fund or seek new business less aggressively can create a situation where the risks of the fund are reduced and excess surplus is created. If the strategy changes after a reattribution all the excess surplus goes to the shareholders. If such a change in policy could have been anticipated before the reattribution, it would be extremely unfair to policyholders who would have based their decision on misleading information. It is therefore important that the Policyholder Advocate and the Company agree that the new business strategy for the fund is reasonable and that after a reattribution the FSA checks that the company follows its stated strategy under its requirement to ensure that a firm manages conflicts of interest, fairly.[87]

[83] Financial Services Consumer Panel Press Release: FSA must do more to ensure Treating Customers Fairly for reattribution of inherited estates, December 2007.

[84] Principle 6 of the FSA's 11 Principles for Businesses: A firm must pay due regard to the interests of its customers and treat them fairly.

[85] Are Customers in closed funds being treated fairly? Raising the bar for advice, administration, communications and governance. Research for the Financial Services Consumer Panel by the Pensions Institute, Cass Business School and IFF Research Ltd, pg 29, para 4.4: Governance.

[86] http://www.fsa.gov.uk/pubs/other/reattribution—letter.pdf

[87] The FSA's Principles for Business: Principle 8: A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

8. We have expressed our concern to the FSA that a firm could set a high risk appetite requiring capital to be set aside to cover this and then after the reattribution adopt a low risk appetite and pass the excess capital to shareholders, circumventing the reattribution. In response to our concern, which is also shared by Clare Spottiswoode, the Policyholder Advocate for the potential reattribution of the CGNU Life and Commercial Union Life Assurance Company Funds, the FSA has said that it expects firms to limit post reattribution distribution.[88] We look forward to an explanation of how this can be achieved.

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

9. The Panel believes that policyholders have a reasonable expectation that a distribution from the inherited estate has a positive value. The inherited estate is built up by with-profits funds over many years and is above the amount expected to be needed to meet current and future policyholder commitments and other liabilities. As such it has a real tangible value; to argue that the inherited estate has a zero value seems to be counter intuitive.

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

10. The Panel suggests that the views of the Policyholder Advocate should be taken into account when the firm decides how the distribution of benefits should take place. We do believe that it is fairer to make a single payment rather than phasing payment over several years. In addition, we believe that it is essential that the views of with-profits committees on this issue should be made public. This would enable policyholders to be aware of the opinions of the body established to represent their interests and their reasons for believing that a particular course of action was appropriate. We can see no reason why these views should not be disclosed.

The role and responsibilities of the Policyholder Advocate

11. Following the AXA reattribution in 2000, the role of the Policyholder Advocate was introduced to enable policyholders to have an independent representative in the process. The Panel welcomed the creation of this role as it is important that policyholders have a strong and appropriately qualified voice in this arena. The appointment of Clare Spottiswoode by Norwich Union in November 2006 is the first time that this new role has been tested.

12. There is no doubt that the creation of the role of Policyholder Advocate has enabled a more effective debate about the reattribution to be conducted. We look forward to a comprehensive review of the role, responsibilities and effectiveness of the Policyholder Advocate on conclusion of the process.

13. We believe that Ms Spottiswoode and her team have done a good job of engaging with the complex issue of with–profits funds and as a result have exposed some potential conflicts of interest that need to be addressed.

The Role of With-Profits Committees of Life Assurance Companies

14. Since 2004, the FSA has required firms to have an independent voice to represent policyholders, such as a with-profits committee ('WPC'). The Panel's research found that while some companies have moved towards a genuinely independent model, 60% of funds had a WPC that was not independent. In some cases the WPC was a sub-committee of the main board, while in others WPC members consisted of current directors, former directors and non-executive directors. In about 10% of cases the firm did not provide information about the composition of the with-profits committee in the PPFM.

15. While 40% of WPC's had a degree of independence, the level of independence varied considerably. Within this group the research found fewer than five cases where the independent members had the majority vote. In the other examples, there was usually only one independent member.

16. The Panel believes that the independence of the WPC should be strengthened and that it should provide a public and regulatory "window" on the firm's use of policyholder capital. The primary purpose of WPCs should be to ensure that the financial management of the fund, which includes the inherited estate, is in the best interests of policyholders. To achieve this clear objective the WPC should be independent of the firm's board. This would require a majority of independent members (or the power for independent members to cast a majority vote) and an independent chair. An independent WPC would be more effective in negotiations on management decisions in relation to the distribution of the inherited estate and ensuring that the TCF principle is taken into account in the management of the fund.

[88] http://www.fsa.gov.uk/pubs/other/reattribution—letter.pdf

17. The Panel believes that the WPC's remit should include TCF. TCF is aimed at directors and senior managers, who must ensure that the principle of TCF is embedded in the corporate culture. At present the management's approach to running the with-profits fund is set out in the PPFM document. Experts consulted in the Panel's research were divided on the value of the PPFM in relation to TCF but there was agreement that the PPFM remains the reference point for the WPC's assessment of fair treatment to policyholders.

18. One way to achieve a better balance between the needs of shareholders and policyholders would be for the WPC to assess the management's adherence to the principle of TCF as well as to the PPFM. For example, the WPC could report on the company's use of capital in relation to its opinion of TCF and the PPFM, setting out any discrepancies between the two. While it is acknowledged that this may establish conflicts between the WPC and the board of the firm, this is not necessarily a negative development, but merely brings into the open conflicts that already exist and which may otherwise be overlooked. The FSA could consider the model used by the Pensions Regulator in the regulation of occupational pension schemes to resolve disputes between the WPC and the board of the firm.

19. The FSA could strengthen the WPC by establishing a "knowledge and guidance centre' for committee members, similar to that provided by the Pensions Regulator for trustees of occupational pension schemes.[89] This could set out the key aspects of regulation that WPC members need to read and understand, for example conduct of business rules and TCF requirements. It could include any requirements to review fund surplus on an annual basis and to review any changes to the PPFM that are material in relation to the fair treatment of policyholders. It could set out considerations for TCF in relation to the management's use of capital, including the inherited estate. To raise the visibility of the with-profits committee as a mechanism for TCF and reassure policyholders that their interests are being represented and protected, it would be desirable for the with–profits committee to have its own website with a clear link from the firm's site.

20. The FSA could further strengthen the TCF regime through the requirement that management produces a simplified annual financial statement that sets out how it has used policyholder capital, including the inherited estate, over the past year and why it expects this use will provide a good return to the fund for the policyholders' benefit. Although in theory this information can be gleaned from the PPFM, with-profits experts interviewed for the research said, of PPFMs, that the management could "tick all the right boxes" but may still not provide a clear picture of how capital has been used. The simplified statement could set out how the fund is invested, including its asset allocation and information about the asset management team. In addition it could include all other uses of capital, for example for new business purposes, to buy closed funds, to pay shareholder tax, to pay mis-selling claims, and to pay comparatively high levels of commission (relative to similar products) to advisers for the sale of new products.

The Approach of the Financial Services Authority to the Issue of Inherited Estates

21 The FSA has an independent role to scrutinise the fairness of reattribution proposals. It has an obligation to consider proposals in the light of its regulatory objectives. We are pleased that the FSA has clearly set out its views on its role in the reattribution process in a letter to Clare Spottiswoode and Norwich Union.[90] We are particularly pleased that the FSA has stated that in conducting its role it will examine whether it appears that the Policyholder Advocate and the firm are able to conduct a full and fair negotiation.

22 It is important that the Policyholder Advocate is properly resourced to enable the proper fulfilment of this important role designed to represent the interests of policyholders. We believe this is a critical role and support the FSA in its aims. We are particularly keen to ensure that policyholders are treated fairly in any distribution agreement. We believe that TCF must be a key feature of any future debate on the permitted uses of the inherited estate.

23 On the wider issue of with profits, the Panel has, in its last annual report, rated the FSA as weak in this area. While we acknowledge that the FSA has taken steps to address some of the issues facing policyholders, we continue to believe that the FSA could do more to help consumers get access to helpful advice and to understand the decisions they need to take on their with profits policies.

Role of The Consumer Panel

The main purpose of the Panel is to provide advice to the FSA. Consequently the emphasis of the Panel's work is on activities that are regulated by the FSA. The Panel is also responsible for assessing and commenting on the FSA's effectiveness. The Panel also looks at the impact on consumers of activities outside but related to the FSA's remit. Examples include European issues and policy proposals by H M Treasury and others. The Panel has regard to the interests of all groups of consumers, including those who are particularly disadvantaged in the context of financial services. The Panel can also advise the Government on the scope of financial services regulation; and consider other matters that assist it in carrying out its primary functions.

[89] http://www.thepensionsregulator.gov.uk/trustees/index.aspx
[90] http://www.fsa.gov.uk/pubs/other/reattribution—letter.pdf

How the Panel Operates

The full Panel meets about 10 times per year. In addition, smaller 'working groups' meet monthly to deal with specific issues in more detail and to consider the Panel's formal responses to FSA and other consultations. FSA staff and other third parties are invited to these meetings and participate in discussions. The Panel also holds meetings outside the FSA's offices with members of the financial services industry, as well as with consumer representatives. The Panel also commissions research to obtain a better understanding of consumers' views and to identify areas of concern. A monthly report of the Panel's work and concerns is provided for the FSA Board.

Accountability

The Panel publishes an annual report on its activities. Annual Reports, responses to consultations, research reports and other information is available on the Panel's website at www.fs-cp.org.uk. The website contains the Panel's e-mail address, but makes it clear that the Panel is not in a position to pursue individual or specific complaints from the public about financial services. The Panel does however consider carefully the wider implications of any complaints or other information provided by consumers and others who contact the Panel.

Membership

Panel members are appointed by the FSA Board following an open recruitment process based on the Nolan principles; the appointment of the Chairman must have the formal approval of the Treasury. Currently the selection process for a new Chairman is taking place following the resignation of John Howard, the Chairman from 1 October 2005 until 31 March 2008. Adam Phillips, who joined the Panel in March 2004, was appointed Vice Chairman with effect from 1 November 2005 and is currently Acting Chairman.

Members of the Panel have a wide range of relevant experience such as consumer advice and advocacy, front-line advice, legal expertise, market research, consumer policy and the media.

April 2008

Memorandum from the Association of Consulting Actuaries

The Association of Consulting Actuaries (ACA) welcomes the opportunity to make a written submission to the Treasury Select Committee on inherited estates as requested in the Treasury Select Committee press notice no. 26 of 26 February 2008.

ACA members act as advisers to friendly societies, life insurance companies and other companies involved in the insurance sector, such as investment banks and Private Equity houses, both in the UK and overseas. Association members act as Head of the Actuarial Function, With Profits Actuary, Reviewing Actuary and/ or peer reviewers to many UK life insurers and friendly societies. Members of the Association are all qualified actuaries and are subject to the Code of Professional Conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial.

The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

With regard to inherited estate issues ACA members could be acting from many different perspectives including: as advisors to shareholders; as advisors to Policyholder Advocates; as with-profits actuaries to smaller companies; as advisers to IFAs advising clients, etc. In this submission we have tried to recognize the many parties involved in the attribution process and the different roles ACA members may play by seeking a process that is fair, as far as possible, to all.

We would stress that each attribution is unique with regard to the specific circumstances of each company, the with-profits fund(s), generations of policyholders, history of the growth of the inherited estate and past practice. Consequently for many of the issues involved here there is no "right" answer to many of these questions. We believe that the aim of the Committee's inquiry should be to bring clarity and a principles based approach rather than prescriptive regulation which may not be appropriate to the individual circumstances of each company.

This submission is in two parts: an executive summary and responses to a number of the specific topics highlighted by the Treasury Select Committee.

Executive Summary

1. Although the inherited estate is owned by the firm as part of its assets in the circumstances where there is excess surplus we believe that the policyholders' reasonable expectations of a distribution may be greater than zero. However, policyholders' reasonable expectations will also be influenced by past practice and statements made to policyholders (including in the PPFM) and the market.

2. The role of the policyholder advocate is an important one and we would welcome greater clarity in the areas that reasonably come within the realm of consideration by the policyholder advocate and what, allowing for the individual circumstances of each company, might constitute a reasonable time length for the negotiation of the inherited estate attribution process.

3. Greater clarity in the roles of the various parties relevant to the process of an inherited estate attribution would be welcome as would a consistent view between the Financial Services Authority and policyholder advocates on the range of appropriate uses of the inherited estate in general. We recognize that individual companies' circumstances can differ widely, and therefore the options for use of the inherited estate will vary from company to company.

4. With-profits committees when appropriately constituted are an effective defender of the interests of with-profits policyholders; in particular in ensuring firms operate in a manner consistent with their documented Principles and Practice of Financial Management. The role of negotiating on behalf on with-profits policyholders is appropriate to the policyholder advocate and is not an explicit role of with-profits committees, although they should of course act in the best interest of the with-profits policyholders.

5. We are supportive of the general approach taken by the FSA on the use of the inherited estate and agree the 90:10 rule is generally an appropriate starting point for distributions, although some companies have used other approaches. We would seek greater clarity on the implications of the 90:10 rule in the different circumstances of a distribution of the inherited estate and its attribution.

6. We believe it is timely to reconsider the appropriateness of the inherited estate being liable to mis-selling compensation costs. However, we consider that an approach of requiring shareholders to bear the full cost of mis-selling could lead to other costs falling on policyholders indirectly.

7. Finally we note that many writers of with-profits business are small and often mutual firms. Any potential changes to regulation or guidance on inherited estates must be appropriate to their circumstances as well as to those of large propriety firms.

Select Committee Topics

8. The ACA wishes to respond, in particular, to five of the bullet points the Treasury Committee requested evidence on:

— Whether policyholders' reasonable expectations ("PRE") of distributions from inherited estates should be zero or have a positive value

— The role and responsibility of the Policyholder Advocate ("PHA")

— The framework for negotiation between the PA and the life assurance companies

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

— The approach of the Financial Services Authority ("Financial Services Authority") to the issue of inherited estates.

Whether PRE of Distributions should be Zero or have a Positive Value

9. We accept the legal argument put forward by the FSA that the inherited estate is owned by the firm as part of its assets and that the policyholders have a contingent claim on these assets.

10. PRE are determined by the level of the inherited estate. Where the inherited estate is used to support the running of the overall business and there is no excess surplus then at that time the PRE of a distribution is generally zero. If the fund has excess surplus (that is more assets than it needs to run its business based on the level of its risk appetite) then the PRE of a distribution may be greater than zero.

11. However, there are many factors governing PRE here. For example, PRE depends on how the company assesses whether there is excess surplus, which in turn depends on areas such as appetite for risk and the financing new business. It also depends on past practice, statements made to policyholders (including in the PPFM) and the market, how past benefit payments have been derived (including smoothing), etc. It is important to consider how the excess has arisen and how much the current generations have contributed to it. In addition there is the issue of how much of the excess can be distributed, and over what period and to whom. All of these questions probably give rise to unique answers for each company and consequently we believe each case should be considered on its own merit rather than setting a general expectation of a distribution.

The Role and Responsibility of the PHA

12. There is clearly a need for the interests of with-profits policyholders to be put forward by an independent voice during the consideration of an attribution of the inherited estate. The company is not in a position to be independent as it must consider the interests of its shareholders and this is not the role of the with-profits committee. Consequently we agree that there is a need for a policyholder advocate.

13. The arguments for and against an independent versus an FSA authorized PHA were discussed in the Treasury's "Consultation on amendments to the Financial Services and Markets Act 2000 (Exemption) Order 2001 for the role of the policyholder advocate" of December 2006.

14. Generally we agree that the most appropriate role of the PHA is as a non-FSA authorized independent individual with the safeguards on the appointment of the PHA detailed in the FSA's New Conduct of Business Sourcebook.

15. We note however that under this arrangement the individual policyholders do not have recourse to the protection of the Financial Ombudsman Scheme ("FOS") if they disagree with the PHA, although they do still have recourse to FOS with regard to the actions of the insurer itself. In addition generally attributions are a court based process where the individual policyholders may make representations, if they so wish.

16. To be too prescriptive on the role of the PHA would be limiting and inflexible in the context of the fact that each inherited estate attribution has special circumstances. However, in the absence of clear guidance on the role of the PHA there is a risk that the PHA may have a wider vision of the role than was originally anticipated or that the attribution process may take a significant amount of time.

17. Currently the reattribution and insurance transfer costs are met by shareholders, but only a reasonable proportion of the PHA's costs are met by the shareholders. We would like to see further clarification on how reasonable is defined, but provided the PHA's fall within a reasonable range we believe an argument could be advanced that most, or all, of these costs should be met by the shareholders. We consider that if an attribution fails it is reasonable that the initiator (usually the shareholder) should pay the PHA's costs.

Framework for Negotiation between the PHA and the Life Assurance Companies

18. There is the potential for a significant overlap in the roles of the various parties (the PHA, the Independent or Attribution Expert and the FSA) relevant to the negotiation process. The key responsibilities of the PHA are to current (and possibly future) with-profits policyholders; of the Expert are to the Court (considering all policyholders) and of the FSA are to all policyholders having regard to their security and fair treatment within the context of the regulations. Bearing these in mind, we would seek greater clarity in the specific roles of each to reduce the duration and associated costs of the process of establishing inherited estate attributions.

19. We would welcome greater general guidance on how the PHA should balance the interests of different groups of with-profits policyholders when negotiating with life insurance companies. Such guidance should be flexible enough to allow that each inherited estate attribution has its own specific circumstances.

20. Although the risk appetite of a firm is documented and its management of the inherited estate is documented in the PPFM there is a risk that the PHA may take a materially different view to that of the firm on the appropriate use of the inherited estate and its consequent capital costs and capital requirements. Whilst acknowledging that this is part of the negotiation process between the PHA and the firm we would look for a consistent approach to be adopted by both the FSA and the PHA on assessing whether a company's proposals on the uses of its inherited estate are appropriate in general terms.

The Role of the With-Profits Committees of Life Assurance Companies

21. The with-profits committee primary role (as laid out in the FSA's Handbook, in particular the New Conduct of Business Sourcebook) is to act as an independent body assessing compliance with the firm's Principles and Practices of Financial Management ("PPFM") and addressing conflicting rights and interests of policyholders and, if applicable, shareholders. The FSA also wrote to CEOs in September 2007 setting out some perceived shortcomings of with-profits governance regimes highlighted by its reviews.

22. Other than compliance with the management of the inherited estate as detailed in the PPFM the with-profits committee has no explicit remit to negotiate on behalf of the with-profits policyholders in an attribution. This is the role of the PHA.

23. Nevertheless the with-profits committee should act in the best interests of the with-profits policyholders (both current and future policyholders) and may be involved in some form in the negotiations relating to the attribution. Much of the information the with-profits committee is exposed to may be commercially sensitive and not for public disclosure.

24. Consequently much work done by the with-profits committees is not done in the public domain and potentially unrecognized. There is a trade off between the transparency of the actions of the with-profits committee and the potential effectiveness of its actions.

25. The ACA believes that currently appropriately constituted with-profits committees are an effective protective element of the governance of with-profits funds and would not seek an extension of their role in the negotiation of inherited estate attributions as this is best currently performed by the PHA.

The Approach of the FSA to the Issue of Inherited Estates

26. We are supportive of the general approach taken by the FSA in the issue of the inherited estate. In particular that the 1995 Ministerial Statement on the 90:10 rule is an appropriate starting point for distributions and attributions. However as has been seen recently the 90:10 rule is understood differently by different parties particularly in the different circumstances of an attribution and a distribution. We would welcome increased clarity on this point. We note that not all companies have followed a 90:10 rule in paying out their surplus and the individual circumstances of each company need to be considered when assessing the appropriate ratio.

27. We support the FSA stance on the uses of the inherited estate as clarified in its letter of 6 December 2007. In particular, we believe that the strength of the arguments for the inherited estate to be subject to mis-selling compensation costs is questionable. If shareholders were subject to these costs potentially there would be less risk of moral hazard in the actions of management and a closer alignment of the interests of shareholders and management. We acknowledge, however, that there are two sides to this argument and if shareholders risk picking up all the costs, there is a chance that they could impose a more onerous compliance regime, the costs of which might ultimately largely be passed on indirectly to policyholders.

28. Finally we would point out that many insurers with with-profits business are both small and mutual firms and that any potential changes to regulation and guidance on the use of inherited estates must be appropriate for them as well as for the large proprietary insurers with significant inherited estates that are currently considering attributions.

14 April 2008

Letter from Sir Nicholas Montagu KCB to the Chairman of the Committee

Thank you for your letter of 25 April, requesting information on a number of issues concerning the Norwich Union With-Profits Committee (WPC), which I chair. Since you have asked for that information by Tuesday 29 April, and I received your letter late on Friday, I hope you will excuse me if there are some areas where my response is less than complete. I have however attempted to reply to your main questions, and my numbering below reflects that in your letter: I have amplified my responses to give additional information where it seemed to me that it was likely to be helpful to your Committee.

By way of background, the newly-constituted Committee took up their appointments in July. The structure—an independent majority, but with two senior Norwich Union members—reflects other companies' experience and discussion with the Financial Services Authority. It aims to avoid the twin dangers of an entirely independent committee being so uninformed about the Company as to be unable to contribute to strategic discussions; and of an entirely in-house committee being insufficiently challenging to the Company's Board and thinking.

1–2. *Members of the WPC and their relationship with Norwich Union/Aviva*

The independent members of the WPC are:

Harriet Maunsell OBE, a pensions lawyer and former partner in Lovells, latterly Chairman of the Occupational Pensions Regulatory Authority

John Hylands, an actuary and former Finance Director of Standard Life

Sir Nicholas Montagu (Chairman), former Chairman of the Inland Revenue.

None of the independent members of the Committee is a present or past member of the Board or officer of Aviva or Norwich Union, nor do they receive any remuneration from those companies other than fees for service on the WPC. None is a shareholder in Aviva or a with-profits policyholder with Norwich Union, apart from John Hylands' holding in a personal equity plan of 98 shares in Aviva plc, which he received from Norwich Union on its demutualisation in 1997.

The company members of the Committee are:

David Barral, Marketing Director, and

Stephen Marsh, Director of Risk and Governance.

I do not know whether they are shareholders or with-profits policyholders; but I assume that in any case your questions on this point were more directed to the independent members of the Committee.

3. *Appointment of WPC Members*

The independent members of the WPC were appointed by the Norwich Union Board following a recruitment exercise conducted for the Company by search consultants (The Miles Partnership); this included preliminary interviews with the consultant and interviews with senior people from Norwich Union, including finally the Chief Executive and Finance Director.

The Norwich Union Board appoints the company representatives on the Committee. Since the roles of members of the Committee are what the Financial Services Authority (FSA) terms "controlled functions", the people filling them must be approved by the FSA: they also took a close interest in the background and experience of the candidates for appointment as independent members of the WPC.

4. *Roles, responsibilities and powers of the WPC*

The primary responsibility of the WPC is to ensure that, inasmuch as their actual and prospective benefits and security are concerned, with-profits policyholders are treated fairly. This involves providing the Norwich Union Board. with an independent assessment of the firm's compliance with its Principles and Practices of Financial Management (PPFM) and of how any competing rights and interests of policyholders and, if applicable, shareholders, have been addressed. This includes an assessment of the way in which any proposed changes to the PPFMs might affect the rights, interests or expectations of with-profits policyholders.

Our formal terms of reference follow the Norwich Union template for terms of reference for the Board Committees (of which the WPC is one); they have been approved by the FSA, whose agreement to them and to any change is required. They are rather long and, in my view, somewhat cumbersome, and we will keep them under review, especially as the FSA moves generally towards more principle-based regulation. The terms of reference themselves require such a review, at least annually, taking account of best practice and regulatory requirements.

As drafted, the terms of reference assumed that the reattribution exercise would have been completed by the time that we took up our appointments. Since that proved not to have been the case, I should emphasise that we have asked for an update on the exercise to be a standing agendum at our meetings and that we shall naturally expect to provide comments to the company on any proposed settlement between them and the Policyholder Advocate (PHA). We are not, of course, a party to the negotiations between Norwich Union and the PHA; but the independent members had a meeting with Clare Spottiswoode in December last year, to enable her and us to understand our respective roles.

These terms of reference mean, in practice, that the WPC's main function is to provide high-level advice and challenge to the Norwich Union Board. Our task is to satisfy ourselves that policyholders' interests have been properly considered and taken into account in any proposal or policy that comes to us. This role includes involvement in all major Norwich Union with-profits proposals, whether routine (eg regular bonus distributions, investment policy or certification of compliance with the PPFM) or one-off.

Our responsibility is to the Norwich Union Board, to whom I report regularly, both in writing and by attendance at Board meetings; we are also required to submit a written report to them annually. We do not have executive powers; but in the event of a substantive disagreement between the Board and the WPC, we have the right to take the matter direct to the FSA. I should stress that this has not happened since our appointment and that where there has been a disagreement, the Board has accepted and acted upon the view taken by the WPC.

We are subject to close and regular scrutiny by the FSA. They receive all our minutes and can call for any of our papers. In addition, I have had three bilateral meetings with them since my appointment, one of them with the other two independent WPC members. I have suggested to the FSA that our next meeting with them might usefully include the whole Committee.

5. *Staff resource committed to the Secretariat*

Norwich Union have in the nine months since our appointment made staff freely available to service the Committee as required. I am afraid that I cannot put an exact figure on the resource committed; the actuary who acts as our main link with the Company and who heads the Secretariat estimates that it accounts for perhaps 25% of his time; there is obviously a knock-on to his PA's time as well. In addition, a member of Norwich Union's legal staff acts as secretary to WPC meetings, taking the minutes. The With-Profits Actuary is also heavily involved, both at and in between meetings, providing the main technical link to the committee and, with the head of the Secretariat taking the lead in pre-meeting briefings. Our induction programme made appreciable demands on time of Norwich Union staff across a wide range of responsibilities. In addition to Norwich Union staff already mentioned, and to those attending for specific papers, the Chief Actuary and the Director of Compliance routinely attend our meetings.

The independence of the majority of WPC members is boosted by the ubiquitous involvement in our business, and the presence at all our meetings, as mentioned above, of the With Profits Actuary. Although he is employed by Norwich Union, his advisory role in many ways mirrors that of the WPC, in that he is independent of both the Committee and the Norwich Union Board, and his performance in this role is

subject to scrutiny by both the FSA and the actuarial profession. In addition to the presence of the WPA, we have independent actuarial advice available to us on a continuing basis from Watson Wyatt, whose representative attends all our meetings. This advice is paid for by Norwich Union, but Watson Wyatt's responsibility is to the Committee, not the Company. Norwich Union have also made clear to us that they will pay for any other outside independent advice that we decide is required on any topic.

6. *Would the WPC welcome a clear mandate to protect policyholders' interests in the with-profits funds?*

The independent members who form the majority of the WPC believe strongly that we already have such a mandate. It is intrinsic to our function and terms of reference that we should ensure that policyholders' interests are protected in proposals put forward by the company and to represent those interests to the Board where we feel that they are not. Our responsibility is to satisfy ourselves that such proposals result in the fairest possible treatment of customers overall, recognising that it will virtually never be possible to optimise the outcome for every single policyholder—a point especially relevant to my reply to your question about the distribution of the special bonus (12 below). We have made clear to the company that, to enable us to reach fully-informed conclusions, we expect the documentation supporting proposals put to us to include a full analysis of the distributional effects, both on the generality of policyholders in different groups and at the extremes.

It is important to understand just what our function is, which is also reflected in my response to your questions on communication. It was perhaps misleading for last week's Which witness to refer to us as "the champion of the policyholders", as this description risks giving the impression that we are there as some sort of court of appeal for policyholders. It follows from my explanation of our purpose and terms of reference that such an impression would be wholly false: certainly we are there to see that policyholders' interests are protected, but at the level of policy-making and review. We are neither tasked nor equipped to handle individual casework involving policyholders' dealings with Norwich Union.

That said, we see it as essential to that function to get a feel for the issues that are in general concerning policyholders. We have therefore asked Norwich Union to ensure that information from surveys and from their analysis of what their customers are saying is made available to us on a regular basis. I return to this point in responding to your questions 10–11 below.

7. *What consideration is the Board of NU obliged to give advice from the WPC?*

As indicated in my reply to question 4 above, the NU Board is obliged to consider advice from the WPC, but is not bound by that advice. The WPC has the right to go direct to the FSA if it feels that a failure to take the Committee advice calls for such action.

8. *How many times has the WPC met during the last year, and what has it considered?*

Since the new independent-majority WPC was appointed last July, it has met eight times (including a strategy half-day), and the topics we have considered include the following:

19 July 2007

- Inauguration of new WPC
- TOR for new WPC
- Consideration of reattribution proposals
- De-risking the cost of guarantees in CGNU/CULAC
- Heritage readiness

14 September 2007

- Reattribution Proposals
- Investment decision process & examples
- De-risking implementation in CGNU/CULAC
- Alternatives to distribution of surplus
- Update on New Business

2 October 2007

- Reattribution PIP Proposals
- Distribution by Special Bonus
- Distribution eligibility & Policyholder Advocate response
- Independent consultancy ToR

31 October 2007

- Reattribution Proposals update & revised PIP proposal
- Marketing strategy for With Profits
- Draft WPC response to PHA on fair treatment in distribution issue

19 November 2007 (morning)

- Strategy workshop

19 November 2007 (afternoon)

- Bonus recommendations
- Reattribution—progress update and December draft communication
- PPFM changes
- New Business
- Investment update
- Policyholder Advocate & Governance
- Diversification of assets
- Commercial mortgages

28 January 2008

- Update on bonus declaration/special bonus
- Progress report on Reattribution
- Review of product development process
- Form of PPFM compliance reporting

20 March 2008

- PPFM Compliance
- MSA renegotiations
- Treasury Select Committee and inherited estates
- Miscellaneous investment items
- Meeting with "Which"

It is worth observing that, at the time of our appointment, Norwich Union envisaged our meeting four times a year. As can be seen from the list above, we have in eight months met twice as many times as that and have considered a wide range of subjects. We are keen to ensure that we make a full contribution to the development of Norwich Union's with-profits policies and proposals and, to that end, have asked the Secretariat to plan on the basis of our meeting six-weekly, rather than quarterly. In addition to the meetings shown above, the independent members of the WPC spent five days in 2007 on induction activities.

9. *What is the time commitment involved with chairing the Norwich Union WPC?*

At the time of our appointment it was envisaged that WPC commitments would involve about eight days a year. In the event, that has proved to be a serious under-estimate, although obviously the time required varies according to what the live issues are at any given point; in addition, induction has added to our time in the first year. The other two independent members reckon their commitment to have been around 20 days in the first 10 months; mine as Chairman has probably been nearer 35–40 days.

10–11. *Mechanisms for communicating with the WPC and amount of communication, inward and outward*

In my reply to question 6 I have made clear that our function is to provide advice and challenge to the Norwich Union Board, so as to ensure that their policy-making at both the strategic and day-to-day level takes full account of and properly reflects policyholders' interests. Norwich Union follow and are bound by the imperative to treat customers fairly which is embedded in the PPFM and is a requirement enforced by the FSA. Our role could be seen as policing that requirement so far as particular Company proposals are concerned.

That role does not usually involve direct communication with policyholders, who will as a general rule be concerned with their particular circumstances and in following up with the Company how they will be affected by decisions or what their policy entitles them to expect. This is what I have branded "casework" in my reply to your earlier question, and it is not an area in which the WPC is or should seek to be involved.

Norwich Union publication of the role and membership of the WPC has led some policyholders to conclude, mistakenly, that we do have an adjudication or appeal role comparable, say, to that of the Revenue Adjudicator in the case of my old Department. As a result a certain amount of correspondence which rightly falls to be handled by the Company has reached them addressed to me. In those cases the relevant correspondence section has replied, prefacing their response with an explanation of our role, and

of why I am not answering, in terms which I have approved. About four or five individual policyholders have contacted me direct by email: I have replied to them, explaining our role and emphasising that, while we cannot get involved in individual cases, we are keen to know the general issues that are concerning policyholders, so that we can take account of these in framing our advice to the Company. With this end in view, as indicated in my reply to your earlier question 6, we have in addition asked Norwich Union to identify those issues from correspondence, telephone calls and other contacts with the Company, including surveys.

12. *What was the WPC's view of the three-year phasing of the special distribution from the inherited estate announced in February 2008?*

I have emphasised earlier that we seek to reach conclusions that identify the fairest solution overall for policyholders, and that inevitably this cannot mean optimising outcomes for each and every one involved. This is well illustrated by our discussion of the distribution of the surplus arising from the de-risking of the CGNU and CULAC funds, and the view that we took accordingly.

In reaching that view, we recognised that the surplus had built up over a long period of time and that as a whole the current generation of policyholders had not contributed to it. We felt that it was desirable to benefit long-term investors more than short-term ones; and also that it was important, in the interests of the generality of policyholders, not to put the funds at risk. Under this head, we were anxious not to encourage a run-off of business—which would have a detrimental effect on remaining policyholders, not least because of the way in which fixed costs have to be spread—or to give the impression that the fund was closed, when in actual fact Norwich Union are actively pursuing a strategy of generating new business into the funds, in line with their PPFM.

With these points in mind we felt that a single distribution would be less effective than a phased one in rewarding continued investment in the funds and could risk a run-off that would discourage new business. We took the view that the distribution should aim to reinforce loyalty and maintain new business at sustainable levels, as well as preventing selection against the funds by new policyholders. We accordingly asked the With Profits Actuary to prepare a paper for the Norwich Union Board reflecting our discussion and with proposals based on rewarding continued investment by increases in asset shares, matched in terms of timing and quantum with equivalent increases in regular bonus to customers over the period of the phasing.

13. *Why has the WPC not responded to the Policyholder Advocate about the decision to phase the special distribution over three years?*

I stressed in my reply to question 4 that the WPC is not a participant in the negotiations between Norwich Union and the PHA; that is critical to preserving the independence of our position and our ability to comment on any proposed settlement between those two parties. I also mentioned that the three independent members of the WPC had met Clare Spottiswoode and her team. At that meeting, on 19 December last year, we were asked to explain our view on the phasing of the special distribution. The PHA has since then written twice to me on the subject, and I have replied to her in each case.

We did not give an explanation, either at the meeting or in the subsequent correspondence, for reasons which the Committee unanimously still believes to be valid. The PHA has been appointed to a very specific task: to represent policyholders' interests in the reattribution of the inherited estate. The special distribution does not form part of that remit. Your Committee will know that when surpluses reach a certain level, FSA rules on distribution become applicable. The de-risking of the CULAC and CGNU funds—prudent moves regardless of the reattribution exercise and its outcome—gave rise to surpluses at a level where those rules became relevant, which was why the With Profits Actuary brought the matter to the WPC. While, therefore, we recognised that the PHA would want to be aware of the special distribution as a possible element in her negotiations with the Company, we felt that her locus and our role made a discussion of our advice to the company inappropriate. Your question mentions the "decision" on phasing: that decision was, of course, taken by the Norwich Union Board, and the reasoning behind it may well have featured in the continuing exchanges between their representatives and the PHA.

That concludes my replies to the questions posed in your letter. There is one additional point that I should perhaps make to your Committee. The WPC, with its independent majority, is extremely keen to sharpen the tools at our disposal to ensure that we represent policyholders' interests effectively in our advice to the Norwich Union Board. With that in view, we are actively undertaking work to refine our view of what treating customers fairly actually does and should mean. We will be exploring this in some depth at a strategy meeting in June. At the same meeting we will be attempting to set out a rigorous strategic framework for our work and, within it, to establish our key goals and measures of success for the coming year. In parallel, we are currently conducting a self-assessment exercise (on the lines of those undertaken by many Boards and by other Norwich Union committees) to enable us to pinpoint the areas of our strength and weakness in the first ten months of our operation and to identify key actions to address the latter. We will share this work and its outcomes with the FSA, with whom we maintain a close and continuing dialogue.

I hope that, in the limited time available, I have been able to provide the main information that your Committee requires; but do please let me know if there is any further help that I can give.

28 April 2008

Supplementary memorandum from John Pilkington, Andrew Edgington, and Philip Meadowcroft, Aviva/Norwich Union With Profit Policyholders' Action Group

1. The Definition of the Inherited Estate

1.a. Treasury Committee Hearings have been called to examine Norwich Union's plans to disperse the Inherited Estates of its CGNU and CULAC funds by Reattribution, rather than by the only alternative, Distribution. Whether the dispersal of the Inherited Estate should be dispersed by Reattribution rather than Distribution must revolve solely around the definition of the Inherited Estate. This essential point is often not immediately grasped.

1.b. The Treasury Select Committee called for an Enquiry into the Inherited Estates. The three largest are believed to be connected to Norwich Union, Prudential, and Legal & General. Currently, only the Norwich Union Inherited Estate is actively being considered for dispersal. The Inherited Estate can be dispersed by Distribution or by Reattribution. Norwich Union have announced their preference for a Reattribution. Neither of the other two insurers have formally announced their respective plans for dispersal.

1.c. We believe, following the evidence which has been presented to the Treasury Select Committee, that the option to distribute or to reattribute essentially and crucially revolves around the definition of the Inherited Estate. We have seen several different definitions of the Inherited Estate, but since it is Norwich Union that is wishing to make a Reattribution then we think it is reasonable for us to examine the definition which Norwich Union must understand fully, and that is the definition which it provided in its submission when under the close scrutiny of the Treasury Committee. In its submission, Norwich Union states:

> "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.d. The term "over and above" applies to the entire Inherited Estate and not just whatever part of it Norwich Union wishes to claim for its own ends. If money is not "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" then the money cannot be in the Inherited Estate.

1.e. Since announcing its Reattribution scheme, over the past 18 months, Norwich Union has deliberately attempted to create general confusion and misunderstanding of the reasons why it wishes to disperse the Inherited Estates by Reattribution rather than by Distribution, by frequently attempting to use another slightly different definition of the IE, where it uses the words "excess surplus" instead of "over and above". The definition of the Inherited Estate, as submitted to the Treasury Committee does not use the term "excess surplus"; instead it uses "over and above" which is a more generally understood expression.

1.f. In Norwich Union's submission to the Treasury Committee, it only uses the phrase "excess surplus" twice, and that is only in the Appendix. Norwich Union clearly knows that using "excess surplus' is the basis of its trick to fool the policyholders, the Policyholder Advocate and others, but Norwich Union has not attempted to use this play on words to fool the Treasury Committee with it in its submission.

1.g. John Thurso MP at the Treasury Committee Hearing on 2nd April 2008 in 0129 said:

> "what is complicated is the process and the fact that everybody wants to talk in oxymorons because we keep talking about excess surpluses and it is either a surplus or it is not, it cannot be excess."

Clearly, John Thurso MP and the Treasury Committee understands that the definition of the Inherited Estate is the crux of the issue.

1.h. Since, by Norwich Union's own definition, the entire Inherited Estate is "over and above" what is required to support the CGNU and CULAC With Profits Fund, now or in the future, the entire IE should be distributed under the FSA's Conduct of Business Handbook rule 6.12.57 and/or the New Conduct of Business Sourcebook rules 20.2.21 and 20.2.22. There is no justifiable reason why the Inherited Estate should be reattributed.

2. The Origins of the Inherited Estate

2.a. According to the submission to the Treasury Committee from Norwich Union, it claims:

> "None of the current generation of policyholders have contributed to the Inherited Estate, nor is it an orphan asset."

However, Norwich Union singularly fails to inform from what source the £5.4 billion in the Inherited Estate actually comes. Which? submission states:

> "Due to a process known as 'smoothing', where investment returns are held back in good years to pay out more than the return achieved in bad years, around £14 billion has built up in what is known as the "Inherited Estate" of these funds."

From the transcript of the Treasury Committee Hearing on 22 April 2008:

> "Q4 Chairman: You state that the Inherited Estate has built up mainly due to a process of 'smoothing' out returns to policyholders between good and bad years, yet many life assurance companies seem unable to identify the source of their Inherited Estate. How can you be so confident about the Inherited Estate's origins?
>
> Mr Lindley: Many life companies do find it difficult to identify the sources of their Inherited Estate, but we know that in Norwich Union's case, because it has been confirmed by the Policyholder Advocate who has looked into this in detail, that all of Norwich Union's estate has built up from money they have kept back from policyholders over the course of many years. Part of that might have been almost deliberate short-changing of policyholders who surrendered early, and part of it will be because they have kept too much back for prudential reasons, but in Norwich Union's case it has all come from policyholders, and shareholders have not contributed almost anything to the Inherited Estate. We have got no problem with shareholders getting their 10% share, but we think 90% should go to policyholders."

3. How Norwich Union uses the Inherited Estate

3.a. Norwich Union has been using the Inherited Estate as a "slush fund"—a description made by The Consumers' Association—out of which it has been paying the normal expenses of running its core business to do the following:

1. Subsidise new business
2. Continue to pay shareholder tax bills if they have done this in the past
3. Pay the cost of compensation when the company has mis-sold a policy
4. Reduce the deficit in the Aviva Staff Pension Scheme (ASPS)

3.b. *Subsidising new business*

There is evidence to suggest that Norwich Union has not actually been opening much, if any, new business in either the CGNU and the CULAC With Profits Funds, and this is discussed in the Policyholder Advocate's submission, Annexe 3 by Cazalet Consulting. As such, both With Profit Funds are possibly now being operated as "quasi-closed" funds in "run-off". If this is so, then COB 6.12.94 or COBS 20.2.53 and 20.2.54 applies and under a fund closure plan, COBS 20.2.56(1) applies, where it is stated:

> "The run-off plan required by this section must:
>
> (1) demonstrate how the firm will ensure a fair Distribution of the closed With Profit fund, and its Inherited Estate (if any)"

Under such circumstances, a Distribution is the only means of dispersal of the Inherited Estate. Reattribution is not a possibility. It appears to us that Norwich Union is seeking to avoid the fund closure rules in order to steal as much as it can for shareholders under a Reattribution plot.

3.c *Shareholder tax bills, Mis-selling and Pensions shortfall*

The submissions and oral evidence of both Which? and the Policyholder Advocate would suggest that they consider these uses of the Inherited Estate as inappropriate. Which? has revealed that Norwich Union has set aside £182 million to cover mis-selling costs; £83 million to pay for the shortfall in Aviva Staff Pension Scheme (ASPS). These misappropriated funds should be returned to the Inherited Estate by Norwich Union prior to Distribution. It is scandalous, in particular, that mis-selling costs are not borne exclusively by shareholders. Mis-selling is totally unconnected with the operation of the With Profits funds, as mentioned by one of the TSC members.

4. Policyholder Representation

4.a. There are two aspects to Policyholder representation. One is the With Profits Committee which is promoted by Norwich Union as independent and "working on behalf of policyholders" and "working to protect their interests" and to promote and "increase the transparency and governance of With Profit funds". The other is the Policyholder Advocate—a position created by the FSA following the AXA debacle.

4.b. At the first hearing, the Chairman pointedly remarked on the lack of any communication from the Norwich Union With Profits Committee, which is chaired by Sir Nicholas Montagu KCB. We then heard the reply from the Policyholder Advocate in response to 066 in the first hearing:

> "what should I (the Chairman) be asking (Sir Nicholas) that would help our session here?"

She said that Sir Nicholas had refused to explain why he,

> "had made the decision to ask the company to phase the Special Distribution over three years . . .policyholders have a right to know why he made that decision."

She added:

> "There are two things I want to see out of with Profits Committee. One is transparency, because it is the only way in which you can be shown to be undertaking your duties on behalf of poIicyholders, and the second thing I would do is to make it very clearly a duty of the WPC that it looked after the interest of policyholders and no other."

4.c. Norwich Union maintains that its With Profits Committee is independent—though independent of what is unclear. The company said that the WPC is a Board sub-committee—but no Board members are members of the WPC. And Norwich Union said that the decisions relating to the Special Distribution were taken "jointly" by the WPC and the Board. This hardly seems to represent any independence on the part of the WPC. In reality the Hearings could only conclude that WPCs are a sham as far as independence is concerned and did not fulfil any genuinely useful role.

4.d. Under the Reattribution scheme devised by Norwich Union, it has put in place a Policyholder Advocate. According to Norwich Union's submission, it states:

> "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."

However, Clare Spottiswoode, the appointed Policyholder Advocate, in her evidence made to the Treasury Committee on 22 April 2008, stated:

> "I do not have any specific powers other than those of illumination"

The Policyholder Advocate has thus admitted to the TSC that she has no ability to negotiate genuinely on behalf of policyholders, and as such, policyholders are completely devoid of any way of genuinely negotiating with Norwich Union.

4.e. Likewise under the Policyholder Advocate's Terms of Reference, as set for her by Norwich Union, it is impossible for policyholders to directly correspond with her and we are kept completely in the dark as to what is going on, supposedly on our behalf.

5. Policyholder Complaints

5.a. Since the Norwich Union Retribution scheme Is supposedly being carded out according to the rules and regulations of the Financial Services Authority, then it seems reasonable to assume that it should be possible for policyholders to be able to pursue formal complaints against both Norwich Union and the FSA, for matters directly relating to the proposed Reattribution and how it might adversely affect individual policyholders. However, although 13 policyholders have made complaints to the FSA, it was disclosed by the FSA at the second TSC Hearing, on 30 April 2008. In response to an enquiry made under the Freedom of Information Act that it has failed to consider any complaint made to it. Therefore, policyholders are being denied any opportunity to challenge Norwich Union's Reattribution scheme. This is patently unfair.

6. Summary

6.a. It is our opinion, that the submissions and oral evidence of both Which? and the Policyholder Advocate are thorough and authoritative analyses by experts with the resources required to study the basis of Norwich Unions Reattribution plans upon which the Reattribution scheme has been devised and the direct implications to the parties involved (ie. Norwich Union policyholders and shareholders) and the indirect implications to a wider public (including Prudential policyholders soon to face a possible Reattribution) and the financial services sector in future. It is our opinion that there is substantial disagreement by both Which? and the Policyholder Advocate with the basis of the Reattribution and claims made by Norwich Union to support its rationale. The opening question at the first hearing by the Chairman and the reply by Peter Vicary-Smith, Chief Executive, Which?, demonstrated the enormous significance of the issue of the Inherited Estates.

Mr McFall said:

> "Why does the issue of With Profits funds Inherited Estates matter to you as a consumer organization?"

To which Mr Vicary-Smith replied:

> "There are two reasons why this matters to us. One is the scale of the issue and the second is the level of detriment which is potentially being suffered by consumers. Between Norwich Union and Prudential alone there is some £l4 billion at stake across five million policyholders, and our belief is that unless something changes, unless what we perceive to be a currently inadequately weak regulatory system changes, then there is going to be potentially some £7 billion pounds of money transferred from policyholders to shareholders, and we do not consider that to be fair."

6.b. We believe that the evidence heard at both TSC Hearings can only lead to the conclusion that the present Norwich Union Reattribution scheme is a scam—confirming what was said by the TSC Chairman in January 2008, at a Hearing involving the FSA, that policyholders were being diddled by With Profits insurers. That the scam has its foundations in Norwich Union's attempt to confuse, mislead and misinform about the true nature of the Inherited Estate, so that the fact that the Inherited Estate is money which is entirely over and above that required to support the fund from which it has been derived will not be properly understood by the policyholders who have a legal entitlement to 90% of the Inherited Estate. It is a confidence trick:

no more, no less.

6.c. Likewise, policyholders have been denied all means of participation in negotiating the dispersal of the Inherited Estate because a policyholder advocate has been employed by the policyholders' adversary, Norwich Union, supposedly to negotiate on behalf of policyholders. However, the appointed Policyholder Advocate, Clare Spottiswoode, says: "I do not have any specific powers other than those of illumination".

Therefore policyholders have no means of negotiation. Furthermore, the FSA fails to investigate policyholders' complaints; therefore 1.1 million policyholders are being "stitched up" by Norwich Union in a major financial scam.

6.d. It was announced on 29 April 2008 by Norwich Union's parent company, Aviva, that it is to drop the historic and well-respected brand name of Norwich Union, and that thereafter, the business of Norwich Union will be carried on under the name of Aviva. It is clear that Aviva is willing to besmirch the good name of Norwich Union in its "smash and grab" raid on the CGNU and CULAC Inherited Estates, knowing full well, that the business will emerge with the new name of Aviva. It's a like a common criminal operating under an alias to avoid detection.

7. Recommendations

Option 1

In view of the serious ongoing public concern about current Reattribution at Norwich Union and prospectively at Prudential, and the potential serious damage to customer interests if those Reattributions proceed; and recognising the need to redress the current serious Imbalance between policyholder and shareholder Interests, we urge the TSC to press:

- that the FSA uses its discretionary powers to intervene in the process so that the present Norwich Union Reattribution plan is brought to an Immediate halt, and the Prudential Reattribution, if announced, be suspended.
- The entitlements of all relevant Norwich Union policyholders, as at 21 November 2006, are frozen and protected until new regulations and a new regulatory regime are introduced, which Incorporate greater protection for policyholders, and the removal of the discretion given to companies to use the Inherited Estate to meet mis-selling costs; writing of new business; ASPS fund deficit "top-ups", and shareholder tax.
- That, in the light of the concerns raised by Norwich Union policyholders who have noted the unfairness that will be suffered by a large number of policyholders (many of whom had paid into their policies for long periods), the FSA uses its discretion to intervene and direct Norwich Union to assess the negative financial impact on all policyholders receiving only one or two payments in the pre-Reattribution Distribution (instead of the full three payments) and make further payment equivalent to that which they would have received had their policies remained In place until 2010.

- New regulations concerning the management and operation of With Profit Funds incorporating the Sandler Review be brought forward by the FSA for approval. In particular that With Profits schemes should have:
  - an explicit smoothing account with smoothing designed to be neutral over the long run;
  - a "100/0" management arrangement, with an explicit management charge to a separate management company and no shareholder participation in With Profit payouts;
  - disclosure of the underlying smoothed and unsmoothed asset values; and
  - standard rules for the calculation of company charges for management of With Profit fund investments to ensure consistency and comparability between providers.
- Abolition of the Office of Policyholder Advocate and its replacement by a Policyholder Committee funded by each insurance company and chaired by an independent person chosen by committee members appointed from within current policyholders, supported by advisers chosen by the Committee, and with direct access to the FSA.
- Full participation, including negotiation with the insurer, of a Policyholder Committee elected by relevant policyholders in any Distribution or Reattribution and in all aspects of the PPFM for relevant With Profit Funds.
- Policyholder Committee, funded by the insurer, should be able to seek advice from Independent experts and the FSA.
- An FSA complaints procedure that will investigate rigorously all policyholder complaints.
- The Policyholder Committee has recourse to the courts to protect policyholders' rights.

Option 2

Should the TSC endorse the proposed Reattributions and allow them to continue within the current regulations and regulatory framework, then we respectfully suggest:

- That the Office of Fair Trading be invited to investigate the "unfair competition" aspects of the Norwich Union practice of charging for the writing of new business to the Inherited Estate and that, should any unfairness be identified, the sum of money involved be returned to the current Inherited Estate (not the reattributed Inherited Estate in the event of a Reattribution taking place) and distributed 90:10 forthwith to all those policyholders eligible as at November 2006—the original eligibility date.
- That FSA uses its discretionary powers to intervene in the NU Reattribution to require Norwich Union to:
  - Ensure that customers are treated fairly by concluding as quickly as possible the FSA consultation on "mis-selling", noting the unanimous and unqualified conclusion of the TSC that this practice is unfair and should cease, with money set aside by Norwich Union and Prudential for mis-selling returned to current inherited Estates (and not the reattributed Inherited Estate should a Reattribution take place); declared forthwith as "surplus" and made available for immediate Distribution.
  - Report back to the Treasury Select Committee on investment decisions of Norwich Union and Prudential in relation to investment "risk appetite" and require companies to return to the current Inherited Estates (and not the reattributed Inherited Estate should a Reattribution take place) any excess funds created by a change in risk appetite.
  - Report back to the Treasury Select Committee by the end of 2010 with an externally audited assessment of new With Profits business written between the eligibility date in November 2006 and 30 September 2010, compared with the current forecast, with the intention of distributing on a 90:10 basis any overestimate of the volume/cost of such new business to all those policyholders eligible as at November 2006—the original eligibility date—with the funds returning to the current Inherited Estate prior to distribution (and not the reattributed Inherited Estate should a Reattribution take place).
- That Prudential be required to appoint a Policyholder Advocate without delay.

Annexe

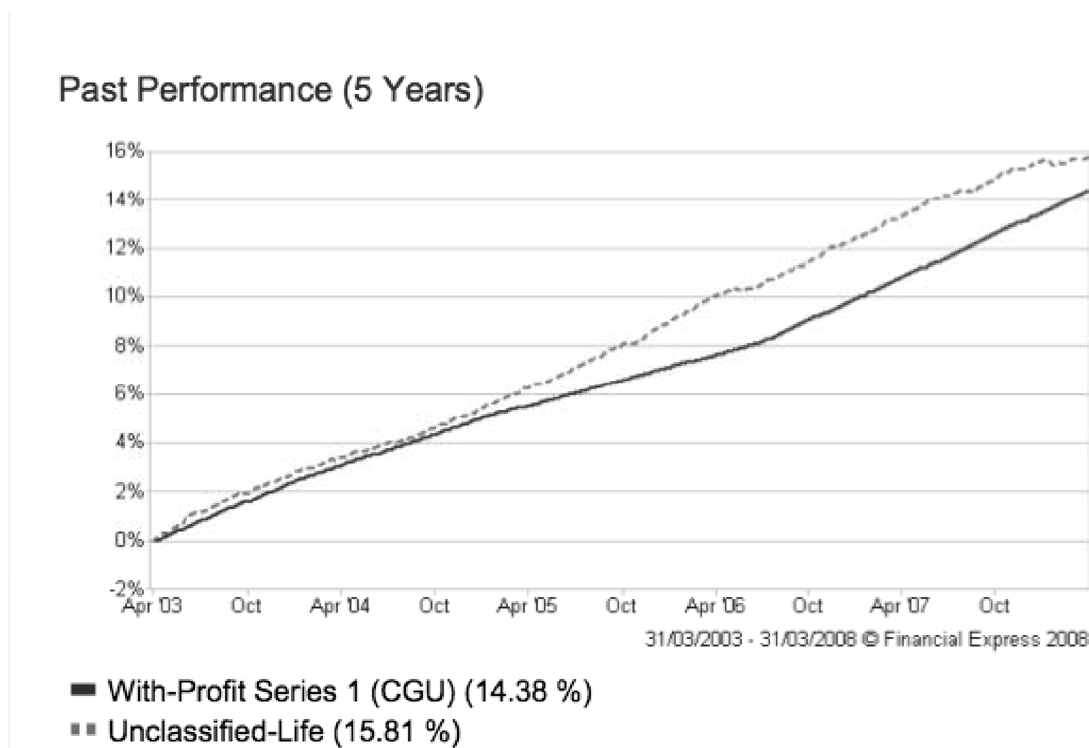
"SMOOTHING" AND ITS ABUSE: THE DEMISE OF THE TERMINAL BONUS

In the past, one of the key features upon which With Profit Fund investments have been sold to policyholders is that it allows investment into equities markets without policyholders suffering the potential wild fluctuations in value that may otherwise adversely affect the returns on the investment. The technique by which this is done by With-Profit Fund managers is known as "smoothing".

Since equity markets are constantly trading stocks and shares at different values throughout each day's trading, the value of market indices, such as the FTSE 100 and FTSE All Share, are also constantly changing. Therefore, the timing of both purchase and sale of equities in such "volatile" markets can have a considerable impact (positive or negative) upon the returns achieved by investing into such markets. The graphical representation of "end of day" trading on, say, the FTSE 100, as per the graph below, shows how the daily values may vary wildly as expressed by the green and red lines, whereas the general "trend" of the FTSE 100 lies somewhere between the extremes of fluctuation, as expressed by the black line.

Source: http://www.bloomberg.com/apps/cbuilder?ticker1=UKX:IN

The graph below shows the increase in value, as returned to policyholders, of the CGNU With Profit Fund over the last five years from April 2003 until April 2008, and the performance of an investment in this fund has been almost perfectly linear, and showing growth of 14.38% over that five-year period.



Obviously, the linear performance of the "smoothed" CGNU With Profit Fund is not a true representation of the actual performance of the investment itself. Although the CGNU With Profit Fund derives its profit from investments in a variety of different asset classes (eg equities, property, bonds etc.), the greatest proportion of the CGNU With Profit Fund is invested in UK equities, and on 18 April 2003 the closing value of the FTSE100 was 3889.20 and on 18 April 2008 the closing value of the FT8E100 was 6056.50, therefore the FTSE100 increased in value by some 55.72%, yet, the return given to policyholders in the CGNU With Profit Fund is just 14.36% for the same period. Clearly, over the past five years, the return to policyholders is considerably less than the actual performance of the CGNU With Profit Fund itself; the difference between the actual performance of the Fund and the return given to policyholders has been held back under Norwich Union's "smoothing" policy.

The underlying principle of a "smoothing" policy is that the increase in value of a policyholder's "asset share" within the With Profit Fund increases on an annual basis by the award of "reversionary" (annual) bonuses, and on termination of the investment, any balance that has been held back by the application of "smoothing" throughout the life of the investment, is returned to the policyholder as a "terminal" bonus, so that the policyholder receives 100% of asset share, including profits, from investing in the With Profits Fund. The basic rationale of "smoothing" is that, in the years when the fund investment does well, a proportion of the profit is held back and not awarded in full to policyholders in the reversionary bonus, and in the years when the fund investment does not perform well, the reversionary bonus paid to policyholders are increased above the actual performance of the fund itself. On exit from the fund, any under-return of asset share throughout the life of the policy is repaid to the policyholder so that the overall effect of "smoothing" on the investment is neutral; ie. a policyholder gets his full dues. The terminal bonus is the final means of "correction" to the asset share, when the total reversionary bonuses paid during the lifetime of the policy have been too conservative.

In theory, "smoothing" has no detrimental impact upon policyholders, however, in practice, under the management of Norwich Union, the "smoothing" policy applied to the CGNU and CULAC With Profit Funds appears to have been abused. As demonstrated in the graphs and explanations above, the reversionary bonuses paid to policyholders in the last five years, at least, have provided a return, which is considerably less than the actual overall performance of the CGNU and CULAC With Profit Funds. This would be fine if policyholders were to receive their full asset share on exit from the funds by the payment of proper final bonuses. However, according to information provided by Norwich Union, terminal bonuses are presently not being paid to policyholders exiting the CGNU and CULAC With Profit Funds. As such, policyholders are not getting 100% of their asset share from their investments.

According to Mr Mark Hodges, Chief Executive of Norwich Union, in a letter dated 8 April 2008, to Dr John Pilkington:

> "As a result of the smoothing process the payout for a policy can represent between 80% and 120% of the asset share,"

Therefore, if the terminal bonus is no longer paid on exit from the CGNU and CULAC With Profit Funds, and that policyholders get paid out at as little as 80% of their asset share, then it would appear that ALL the present generation of CGNU and CULAC With Profit Funds policyholders are being routinely and systematically defrauded by Norwich Union's abuse of its smoothing policy.

So, if a policyholder only receives 80% of asset share as a final payout on exit from a CGNU or CULAC With Profit Fund investment, then who gets the retained 20% of the policyholder's asset share?

If terminal bonuses are not paid out by Norwich Union, then it seems unlikely that this money will never be available to other policyholders. In view of the fact that the With Profits investment market is generally in decline (as recorded by Cazalet Consulting, in Annexe 3 of he Policyholder Advocate's submission to the TSC, entitled: "With Profit: Commentary for the policyholder advocate"), then as the total number of policyholders in any single With Profits Fund, such as CGNU and CULAC With Profit Funds, declines, there will be less and less policyholders remaining in the With Profits Fund, none of whom will benefit from the retained asset share of former policyholders who left the With Profits Fund with only 80% of their asset share.

Since the Inherited Estates of the CGNU and CULAC With Profit Funds have both dramatically increased in size over the past five years, whilst at the same time, the returns paid to policyholders have been small, as a consequence of poor reversionary bonuses, and since no terminal bonuses are being paid, it would appear that the growth of the Inherited Estate is at the expense of returns to the present generation of policyholders receiving only 80% of asset share.

It would appear CGNU and CULAC With Profit Funds policyholders are being fleeced wholesale by the Norwich Union's abuse of its "smoothing" policy.

15 May 2008

Supplementary memoranda from Which?

I am writing to follow up on the responses that Norwich Union gave during their evidence to the Treasury Select Committee inquiry. Which? is concerned that these may have been misleading.

Which? continue to believe that charging the staff pension scheme deficit to the inherited estate is a prime example of how firms are able to change the way the inherited estate is used to the detriment of policyholders.

Q195—*Changes to Norwich Union's Principles and Practices of Financial Management*

In response to Q195 about the changes Norwich Union made to their Principles and Practices of Financial Management (PPFM) on pension costs, Mr Lister replied:

> "To start with we did not change our PPFM. I am not quite sure where Which? got that from."

Which? obtained this information from the Norwich Union document "CGNU / CULAC PPFM Summary of Change. Section 3e, "Changes at 1/1/2006", notes a change to Section 4.2:

> "We have clarified how certain parts of the Staff Pension Scheme deficit can be credited or charged to the inherited estate".
>
> http://adviser.norwichunion.com/product-literature/files/in/in16023.pdf

In order to illustrate this "clarification" it is helpful to note that in 2005 there was no mention in the PPFM that the deficit in the staff pension scheme could be charged to the inherited estate (see enclosed). The latest version of the PPFM states:

> "In the event of a surplus or deficit arising in the Staff Pension Fund, a portion of which is attributable to the Fund in respect of periods prior to the introduction of the MSA, then a credit or charge may be made to the inherited estate of the Fund. This would be subject to the approval of the With Profits Committee and the Board following the advice of the With-Profits Actuary."
>
> http://adviser. Norwichunion.com/product-literature/files/in/in16004.pdf

Q187—*Use of the inherited estate to support Norwich Union's staff pension fund*

In response to Q187, where Norwich Union was asked to clarify that the use of the inherited estate to support its staff pension fund is a new development, Mr Hodges replied:

> "It is not a new development."

Which? would point to Aviva's Annual Report and Accounts 2005. Under the heading "Other liabilities—pension deficit" it is stated that:

> "Currently, substantially all of the deficit is borne by shareholders as historic contractual arrangements have, to date, meant that no deficit funding has been recharged to our UK with-profit funds. We are close to finalising our negotiations on the appropriate proportion to be borne by the UK with-profit funds and are hopeful that these funds will contribute approximately 12% of the future deficit funding payments to the Norwich Union pension fund. Should this level of deficit funding be agreed, shareholders' funds will improve by approximately £120 million (pre-tax), and this will be accounted for in 2006."
>
> http://www,aviva.com/files/reports/2005ar/index.asp?pageid = 22

We hope this information is of use, and apologise for the delay in providing this information. This resulted from Norwich Union's refusal to provide us with a copy of their 2005 PPFM document. We therefore had to obtain a copy of the document from other sources.

21 May 2008

WHICH? Analysis of OFT evidence to the Treasury Select Committee inquiry into Inherited Estates

Which? believes that FSA rules which allow firms to use the inherited estate to subsidise new business, pay shareholder tax and misselling claims are distorting competition.

We are concerned that the OFT's evidence to the Treasury Select Committee has failed to consider some of the key points which could distort competition in the market for with-profits products. As a result we do not think that it has conducted a fair and reliable assessment of the competition impacts of inherited estates. We hope the Committee will recommend that the OFT conducts a more detailed investigation into this subject.

We are concerned that the OFT has placed too much emphasis on information and assertions from the FSA rather than undertaking a detailed investigation of the facts. The OFT's conclusion that the use of the inherited estate does not significantly distort competition 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 believe these arguments are incorrect for the following reasons:

— The OFT has failed to consider the evidence provided by Which? That subsidies for new business from the inherited estate continued after the introduction of FSA rules in 2005.

— Shareholders face a reduced risk from using the inherited estate for new business as they only bear 10% of the losses if the new business turns out to be loss making.

— Firms are constrained regarding how they can use the capital in the inherited estate. If it is not used to write new business then it has to be distributed on a 90:10 basis to the current generation of policyholders.

— The charging of shareholder tax and misselling costs to the inherited estate means that existing funds possess an advantage over new entrants. Which? estimates that the value of the tax concession alone means that shareholders distributions from the fund are around 15%–18% greater than if the tax was borne by shareholders.[91]

— The regulatory regime, industry environment and charging structures were very different "20 or so years ago" when market entry did occur. As a consequence we believe that little reliance can be placed on this factor to support the argument that inherited estates and the use of them by insurance companies does not significantly distort competition.

New business subsidies

The OFT has failed to consider the evidence provided by Which? that:

— The impact of new business eroded the value of the inherited estates at Norwich Union and Prudential during 2006 and 2007.

— Norwich Union had been using the inherited estate to subsidise an expensive inflation-linked guarantee on its with-profit bonds.

[91] The exact difference would depend on the split of business within the fund between pensions and non-pensions business

These activities have taken place after the introduction, in 2005, of the FSA rules concerning the terms on which new business can be written. This would seem to indicate that the FSA's rules have not been effective in removing the distorting effect on competition of inherited estates. We would have expected the OFT to examine the projected Internal Rate of Return (IRR) on the capital used from the inherited estate and compare that with the average IRR required by shareholder capital used to fund new business.

Reduced risk for shareholders

The OFT fails to acknowledge the significant point made by both Which? and the policyholder advocate that writing new business using the inherited estate means that any losses will be borne by the inherited estate and not shareholder capital. This means reduced risk for shareholders, as they will only bear 10% of any losses.

We welcome the fact that the Chairman of the Treasury Committee has already made reference to this issue in an interview in Moneymarketing when he said that "In terms of new business, firms with inherited estates are not taking the same risk as other firms"[92]

Incentives faced by the firm

In paragraph 3.34, the OFT states that "it is not immediately 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". We believe the OFT has misunderstood the advantages to the firm in ensuring that the with-profit fund remains open. FSA rules require any excess surplus in the inherited estate to be distributed on a 90:10 basis. The firm is therefore constrained by what it is able to do with the inherited estate if it is not used to subsidise new business. We believe that in terms of surplus capital in nonwith-profit funds, these constraints are not normally present.

If the fund was closed to new business then the FSA would require the firm to put in place a run-off plan and for the inherited estate to be distributed, over time, on a 90:10 basis to the current generation of policyholders. By keeping the with-profits fund open to new business, the firm will be able to carry out a reattribution and obtain more than 10% of the inherited estate for its shareholders.

The OFT also has not appreciated the incentives facing the firm during a reattribution. In this process, the firm has an incentive to project higher than expected levels of growth in new business to minimise the offer it needs to make to existing policyholders for the inherited estate. As shown by the AXA case, once the firm has completed the reattribution the incentive to keep writing with-profits new business diminishes.

Shareholder tax and misselling

The OFT has not acknowledged the practical effect of the FSA rules is to give existing incumbents an advantage. They are allowed to charge shareholder tax to the estate which could be classed as a subsidy for new business and is certainly a preferential tax treatment compared to new entrants. The FSA has indicated that this practice will be allowed to continue.

Which? estimates that the value of shareholders distributions from the fund could be around 15%–18% greater due to the ability to charge shareholder tax to the inherited estate rather than the tax being paid by shareholders. We would have expected the OFT to have undertaken a detailed analysis of this point.

The fact that with-profits firms are able to charge misselling costs to the inherited estate also provides an advantage to those firms. In new entrants and other firms without an inherited estate, the costs to a firm of failing to meet its regulatory obligations will fall on shareholders.

Market entry

The OFT also argues that inherited estates do not distort competition because "20 or so years ago" entry in competition with with-profits companies did occur. The reliability of this argument must be called into question due to the substantial changes in the regulatory regime, charging structures and industry environment over the past 20 years.

30 May 2008

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[92] http://www.moneymarketing.co.uk/cgi-bin/item.cgi?id = 164528&d = pnd2&h = pndh2&f = pndf2

Letter from Mr Mark Hodges, Chief Executive, Norwich Union, to the Chairman of the Committee

Thank you for your letter dated 20 May 2008 requesting further information on the inherited estate.

I confirm that the evidence, both written and oral, given to the Select Committee was correct. The funds are open to new business and as we reported in our recent Life New Business announcement the sale of with profits continues to be an important source of revenue for Norwich Union, because these excellent guaranteed products continue to meet increased customer demand in these times of global financial turbulence.

The inherited estate continues to provide support by meeting the capital strain imposed by new business. This support is repaid to the estate over the life of the product.

For a limited period, the board decided to offer an additional guarantee on our new product which was charged to the Inherited Estate, rather than policyholders. This was in addition to the support for the capital strain of new business. This additional support was withdrawn from 1 January 08, but our policy of using the Inherited Estate to fund the capital strain imposed by new business continues.

The report that is referred to in your letter is the annual report by Norwich Union that confirms the board's compliance with our Principles and Practices of Financial Management. Each year we send out an annual statement to every policyholder. As well as setting out each policyholder's individual sum assured and bonus the statement refers the reader to our website www.norwichunion.com/ppfm where the report can be found.

If any customer does not have access to the internet, we send out hard copies on request. For ease of reference I enclose the report for CGNU and CULAC.[93]

23 May 2008

Further memorandum from the Association of Mutual Insurers

WITH-PROFIT MUTUAL LIFE ASSURERS DISCUSSIONS WITH FSA ON THE APPLICATION OF FSA CONDUCT OF BUSINESS RULES TO MUTUALS—PROJECT CHRYSALIS

PURPOSE

1. The purpose of this paper is to:

   a. Describe the issues that mutuals were having with the application of the FSA rules applying to with-profit business and the approach proposed by the mutuals to resolve the problem;

   b. Describe the current positions of both parties; and

   c. Describe the process that is underway for the resolution of the issues.

BACKGROUND

2. The Association of Mutual Insurers (AMI) is the trade organisation which represents the interests of the mutual insurance sector in the UK. AMI has 31 member organisations which represent 99% of sector in the UK, a total of 15 million policyholders and £83 billion in assets under management.

3. Mutuals have been writing life assurance business for well over 150 years starting off primarily seeking to assist self-help for the poorest in the community. The initial business written was non-profit in nature but, as the businesses grew and in accordance with the origin and purpose of the mutuals, profits started to be returned to the members as they arose. This became formalised in the creation of with-profits business which was written in the same mutual fund as the non-profit business.

4. Over the decades mutuals have successfully mixed their new business levels between non-profit and with-profit business dependent on the market conditions prevailing at the time. This has never caused a problem in the past with regard to the application of the rules of the Regulator and we do not believe that recent market and product evolution should cause a problem now.

5. With-profit mutuals continue to provide good quality products to consumers. The most recent 2008 Money Management with-profits survey shows that a 25 year with-profit endowment payout from a mutual is 26% higher on average than that of a PLC.

6. The life insurance industry, under the auspices of the ABI, has started providing the results from surveys of customers. In the latest set of annual results, mutuals fared better than PLCs in a majority of measurements including clarity of communication, ability to solve customer queries, customer service and likelihood of recommendation. This is no real surprise as mutuals are better able to place the interests of members and customers at the heart of everything that they do whereas PLCs have to be very cognisant of the needs of their shareholders.

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[93] Not printed.

Membership

7. It is important to understand the issue of ownership in a mutual. Each mutual insurance company is owned by the ever-changing group of policyholders who happen to be its members at any point in time. It is not owned by a fixed group of past or current members, except in the unusual circumstance where it is forced to close to new membership—even then policyholders cease to be members as their policies mature and are paid out. Some with-profits policyholders may be members, and some may not. Some non-profit policyholders may be members, and some may not—it all depends on the definitions contained within each individual mutual's constitution. Payment of bonuses to with-profits policyholders is standard practice but does not in itself confer exclusive ownership rights. Benefits that relate to membership and/or ownership clearly apply to all members, whether or not they are with-profits policyholders.

8. Most mutuals were established for the benefit of their members before with-profits business came into existence. If a mutual decided not to write with-profits business in the future for whatever reason, in our view it would and should be possible for it to continue in existence to serve its members much as other mutuals which have never written with-profits business. (Some friendly societies and all building societies currently operate for the benefit of their members without any comparable class of "with-profits" business).

Detail

9. The starting point for the Chrysalis Project was the realisation by the with-profit mutuals that the combination of the way that the FSA Conduct Of Business rules (COBS) are framed, together with the current challenges associated with with-profits business, had the potential to inflict damage on the whole mutual insurance sector. As we have demonstrated, the sector has generally served its customers well and has the ability to continue to do so in future—we do not believe there should be any reason, or desire, to cripple it.

10. Most mutual insurers have been around for about a hundred years or more and continue to be a force for good in the marketplace. Most of them started by writing non-profit business and the problem we are focusing on here has been created by the overlay of the FSA Handbook with its associated Glossary and COBS rules in recent years.

11. The COBS rules require a Glossary definition to enable their proper application to the "with-profits fund". Proprietary companies have clearly-defined with-profits funds which are distinct from their shareholders' funds and a few mutuals that have acquired funds from other insurers also operate ring-fenced with-profits funds for the acquired business. However, apart from these special cases there is no clear definition of what a "with-profits fund" is in the context of a mutual. The wording in the FSA's rules is ambiguous: it could either be taken to refer to assets that underpin with-profits policies only, or it could be taken to mean a greater proportion of the assets of the mutual and maybe even the assets that underpin all of its business, not just with-profits business. This lack of clarity is clearly an unsatisfactory situation in itself.

12. Apart from the special cases described above, there is only normally one single fund in a mutual—we describe this as the Main Mutual Fund. There is no with-profits sub-fund (unless one has been established for particular historic reasons, like a merger). When declaring bonuses to with-profits policyholders, a mutual takes into account the contribution made by with-profits policies themselves (generally using asset shares), and would also give consideration to the performance of the Main Mutual Fund and the extent to which it provides backing for all of the business of the mutual.

13. We had been comforted to hear during discussions with the FSA that in framing the COBS rules in the first place, the FSA always intended to allow for the existing manner in which mutuals conducted their business. However this was recently contradicted by the FSA. We are concerned at the possibility that, due to the lack of clarity in the rules, different firms will be treated in a different manner by the FSA.

14. Inappropriate application of a particular interpretation of the FSA's rules in this unclear situation could well cause the closure of a mutual, and result in a "windfall" payment to the generation of with-profit policyholders whose policies happened to be in force at the time of closure, which would be in excess of their true interests and rights—and would be paid to them at the expense of other policyholders who also constitute the membership of the mutual, as well as at the expense of future generations of with-profits and non-profit policyholders.

15. The mutuals held a number of meetings with the FSA in spring and summer of 2007 to explain the problem and propose a solution. Our proposed solution involved the establishment of industry guidance for mutuals that would have been approved by the FSA and would have clarified how the COBS rules would apply in practice. The FSA indicated that they were looking for something more explicit and we confirmed that we were equally happy to discuss any other way of eliminating the risk of damage caused by an application of the rules that did not match their original intent.

16. At the heart of our proposed industry guidance was a new definition of a with-profits sub-fund for a mutual, so that the COBS rules could apply properly to it and could be seen to apply more transparently. The corollary of this was that the mutual would have capital outside the with-profits sub-fund, which we refer to as "mutual capital". Movements between the various sub-funds would be explicitly declared and subject to due process in terms of governance. The rights of with-profits policyholders would not be affected

in any way by the adoption of clearer definitions which support greater transparency around the way that best practice has always worked in mutuals. With-profits policyholders would have no greater or lesser rights to profits arising within the mutual than in the past but would benefit from the increased transparency.

17. We did not seek to make a case that "mutual capital" already explicitly exists within a mutual as that would require a pre-defined with-profits sub-fund. However, mutuals have operated in a way that is consistent with such a distinction—as they have always had to meet the appropriate solvency requirements at the time. We have therefore made the case that for the COBS rules to apply as originally intended, it would be helpful to create a clear definition of a with-profits sub-fund for mutuals—and therefore, by implication, of mutual capital.

18. To define the with-profits fund as equating to the Main Mutual Fund would have the effect of transferring ownership of the mutual capital from members as a whole (who, it should be remembered, will include non-profit policyholders) to the exclusive ownership of with-profits policyholders. This would directly conflict with the obligations of mutuals to comply with their constitutions and in practice, over time, would force a large number of mutuals to close—whether or not they were operating in a sound commercial manner. Naturally we believe that this is neither desirable nor acceptable to us, or, we believe, to society in general.

19. An important practical point is that the introduction of new definitions to support the fair implementation of the rules does not require any form of reattribution process to establish clarity around ownership, since no rights are being altered and no money is changing hands. The new definitions simply make the situation clearer and minimise the risk of unintended application of the COBS rules. Each mutual would need to create an opening definition of the size of the newly-defined with-profits sub-fund and of its mutual capital, but we believe this can be done in a fairly straightforward manner.

20. Having reached what we thought was a clear consensus with the FSA about the problems and the potential solution in July 2007, the FSA said that they needed to consult internally. They subsequently indicated that they needed to take their own legal opinion.

21. The FSA came back to us in late March 2008 and it became clear there was a difference of opinion between us. Accordingly we have now embarked on an exercise with the FSA to look at a number of with-profit mutuals as case-studies and understand how their constitutions and legal documentation interact with the established practice within the mutual and also to determine the boards' views of what the interests and rights of with-profit policyholders are compared with the interests and rights of members generally. This should enable the FSA to gain a better understanding of how mutuals operate and hence enable clarification of how the Main Mutual Fund might be hypothecated between the members and with-profits policyholders.

22. This process is likely to be completed in the autumn of 2008.

On behalf of: Engage Mutual Assurance; Exeter Friendly Society Limited; Liverpool Victoria Friendly Society Limited; MGM Assurance; National Deposit Friendly Society Limited; NFU Mutual; Police Mutual Assurance Society Limited; Reliance Mutual; Royal Liver Assurance Limited; Royal London; Scottish Friendly Assurance Society Limited; Teachers Provident Society; The Children's Mutual; Wesleyan Assurance Society.

28 May 2008

Memorandum from Chris O'Brien, Director, Centre for Risk and Insurance Studies, Nottingham University Business School

This note suggests that the Office of Fair Trading paper[94] has understated a number of issues. It focuses on four issues.

The operation of with-profits business has involved distortions to the market. Most new business is now unit-linked and customer detriment is, in that respect, limited. However, the distortions are also affecting issues of equity between shareholders and policyholders.

(1) Risks are largely borne by the inherited estate rather than by shareholders:

— with-profits firms can use the inherited estate to take risks (in particular, to invest substantially in equities despite having given guarantees) which, if they go wrong, means the inherited estate is depleted rather than having much effect on shareholders' profits;

— OFT refer to firms who entered the business from the 1960s not having offered with-profits business because of a lack of a track record for marketing. However, this decision was affected by their inability to compete with firms who had an inherited estate and who could take investment risks;

— With-profits firms have been able to charge mis-selling costs to the inherited estate, an option not available to other firms: FSA has announced a review of this; and

[94] Paper to Treasury committee enquiry on inherited estates, OFT993, April 2008.

- these distortions have probably encouraged existing with-profits firms to write more with-profits business than otherwise, but only to a limited degree as the demand for with-profits business has reduced.

(2) The inherited estate is passed on from generation to generation; new policyholders have some expectation of distributions from the inherited estate but don't pay for this (indeed, it would be difficult to devise a fair charge since such expectations are imprecise):

- this means that the people expecting to benefit from future distributions are current policyholders, future policyholders and shareholders;
- but, in a reattribution, future policyholders do not have a vote, so shareholders will hope to take that part of the inherited estate that future policyholders would have expected (hence breaching the 90:10 rule); and
- this also leads to firms proposing a reattribution having an incentive to exaggerate new business forecasts, which would imply that only a small part of the inherited estate would be expected to be distributed to existing policyholders.

(3) Firms have been able to subsidise new business: the inherited estate was depleted in Prudential by £49m in 2006 and £94m in 2007; in the Aviva companies by £105m in 2006 and £59m in 2007:

- these are substantial amounts without which we assume new with-profits business would have been noticeably lower; and
- FSA rules introduce a potential distortion: they require that the inherited estate is distributed 90% to policyholders if the fund is closed to new business, whereas shareholders of an open fund can propose a reattribution where they try to gain more than 10%: hence there are undue incentives to stay open to new business.

Mr Sants indicated to the Committee (22 January 2008) that they would not allow new business to be subsidised. It remains to be seen what happens. However, FSA are permitting a particular subsidy regarding shareholders' tax: see (4).

(4) Firms are able to charge shareholders' tax to the inherited estate[95] (shareholders' tax is the additional tax payable when part of the surplus is distributed to shareholders).

- this is a subsidy that FSA permit notwithstanding Mr Sants' comments above; and is a benefit to shareholders not available to other firms;
- FSA have admitted this is a "concession" but we have been unable to find a coherent explanation of why it has been allowed; and
- it may be argued that shareholders need to use the inherited estate so that they can receive 10% of the distributed surplus. However, this is flawed:

  Say policyholders receive £90 and shareholders receive £10, and £2 shareholders' tax is payable:

    I would expect shareholders to pay £2 tax. They then receive 10% gross, 8% net. Policyholders receive 90% gross, and a lower amount net (depending on what type of policy they have and their personal tax rate).

    If shareholders use £2 from the inherited estate to pay the tax, then effectively £102 of the surplus in the fund is being distributed. Shareholders receive 11.8% gross ((10 + 2)/102), while policyholders receive only 88.2% (90/102) gross. Therefore, the 90:10 rule is being breached. Net of tax, shareholders receive 9.8%, policyholders less than 88.2%.

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3 June 2008

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[95] Provided this is past practice and is mentioned in the firm's Principles and Practices of Financial Management document.

Printed in the United Kingdom by The Stationery Office Limited
6/2008 399343 19585