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FSA With-Profits Regime Review Not quite a gold star..

The FSA has recently published its review of the With-Profits Regime. This review has been prompted partly by concerns raised by the Treasury Select Committee and other stakeholders, and partly by the FSA's own supervisory experience over the last few years. This article outlines the key messages from the FSA and the likely practical implications of these messages for firms.



The current with-profits regime has been in place since 2005 and this is the first full review to have been conducted by the FSA since then. It is probably fair to say that the outcome of this review is fairly mixed, with the general message that most firms are going a long way in complying with FSA rules but a significant few are falling short in a number of key areas. In all, 17 firms were assessed and included mutuals, friendly societies and proprietaries; small and large; operating both open and closed funds; covering about 80% of the with-profits market.

The review focused on firms' compliance with FSA Principles, in particular Principles 6 - Customer's Interests, Principle 7 - Communications with clients, and Principle 8 - Conflicts of interest, and also the rules and guidance provided in Chapter 20 of the FSA's Conduct of Business Handbook (COBS20). As a reminder see Table 1 for Principles 6, 7 and 8.

The FSA looked closely at certain key areas as part of their review. These are summarised in the following sections, along with a summary of some of the key areas the FSA felt improvements could be made.

Governance

The FSA looked at the role of the With-Profits Committee (WPC) to see whether it operated independently and provided sufficient challenge to the Board. They found most WPCs went some way to fulfilling these aims but some concerns were raised, especially around the mix and experience of WPC members. They also looked at the role of the With-Profits Actuary ("WPA") to assess whether this was providing the intended protection of policyholder interests and helping to generate increased consumer confidence. (See Table 2.)

Interestingly the FSA did not express any concerns about the "independent person" equivalent to the WPC but only 3 of the firms in the sample had chosen this route.

Policyholder communications

The FSA focused on the appropriateness and timeliness of post sale communication by with-profits firms and assessed these against the requirements of COBS 20.4 and the relevant Principles, particularly Principles 6 and 7. Non-Directive friendly societies selling with-profits business are not subject to the specific requirements of COBS 20.4, but must still give consideration to the needs of their policyholders and communicate in a way that is clear, fair and not misleading in accordance with Principles 6 and 7.

Different forms of post sale communication were included in the review including CFPFMs (the 'customer friendly' version of a firm's main PPFM), annual reports, pre-maturity and surrender statements and bonus notices. (See Table 3.)

Maturity and surrender payouts

The FSA looked at the overall transparency of the payout setting process. The aim of the rules and guidance is to provide policyholders with the confidence that the payout they receive is fair value and that the

with-profits fund has been managed in a responsible manner. There is obvious recognition that firms need to have discretion in setting payouts and so the rules and guidance are designed to support this, for example asking firms to manage the majority of their payouts within pre-defined "target ranges" (a target range is the range in which the payout expressed as a percentage of asset share can move). The FSA has therefore assessed firms on the basis of how they exercise their discretion and whether this is perceived to be fair in the eyes of the policyholder.

The FSA observed that there were many 'very wide' target ranges, with some firms setting ranges of 70% for maturities and surrenders, leading to the risk of unfairness to both exiting and existing policyholders. (See Table 4.)

Expenses, new business and closed fund management

The focus on expenses is to ensure that the only expenses charged to the with-profits fund are those directly incurred by the fund, and that fixed overheads are allocated in a proportionate way. Generally, the FSA found that firms appeared to be allocating expenses appropriately.

Firms are only allowed to write new business if the Board considers it is unlikely to have a material adverse effect on existing policyholders. Some firms were found to have a threat of 'systematic under-recovery' of expenses on certain products and other firms did not have a clear product strategy, or governance procedure, for new business in place.

The FSA were keen to see whether firms had a reasonable plan for managing the run-off of a closed fund in an orderly and fair way, with appropriate governance in place and a clear communication strategy for policyholders. They did not identify many clear weaknesses in the general management of closed funds but did highlight that even those funds that are not required to submit run-off plans

should be able to demonstrate that they are continuing to treat policyholders fairly, are actively planning for the next stages of the fund run-off and are communicating regularly with policyholders over their plans for the fund and the possible future impacts. (See Table 5.)

Aviva reattribution

The FSA also reflected on the implications for with-profits funds of the recent Aviva reattribution of its inherited estate, commenting that the most significant lesson learned was the length of time taken over the process and how this is unlikely to have been in policyholders' best interests. The complicated nature of such a process and the range of interested parties providing input meant that delays were surely inevitable in reaching the 'correct' conclusion. Further rules and guidance on this area can be expected at some later stage.

Conclusion

The FSA insurance sector director Ken Hogg is quoted as saying "Our focus on with-profits does not end with this review. Firms should make sure that their communications with policyholders are clear and manage expectations about the likely performance of their policy. They should also ensure that their with-profits committees are providing an independent challenge to their management. We will continue our intensive supervision of the with-profits sector and we expect firms to take action to address our concerns." (Source: Telegraph.co.uk, 1 July 2010)

It is quite clear from this statement, and from the comments made in the review paper, that the FSA is not going to relax its scrutiny of the with-profits sector any time soon. It is now intending to review COBS 20 with a view to publishing any proposed changes in a consultation paper later this year. Any potential impact from Solvency II will be incorporated during 2011. In particular the FSA appears to be postponing a detailed review of the rules and definitions relating to 'excess surplus' until the full implications of Solvency II and their requirements have been fleshed out further.

The FSA is specifically asking firms to review the findings of this review to ensure that they meet the current requirements. It has warned that simply complying with the minimum standards laid out in COBS20 may not be sufficient to ensure that their overall aims for treating policyholders fairly are being met.

So... it appears there is no gold star for the with-profits industry this time. The report is more likely to read "tries hard but still plenty of room for improvement"...

Table 1: FSA Principles 6, 7 & 8

Principle	Description
6 Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly.
7 Communications with clients	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8 Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

Table 2: Key areas for improvement – governance

1	Ensure appropriate level of experience of WPC members.
2	Ensure appropriate mix of WPC members – any Board/senior management appointments raises concern over independence and possible conflicts of interest.
3	Be able to demonstrate proper interaction between Board and WPC.
4	Be able to provide sufficient documentation of the WPCs stance/involvement on particular with-profit related issues.
5	Care required over whom the WPA reports to avoid potential conflicts of interest.
6	Be able to provide sufficient evidence of the WPA's input on material issues affecting with-profits and that the appropriate challenge has been made and recognised.

Table 3: Key areas for improvement – policyholder communications

1	Clarification over which department 'owns'/holds ultimate responsibility for post sale material.
2	Quality of post sale material needs to be given sufficiently high priority at senior level.
3	WPCs should be actively involved in the monitoring of post sale material for suitability.
4	Explanation in CFPPFMs needs to be strengthened and made much clearer in some areas.
5	Consequences of asset mix changes should be clearly explained (or signposted) in annual reports.
6	The application of market value reductions (MVRs) and their impact should be clearly explained, and any MVR-free guarantee points should be highlighted.
7	The impact of surrender penalties should be highlighted and explained.
8	Any loss of guarantees or options should be clearly explained.

Table 4: Key areas for improvement – maturity and surrender payouts

1	Have robust procedures in place for responding to changes in the market when setting target ranges (the FSA does not see volatility of markets as an adequate excuse for having very wide target ranges).
2	Document and be able to justify the reasons for wide target ranges.
3	Be able to demonstrate that smoothing policy is neutral over an economic cycle (that is, that total payouts equated broadly to total asset shares over a period of time).

Table 5: Key areas for improvement – expenses, new business and closed fund management

1	Continue to monitor expense allocations for with-profits business carefully.
2	Provide 'strong justification' for any product to be sold that is unprofitable, even if it is part of a strategic cross-selling strategy that results in overall profitability across all products being sold.
3	Maintain a clear product strategy and governance procedures.

OAC comments

The FSA's agenda here seems to have been largely driven by the views of the Treasury Select Committee and the consumer stakeholders. It is welcome that in general the FSA's review found no evidence of poor outcomes due to "unfair operation" of with-profits funds, that MVR's were generally being applied appropriately, that there were adequate controls on target ranges, and that expenses were being applied fairly. Clearly not everything is perfect, however, there was obviously no compelling evidence of the consumer detriment that the consumer stakeholders had been claiming.

Clearly one area where there is some evidence that improvement is needed is that of governance. The number of with-profits committees suggests that the sample contained a high proportion of large firms. It is reassuring that the FSA found that the majority of firms had given their with-profits committee a wide remit, and were engaging adequately with them, but there are clearly gaps in the process for some firms which need to be filled. Where the Board relies on an Independent Person or a non-executive Director the same points apply, that there must be good engagement with the appointee and the firm needs to be able to demonstrate that this is taking place.

The FSA's comments on the role of the With-Profits Actuary show that perhaps their view of the role is not exactly the same as the industry's. The prohibition on the With-profits Actuary being a Director means it is more than likely that they will not be as senior as the Chief Actuary or Actuarial Function Holder in the firm's hierarchy. It is also no surprise that in general they will be internal appointments as it is clearly a prestigious role which can be held out to be one of the pinnacles of the company's actuarial tree for ambitious actuaries.

It is surprising that the FSA appear to regard the WPA role as adversarial and isolated rather than a team leader's role, which it usually is. One possible interpretation of the report is that the Directors are out to give the policyholder as little as possible and it is the WPA's role to stop that happening. While there may be isolated cases, this is not, in our experience, the general situation in the industry. It is certainly not the case in mutual organisations. The independent challenge is really the role of the with-profits committee or Independent Person.

The FSA's point about policyholder communication is well made. It is important for ownership to be clear and for the with-profits committee to be able to see the literature and consider whether it is likely to achieve its purpose.

In terms of the CFPPFM this has always been a difficult path to steer between making it comprehensible to the average consumer and overloading it with technical information. The particular weaknesses to which the FSA refers are items which may well be set out in the full PPFM, but are considered too technical for the CFPPFM.

In terms of closed funds, here again it seems that some commentators have been crying "Wolf" as the FSA generally found that management plans were in place, including management of costs and distribution of the surplus in the fund.

It is no surprise that the Aviva reattribution took a long time, given the adversarial nature of the process introduced by the FSA's new rules for a policyholder advocate. It is also no surprise that having watched that process other firms like the Prudential have decided it may not be worth the hassle.

One disappointing element of this review is that there is very little mention of

proportionality or recognition of cost. A number of proposals are made, such as external benchmarking of a firm's costs and external support for the With-Profits Actuary, without acknowledgement of the fact that at least 90p of every pound spent in this manner will reduce the funds available for policyholder benefits (100p for mutuals). We hope that the FSA will bear the principle of proportionality in mind when considering any further changes to COBS and other aspects of its with-profits regime.

We also think it is unfortunate that the FSA is considering new proposals to mandate the wider use of with-profits committees. Our experience as a firm is that the Independent Person role can work as well as, if not better than, a with-profits committee. The main advantages that the Independent Person offers are the speed of response and lower cost than using the mechanism of a committee. The Independent Person may also be capable of adopting a more 'hands-on' role and therefore dig slightly more deeply than the members of a committee.

How can OAC help?

OAC is a financial services consultancy providing AFH/WPA and actuarial support services to a range of insurance firms. We have intimate knowledge on the management of with-profits funds and are ideally placed to provide specific or general support to firms who need help or assistance in this area.

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