

Commentary on...

PS12/4 – Protecting with-profits policyholders

April 2012

The FSA's Policy Statement on protecting with-profits policyholders (PS12/4) summarises feedback to the earlier consultation paper (CP11/5) and presents the amendments to Section 20 of the Conduct of Business Sourcebook in the FSA handbook.

Background

CP11/5 set out the FSA's proposed changes to the way in which with-profits funds operate. This aimed to address the issues raised by the with-profits regime review (WPRR), published in June 2010, and Project Chrysalis. The aim was to establish rules and guidance to ensure that existing with-profits policyholders are protected. CP11/5 proposed significant additions and, whilst some of these have been dropped, a considerable number remain unchanged or in amended form.

It is important that firms writing with-profits business are aware of and consider the impact of the new rules and guidance which came into effect on 1 April 2012. Some transitional arrangements exist delaying compliance to 1 July 2012 or 1 October 2012 in a number of places.

This note highlights some key points from PS12/4.



Key Points

Governance

The FSA believes that much can be achieved by more effective governance arrangements, though this in itself is not sufficient. The proposals in CP11/5 were designed to improve the existing corporate governance regime. In response to the feedback received, the FSA has modified a number of the proposals and decided not to proceed with some rules at this stage. A summary of the main points is set out below:

- The requirement to have a with-profits committee (WPC) for all funds with liabilities in excess of the £500m threshold has been replaced. Instead governing bodies will have to consider whether, having regard to the size, nature and complexity of the fund, a WPC is appropriate, or whether a with-profits advisory arrangement would be satisfactory.
- The WPC is no longer required to be fully independent since it has been recognised that there are benefits from allowing internal appointments, such as knowledge and experience of the firm. A WPC does require an independent majority.
- Firms are required to publish WPC terms of reference on their website, if they have one. For those that do not, the requirement has been relaxed and it is sufficient to make the terms available on request.
- The proposed, non-exhaustive, list of issues for a WPC to consider has been included.
- Governing bodies will be required to communicate, to the WPC, the reasons for any planned material departures from the WPC's advice or recommendations and any subsequent reasons that ultimately lead to it departing from the advice or recommendations.
- The expectation that the FSA is alerted of disagreements between the governing body and the WPC only in exceptional circumstances has been added as guidance.
- Guidance in respect of the responsibility of meeting the costs of external advice, sought by the WPC, has been amended. This now reflects the fact that responsibility may not be exclusive to either the fund or the firm and it could be shared, depending on the ownership of the issue.
- The rule requiring a WPC to work closely with the with-profits actuary (WPA) has been re-classified as guidance. This is to give the WPC greater discretion over how it works and maintains separation between the WPA and WPC within internal governance structures.

Firms have until 1 July 2012 to amend their governance arrangements to comply with the revised rules.

In general, the FSA believes it best practice to have a WPC and considers there to be merit in requiring all firms to establish one, with the exception of those whose low

level of complexity would mean an independent person could fulfil the role.

Further thought is going to be given to this with the intention of consulting on revised proposals in due course.

With-profits policyholders and other stakeholders

COBS 20.2 currently sets out rules and guidance aimed at addressing potential conflicts of interest that may arise in the operation of with-profits business and a number of amendments to this section had been proposed in CP11/5.

The guidance proposed in CP11/5, which sets out the FSA's high-level view of with-profits policyholders' interests in a with-profits fund, will be adopted. The FSA has also extended the guidance to reflect its expectation for firms to demonstrate that reasonable care has been taken to ensure its operating practices are fair.

Some concerns had been raised, particularly by mutuals, that the guidance may inappropriately elevate the rights of with-profits policyholders above those of other stakeholders, such as members in a mutual. However, the FSA is satisfied that the need to comply with Principle 6, which requires firms to treat their policyholders fairly, should ensure that these principles of fairness are incorporated.

Distribution of mutual capital

The FSA has decided not to proceed with the proposal to include guidance clarifying how the 90:10 distribution rule applies to those firms where their practice had not clearly been communicated to with-profits policyholders. This is in response to feedback, which argued that practices could still be seen as fair despite not being communicated clearly, and the considerable complexity of this area.

Terms under which new business is written

The FSA's proposals covered the terms under which new business can be written. The intention was to safeguard with-profits policyholders against a possible depletion of the estate. The proposals have largely been incorporated but have been subject to some amendments, including:

- Reducing the scope of the analysis that has to be undertaken to demonstrate that new business is not likely to be detrimental to policyholder interests; and
- Clarifying that the governing body should be satisfied that new business is likely to be financially self-supporting and will add value over the long-term, short-term losses should not automatically suggest that overall new business is in the adverse interests of policyholders.

A transitional arrangement will apply for new business agreed prior to 1 April 2012, until 1 July 2012. All business agreed after 1 April 2012 will need to comply with the new regulations. Increments and new business arising out of the exercise of options on existing business are not within scope of the rule changes.

Falls in volumes of new business

Feedback was reported as being generally positive in respect of the proposals for early dialogue between a firm and the FSA in the event of sustained or substantial falls in the volume of new business. Consequently, the FSA's proposals have largely been adopted, with the exception of the requirement for firms to produce updated management and distribution plans. This requirement has been dropped, given additional costs involved and overlaps with existing requirements under the existing ICA process and expected requirements under the Solvency II ORSA process.

Run-off plans

Firms with funds that closed to new business prior to 2005 will now have to draw up run-off plans. The FSA does not expect this to be a considerable burden as the information should already be available to produce plans that are proportionate to the issues faced. A submission deadline of 31 December 2012 has been set.

Market value reductions (MVRs)

Consumer organisations welcomed the proposal that MVRs could not be applied on the grounds of surrender volumes alone and it was reported that there was little resistance from firms. The FSA recognised the need for an element of pragmatism on how the rule is applied to enable asset share payouts to be achieved in aggregate over time.

Strategic investments

The requirement to demonstrate that purchasing or retaining a strategic investment, has no adverse effect on the interests of with-profits policyholders was proposed in CP11/5. The term "strategic investment" is taken to mean a significant investment in a single asset which, while it may be tradable, is often illiquid or has the potential to be hard to value and/or sell.

This requirement, and the additional requirement to keep adequate records setting out the strategic purpose for such an investment, has been incorporated as a rule.

Charges to with-profits funds

Following concerns raised, the proposal to amend the rule in respect of expenses charged to funds, and requiring that they are limited to only those expenses incurred in providing the required service, has not been proceeded with.

The FSA still believes that approaches need to be adjusted and that there could be better disclosure. Consideration will be given to these aspects and further consultation could be expected but, in the meantime, the FSA notes that the fairness of charges will be scrutinised by itself and as part of firms' internal governance.

Reattributions

The proposal to clarify the distinction between a distribution of a firm's excess surplus and a reattribution of the working capital has been retained as has the requirement that, prior to any such reattribution, the firm must determine whether there is an excess surplus. In the main, the proposals in respect of the reattribution process have been adopted.

Policyholder advocates will, however, now be required to consult the firm about policyholder communications but will retain the right to communicate independently if agreement is not reached in adequate time. The FSA notes that the process currently envisaged is designed for proprietary firms, not for mutuals, and an alternative process will need to be considered that is appropriate for mutuals' circumstances.



Commentary

Whilst the FSA attempts to reassure that it is conscious that protecting policyholders need not be achieved at the cost of the continued existence of with-profits funds and the firms that offer them, there will be an associated cost and time required to comply with the significant changes to the rules and guidance. This comes at a time when firms are also incurring costs of implementing a range of other regulatory changes.

PS12/4 will be welcomed as firms have finally received confirmation on the FSA's proposals, which have been relaxed in a number of places. There still remain a considerable number of changes that, in the main, took effect on 1 April 2012.

There are a number of areas where the FSA has flagged that it plans to undertake future work. While the industry is keen that the regulatory environment supports the way that it is best designed to operate this also leaves continued uncertainty around the future of with-profits regulation.

How can we help

A number of key changes to the rules and guidance in COBS 20 result from PS12/4 came into force on 1 April 2012. We can help by doing an independent review to identify potential gaps and to work with management towards meeting the requirements.



Investment
Investment
future income or be
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gain profitable retur
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For further information

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