

FSA's "Dear CEO" letter to Mutuals

Mutual insurance companies and friendly societies should all have received a letter from the FSA setting out its views on various aspects of with-profits business. This article explains what the letter is saying and provides a brief commentary on its implications.

The FSA has raised questions on the future of with-profits funds because for some firms sales of with-profits business are in decline, or sales of other types of business, such as Child Trust Fund, are growing and there is significant concern about how the rules in COBS 20 are to be interpreted.

The FSA has sought legal advice as to the extent of the interests of with-profits policyholders in the with-profits fund. This advice has concluded that "the general position is that the with-profits policyholders, in their capacities as policyholders and as members of a mutual, will be entitled ultimately to all or almost all of the assets in a mutual's long-term fund after the mutual's contractual obligations in respect of policies written into that fund have been satisfied". The letter goes on to explain the FSA's view that where there is declining with-profits new business, irrespective of the amount of non-profit business being written, then the with-profits fund will, at some point, have to close to all new business

(with-profits and non-profit business alike) and distribute its excess assets to the with-profits members.

COBS 20.2.54 defines the criteria by which a firm will be judged to have ceased to effect new business. However, COBS 20.2.55 takes this further by deeming that ceasing to effect a material volume of new with-profits business could be considered by the FSA to mean that the firm has ceased to transact new business, no matter how healthy its sales of non-profit and unit-linked business may be.

Clearly the firm has a responsibility to protect the interests of its with-profits policyholders, as it has a responsibility to protect the interests of all its members. However, the FSA's stated view is that all the surplus in the fund, including the present value of profits on the non-profit business, should be distributed to the members holding with-profits policies as these policies run-off. This stance does not seem to take any account of the sources of that surplus.

The FSA also says that if it is not possible to effect new business on terms which allow the with-profits business to run-off fairly then they may require the firm to close to new business completely.

The letter goes on to discuss what options there may be for a firm in this situation. These are:

- continue to write new non-profit business for a limited period of time;
- develop a new "participating" type of non-profit contract;
- a strategic investment option; and
- seek the consent of with-profits policyholders on how its capital may be used.

Continue to write new non-profit business for a limited period of time

If the firm wants to continue to write new non-profit business then it will have to ensure that the profits emerging can be distributed to the with-profits policyholders before the last with-profits policyholder leaves, even if the non-profit business has a longer outstanding term.

Develop a new "participating" type of non-profit contract

One proposal which has been put to the FSA is the development of a "participating" product which would, for example, entitle its holders to a share of any surplus available on a winding-up but which would not attract regular bonuses. Firms looking to explore this option are invited to discuss their proposals with the FSA but would need to overcome their concern that the entitlement of traditional with-profits policies would not be affected.

A strategic investment option

The FSA offers the option of so-called "strategic investment" which would, it says, allow the writing of new business in a sub fund or subsidiary.

If the new business is normal non-profit business then it would need a loan from the with-profits fund to cover the non-profit business's capital requirements. The terms of that loan would need to be on commercial terms (and meet the other conditions of COBS 20.2.32R) and will have to



be repaid over the lifetime of the with-profits business, not the lifetime of the new business that has been written. But in addition to this, the economic value of the new business must also be repaid to the with-profits fund over the lifetime of the with-profits business.

Alternatively, if the vehicle is used for the new style "participating" products then the requirement is for a commercial return to be paid on the capital invested in the new vehicle, but profits arising in that vehicle will be for the benefit of the new "participating" policyholders.

Seek the consent of with-profits policyholders

Paragraph 27 of the FSA's letter says that a firm will need to seek the agreement of its with-profits policyholders if it proposes to change participation rights. It is likely that most mutual firms will have a rulebook defining the rights of members and this may or may not accord different treatment to members with with-profits policies.

The letter goes on to say that options such as defining or splitting out the "mutual capital" may amount to a reattribution and might have to go through the formal process (which would presumably include a policyholder advocate).

The FSA's next steps

In the last section the FSA says that it expects all Boards of mutuals to consider the implications of the letter for their firms. The Board is required to consult its with-profits committee, or equivalent, and to be ready to communicate the results of its deliberations to the FSA before the end of the year.

OAC's commentary on the letter

We have a number of concerns about this letter as drafted and the legal opinion which accompanies it.

The legal opinion

Firstly, we believe that the legal opinion is flawed. We agree with paragraph 8 that it is likely that members who hold with-profits policies will be entitled to a greater proportion of surplus distribution than those who do not, but we cannot agree the leap of logic which has been made in paragraph 10 which states that with-profits policyholders "will be entitled ultimately to most of, indeed it seems probable, almost all, the assets in the long-term fund in the event of a run-off."

The paragraph finishes with the statement that there may be exceptions to this rule, but the footnote implies that the exception may be in a differentiation between with-profits policyholders who are members



and with-profits policyholders who are not members. Our experience is that there are a number of firms where the surplus in the fund has been built up from surplus on non-profit business where the non-profit policyholders have membership rights. Therefore, it seems to us that paragraph 10 goes too far in attributing surplus that has been built up in this way to the existing generation of with-profits policyholders. Indeed, for many firms, it could be argued that a high proportion of excess assets (after making full provision for the reasonable expectations of the with-profits policyholders) have been established through the members who have had non-profit policies in the past.

We believe that the second flaw in the legal opinion is that it relies heavily on the provisions of COBS Chapter 20. When COBS was being drafted, its key focus was to attempt to define the rights of with-profits policyholders vis-à-vis shareholders in proprietary companies. We do not therefore consider it should be relied on when defining the rights of with-profit policyholder members of mutual firms vis-à-vis the rights of other members. This is a matter for the rulebook of the firm.

We also note the legal opinion states the COBS 20.2.60(G) requires the consent of existing policyholders to be obtained. This paragraph is only signed as Guidance and cannot be allowed to override provisions in the firm's rulebook. In addition, it is only Guidance in the context of a run-off plan and it does not appear to us correct to imply (in paragraph 37) that such an approach can be used outside the context of such a plan.

We think that this opinion could be subject to challenge, and we understand that a trade body has received legal advice which differs from this opinion.

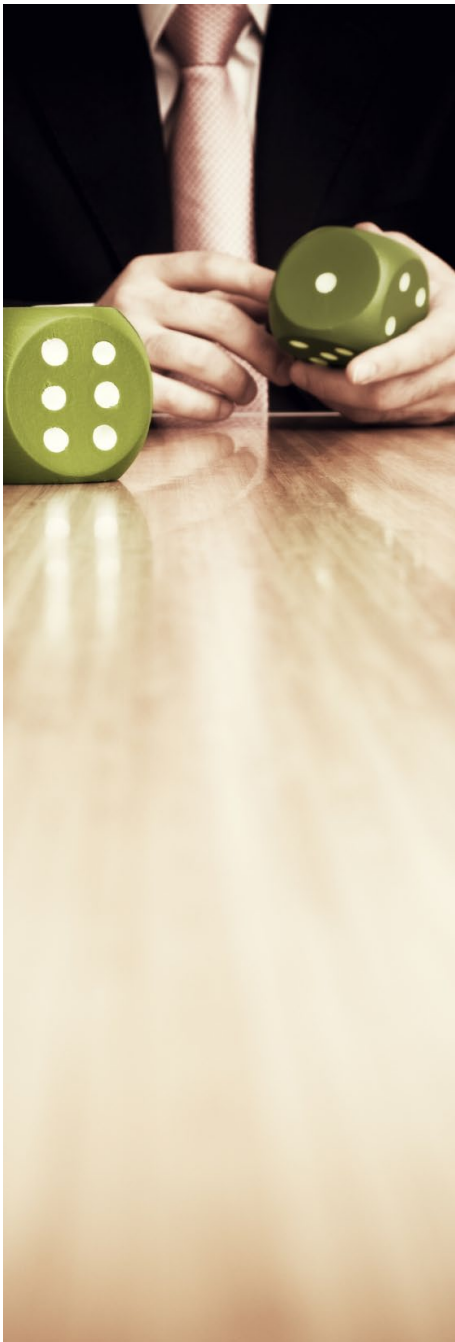
The FSA letter

Turning to the FSA letter itself, the first point to make is that the position of the Holloway Friendly Societies is very ambiguous. The arguments in the FSA letter are based on COBS Chapter 20 from which Holloway Societies are specifically excluded. While they may have the same issues to face as other mutuals they are not governed by COBS 20; the FSA need to clarify their position on this.

We think that the FSA has relied very heavily on a legal opinion which has been framed in the context of its own rules. This makes the situation slightly circular. As we have said above we do not believe that COBS 20 is intended to be a definitive statement of the rights of with-profits members vis-à-vis other members of a mutual firm and we therefore believe that reliance on it for this purpose is unsatisfactory.

We agree with the expression in paragraph 8 of the legal opinion which states that "it is likely that a greater proportion of surplus will be distributed to members who hold with-profits policies than those who do not", but we do not agree with the statement in paragraph 10 that this should mean "most if not all the assets in the long-term fund", and we do not agree with the way the FSA has uncritically accepted this interpretation and used it to justify the position set out in its letter.

We see no reason why a mutual which is continuing to write, for example, significant amounts of Child Trust Fund business should be forced to distribute all the expected profits from that business before that business matures. This requirement makes it impractical to write such business because it means that the firm is unlikely to be able to meet the statutory capital requirements because it will have been



forced to distribute its available capital to its with-profits policyholders. We therefore disagree with paragraphs 15 and 16 of the FSA letter which requires all the profits from new business to be distributed over the lifetime of the with-profits policies.

We believe that where a firm can demonstrate that its capital has been built up from sources other than its with-profits policies then such capital (which we would include in the definition of mutual capital) should not be required to be distributed to existing with-profits policyholders but should be allowed to remain in the fund for the benefit of all the firm's members whether they hold with-profits or non-profit policies. We also believe that, as long as the firm can continue to write profitable new business and meet the requirements of COBS 20.2.28 there is no reason why it should not be allowed to continue regardless of whether it is writing with profits, non profit or unit-linked business.

We think there are real difficulties with the "strategic investment" approach, whether conducted in sub fund or other vehicle. Apart from the costs involved there is again the problem that if the loan has to be repaid before the newly written business runs off there will be no available capital to meet regulatory solvency requirements. We also have concerns about the need in paragraph 27 to seek agreement from with-profits policyholders as this appears to override the firm's obligations to consult all its members on changes in its approach.

We also have serious concerns about the statement in paragraph 28 that many of the options are likely to amount to a reattribution. The changes made to COBS in 2007 now require the appointment of a policyholder advocate and any such reattribution process is likely to be time-consuming and expensive, and would

potentially reduce, if not exhaust, the assets it is meant to apply to.

FSA Guidance is that the cost of such a process should normally be met by shareholders, but this is not a course of action available to mutuals! It seems to us that any Board which opted to consider a reattribution process could be contravening COBS 20.2.39 as the costs of the reattribution could have a material adverse effect on the interests of all its policyholders, including the with-profits policyholders.

Our conclusion is that this is not a very helpful letter which raises as many questions as it answers. We think it is a pity that the proposals in this letter have appeared in this form rather than in the form of a consultation document on which feedback could have been provided and we are worried at the notion of "regulation by CEO letter".

We do not believe that this letter should be a significant concern for firms which are writing stable amounts of with-profits business which are not declining as a proportion of total new business. However, to meet the FSA's requirements, Boards of Mutuals will have to discuss how this letter applies to them, and we are more than happy to help firms in this process.

How can OAC help?

If you would like to discuss further any of the issues raised in this article, please contact me.

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