

Are customers in closed life funds being treated fairly?

'Consumers need to have confidence that the insurance firm they deal with is soundly managed [...]. Most importantly, we want to ensure that firms' senior management take responsibility for their obligation to treat customers fairly.'

FSA, 'Delivering the Tiner Insurance Reforms', April 2005.

Foreword by John Howard, Chairman, Financial Services Consumer Panel

There are thought to be around 11 million consumers with up to £190 billion in 'closed' with profits funds. You may have one without realising it because they were marketed as endowments, bonds, savings policies and life assurance. Some with profits funds, once they close, continue to perform well; others don't, so consumers need to be able to make a rational decision about whether to stay with the fund or move to another investment. Sadly the information sent out by firms is too often incomprehensible and it is almost impossible for most people to get advice about their policy. Suspicions about the operation of these funds once they close have been heightened by the fact that the so called 'independent' committees meant to protect consumers are often packed with company men.

Against this back-drop the Panel decided that the time was right to commission a piece of work to identify if in fact policyholders in closed funds were being treated fairly. This report is the outcome. Whilst the focus of the work was on funds managed by proprietary companies that are closed to new business, there are important lessons across the whole with-profits sector.

With-profits policies were the main retail investment until the early 1990s, and were targeted at the less experienced and cautious investor, although as the report highlights, few consumers understood how these products worked. The fact that there could be as many as 8 million policy-holders in open and closed funds who have policies which are uneconomic for the advice sector to adequately service provides the industry and FSA with a real problem.

Some people interviewed stated that providing information to this group of consumers was limited as the costs outweighed the benefits. This raises serious questions over discrimination and the extent to which this group of consumers can in reality be treated fairly. It also brings into question the value of trying to make a direct comparison between actual costs incurred and intangible benefits which are difficult to quantify. Without doubt, confident consumers who can make informed investment choices will benefit the entire industry. This won't be possible until the industry sees benefits in more than simple cash terms.

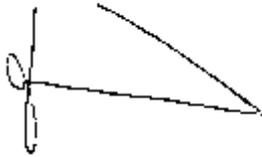
The number of consumers and value of funds under management, and the clear deficiencies which are leading to consumer detriment, point to a real need for both the industry and the FSA to seek ways in which the consumers' lot can be improved. Action needs to be taken to address concerns over administration and communications; to bridge the advice gap; and to take a serious look at the governance of these funds if the treating customers fairly initiative is to work in this market sector.

The report makes a number of valuable recommendations, which if implemented would go a considerable way to ensuring fairer treatment of customers with these policies. I think the most important could turn out to be the need for a truly independent voice for policyholders in every fund. The report suggests that with-profits committees are best placed to do this but only if they have a majority of independent members on them. These committees came into existence in response to FSA requirements introduced in 2004 but still far too many of these committees are simply a sub-committee of the main board. They may be able to act independently but the Panel feels they should be composed of a majority of people entirely independent of the board.

The FSA may also need to encourage these committees to exercise greater discretion. At present the committees often appear to limit themselves to reporting to policyholders on management activity in relation to the stated Principles and Practices of Financial Management (PPFM) – a document described by one person interviewed for the research as 'a charter for abuse'.

This report confirms that some customers are being treated unfairly as a result of a number of failings in the current system. Clearly these concerns need to be properly addressed in order that consumers are able to make an informed choice about whether to stay with the fund or choose an alternative investment and if it is economically viable for them to switch.

I would like to thank Debbie, Alistair, and Tim and his team at IFF for their invaluable work in conducting the research and completing this report.

A handwritten signature in black ink, consisting of a vertical line on the left, a horizontal line extending to the right, and a diagonal line extending upwards and to the right from the end of the horizontal line.

John Howard

Are customers in closed life funds being treated fairly?

Raising the bar for advice, administration,
communications and governance

Research Report

Prepared for

The Financial Services Consumer Panel

by

The Pensions Institute, Cass Business School

and

IFF Research Ltd

September 2007

TABLE OF CONTENTS

1. BACKGROUND, OBJECTIVES AND RESEARCH METHODOLOGY	2
Background to the research	2
Research objectives	2
Discussion of objectives	3
Research methodology	9
2. KEY FINDINGS AND RECOMMENDATIONS	11
2.1: The advice gap	11
2.2: Administration.....	12
2.3: Communications.....	13
2.4: Governance	13
3. BACKGROUND TO THE WITH-PROFITS MARKET	15
4. THE ANALYSIS IN DETAIL	20
4.1: The advice gap	20
4.2: Administration.....	24
4.3: Communications	26
4.4: Governance	29
5. CONCLUSION	36
Appendix 1: With-profits time line.....	38
Appendix 2: Listing of closed funds	40
Appendix 3: The with-profits review process and modelling tools.....	41
Appendix 4: The workshop	42
Appendix 5: Terminology	46
Appendix 6: Bibliography	48
Appendix 7: About the authors	50
Appendix 8: Acknowledgements.....	51

1. BACKGROUND, OBJECTIVES AND RESEARCH METHODOLOGY

Background to the research

The retail life fund market has changed rapidly and dramatically over the past decade, during which time many funds have closed to new business. In the first quarter of 2007, more than 11 million policyholders had assets in 70 formally closed life office funds worth in aggregate about £190bn.¹ Of this figure, the consolidators – companies set up specifically to buy and aggregate closed insurance company funds – have bought closed funds valued at approximately £80bn.²

It is likely that the closed and consolidated fund market will continue to grow – as more funds close formally to new business – before it diminishes, as a result of maturing policies and early exits.

The 2006 *Closed UK Life Office With Profits Funds Report*, published by AKG Actuaries & Consultants, shows that the majority of closed fund policies are with-profits.³ The actual proportion varies between companies but is a minimum of about 65%, rising to 100%. Due to the dominance and also the complexity of these policies, we decided that with-profits should be the focus of our research. The FSA estimates that there are 32 million policies in open and closed with-profits funds valued at £432bn.⁴ Products in these funds include regular premium endowments, single premium with-profits bonds, and a range of group and individual pension policies. As we discuss later in this report, most of the funds that are open are in effect ‘quasi-closed’ and in run-off, as they are not actively seeking new business.

Although we do not address specifically the position of customers with unit-linked, protection, and annuity policies in closed funds, our recommendations are also relevant to these customers in the context of Treating Customers Fairly. In addition, our recommendations will be relevant to policyholders in open funds that are, in fact, ‘quasi closed’.

Research objectives

In the light of the rapid changes in life fund status and ownership, the Financial Services Consumer Panel (FSCP) decided it was timely to consider whether policyholder protection has kept pace with market and regulatory developments. In April 2007 it commissioned the Pensions Institute at Cass Business School and IFF Research to assess the position of closed fund policyholders with reference to the FSA’s Treating Customers Fairly (TCF) principles-based regime, introduced in 2005, and which is encapsulated in the six ‘outcomes’ set out at the end of this section. The FSCP also asked the researchers to consider the treatment of policyholders in the wider regulatory and legal context.

¹ *Money Management*, March 2007, and FSA, ‘The regulation of closed with-profits funds’, September 2004. In the FSA report the total long-term insurance sector was valued at £940bn.

² *Ibid.*

³ The AKG annual reports on closed and open with-profits funds are based on FSA annual returns and the Principles and Practices of Financial Management (PPFM) reports, among other sources.

⁴ FSA, ‘Quality of post-sale communications’, May 2007.

The FSCP realised that in order to answer these questions conclusively and for the FSA to act on the recommendations, it would be necessary to conduct research in two stages – the second including consultation with the industry and consumer testing.

This report represents stage one of the research. Our objective was to produce a report based largely on qualitative research, but which also includes an element of quantitative research. Stage one of the research set out to achieve three objectives.

- To discover if the apparently widespread concerns about the ‘unfair’ treatment of policyholders in closed funds reflected in the press, and in independent reports, were justified and if so, in which specific areas is there evidence that life offices are not treating policyholders in closed funds fairly.
- To make recommendations to the FSA that could improve the position of policyholders who were being treated unfairly.
- To identify issues that gave rise to concern but which require further research to assess thoroughly.

It is important to stress at the outset that there are several reasons for closure and that this change in status does not automatically imply customer detriment. Policies in a minority of closed funds have continued to perform as policyholders originally were led to expect. Where customers do appear to have suffered and are in closed funds, closure is often a *result* of and not the *cause* of poor financial management and poor returns.

Given the size of the market, we felt it was important to consider very carefully our specific focus in relation to the question the FSCP posed, and which is the title of this report: ‘Are policyholders in closed life funds being treated fairly?’

There are important embedded questions here that we addressed at the outset. These were:

- Is the difference between mutual and proprietary company relevant and if so why?
- How do we define a closed fund?
- What is the impact of closure on asset allocations and ongoing costs?
- What does TCF mean in the context of our research?

Discussion of objectives

Governance focus: proprietary companies

Within the with-profits market our findings and recommendations on advice, administration, and communications apply equally to proprietary companies and mutuals. However, with reference to governance, our main focus is proprietary life offices – that is, companies with shareholders. These companies may be publicly or privately owned.

The reason for our focus on proprietary companies in relation to governance is that the potential for conflicts of interest between shareholders and policyholders is an important issue for TCF in the context of with-profits funds. Mutuals are owned by their members and distribute 100% of profits to policyholders. Their key area of conflict is between the differing interests of the current generation of policyholders and future generations.

Proprietary companies typically distribute 90% of profits to policyholders and 10% to shareholders. This indicates that any improvements in cost management and investment returns achieved by the fund should benefit both interest groups. However, several experts interviewed for this report expressed concern that where the policyholders bear a disproportionate amount of expenses and investment risk, for example, the actual ratio might be more than 10% in the shareholders' favour. This is a complex issue and one that we recommend for further research.

Definition of closed fund

The FSA sets out a clear process for formal closure. When a fund formally closes to new business it must notify all policyholders within 28 days of the cessation of new contracts in the with-profits fund and it must submit a run-off plan to the FSA within three months, which includes details of how it will distribute the inherited estate.

Put simply, the inherited estate is the surplus of assets over liabilities. A more accurate description is the excess of realistic assets over realistic liabilities, where the liabilities allow for future bonus declarations. The capital may be passed on from generation to generation of policyholders but once the fund is closed this surplus must be distributed.

There are very few large inherited estates left among open funds and these include the estates of Aviva and Prudential. Both companies have appointed a policyholder advocate to negotiate on behalf of policyholders in the 'retribution' of the estate between policyholders and shareholders.⁵

Reasons for closure vary but are likely to include a combination of financial weakness, a change in business strategy, and low sales. The FSA defines a closed fund as one where the governing body has decided not to offer new contracts or where there is no evidence of new business except by increment.⁶ The FSA states that insurers should not put off formal closure in an attempt to avoid the requirements this process entails.

In practice the definition of 'closed' is more complex than the above description suggests. Some funds that are formally closed receive a significant level of new cash flows from regular premiums and increments to premiums on existing policies. They may even gain new policyholders, for example where the with-profits fund is the default option in a defined contribution (DC) group personal pension plan, an occupational DC scheme, or an additional voluntary contribution (AVC) scheme. However, in these cases insurers are not *actively seeking* new business.

Currently, with the exception of about five life offices, which are actively seeking new business (as is demonstrated in their latest new business figures), most open funds appear to be 'sleeping' or 'quasi-closed', that is, they are not formally closed but are not at present seeking new business.⁷

⁵ Technically, 'retribution' applies to the distribution of surplus to policyholders and shareholders in open funds, while 'distribution' of surplus applies to closed funds.

⁶ 'Update on Closed With-Profit Funds, FSA, November 2005.

⁷ Evidence suggests, however, that sleeping funds do, in some cases, reopen. See O'Brien and Diacon (2005) 'Closed life funds: causes, consequences, and issues' CRIS Research Report 2005-2, Centre for Risk and Insurance Studies.

Therefore, apart from the minority of actively marketed funds noted above, in 2007 the distinction between closed and open is not clear-cut and it is evident from analysts' report, as well as returns to the FSA, that the bulk of the with-profits market can be considered in 'run-off'.⁸ Analysts such as AKG and Cazalet Consulting argue convincingly that many funds that have not closed formally are closed in all but name. They share the characteristics of formally closed funds but operate under different rules in relation to key aspects of policyholder protection and fair treatment.

In this report we categorise life office funds as follows:

- **Open** and actively seeking new business, as is demonstrated in new business figures, as distinct from premiums relating to existing policies.
- **Closed formally** with a run off plan submitted to FSA, which sets out a process for the distribution of the inherited estate. Policyholders must be informed of formal closure.
- **Quasi-closed** or **sleeping**, where little or no new business is written but the policyholder protection processes of formal closure are not in place.
- **Closed and consolidated** where a fund has changed ownership to a company that specialises in running closed funds. About ten million policyholders are in funds owned by Resolution and Pearl (the chief consolidators), Swiss Re and Reliance Mutual.
- All the above categories can occur in the context of **proprietary companies**, which have shareholders, and **mutuals**, which are owned by members.

It was suggested that while it is not unreasonable for a fund to remain in a quasi-closed state for the short term – on the basis that it may decide to actively seek new sales if the market environment changes – for funds to continue over the medium and longer term in this state raises important issues for TCF.

Advisers, analysts, and consumer representatives interviewed for this research, broadly agreed (with a minority strongly disagreeing) that it is unfair to policyholders if funds are deferring formal closure merely to avoid the requirements that apply to closed funds. This view is also shared by the FSA, which has stated:

A firm should not avoid taking a formal decision to cease to effect new contracts of insurance in a with-profits fund in an attempt to avoid the requirements of C.O.B. 6.12.94R (ie the requirement to notify policyholders of closure and to submit a run-off plan to the FSA).⁹

Until formal closure, funds have considerable discretion in the use of the inherited estate, which may be used to pay shareholder tax, to pay mis-selling compensation claims¹⁰, and to fund new business developments that are separate from the with-profits business, among other items. All these possible uses of the inherited estate – which are permitted by the FSA's C.O.B. rules – should be outlined in the company's Principles and Practices of

⁸ The main sources of data used in this report are the ABE, the Actuarial Profession, AKG annual reports on closed and open funds, the Centre for Risk and Insurance Studies at Nottingham University, Cazalet Consulting and *Money Management*.

⁹ FSA, 'Update on Closed With-Profit Funds', November 2005.

¹⁰ COB 6.12.67 allows a firm to pay compensation to a with-profits policyholder 'from assets otherwise attributable to asset shares, if, in the reasonable opinion of the firm's governing body, that compensation cannot be paid from the assets [...] in the inherited estate [...] or assets attributable to shareholders, whether or not they are held within a long-term insurance fund'.

Financial Management (PPFM), which sets out how the company runs the fund. It was suggested to us (with a minority strongly disagreeing) that such uses of the fund (policyholder capital) could be detrimental to the customer. One industry expert suggested to us that in certain cases the PPFM could be a 'charter for abuse for senior management.

The impact of closure: asset allocation

There are important differences between open and closed (or quasi-closed) funds in respect of asset allocation, as the table below demonstrates. An open fund that actively seeks and acquires new business will inevitably have more flexibility over the equity-backing ratio (EBR), as new premium income would aid liquidity. The EBR is the proportion of the fund's total assets invested in equities and property. The asset allocation of a closed fund, even where a high EBR is maintained in the short-to medium-term, will inevitably move towards fixed interest over time, as policies mature and the need to hold appropriate assets to meet the remaining guarantees on maturity payouts increases. Such a situation could be averted through consolidation, which helps to maintain critical mass.

Equity Backing Ratios (EBRs) of Closed and Open Funds

	<u>2003</u>	<u>2004</u>	<u>2005</u>
Average EBR of 33 Closed Funds	31.5%	31.4%	36.0%

% funds raising EBR over 2003-05 = 55%

	<u>2003</u>	<u>2004</u>	<u>2005</u>
Average EBR of 31 Open Funds	56.4%	56.4%	59.2%

% funds raising EBR over 2003-05 = 71%

Average open fund EBR in excess of average closed fund EBR	24.9%	25.0%	23.2%
--	-------	-------	-------

Source: Pensions Institute analysis of AKG data. EBR includes equity and property assets.

The failure to maintain good quality investment strategies and to maintain a high EBR is likely to lead to lower returns and the subsequent exit of policyholders, whose policies are not close to maturity. This will only exacerbate the problems associated with falling assets under management, which makes it difficult to justify high quality asset management, administration, and communications. The November 2005 Staple Inn Actuarial Society (SIAS) report, 'Management of Closed Funds', suggests that active asset management may

be less appropriate where assets under management are falling, as the cost may outweigh the risk and the benefits.¹¹

The move towards fixed interest is not necessarily unfair to policyholders, as it serves to protect the guarantees associated with certain with-profits policies and it may also be an asset allocation of choice in the context of any long-term investment that is approaching maturity. The use of lifestyling overlays for DC pension plans, such as personal pensions, for example, aims to reduce risk in the run up to retirement and therefore switches the investor gradually out of equities and into bonds and cash.

However, it is also the case that a closed fund, which is not seeking to attract new business, has little incentive to improve the EBR. This is at least in part because it does not need to focus on league table performance, which is a priority for providers seeking new business. Rather, the closed fund's focus is to meet the FSA's solvency requirements and to be able to pay fixed guarantees, both of which indicate that a higher weighting in fixed interest assets is prudent.

The impact of closure on asset allocation was an issue the Treasury Select Committee considered in its report on endowments in February 2004.¹² The report notes that 'on closing to new business, a with-profits fund will typically switch a substantial proportion of the investment portfolio out of equities into bonds in an attempt to reduce the volatility of the fund and minimise the capital the insurance company may need to support the fund.' The report gives an example from Royal & Sun Alliance (now owned by Resolution under the Phoenix fund name), which reduced its equity weightings in 2003 – the year after it closed its two main life funds – from 59% to 21% and from 41% to 10%.

The Select Committee report provides a projection example: A £50,000 with-profits pensions policy with ten years to go to retirement is likely to produce a final fund worth £6,000 less if the fund is closed, due to changes in asset allocation.

The report goes on to say that in the case of Royal & Sun Alliance, although the company wrote to policyholders to tell them about the funds' closure to new business, 'policyholders were given no particular opportunity to leave the fund and if they chose to do so normal exit penalties would apply'. This is a good example where communications literature complies with regulatory requirements but does not empower customers to make informed decisions.

While asset allocation may not be a suitable absolute measure of TCF in the case of individual policyholders, it is evident that an improvement in the EBR is likely to benefit policyholders as a whole, as the returns should (but cannot guarantee) to be higher than a predominantly fixed-interest portfolio. However, raising the EBR is not a win-win situation for all policyholders. In order to increase the EBR, the provider may have to reduce bonuses in the short term, as it will need higher reserves to back its equity allocation, as is required by regulation. This is a good example of the type of issue where independent representation of policyholders within the life office structure can help ensure the right balance between different generations of policyholder.

¹¹ Staple Inn Actuarial Society, 'Management of Closed Funds', November 2005.

¹² Treasury Select Committee, Endowment Mortgages, 2004.

The impact of closure: ongoing costs

The closure of a with-profits fund can lead to lower costs in the shorter term on the part of the life office, which no longer has the expense of seeking new business, with its associated initial commission payments to advisers, among other costs. Consolidators may be able to achieve economies of scale, as they can amalgamate the administration of their funds. However, the SIAS report of November 2005, 'Management of Closed Funds', notes that if a fund does not amalgamate with others, then fixed costs will be an increasing burden as the fund proceeds in run-off. These fixed costs include asset management, IT, management overheads – such as audit and other fixed fees – and accommodation. The report warns that diseconomies of scale in a closed fund could mean that expense growth is higher than for an open fund, possibly by as much as 2%-3% per annum:

This could mean that the expense growth is out of step with policyholders' reasonable expectations [now replaced by TCF] or the assumptions made in the product pricing, both of which could have been set assuming an open fund.

The report also notes that investment in new IT systems to improve service levels may disadvantage policyholders if the expense is disproportionate to the benefits. 'However, there are responsibilities around treating customers fairly which will include a certain level of service,' the report stresses.

The SIAS report concludes on this point that there are measures that can be taken – and, we would add, which could provide benchmarks for the measurement of TCF – to reduce the impact of rising costs per policyholder. These are:

- The office must proactively plan to reduce costs, including staff numbers as the business declines. Careful management and hard decisions will be needed.
- Rationalisation of the business should be done sooner rather than later, to spread the costs over the largest possible book of businesses.
- It is important to monitor the size of the book, and to be prepared to take further action on an ongoing basis, as and when necessary.
- On closure, there needs to be a change in mindset. Priority for systems and resources needs to be shifted away from sales and marketing activities towards efficiency and cost reduction measures.

TCF in the context of with-profits policyholders

TCF is not a new requirement. The FSA's 11 Principles for Businesses have existed since the implementation of the Financial Services and Markets Act in 2000. Principle 6 says: 'A firm must pay due regard to the interests of its customers and treat them fairly'.

The meaning of TCF is now enshrined in six 'outcomes'. On the 'frequently asked questions' page of its website, the FSA says it expects TCF to be embedded throughout regulated firms, 'not just in systems and controls but in business culture, including strategy, training, remuneration and staff behaviours'.¹³

¹³ Source: FSA, 'Treating customers fairly – towards fair outcomes for consumers', July 2006. The FAQ page is at <http://www.fsa.gov.uk/Pages/Doing/Regulated/tcf/faqs/index.shtml>

The six outcomes are:

Outcome 1: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.

Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.

Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.

Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances.

Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect.

Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

In 2001 the FSA announced it would review with-profits business. The key themes were:

- A process for dealing with the attribution of the inherited estate
- Regulatory reporting
- Disclosure to consumers
- Discretion and fairness in with-profits policies
- Governance of with-profits funds and the future role of the appointed actuary

Since then the FSA has published a series of consultation papers and reports, which formed part of the initial analysis for this report.¹⁴

Research methodology

The initial discussions for the research between the FSCP and the Pensions Institute and IFF Research began in March 2007. Work commenced in April and the report was completed in early August.

To achieve our research objectives we started with a thorough analysis of the closed life fund market, including an examination of the regulatory regime for TCF, the considerable number of FSA reports on with-profits, and the existing independent research, which is listed in the appendices. The following sources were particularly important for this analysis:

- AKG Actuaries & Consultants provided us with access to their September 2006 *Closed UK Life Offices With Profits Report*. (The company also publishes a similar

¹⁴ A full list can be found at http://www.fsa.gov.uk/Pages/Library/Other_publications/Profits/index.shtml

volume on open funds.) The 2006 report is based on data as at December 2005, an example of which is shown in Appendix 2.

- Barrie and Hibbert, the risk consultancy, provided us with access to its with-profits policy review model. See Appendix 3.
- The Centre for Risk and Insurance Studies at Nottingham University gave us permission to use data from its paper, 'Closed life funds: causes, consequences, and issues', published in 2005. Cazalet Consulting, a recognised specialist in the field, provided access to relevant presentations and reports. *Money Management* assisted the research by identifying relevant published surveys on with-profits endowment policies and related features on life office strength and the consolidation of closed funds. These sources are listed in the bibliography in Appendix 6.
- The Actuarial Profession's February 2007 'Briefing Note: With-profits endowment payouts' provides evidence that some insurers were making payouts of up to 124% of the asset share during the period 1984-2005. This is likely to be a major factor in the reduced financial strength of insurers. For readers seeking to understand payout policy and the relevance of the asset share, this is an excellent source document.¹⁵

Following the review of existing research, we carried out a series of more than 50 interviews – face-to-face and by phone – with regulators, life offices, advisers, benefit consultants, analysts, consumer bodies, policyholder advocates, lawyers, and trade associations. The interviews took place between April and early June.

On 13 June we held a workshop at Cass Business School, under Chatham House rules, at which 30 selected experts, representing the various interest groups above, were invited to debate our proposed measures of TCF. This enabled us to 'stress test' our methodologies and strengthen our recommendations. Following the workshop we conducted further interviews, which focused on the specific issues raised by participants. Details about the workshop and its debates can be found in Appendix 4.

Participating organisations in the research are listed in the acknowledgement section in Appendix 8. This list also identifies the organisations that took part in the workshop.

¹⁵ 'Briefing Note: With-profits endowment payouts', the Actuarial Profession, www.actuaries.org.uk/files/pdf/life_insurance/endowmentpayouts_briefnote.pdf. Since 2005 payouts have generally been close to 100% of the asset share.

2. KEY FINDINGS AND RECOMMENDATIONS

This report identifies three areas – advice, administration, and communications – where we found evidence that some customers are being treated unfairly. We also identify a fourth area of particular importance – governance – where there was considerable concern over the fair treatment of policyholders and their lack of representation within the life office structure. While we identify this gap clearly and suggest how this issue might be addressed, due to the constraints of time and resources we decided not to make firm recommendations that would improve the situation. Therefore, in respect of the governance of closed funds, we set out our findings and suggest areas for further research to provide the necessary evidence for regulatory change.

2.1: The advice gap

We found that as many as eight million policyholders may be disenfranchised from the independent advice system.

TCF Outcome 5 includes the requirement that customers should be ‘provided with products that perform as firms have led them to expect’. In its ‘Quality of post-sale communications’ report of May 2007, the FSA states that where the investment mix of the underlying fund has changed since the customer bought the policy – for example where it has switched from a predominantly equity and property-based fund to one invested largely in fixed income – it is likely that it will perform differently to what policyholders were led to expect at the date of purchase. In these circumstances, the FSA says, customers can reasonably expect to be alerted to the change and to seek independent advice to determine whether it is appropriate to switch to an alternative product that matches more closely the original investment objectives.

While in theory all customers have access to advice, our research indicates that in practice customers with small policy values – about eight million – may be disenfranchised from the independent advice market. Fee-based advice is costly relative to the value of smaller policies (£70 per hour is typical), while commission-based advisers report that it is uneconomic to provide a with-profits review service where the policy value is small. This is due to the complexity of the work required and the low level of commission advisers would receive in return, which would be based on the fund size. It is also due to adviser concerns about the residual regulatory risk – that is, that the FSA may decide at a later date that a recommendation to switch was a case of churning. The adviser’s position may be made more difficult if the firm sold the policy in the first place.

Recommendations

- The current regulatory model for ‘limited’ or ‘focused’ advice, which provides a detailed analysis of a specific investment but not a full financial planning service, is an initiative that could be developed further for with-profits policyholders.
- To help advisers provide this type of advice, life offices should consider making available, free of charge on their websites, with-profits review tools and models. A minority of insurers already do so.
- Advisers prepared to offer limited or focused advice along the above lines might consider forming a trade association to help consumers identify which firms to contact.

- Alternatively, or in addition, the ‘industry’ (for example the ABI and the Association of Independent Financial Advisers) could consider uniting to provide a central source of limited or focused advice, which would offer economies of scale that individual firms of advisers might not be able to achieve.

2.2: Administration

We found three specific areas where weak administration processes are detrimental to market liquidity and to the policyholder’s freedom and flexibility to exercise their rights.

Liquidity is an important aspect of the with-profits market and there are three ways in particular that a policyholder might end the contract with the original provider. These are the market value reduction (MVR)-free period, the sale of an endowment in the secondary market, and the use by pensions policyholders of the open market option (OMO) at retirement to buy an annuity from a different provider. Weak administration can be a significant barrier in all three areas.

With reference to TCF Outcome 3, ‘Consumers are provided with clear information and kept appropriately informed, before, during and after the point of sale’, the FSA reports that three-fifths of advisers encountered problems in getting information from product providers, for example about MVRs and MVR-free periods.¹⁶ The MVR is imposed where the policy’s underlying value (the asset share) is lower than the unit value shown on the annual statement. The unit value usually only applies at certain dates, including maturity and death.

The traded endowment policy (TEP) market can enable customers who want to stop an endowment policy to secure a better price than the surrender value offered by the provider. TEP market makers told us that closed funds were particularly difficult to deal with and that it was often impossible to obtain information and duplicate policy documents, for example, in a timely manner. As a result, sales were delayed and in certain cases could not proceed at all.

Annuity advisers reported similar problems where they request a transfer of a client’s maturing pension fund via the OMO to secure an appropriate annuity product (for example the existing provider may not offer enhanced terms for smokers) and a competitive annuity rate. The OMO is a right that has been written into most pension contracts following its introduction in the Finance Act 1988. Among other problems, where the fund transfer cannot be arranged within the annuity rate quotation period (14 days), the quotation would lapse. If annuity rates have fallen during this period, the customer would receive a lower retirement income as a result of the delay.

Recommendations

- The FSA, in conjunction with the ABI, consumer representatives, and other interested parties, could focus on three key areas for improvement in administration and establish a system for their measurement. The intention would be to make improvements in timeliness and the availability of the required information. The key areas for improvement are in the provision of information about the MVR and MVR-free exit dates, the arrangement of a TEP sale, and the arrangement of an OMO annuity sale.

¹⁶ ‘Quality of post-sale communications’, FSA, May 2007.

- The FSA could consider employing ‘mystery shoppers’ to check administration standards and report cases that fall short of TCF standards.

2.3: Communications

We found four specific areas where communications literature impedes policyholder understanding and their ability to make informed decisions.

TCF Outcome 3 states that consumers should be provided with clear information and kept appropriately informed, before, during and after the point of sale. In its post-sale report of May 2007, the FSA explained what this means:

Post-sale information needs to be clear enough for customers (or their advisers) to understand how their investment is performing, so they can judge if the policy still meets their requirements. It should also remind them of the key benefits of that policy, particularly if they are about to take actions, which would result in them losing these benefits.

Our research found that certain communications documents, while adhering to regulatory requirements, do not set out the key information clearly and do not provide sufficient information to enable customers to make informed decisions. The four key documents we identified as problematic are the consumer-friendly principles and practices of financial management (CFPPFM), the annual statement, the timeliness and availability of information about MVR-free exit periods, and information about closure and consolidation.¹⁷

Recommendations

- Communications should not assume that the policyholder has access to independent advice and should always include details of limited or focused advice. The availability of limited or focused advice should be emphasised at the top of communications literature with information on how to obtain this.
- Key documents should include all material facts and be written clearly so that policyholders can understand and, importantly, can act on the information. These documents include the consumer friendly PPFM (CFPPFM), the annual statement, information about MVR-free exit dates, and information about a change in fund status or ownership.
- The industry should work towards standard formats for these specific communications documents and assess them through regular consumer testing.

2.4: Governance

We found that TCF in relation to the company’s use of policyholder capital may be inconsistent and that the mechanisms to ensure policyholder representation appear to be incomplete.

For proprietary companies running with-profits policies, there may be conflicts of interests between the shareholders and the policyholders. In 2004 the FSA introduced guidance on

¹⁷ The CFPPFM and documents reporting closure and consolidation in many cases are available on company websites.

the implementation of 'appropriate' governance arrangements. This could be an independent individual or a 'with-profits committee' (WPC), which would act in the interests of, and report to policyholders. Most firms have introduced a WPC and our impression is that this model for policyholder protection is considered best practice, even though it is not a regulatory requirement.

At present, however, the 'independence' of the WPC varies considerably between companies. In our assessment of the membership of the WPC in closed funds, we found that in almost 60% of cases the WPC was a sub-committee of the main company board or comprised of current and former directors and non-executive directors, with no genuinely independent member. This figure includes the minority of funds, which, for reasons that are not clear, do not provide details of the WPC in the PPFM.¹⁸

Recommendations

- Further research should be carried out to determine the most appropriate way to ensure that the financial management of the fund, which includes the inherited estate, is in the best interests of policyholders. A truly independent with-profits committee (WPC) appears to be the right mechanism to achieve this objective.
- The WPC's remit should be TCF and not just the Principles and Practices of Financial Management (PPFM) document, which is written by the management and at present provides the frame of reference for WPC reports to policyholders.
- There should be further research and consultation on the uses to which management puts the with-profits fund. While these uses are permitted in the FSA's C.O.B. rules, specific areas of concern are:
 - The use of policyholder capital to fund new business costs
 - The payment of shareholder tax
 - The payment of endowment and pensions mis-selling compensation
- The FSA could strengthen the TCF-focus of the WPC through the establishment of a central knowledge and guidance centre, along similar lines to that available from the Pensions Regulators for trustees of occupational pension schemes.
- The FSA could further strengthen the TCF regime through the requirement that companies produce a simplified annual financial statement that sets out how it has used policyholder capital, including the inherited estate, over the past year. This would be of use to the FSA itself, the WPC, with-profits analysts, and other interested parties.
- The role of the With Profits Actuary and Company Actuary (the Actuarial Function Holder) should be carried out by separate individuals. At present one individual may carry out both functions.

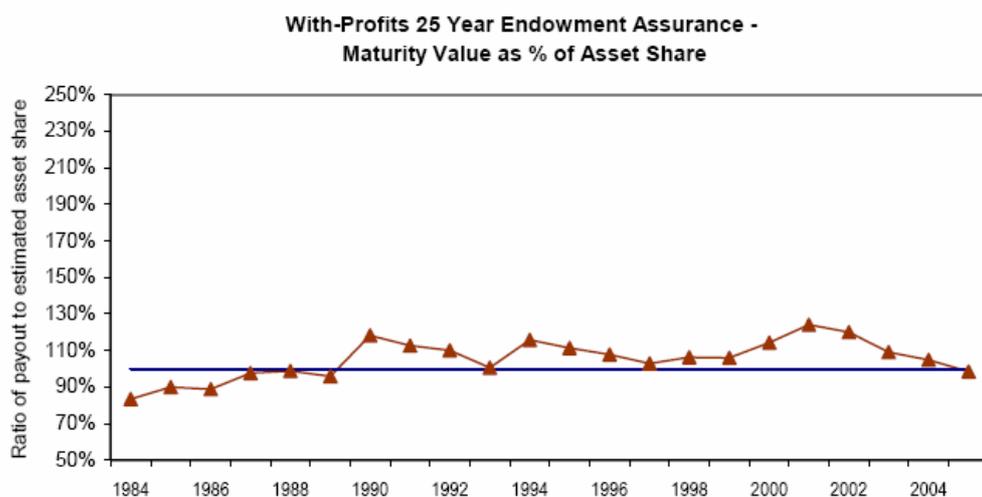
¹⁸ The members of the WPC and their current or past relationship with the company are provided in the with-profits Principles and Practices of Financial Management reports. The AKG reports on closed and open funds also list WPC members under its sections on governance, where this information is provided in the PPFM.

3. BACKGROUND TO THE WITH-PROFITS MARKET

Issues for the current market

Since the turn of the century, regular reports in the personal finance and trade press have suggested that customers could be suffering as a result of the significant changes in asset allocation associated with closed with-profits policies, which comprise the majority of policy types in closed funds and which are the main focus of our report.¹⁹ The personal finance press has argued that customers were, in effect, trapped because with-profits funds have the discretion to make a 'market value reduction' (MVR) to policy values where the policy is terminated early. In addition, the relatively weak financial strength of most closed funds means that they may be unable to improve bonus prospects in future.

This weakness is not only due to falling markets. The Actuarial Profession's February 2007 briefing note on with-profits endowment payouts demonstrates that in the period 1984-2005 some insurers were making payouts at maturity well in excess – up to 124% - of the policyholder's asset share. This is shown in the table below. While this may have enabled providers to maintain league table positions at the time, the result is that reserves were depleted. This is a good example of management decisions that benefit earlier generations of policyholders at the expense of current and future policyholders.



25 year policies with premiums of £50pm maturing on 31st December in relevant year

Source: Tillinghast (in Briefing Note: With-profits endowment payouts, The Actuarial Profession, February 2007). The straight line indicates asset share, the triangle line represents actual payouts.

¹⁹ Our research on negative press coverage found prominent features in the following national newspapers: the *Daily Mail*, *Mail on Sunday*, *Observer*, *Sunday Telegraph*, and *Sunday Times*. In the trade press, the plight of with-profits policyholders has been the subject of regular coverage in *Money Management* and *Financial Adviser*.

Reports by the Treasury Select Committee, the FSA, and The Pensions Advisory Service (TPAS) have also raised concerns over the fair treatment of policyholders in closed funds, and in particular those with with-profits policies.²⁰ The Treasury Select Committee 2004 report on mortgage endowments argued that where the asset allocation of a with-profits policy has changed significantly, policyholders should be allowed to switch to another product without facing an MVR. In practice the allocation to equities and property fell from about 70% in the late 1990s to about 30% by 2003.

The FSA 'Quality of post-sale communications' report of May 2007, and the TPAS annual report of June 2007, both found evidence of weak administration and communications, which meant that customers were either unable to make informed choices in response to significant changes in their policy or, if they did want to make changes, they faced delays and difficulties obtaining the necessary information from insurers' call centres.

Cazalet Consulting has provided evidence that with-profits policyholders' capital is being used by providers to fund new business ventures, which are unlikely to be profitable and, therefore, which are not in the policyholders' best interests. This is partly due to poor persistency rates and partly due to the fact that the initial commission paid to advisers is not recouped by the provider through the annual management charge before the commission-clawback period is over. This, Cazalet Consulting argues, encourages advisers to churn policies after three or four years, creating a net loss to the provider.²¹

Brief history of the with-profits market

In order to appreciate the complexity of with-profits policies and the challenges they present to the assessment and measurement of TCF, it is helpful to know a little about their history.

Briefly, with-profits policies were the main retail investment until the early 1990s. They aimed to offer the inexperienced and more cautious investor significant exposure to growth assets, such as equities and property, but with returns that were 'smoothed' to reduce year-on-year volatility.

An important function of the with-profits 'appointed actuary' was to decide what proportion of the investment return to withhold in years of rising markets in order to maintain an attractive return when markets were falling. This smoothing mechanism was – and still is – largely discretionary for most funds. We were told that even where companies have prescribed their smoothing mechanism in the PPFM, they reserve the right to change this if circumstances dictate.

²⁰ Treasury Select Committee, Fifth Report, 'Endowment Mortgages', February 2004; 'Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholders', FSA, May 2007 (a full list of the FSA reports on this subject is provided in the bibliography); 'Advising on pensions: A review of activities', The Pensions Advisory Service, June 2007.

²¹ Cazalet Consulting, 'Polly Put the Kettle On: Pensions Profitability', January 2006. The report states that 50% of new pensions policies lapse within the first four years. Initial commission ranged from 3% to 7.5% at the end of 2005 for single premium policies, while the annual management charge was between 0.75% and 1%. The period over which providers recoup the cost of commission varies from 3.8 to 9.5 years. Commission clawback for early lapses ranges from 2 to 4 years and is 3 years on average.

Typically, until the turn of the century, funds invested about 70% in equities and property (the equity backing ratio), with the balance in fixed interest assets and cash.²²

The complexity of with-profits policies is very relevant to this research. The type of customers targeted by providers and advisers bought on trust, on the assumption that the policy would meet their long-term investment objectives for mortgages, pensions and other savings purposes, while at the same time smoothing year-on-year volatility. It is fair to say that very few customers understood how the product worked.

The main with-profits policy types are:

- Regular premium endowments, which combine the with-profits investment policy with decreasing life assurance. For mortgage endowments, in the event of early death, the combination of the fund value and the life assurance would be sufficient to repay the mortgage debt.
- Individual and group defined-contribution (DC) pension policies, including retirement annuity policies (the predecessor to personal pensions), personal pensions, contracted out ('appropriate') personal pensions, and group personal pensions (GPPs). Typically, the bulk of the fund at maturity would be used to buy an annuity, which provides a guaranteed regular income for life.
- Occupational DC schemes (also known as money purchase schemes), which are trust-based (unlike GPPs, which are contract-based). A board of trustees is responsible for acting in members' best interests.
- Occupational 'additional voluntary contribution' (AVC) schemes, which allow occupational pension scheme members to boost their pension income. AVC schemes in the private sector are usually DC plans.
- Single premium bonds, some of which are whole of life policies and so combine life assurance. Bonds can be fixed term – for example, ten years – or open ended, as is the case with whole of life policies.

By 2007, new with-profits business levels had fallen dramatically, even for the small number of companies that were still actively marketing and selling bonds. According to Cazalet Consulting, the majority of funds now have negative cash flow – that is, claims (maturity, death, early surrender) are greater than inflows from premiums.²³ For most providers, therefore, it appears that the with-profits fund is, in effect, in run-off even if is not formally closed to new business.

The original or 'conventional' with-profits policy

'Conventional' policies provided contractual guarantees, such as a minimum sum assured at maturity (the end of the policy term or death) and a minimum rate of annual return (the 'regular' bonus), which, in the era of relatively high inflation, typically was 5% and may have been as high as 7.75%. Regular bonuses, once added, cannot be taken away and so are guaranteed. In addition there may be a final or terminal bonus, which is discretionary.

Conventional policies have been associated with poor surrender values – that is, where the customer decides to cash in the policy before maturity, as is the case in about 70% of

²² Source: *Money Management* annual surveys of with-profits endowments.

²³ Cazalet Consulting, 'Polly Put the Kettle On'. See Note 4.

endowment policies and 50% of pensions policies.²⁴ However, it would appear that this practice is changing now that companies are required to include within their PPFMs a target range of payouts based on the asset share. Charges on conventional policies are deducted before the bonus is declared and are not transparent.

Many conventional with-profits pension policies have a particularly valuable feature in the form of a guaranteed annuity rate (GAR). The annuity rate is the percentage of the pension policy fund the insurance company offers as a guaranteed annual income. So, a 9% annuity rate, typical of such guarantees, would yield an annual income of £9,000 on a fund of £100,000.

GARs were issued in the days of double-digit inflation and were largely discounted as a liability by actuaries until the mid-1990s, when inflation fell and the guarantees for the first time were 'in the money' – that is, they offered a rate of annual income in excess of open market annuity rates. The OMO rate currently is about 6%, so a GAR of 9% would provide an additional £3,000 a year on a £100,000 fund, compared with the OMO rate. Over a 25-year retirement, this would add £75,000 to the annuitant's aggregate income.

Equitable Life's troubles and its closure to new business in 2000 were partly due to its GARs and its later attempts to renegotiate this guarantee with its policyholders, which led to a legal battle that continues today.

The move to 'unitised' with-profits policies

In the late 1980s and early 1990s most life offices replaced their conventional with-profits policies with the 'unitised' version, which aimed to make charges more transparent through the introduction of an annual management charge (AMC). The payout from a unitised policy comprises the value of units plus a final bonus, which is discretionary.

An important and controversial feature of unitised policies is the 'market value reduction' (MVR), a discretionary adjustment for early surrenders at times of falling markets. The MVR aims to offset the difference between the 'current' or face value of a policy, as set out in the unit value on the annual statement, and its actual 'asset share', which may be lower at times of falling stockmarkets.

The asset share

The asset share is an important concept for with-profits. This is equal to total premiums paid, less expenses, tax and other charges, increased by the rate of investment return achieved. The asset share may be determined for specimen samples of policies and the result applied to groups of policies for which it is considered appropriate.

The Actuarial Profession, in its February 2007 Briefing Note on with-profits endowment payouts, says that asset shares are 'the main tool insurers use to establish the fair maturity value of a policy'. At maturity, where the asset share is larger than the face value of the policy, 'the insurer will determine a rate of final bonus which will largely make up the

²⁴ The source for the endowment figure is the Association of Policy Market Makers; the source for pensions policies is Cazalet consulting, 'Polly Put the Kettle On'. The Cazalet research found that 50% of pensions policies lapse within the first four years and that persistency appears to be deteriorating. For group pensions business, the lapse rate is 60% within the first three years.

difference'. If the asset share is less than the face value of the policy at maturity, the insurer will make up the difference by drawing on assets, which it holds for this purpose. The report adds, 'Generally, no market value reduction (MVR) can be applied at maturity'.

Financial strength

The payment of bonuses in the 1980s and 1990s that were high relative to returns and reserves (up to 124% of asset share, as noted earlier), the cost of compensation payments for mis-selling personal pensions, increasing longevity, and the impact of annuity rate guarantees that were by now 'in the money', were some of the reasons why many funds were in a financially weak position when they entered the equity bear market of 2000-2002.

To maintain solvency, in terms of the regulatory requirement to hold sufficient assets to meet guarantees, many funds sold equities when prices were historically low and bought bonds, when prices were historically high, leading to significant net losses for the fund. The allocation to equities typically fell from about 70% to 30%, while a minority of funds moved entirely into fixed interest. Annual bonuses fell, in some cases to zero.²⁵

The introduction by the FSA of capital requirements based on the 'realistic balance sheet' (RBS) in 2004, aimed to prevent insolvencies and appears to have been successful in this respect, helped by rising equity returns and bond yields.

With-profits today

Understandably, the apparent gap between the rising markets of recent years and the comparatively low annual bonus declarations, which in some cases has been zero, has led to a mood of suspicion on the part of policyholders and the personal finance press. Having said that, certain press comments have not always demonstrated a clear understanding of the nature of bonus smoothing, which inevitably implies a disconnection between bonus rates and market returns in any single year.

There have also been rapid changes in status and ownership. Some ten million policyholders have seen a change in ownership from the original 'household name' insurer, with its connotations of brand and trust, dating back in some cases to the eighteenth century, to an unknown and newly formed consolidator.

To conclude this section, there is no doubt that the with-profits market as a whole is inherently complex and heterogeneous. Taken in isolation, individual funds also resist a single focus of analysis for TCF purposes, as typically they comprise several cohorts of policyholders for whom different policy terms apply. Some policies have guarantees that may indicate that the policy continues to provide value for money. Those without valuable guarantees may be more vulnerable to changes in asset allocation and falling bonus payments. Any changes to the way with-profits funds are managed, administered, and communicated, must bear this important fact in mind.

²⁵ Source: Money Management's annual with-profits endowment surveys.

4. THE ANALYSIS IN DETAIL

In this chapter we set out the analysis that supports our key findings and recommendations.

4.1: The advice gap

We found that as many as eight million policyholders may be disenfranchised from the independent advice system.

The current situation

While good financial management and transparency in relation to TCF are vital to ensure companies treat policyholders fairly in future, they do not necessarily help policyholders who made their purchase some years ago and whose original investment objectives are no longer being met. Policyholders, who may have suffered as a result of reduced financial strength and a significant change in asset allocation, need to know if their policy continues to meet their original objectives. They may have purchased a smoothed growth product in the 1980s or 1990s in a fund with an allocation to equities and property of about 70%, and in 2007 have a policy that is predominantly invested in fixed interest assets.

Equally important is an assessment of the provider's ability to smooth annual returns (bonuses). With-profits funds aim to retain part of the profits in years when markets have performed well in order to deliver a comparatively attractive return in years when markets are falling. To achieve this effectively, the firm may decide to maintain financial reserves beyond those required for regulatory solvency requirements. The financial strength of the provider, therefore, largely dictates the fund's ability to maintain a high EBR and to deliver attractive returns throughout all market conditions. This is because equity returns are more volatile than fixed interest returns and so the provider needs to retain a buffer to maintain bonus rates when markets are falling. Overall, it is fair to say that financial strength ratings are considered a key metric for the market and for the assessment of a with-profits policy in a formal review.

For a range of reasons already noted, most closed funds, although meeting FSA solvency requirements, have a low level of financial strength. This makes it difficult for the fund to increase the equity exposure. Some providers have made welcome progress in this area and have been able to increase the EBR, which in turn makes the prognosis for policyholders more optimistic over the medium and longer term.

TCF Outcome 5 includes the requirement that customers should be 'provided with products that perform as firms have led them to expect'. In a May 2007 report the FSA states that where the investment mix of the underlying fund has changed since the customer bought the policy it is likely that it will perform differently to what they were led to expect. In these circumstances, the FSA says, customers can reasonably expect to be alerted to the change and to seek independent advice to determine whether it is appropriate to switch to an alternative product that matches more closely the original investment objectives. This view concurred with the opinion of the Treasury Select Committee Report of February 2004.²⁶

A good example of the potential detriment to policyholders of such a change in asset allocation and bonus policy is the contracted out ('appropriate') personal pension, which, since the late 1980s, has been used to invest rebates of the National Insurance (NI)

²⁶ Treasury Select Committee, 'Endowment Mortgages', 2004.

contributions that would otherwise have earned benefits under the additional state pension.²⁷ The justification for the sale of this type of policy in the late 1980s and throughout the 1990s was that the investment in stockmarket assets of the annual rebates of NI contributions would provide a better pension at retirement than the state scheme. A policy purchased during this period but which has subsequently changed its asset allocation to predominantly fixed interest could not reasonably hope to achieve this objective.

Whatever the policy type, the decision to switch cannot be based on the characteristics of a fund alone. Much will depend on the policy's term to maturity and its guarantees, where applicable, as well as the policyholder's attitude to risk. As mentioned, within each fund there will be different cohorts of policyholders with differing guarantees. This indicates that the assessment should be at policyholder rather than fund level.

In the context of advice, the value of a policy is very relevant. Data collected in our research from company statements (in particular Pearl and Resolution), together with analysis of the AKG closed fund report, indicates that the consolidators' policies have an approximate average value of £8,000 - £10,000 and many are worth less than £1,000. Smaller policies might typically be associated with customers who are not financially sophisticated and who do not have access to affordable independent advice relative to the policy value.

Our research into the remuneration system for advisers indicates that in practice customers with small policy values may be disenfranchised from the independent advice market.²⁸ This group is likely to include ex-industrial branch (IB) policyholders. IB was the old door-to-door sales and premium collection practice and while this channel no longer exists, the FSA says that there are some eight million IB with-profits policies still in existence.²⁹

Ex-IB customers usually have small policy values, based on typical monthly premiums of as low as £5. The average annual premium today for IB whole of life policies is £50 and for IB endowments is £100.³⁰ Several life offices with IB business interviewed for this research said that the provision of information to this category of policyholder by necessity was limited; otherwise the cost would outweigh any benefit. While this may make sense from the economic perspective, it does raise issues about discrimination in relation to the fair treatment of all policyholders, irrespective of the policy value.

While the eight million ex-IB figure refers to policies and not policyholders, it is likely that the total number of IB policyholders, together with customers with smaller policy values, who purchased their product through other distribution channels (collectively known as 'ordinary branch'), could exceed eight million. Indeed the FSA itself has stated:

In summary, our analysis of industry data combined with the research leads us to conclude that most with-profits customers do not have an adviser. And, even where

²⁷ The 'additional pension' refers to the State earnings related retirement pension scheme (Serps), now known as the state second pension (S2P). Since 1987 it has been possible for employees who are not in a company scheme that is contracted out of the additional pension, to request a rebate of National Insurance contributions and to invest these in an 'appropriate' personal pension of their choice.

²⁸ See the Pensions Institute's reports, 'Delivering DC?', 2004, 'Accessible Annuities', 2006 and 'Dealing with the Reluctant Investor', 2007. www.pensions-institute.org.

²⁹ FSA, 'Quality of post-sales communications', May 2007.

³⁰ These figures are based on Pearl's closed funds.

*they do, it is unlikely that their with-profits policies are not actively reviewed in the same way as other investments.*³¹

A close examination of FSA returns, ABI and HMRC data, and other industry sources would be necessary to identify the precise figure of the disenfranchised with-profits policyholders.³²

Fee-based advice is costly relative to the value of smaller policies (£70 per hour is common and some firms charge much more than this), while commission-based advisers report that it is uneconomic to provide a review service where the policy value is small. This is because a review of a small policy is likely to require the same amount of work as that of a large policy. If the recommendation is to keep the existing product – as might be the case where the policy includes valuable guarantees – then the adviser receives no commission. If the recommendation is to switch, the commission on a new sale (typically 3% initial commission and so £30 on a policy worth £1,000) is uneconomic relative to the work involved.

There is also a concern for advisers about the residual regulatory risk of advising on with-profits policies. The FSA may decide at a later date that a recommendation to switch was a case of churning. This may be a particular issue for advisers who sold the customer the policy originally.

We have examined developments in the advisory market closely and, in the authors opinion there remains doubt as to whether the needs of smaller with-profits policyholders can be met by the FSA's proposed channel for primary advice or by any generic advice system that emerges from the Thoresen Review.³³ Both concepts assume that the advice is forward looking and relates to simple products.

Recommendations

4.1(a) We propose that the existing regulatory tool, known as limited (or focused) advice, which provides a detailed analysis of a specific investment, but not a full financial planning service, is a model that could be developed further for with-profits policyholders. Limited or focused advice limits the scope of the service but not the depth. This type of advice, if more widely available, could be used by customers with small policy values and those who do not have a portfolio of assets, where the remuneration for advice on other investments could cross-subsidise the advice on the with-profits policy.

In its 'Quality of post-sale communications' report of May 2007, on page 33, the FSA states that limited or focused advice in the context of with-profits policies should, as a minimum requirement, include:

³¹ FSA, Quality of post-sales communications, May 2007.

³² Low value policies would include lapsed regular premium endowments, lapsed personal pensions, and lapsed 'appropriate' personal pensions used to contract out of the second state pension for just a few years. Sources, including Cazalet Consulting, indicate that currently up to 50% of regular premium personal pensions lapse within four years (the figure for the early 1990s was about 25%). Policies that had lapsed by the early-1990s would include a high proportion of with-profits policies, so an analysis of sales figures would be a useful step to determine the number of small with profits policies. Active low value pension policies will also be an issue for financial advice. According to HMRC, for the year ending 5 April 2005, there were about 3.6m policyholders with pension policies worth less than £5,000, although this figure does not tell us the number of with-profits policies.

³³ FSA, 'A Review of Retail Distribution', June 2007; The Thoresen Review of Generic Financial Advice was announced by the Treasury in January 2007.

- The customer's investment objectives
 - The strength of the with-profits fund
 - The terms of the customer's policy
 - The customer's attitude to risk
 - How the policy may fit in with other investments the customer may have
 - The customer's understanding of what benefits are being given up if they follow a particular recommendation, in relation to the what they might expect from a new investment (that is, the critical yield required to match the investment they hold)
- 4.1(b) To help advisers provide limited or focused advice that is appropriately priced for policyholders with small value policies, life offices could consider making available, free of charge on their websites, with-profits review models and tools. Several providers have already taken this welcome step.
- 4.1(c) Advisers prepared to offer limited or focused advice might consider forming a trade association for this purpose as a central source for consumers. A code of conduct could be introduced to prevent 'ambulance chasing'. There might also be an agreement among these advisers to avoid 'bulk' requests for information from providers.
- 4.1(d) In addition, or as an alternative, the 'industry' (for example the ABI and the Association of Independent Financial Advisers – AIFA) could consider uniting to provide a central source of limited or focused advice, which would offer economies of scale that individual firms of advisers might not be able to achieve. This could be an Internet service based on the ten questions for policyholders currently available on the FSA website and could be supported by with-profits review models and tools.

The ten key questions the FSA set out in its November 2005 'Update on Closed funds Briefing' and available on the FSA website are:

1. What sort of policy do I have?
2. Does the policy still meet my needs?
3. How long have I had the policy and how long is left?
4. What can I expect my policy to be worth if I keep it until it matures?
5. What benefits does my policy have?
6. What could I get if I cashed it in today?
7. Is there a way to cash the policy in without incurring a surrender penalty?
8. If I cash in the policy, what should I do with the money?
9. I've received a letter from my insurer saying I should switch to unit linked – should I?
10. Should I move my money to another insurer?

We provide further details of the with-profits review process and models in Appendix 3.

Inevitably there are constraints associated with a limited or focused advice process and there would be policyholders whose personal circumstances are too complex to handle in this way. As a result a minority of policyholders may make a poor or inappropriate decision but we suggest this should be set against the opportunity that the majority would be treated more fairly than is currently the case. Put another way, limited or focused advice is better for the majority than no advice.

4.1(e) The FSA's 'Quality of post-sale communication' report also expressed concern about the opportunities for churning with-profits policies of all values. Advisers, providers, and analysts interviewed for this research said that commission bias has been and may continue to be a serious issue for with-profits policies. To illustrate this point we would cite the sale of with-profits bonds, which flourished in the 1990s and peaked in 2001, when annual sales were worth about £15bn. In return for the sale of these single premium bonds, providers paid advisers an initial sales commission of up to 7%, compared with the 3% typical of alternative investments, such as unit linked and unit trust products. In some cases the adviser may have rebated part of the commission, so a lower amount would be deducted from the customer's investment. Nevertheless with-profits bonds represent a case where commission bias may have affected the choice of product. We recommend that the FSA investigates cases of potential commission bias in order to avoid the potential for mis-selling with-profits policies in future. A clearer indication of the full charges on all relevant documents, including the annual statement, for example, showing the reduction in yield (RIY) or total expense ratio (TER), may help consumers assess value for money (see 4.3(d) below).

4.2: Administration

We found three specific areas where weak administration is detrimental to market liquidity and to the policyholders' freedom and flexibility to exercise their rights.

The current situation

Liquidity is an important aspect of the with-profits market and there are three ways in particular that a policyholder might end the contract with the original provider and achieve a better deal than is offered through a typical surrender of the policy. These are the MVR-free period, the sale of an endowment in the secondary traded endowment policy (TEP) market, and the use of the open market option (OMO) at retirement to buy an annuity from a different provider. Our research found that weak administration can be a significant barrier in all three areas.

The Pensions Advisory Service report of June 2007 expressed concern over the use of MVRs when markets are rising and also said that administration problems, of which it had reviewed 500 cases, were on the rise.³⁴ It states, 'Poor administration complaints concerning personal pension arrangements rose by 43% [over the previous 12-month period]. The worst offenders are insurers that are closed to new business. Their lack of regard for the needs of their customers is often unacceptable.' The report adds:

If the industry does not voluntarily tackle this problem, we would look to the regulatory authorities to intervene on behalf of consumers, who are often unable to extricate themselves from their policy except at great financial cost.

³⁴ TPAS, 'Advising on pensions', June 2007.

The FSA introduced a requirement constraining the use of MVRs that came into effect in mid-2005 (COB 6.12.45R) and introduced a further rule relating to MVRs that took effect early in 2006 (COB 6.12.48(3)).

Many of these companies are part of larger organisations that are still in the market for new business. However, if the buying public knew what little regard they seem to have for the customers of companies they have taken over, they may be less keen to enter into new business with them.

With reference to TCF Outcome 3, 'Consumers are provided with clear information and kept appropriately informed, before, during and after the point of sale', the FSA reports that three-fifths of advisers said they encountered problems in getting information from product providers, for example about MVRs and MVR-free periods, although it has 'challenged' senior managers of with-profits firms to improve the way information is provided.³⁵

Defects in administration standards can also undermine the liquidity of the with-profits endowment and personal pensions markets. The traded endowment policy (TEP) market can, in many cases, enable customers who want to stop an endowment policy to secure a better price than the surrender value offered by the provider. TEP market makers told us that closed funds were particularly difficult to deal with and that it was often impossible to obtain information and duplicate policy documents, for example, in a timely manner. As a result, in some cases the sale could not proceed. Other delays reported by advisers and TPAS were in the receipt of maturity values.

Separately, Irwin Mitchell, a firm of solicitors, told us that in its initial investigation into complaints from policyholders with Royal & Sun Alliance (now owned by Resolution) revealed that most policyholders had lost their original documents, without which it was impossible to investigate their case (and, as noted above, providers may refuse to provide duplicates). Similar problems arise where the provider fails to keep records of older policies – a situation, which, we were told, is not uncommon in the case of industrial branch policies.

Annuity advisers reported administration problems where they request a transfer of a client's maturing pension fund via the OMO. The OMO, introduced in 1978 and an option written into most pension policies after that date can be used to secure a more competitive annuity rate than is available from the original provider. The top annuity providers are not the same as the top pensions providers (by size), which is why the OMO is an important feature. Also many providers do not offer specialist annuity rates for smokers and the obese, among other life-shortening lifestyle features. An enhanced annuity may be worth up to 30% more than a standard annuity. Where the transfer cannot be arranged within the 14-day annuity rate quotation period, annuity rates could change and the customer could receive a lower retirement income. TPAS said that the most common administration case it is asked to resolve concern pensions maturity values and the OMO.

Recommendations

4.2(a) Throughout our research, including the workshop, there was a consensus that administration standards provide a key metric for the assessment of TCF. We propose that the most important areas for administration should be identified and measured with the intention of making improvements in timeliness and the availability of the required information, including duplicate policy documents. The areas for immediate consideration are information about the MVR and MVR-free exit dates, the arrangement of a TEP sale, and the arrangement of an OMO annuity sale.

³⁵ 'Quality of post-sale communications', FSA, May 2007.

4.2(b) The FSA might consider employing 'mystery shoppers' to check administration standards and report cases that fall short of TCF standards.

4.3. Communications

We found four specific areas where communications literature impedes policyholder understanding and their ability to make informed decisions.

The issue

TCF in relation to communication literature is already an important focus for the FSA and the ABI and we would hope that our proposals could build on this work. While many customers may never fully understand the structure of the product they bought and why this has changed, nevertheless they must be given every chance to increase their financial knowledge and to take advantage of their options. This view is consistent with the aims of the FSA and the government to improve financial literacy and to encourage buyers of financial products to take more responsibility for their decisions.

In the context of with-profits policyholders who have already made a purchase, the focus of our analysis of communications is the post-sale literature.

An important point to stress is that a well-governed with-profits fund may still be inappropriate for a particular customer. For example, the structure of the fund and the profile of its policyholders may warrant a conservative fixed-income strategy, but the individual customer may require an equity-based strategy with a higher expected return to meet his or her original objectives.

As the Staple Inn Actuarial Society (SIAS) November 2005 report, 'Management of Closed Funds' warned, 'The downside risk of not providing information is that it can create the impression that the fund is hiding something, for example it is under-performing or isn't exercising proper consideration for the welfare of its policyholders'.

In its May 2007 report, 'Insurance Sector Briefing: Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholders', the FSA states that communications material it reviewed frequently did not always explain important changes, such as the asset allocation, and that this should be presented in a way that is 'clear, fair, and not misleading'.

TCF Outcome 3 states that consumers should be provided with clear information and kept appropriately informed, before, during and after the point of sale. In its post-sale report of May 2007, the FSA explained what this means:

Post-sale information needs to be clear enough for customers (or their advisers) to understand how their investment is performing, so they can judge if the policy still meets their requirements. It should also remind them of the key benefits of that policy, particularly if they are about to take actions, which would result in them losing these benefits.

Our research indicated that many communications documents, while adhering to regulatory requirements, do not set out the key details clearly and do not provide sufficient information to enable customers to make informed decisions.

Recommendations

- 4.3(a) As with administration, there was a consensus among those interviewed for this report and at the workshop, that communications is an important metric for the assessment of TCF. At the very least policyholders must be provided with all necessary information in a format that is appropriate for their profile to enable them to understand how their policy is being managed. Communications literature should set out clearly the reasons for contacting the policyholder and, where relevant, what has changed. Importantly, the implications of the communication should be summarised and highlighted at an early stage, setting out the policyholder's available courses of action and how these can be implemented.

Communications literature could be measured in two stages. First, was the necessary information provided? This is simply a 'yes' or 'no' measure of TCF. Second, the FSA needs to judge whether policyholders can understand and act on this information, and this is likely to require consumer testing.³⁶

Communications should not assume that the policyholder has access to independent advice and should always include details of limited or focused advice and where this can be obtained.

- 4.3(b) We recommend that the industry should work towards standard information that is set out in key communications documents and that these documents should be assessed by regular consumer testing. Our research indicates that the most relevant documents include the consumer-friendly principles and practices of financial management (CFPPFM) and the annual statement, while there should be a timeframe for sending policyholders information about MVR-free exit periods and information about closure and consolidation.

Consumer-friendly PPFMs (CFPPFMs), introduced in 2005, which must be sent to all policyholders, vary in their quality of communications. In the cases we examined, they fall short of being user-friendly and use technical terms the policyholder cannot be expected to understand. Providers told us that it is very difficult to translate the complex information they provide in their PPFM into consumer-friendly language, without over-simplifying details to the point of inaccuracy. Our assessment of CFPPFMs indicates that where a fund is still open to new business, these tend to be more accessible to the reader than where the fund is closed. In certain cases we found a marked difference between the CFPPFMs provided by the same life office but with respect to open and closed funds under management. Moreover, our analysis indicates that certain companies exclude important information from this document that is presented in the PPFM. This issue requires further analysis on the part of the FSA.

There is a conundrum here, however. FSA research indicates that of the 20% of advisers who are aware of CFPPFMs, only 4% thought that their clients read and understood this document – that is, 0.8% of advisers as a whole.³⁷ This raises the question of whether striving for a more customer-friendly format is an appropriate

³⁶ In practice, under principles based regulation, the FSA's approach is to put the onus on senior management to make a judgement over what is appropriate in many circumstances, rather than use prescriptive rules.

³⁷ FSA, 'Quality of post-sale communications'. The calculations are based on data shown on page 18.

use of resources. While we note that it is unlikely that many customers read the CFPPFM, nevertheless, this is a relatively new and therefore key document that can be measured in terms of TCF. If the document was more accessible then more advisers and customers might read it – a point we would urge the FSA to consider and which an independent with profits committee (WPC) might address. (See Section 4.4 below for details of proposals for the WPC.)

The same issue of plain language is also true of the information sent to policyholders when the fund status or ownership changes. From our analysis of information provided on websites, it seems that certain companies are merely fulfilling a regulatory requirement rather than taking this initiative as an opportunity to enhance policyholder understanding.

Informing policyholders at the point of closure or change of ownership could be regarded as too late – they are presented with a ‘done deal’.³⁸ This is a difficult issue. With-profits fund analysts pointed out to us that a change of ownership is often deemed price sensitive stockmarket information and cannot be disclosed in advance. ‘Since policyholders don’t get a vote in such circumstances it is difficult to see what they would do with this information anyway’, one analyst said. While this is a complex issue and would require further analysis, an independent WPC could ensure that policyholders’ best interests were taken into account. This is particularly important, in the light of the fact that policyholders do not, at present, have the right to vote on such critical issues. (See Section 4.4.)

- 4.3(c) The ABI has carried out research to improve the format of the annual statement and this could be the starting point for further reform.³⁹ We propose that the annual statement should include details of the fund’s asset allocation and how this has changed since the policy was purchased. The statement should also include the surrender value, which is underlying value of the policy or ‘asset share’, as well as the face value, which only applies at certain trigger dates, such as maturity, death and, in the case of certain unitised policies, MVR-free exit dates.
- 4.3(d) We suggest that the annual statement should also include clear details of charges and any ongoing commission payments to advisers. Conventional with-profits policy charges, in particular, are opaque. We propose that the FSA considers requiring that providers express charges clearly on all relevant documents, including the annual statement, as a reduction in yield (RIY) or a total expense ratio (TER). While the FSA does not regulate product prices, such a move would improve transparency. It would enable policyholders and advisers to see how much customers are paying and put them in a better position to judge value for money.

³⁸ As a counter-argument to this observation it was pointed out to us that the FSA requires firms to notify policyholders of a change of ownership and that policyholders have the right to appeal. In practice the authors found cases where the notification was written in technical jargon, while the ‘opportunity’ to protest in practice required the individual member to take the case to the High Court. We argue that such communications, while meeting regulatory requirements, do not empower the customer to make an informed choice. For an example of such communications go to www.phoenixlifegroup.co.uk/phoenixlife/About%20Us/funds_merger06.shtml. Bearing in mind the number of ex-IB policyholders and our above comment on their inability to make informed choices based on technical communications, we stand by our opinion that customers are presented with a ‘done deal’.

³⁹ ‘ABI Review of Yearly Statements: Making information work for customers’, 2006.

- 4.3(e) The quality of verbal information should also be monitored more closely by the FSA, as many people interviewed for this research said that call centres, particular those of closed funds, were far from helpful. TPAS also noted this point and told us, 'When we do get to speak to someone, they often admit that the problem is under-resourcing, which only came about after the closure of the company to new business'. The FSA could test the quality of verbal information provided by call centres through 'mystery shopping'.
- 4.3(f) We propose that the availability of limited or focused advice should be emphasised at the top of communications literature with information on how to obtain this.

4.4: Governance

We found that TCF, in relation to the company's use of policyholder capital, may be inconsistent and that the mechanisms to ensure policyholder representation appear to be incomplete.

The current situation

With-profits policyholders do not directly own their share of the with-profits fund (the asset share) but rather they entrust their capital to the management team to invest wisely and prudently on their behalf. Sound financial management in investment matters and in the use made of policyholder capital, including the inherited estate, are important issues if policyholders are to be treated fairly and given every chance of meeting their original investment objectives.

The potential for conflicts of interest between shareholders and policyholders is relevant in the context of proprietary companies. The key issue is how to ensure these conflicts are managed, so that the company's use of capital reflects TCF, as well as shareholder interests.

For closed funds retained by companies that continue to write new business elsewhere in the group, it was suggested to us that capital should be used to support the investment returns and policy payouts for the policyholders of the closed fund and not to support other lines of business. For consolidators, it was suggested to us that the issue is how best to deploy what is often a severely limited amount of capital available within the fund for the maximum benefit of policyholders. For companies selling closed funds, it was suggested that the issue is to ensure policyholders' interests during and post-takeover are at the forefront of the deal. This will influence the choice of consolidator.

There was a strong view among consumer representatives interviewed for this report – and indeed among certain providers – that conflicts of interest between shareholders and policyholders can, in effect, be 'written into' the Principles and Practices of Financial Management 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 (COB) rules encourage such use. However, given the concerns we encountered in our research, in the interests of policyholders we suggest that firms' use of policyholder capital is reviewed in an open debate.⁴⁰

There was a particular concern over the amount of capital that might be used to invest in new business that achieves a poor level of persistency and therefore which might lead to financial loss. This issue is examined in detail in the 2006 report on pension's profitability by Cazalet Consulting. While we were advised that the major concerns over the use of policyholder capital arise in proprietary companies, the Cazalet report said that concerns also applied to mutuals:

In some life offices, especially mutuals, policyholders ... effectively may be suppliers of capital. If their life office is writing substantial volumes of new business of nil or doubtful profitability over a sustained period, this could translate into a reduction in asset share accruals on with-profits policies as well as jeopardising the financial condition of the life office as a whole.⁴¹

The report goes on to say:

We think that with-profits policyholders should give consideration to the structure of the long-term fund in which they are invested and whether this causes them to be exposed to business risks arising from the writing of pensions business on unprofitable terms.

Within the life office structure, the governance mechanism to ensure policyholder representation and protection appears to be inconsistent and incomplete. Potential conflicts between shareholders and policyholders, therefore, may not reflect TCF. Better governance and accountability in relation to TCF would provide a mechanism whereby conflicts of interest could be resolved in a more transparent manner, which would help the FSA, consumer bodies, advisers and analysts to judge TCF, and, where necessary, to challenge weaknesses in this process.

In 2004 the FSA introduced the requirement for independent judgement to ensure conflicts of interest are managed within an appropriate governance framework. Most firms established a With-Profits Committee' (WPC) for this purpose. Whoever is responsible for providing the independent view must report to policyholders on management activity – at present in relation to the PPFM. Following industry consultation and concerns raised by firms, the FSA stopped short of requiring the WPC to be truly independent of the company board. In the consultation process, providers objected to the FSA's original guidance on the

⁴⁰ For more details about the FSA consultation and approach on this point, see CP207 (December 2003) and CP0414 (August 2004). The phrase 'policyholder capital', used in this report, is not recognised by the FSA. It is the opinion of the authors of this report, however, that while technically with-profits policyholders do not directly own their share of the with-profits fund (the asset share), they do entrust their capital to the management team to invest wisely and prudently on their behalf and the whole concept of with-profits as a mass market product is based on this 'contract of trust'.

⁴¹ Cazalet Consulting, 'Polly Put the Kettle On', January 2006. Cazalet's report is particularly illuminating with respect to the substantial losses that life offices have suffered due to the poor returns on new business.

WPC, as it gave the impression that this would be the preferred governance model.⁴² Providers also said external members would cause practical problems and, besides, there was a lack of suitable candidates.

Providers and analysts interviewed for this research agreed that the independence and competence of the WPC varies considerably between companies. While some companies have moved towards a genuinely independent model (and we understand that the FSA is encouraging this trend), many WPCs are little more than a sub-committee of the company board. In our analysis of AKG's 2006 closed with-profits fund report, we found that almost 60% of funds had a WPC that was not independent of the company board. In some cases the WPC was simply a sub-committee of the main board, while in others the WPC members comprised of current directors, former directors, and non-executive directors. In about 10% of cases the company did not provide information about the composition of the WPC in the PPFM. We found only one case where the WPC's stated objectives included making recommendations about changes to the PPFM to the company board, but this WPC was not independent.

In the 40% of WPCs, where a degree of independence is evident, the level of independence varies considerably. Within this group we found fewer than five cases where the independent members had the majority vote. In the other examples, there was usually only one independent member. Independent member profiles include consumer representatives, lawyers, and actuaries. Interestingly the same independent actuary is used by several WPCs.

Our research, therefore, identifies an important area where policyholder representation and protection, in the context of managing the fund in the policyholders' best interests, is insufficient and flawed. However, due to constraints of time and resources, we were not able to give clear recommendations as to the best ways to measure the impact of this lack of representation and to improve the situation. We are, however, able to make a range of initial proposals that could form the subject of further research.

Proposals

4.4(a) We propose, if further and more detailed research concurs with our findings, that the WPC should become a public and regulatory 'window' on the board's use of policyholder capital. It was suggested to us that the WPC's primary purpose should be to ensure that the financial management of the fund, which includes the inherited estate, is in the best interests of policyholders and that to achieve this clear objective the WPC should be independent of the company board. The meaning of independence can be debated but we suggest that this may require a majority of independent members (or the power for independent members to cast a majority vote) and an independent chair. Cost permitting, the WPC could have its own website, with a clear link from the main company site. This would raise the visibility of the WPC as a mechanism for TCF and might reassure policyholders that their interests are being represented and protected.

We considered the merits of including policyholder-nominated members on to the WPC. However, while we would not rule this out – member-nominated trustees continue to play an important role on the trustee boards of occupational pension

⁴² FSA, 'With-profits governance, the role of actuaries in life assurance, and certification of insurance returns', January 2003.

schemes, for example – we anticipate that the election process could be expensive and that there may not be sufficient policyholders with adequate knowledge to serve on these committees.

This issue requires further investigation. One option might be to find policyholders who are also practitioners in the financial services market. An alternative might be to appoint an experienced and genuinely independent individual, such as a policyholder advocate, who could act on the policyholders' behalf.

We suggest that an independent WPC could be more effective in negotiations on management decisions in relation to formal closure, the distribution of the inherited estate, and consolidation, to ensure TCF principles are taken into account. Clearly, the FSA would need to consider how disputes could be resolved effectively and efficiently, where they arise between the WPC and the company board. Again, we suggest that the example set by occupational pension schemes might be a useful model to consider in this context, as dispute management is a key issue for trustees and the Pensions Regulator.

A further important function of the WPC could be to ensure that on consolidation the terms and pricing of any management contracts reflect TCF. This is particularly important in the case of agreements between any management and other companies in the group, for example asset management and administration service providers. Mis-pricing of such services could favour shareholders over policyholders.

- 4.4(b) There was a strong view among providers and analysts who participated in this research that independence, while necessary, is not sufficient on its own to ensure adherence to TCF. These experts argued that the effectiveness of the WPC could be dependent on its members having the right competencies. Competency is not easy to measure and it was argued that only the FSA is equipped to assess the effectiveness, as well as the composition, of the WPC. We propose that a review of the functioning and effectiveness of the WPC should form part of the FSA's regular ARROW visits and Risk Mitigation Programmes.

ARROW is the framework used by the FSA to make risk-based regulation operational. It stands for 'Advanced Risk-Responsive Operating Framework'. ARROW visits are regular – typically every two or three years. At these visits the FSA investigates how the organisation manages and assesses all risks. For the ARROW visit the FSA provides a Risk Mitigation Programme – that is, a set of actions the organisation is required to carry out resulting from the risk assessment. This in turn influences the amount of regulatory capital the organisation is required to hold.

- 4.4(c) It was suggested that the WPC's remit should be TCF and not just the PPFM document, which is written by the management. TCF is aimed at directors and senior managers, who should ensure that the regime's principles are embedded in the corporate culture. At present the management's approach to running the with-profits fund is set out in the PPFM document – a requirement introduced in 2004. This document provides useful details about payout strategy, bonus policy, smoothing policy, investment strategy, business risks, charges and expenses, and equity between policyholders and shareholders in relation to the inherited estate, among other information.

Experts were divided on the value of the PPFM in relation to TCF but there was a strongly presented argument that if the PPFM remains the reference point for the WPC's assessment of fair treatment to policyholders, no amount of independence will ensure policyholders are treated fairly in a consistent way across all funds.

Therefore we propose that TCF should be regarded as the overarching framework within which the fund should be managed on policyholders' behalf. The PPFM is one way that a company can demonstrate its commitment to TCF but we suggest that this should not be the only measure.

To achieve a better balance between the needs of shareholders and policyholders, we propose that WPCs could establish a 'TCF Charter' and in its annual report to policyholders could assess the management's adherence to this charter as well as to the PPFM. For example, the WPC could report on the company's use of capital in relation to its TCF Charter and the PPFM, setting out any discrepancies between the two.

We appreciate that this may establish conflicts between the WPC and the company board but suggest that this is not necessarily a negative development but merely brings into the open conflicts that already exist and which may be overlooked.

- 4.4(d) The FSA could strengthen the role of 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.⁴³ This could set out the key aspects of regulation that WPC members need to read and understand, for example conduct of business (C.O.B.) 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.
- 4.4(e) It was suggested to us that the FSA could further strengthen the TCF regime through the requirement that management produce 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 this 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.

⁴³ <http://www.thepensionsregulator.gov.uk/trustees/index.aspx>

The simplified annual financial statement might also include considerations for TCF in relation to a proposed change in fund status, for example through closure and consolidation.

Apart from its use for FSA supervisory purposes, this would be a key source document for stockmarket analysts, with-profits analysts, consumer representatives, credit rating agencies, and the financial press, and other interested parties.

Cazalet's report on pension's profitability (see footnote 34), said that lack of clarity over the use and cost of capital is a concern for the market as a whole, and not just policyholders:

We urge providers of capital not to take vague so-called new business 'margin' numbers at face value, and suggest that sell-side and buy-side analysts press managements to reveal the construction of their profitability models and to challenge them on the methodology and the assumptions embedded therein, particularly with regard to persistency and discontinuance risks arising from pricing tactics [for example, commissions to advisers and the impact of discontinuance] as well as querying the bases for the assumed cost of capital.

If the proposal for a simplified annual financial statement were adopted, we would suggest that the FSA might establish a clear format for this document and the items it must include. Significant conflicts and constraints could be identified and explanations given as to how these have been addressed. We do not suggest this should be a prescriptive document, as this might lead to the duplication of the PPFM. However, it was suggested to us that the document should include the following details, among others:

- How the fund has been invested, including asset allocations and information about the asset management team
- Performance of the asset management team and actions taken to rectify areas of poor performance
- Significant conflicts in the use of capital and how these have been addressed
- What use the company has made of the inherited estate, how this is intended to provide a good return, and who will benefit – that is, the policyholders or the shareholders
- Limitations on the efficient use of capital, for example in relation to the needs of policyholders with and without guarantees.

Any discrepancies between the TCF Charter and the use of capital set out in the simplified statement could be the subject of discussions between the FSA, the WPC and the management.

- 4.4(f) The role of the with-profits actuary (WPA) is also important, as this individual should support the WPC and its TCF Charter. Following the Equitable Life debacle, the FSA required with-profits providers to split the single appointment of the 'appointed actuary' into two: the company actuary, known as the actuarial function holder (AFH), and the WPA. Rather like the separation of the roles of a company chairman and chief executive, this move aimed to improve governance, particularly in respect of policyholders' interests.

However, the FSA permits life offices to continue with a single actuarial appointment – albeit with two different functions – provided the individual is not a director. We suggest that a single appointment undermines the transparent separation of powers that the division of the roles aimed to achieve originally. We propose, therefore, that in order to support the WPC’s independence from the company board, for proprietary companies the with-profits actuary should not be the same individual as the company actuary.

5. CONCLUSION

In this report we have identified three areas in the with-profits market where some customers are not being treated fairly. Although the initial focus of this research was closed funds, we believe that, taken together or introduced separately, our recommendations for accessible advice, raising administration standards, and improvements in communications literature will benefit policyholders in with-profits funds that are closed, quasi-closed, and those still actively seeking new business. We also believe that customers with non-profit and unit-linked policies in closed funds would benefit from these changes.

Our proposals on governance focused on the proprietary with-profits providers but if further research confirmed our initial findings, then all with-profits policyholders could benefit from the establishment of a truly independent with-profits committee, with its remit based on a TCF Charter as well as the PPFM.

We recognise that our proposals to improve the independence of the With-profits Committee (WPC) may be controversial. Providers may argue that to achieve true independence for the WPC would be costly and that this might adversely affect policyholders if these costs were passed on to them. However, the fact that some providers have already moved towards greater independence demonstrates that the barriers may not be insurmountable and that there are already examples of best practice available in this area on which the FSA can build.

It is important to consider the wider impact of improvements to governance. It was proposed that additional costs could be detrimental if a fund is financially weak and / or lacks critical mass and could push funds into closure and consolidation.

Our response, based on our initial research, is that a provider in this position is very unlikely to attract (and, arguably, could be wrong to accept) new business. Companies in this position almost certainly fall into the 'quasi-closed' category at present. Formal closure – which requires the notification of policyholders and the submission of a run-off plan to the FSA, which includes details of how the fund will distribute the inherited estate to policyholders – would appear to provide greater policyholder protection than quasi-closure.

Funds that do not have the critical mass necessary to run efficiently might also better serve the policyholder if they are taken over by a consolidator. However, the choice of consolidator is critical, and it would be an important function of the WPC to ensure the acquiring company met the standards of best practice outlined in this report in relation to TCF. Critically, the consolidator's commitment to TCF should incorporate processes that provide the potential for improvements in policyholder representation and expectations. If the TCF benchmark for a consolidator is that policyholders should be 'no worse off', and if discrimination against the policyholder is written into the PPFM, then millions of policyholders will continue to lose out.

The emergence of major consolidators is a recent phenomenon and has been greeted with mixed views. Our investigations, interviews and analysis suggest that consolidators work in very different ways and should not be treated as homogenous. Moreover, as more players enter this market, competition will increase. This will be a very welcome development provided existing and new consolidators take on board our concerns about governance and the FSA seeks to implement our recommended changes in this area. This will require further research on the part of the FSA and consultation with the industry. Should this research be

undertaken, we would hope that it would take an impartial approach and, while taking account of providers' opinions, does not give way to the formidable vested interests that inevitably exist in a multi-billion pound market.

To conclude, this report has important messages for the industry, the FSA and consumers. With the majority of the with profits funds in run-off, it is essential that regulation enables policyholders to be given the best opportunity to make informed decisions and that where they choose to continue their policies, every endeavour should be made to ensure that policyholders' original expectations are met. While improvements in advice, administration and communications will go some way to improving the position of with-profits policyholders, it is the opinion of the authors that governance is the central issue here. An improvement in governance arrangements should be a key priority for further research and should form the basis for a full and public debate.

Appendix 1: With-profits time line⁴⁴

- 1956 – the first with-profits retirement annuity policies (or ‘contracts’) were introduced, replaced by personal pensions in 1988.
- Late 1970s – with-profits endowment mortgages were offered as an alternative to repayment mortgages. Low-cost endowment mortgages combined with life assurance premium relief (LAPR) made repayment terms very attractive relative to repayment mortgages.
- Late 1980s – unitised with-profits policies began to replace the conventional contract. At the same time unit-linked policies began to replace with-profits for long-term savings purposes.
- 1990s – single premium with-profits bonds were heavily sold. Concerns about high sales commission rates emerge. Falling interest rates push guaranteed annuity rates (GARs) into the money.
- 1998 – the Government Actuary forced life offices to set aside reserves to cover GARs.
- 1999 – the start of the Equitable Life debacle. Equitable Life claimed the right to reduce terminal bonuses where GARs applied.
- 2000-2002 – falling equity markets
- 2000 – FSA consultation paper 75 on endowment mortgage complaints
- 2001
 - FSA’s 11 Principles for Business set out in the Financial Services and Markets Act. Principle 6 says: ‘A firm must pay due regard to the interests of its customers and treat them fairly’.
 - FSA launches a with-profits review on governance and transparency.
- 2002 – Sandler Review of long term savings recommends new with-profits funds should be ring-fenced from the rest of the insurer’s business; The Actuarial Profession publishes a report on the customers’ interests working party
- 2003 – FSA publishes consultation on the role of the With-Profits Committee, with-profits governance, and the role of actuaries in life offices.
- 2004
 - FSA introduces the requirement for Principles and Practices of Financial Management (PPFM) reports.
 - Treasury Select Committee report on endowment policies argues that a material change in asset allocation for policyholders in closed funds is sufficient reason to grant policyholders an MVR-free exit.

⁴⁴ This is an overview – for a full list of the numerous FSA reports on this subject, see the bibliography.

- FSA introduces new capital adequacy standards for life offices, prompting some of the weaker companies to accelerate the switch from equities to bonds. Under the new rules, the higher the risk profile of a fund, the higher the reserves required.
- FSA introduces the requirement for with-profits providers to introduce a WPC to act on behalf of policyholders. It also separates the role of the Appointed Actuary into two functions
- Major consolidations under way, dominated by Resolution Life and Pearl
- 2005
 - FSA sets out TCF 6 'outcomes'
 - FSA publishes:
 - 'Delivering the Tiner Insurance Reforms', setting out strategy for ensuring a fair deal for customers and a review of life office management
 - 'Principles and Practices of Financial Management' and introduces the requirement for providers to publish a 'consumer friendly' PPFM (CFPPFM) version
 - 'Update on Closed With-Profit Funds', which sets out the requirements for closure of a with-profits fund and warns that funds should not avoid formal closure where new business has ceased
 - Staple Inn Actuarial Society publishes 'Management of Closed Funds' in which it states that closure should not be an excuse for poor investment performance and that the run-off of the fund should be actively managed with regard to bonus rates and any distribution of the inherited estate. It also states that policyholders should have access to sufficient information to allow them to judge how a closed fund is performing.
- 2006 – FSA requires life offices to produce sample cash-in (surrender) values within 30 days of any request and to include these, plus specified maturity payouts, in PPFMs.
- 2007
 - February, The Actuarial Profession publishes its briefing note on payouts of with profits endowments
 - April, AIFA publishes first 'stakes in the ground' report on with-profits, raising concerns over the lack of information from providers
 - May, FSA publishes 'Treating Customers Fairly initiative: progress report'. Firms regulated by the FSA must meet TCF deadlines by the end of December 2008.
 - May, FSA publishes 'Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholder', which raises concerns over the availability of advice for with-profits policyholders.
 - June, FSA publishes 'A Review of Retail Distribution', which proposes a source of 'primary' advice, based on a range of simple products.
 - June, The Pensions Advisory Service (TPAS) report highlights a significant increase in complaints about the administration of personal pensions

Appendix 2: Listing of closed funds

Closed funds with over £500m of with-profits (WP) assets as at 31 December 2005

<u>Group</u>	<u>Company</u>	<u>Fund</u>	<u>WP Assets £m</u>	<u>Total Assets £m</u>	<u>WP %</u>	<u>Notes</u>
AEGON	Guardian	Guardian Assurance Life Fund	4,136	6,166	67%	
AEGON	Scottish Equitable	Various funds	9,726	10,845	90%	(1)
AXA	AXA Sun Life plc	Old With-profits Fund	1,664	1,724	97%	
Equitable Life	The Equitable Life Assurance Society	Sterling With-profits Fund	9,923	15,488	64%	
GE Life	GE Pensions Ltd	National Mutual Fund	2,243	2,883	78%	
HBOS	Clerical Medical Investment Group Ltd	Invested Annuity With-Profits Fund	18,503	18,529	100%	(1)
Liverpool Victoria	Liverpool Victoria Life Company Ltd	RNPFN Fund	1,137	1,753	65%	
MGM Assurance	Marine and General Mutual Life Assurance Society	Various funds	4,343	4,351	100%	
Norwich Union	Norwich Union Life & Pensions Ltd	Provident Mutual Fund	2,407	3,225	75%	
Pearl Group	London Life Ltd	Various funds	1,475	1,483	99%	
Pearl Group	National Provident Life Ltd	With-profits Fund	6,165	6,422	96%	
Pearl Group	Pearl Assurance plc	With-Profits Fund	10,405	10,680	97%	
Prudential	Prudential Assurance Company Ltd	Scottish Amicable Insurance Fund	14,354	15,322	94%	
Resolution	Alba Life Ltd	Ordinary Long Term Fund	1,616	1,966	82%	
Resolution	Britannic Assurance plc	Ordinary Branch With-profits Fund	5,251	6,001	88%	
Resolution	Phoenix & London Assurance Ltd	Long Term Business Fund	5,759	6,688	86%	
Resolution	Phoenix Life & Pensions Ltd	Long Term Business Fund	6,871	8,225	84%	
Resolution	Scottish Mutual Assurance Ltd	With-profits Sub-Fund	7,694	7,694	100%	
Resolution	Scottish Provident Ltd	SPI Fund	4,847	4,879	99%	
Royal London	The Royal London Mutual Insurance Society Ltd	Scottish Life Fund	4,360	4,835	90%	
Royal London	The Royal London Mutual Insurance Society Ltd	United Friendly OB Subfund	10,237	18,064	57%	(1)
Sun Life Financial of Canada	Sun Life Assurance Company of Canada (UK) Ltd	With-Profits Fund	1,781	1,781	100%	
Swiss Re	Windsor Life Assurance Company Ltd	With Profit Fund	514	4,421	12%	
Wesleyan	Wesleyan Assurance Society	Medical Sickness Society Fund	2,183	3,470	63%	(1)
Winterthur Life	Winterthur Life UK Ltd	With-Profit Fund	1,725	1,814	95%	
Zurich Financial Services	Zurich Assurance Ltd	90:10 With-Profits Fund	3,527	3,527	100%	
Zurich Financial Services	Zurich Assurance Ltd	100:0 With-Profits Fund	1,053	1,053	100%	
			143,900	173,290		

Notes: (1) Asset figures relate to a fund where some sub-funds are open for new business and some sub-funds are closed.

Source: AKG Actuaries and Consultants Ltd and Pensions Institute analysis

Appendix 3: The with-profits review process and modelling tools

Customers with investments in a with-profits fund that has closed and been subject to changes in asset allocation may need to assess whether the product still meets their needs and consider whether there are better alternatives available. The customer's choices are to:

- Retain the with-profits policy
- Switch to another product offered by the same provider
- Cash in the policy and switch to a product from another provider

Given that the outcome depends on unknown future investment returns, there can be no certainty that one course of action will be better than the others. However, it is important for the customer to know which is *likely* to be the best approach.

A number of consultancies offer tools that can help in the review of with-profits policies. Advisers use these directly or via the websites (extranets) of insurance companies.

The following description is based on the DecisionsDecisions With-profits Analyser provided by risk management consultancy Barrie and Hibbert. Other tools work on a similar basis.

The customer – most likely under the guidance of an adviser – enters their personal details and selects the relevant policy category from the range stored in the tool. The customer or adviser inputs policy details such as values and MVR-free dates. The customer is also able to specify objectives such as the required return, the time horizon and his or her attitude to financial risk.

The tool provides a direct link to the Principles and Practices of Financial Management document published by the insurer and to financial strength ratings from Cazalet Consulting. These are available for the adviser to use, but do not directly affect the modelling of expected returns.

The model simulates thousands of economic scenarios in order to generate the distribution of returns likely from the policy. A key driver of the range of returns will be the asset allocation of the fund. This distribution can then be used to assess the probability (for example, a one-in-ten chance) of the policy meeting the customer's objectives. The tool can also provide details of alternative investment strategies – both with the current provider and with alternative providers – that might raise the probability of success in meeting the customer's objectives.

The customer and the adviser can then discuss whether any action is required. Importantly, from the adviser's point of view, the tool generates reports and an audit trail that can be used to explain and justify the advice given if it is subsequently challenged. The adviser will also have to take account of a range of factors that cannot be captured by the modelling tool, for example the financial strength of the provider. There may also be policy details, such as guarantees, which cannot be handled by the model and need to be considered in the advice of the adviser.

Appendix 4: The workshop

An important part of our research was the workshop we held at Cass Business School in London in May 2006. This enabled us to ‘stress test’ our methodologies and strengthen our recommendations.

The workshop was held under Chatham House rules and attended by 30 selected experts representing the various interest groups, including providers, advisers, consumer bodies, trade bodies, and analysts.

Participants were divided into five groups and were invited to debate our proposed measures of TCF. The following text outlines the views of participants, whom we do not identify for reasons of confidentiality.

The meaning of TCF

We asked if TCF implies that policyholders should be ‘no worse off’ or that they should reasonably expect improvements. If the latter, then in which areas could improvements be expected, for example administration, communications, asset allocation, asset management, and charges. Would it be possible to establish absolute standards or benchmarks in this area?

Responses were divided but with a majority in favour of the idea that TCF implies that policyholders should reasonably expect improvements. Areas that could be improved and measured included administration, communications, and asset allocation. However, it was noted that an improvement in asset allocation – the equity-backing ratio – would not necessarily imply an immediate improvement to policies due to mature shortly, but that the higher expected returns should improve outcomes for policies maturing in the medium- and longer-term.

Responses were also divided on the position of quasi-closed funds. Some argued that a period ‘sleeping’ should not trigger formal closure, as in some cases the fund might open again to new business. Others felt that formal closure was a helpful process in relation to the fair treatment of customers.

It was generally agreed that charges were important but that these, in isolation, were not a good measure of fair treatment of customers. A counter-view was that in a period of comparatively low returns, charges were indeed significant and that it would help to have these specified as a reduction in yield or total expense ratio. It was also noted that currently it is very difficult to assess charges, as these are not transparent in with-profits policies.

The impact of closure

We asked participants to identify the positive and negative features for the policyholder of closure, in relation to asset allocation, bonuses, charges, and the distribution of the inherited estate.

There was a consensus on the fact that many closed funds were already in a poor financial state at the point of closure and that closure in itself did not cause this. However, it was agreed that despite the problems of the past, all policyholders should be treated fairly going forwards.

Asset allocations are provided on the PPFMs but there is no central source for this data. We asked if an ABI classification system might help, along similar lines to that used for managed unit linked funds. Views were mixed and there was no consensus.

One of the difficulties for funds is that in a single fund there can be several categories of policyholder and that achieving 'fair treatment' for one group – for example those with guarantees – may not necessarily achieve fair treatment for others. One example was the case of with-profits annuitants, who would benefit from larger annual bonuses at the expense of terminal bonuses.

This same problem arose in the context of the distribution of the inherited estate, in that what might seem fair to some policyholders – for example a payout shortly before maturity – might not seem fair to others. However, participants noted that good independent governance was an important aspect of fair treatment of policyholders in relation to the distribution of profits and the inherited estate. Independent representation could be a measure of good governance. Participants also said that where part of a maturity value is met by the inherited estate, this should be set out clearly.

A view expressed by many participants was that improvements for policyholders with smaller policy values and/or in weak funds should be weighed carefully against any costs that might be detrimental.

Advice to policyholders

We asked participants to explain the respective roles of advisers and providers, to consider the availability of advice where policy values are small, and the relevance of 'focused' advice.

Participants agreed that many policyholders were in effect disenfranchised from the independent advice process. They said that it is difficult to advise policyholders with smaller policy values, as these customers were unattractive for economic reasons. Limited or focused advice could help in this area and participants were interested in the development of with-profits review models and tools that could assist recommendations. There was interest in the idea of a central source of limited or focused advice.

Providers expressed concern that a marked increase in limited or focused advice could lead to 'bulk requests' of information for customers and that this might impose unacceptable administration burdens.

It was also noted that policies with a small value that are currently invested mainly in fixed interest assets could be converted to a simpler product.

There are certain advice problems specific to trustees of occupational DC schemes and AVC schemes. Where the scheme uses a with-profits fund as the default, a wholesale switch of members to an alternative fund would benefit some policyholders but disadvantage others – for example earlier members who have guarantees. Trustees are authorised by the Pensions Regulator and not the FSA. This means they cannot give one-to-one advice, while the cost to the scheme or employer of making authorised independent advice available in many cases is prohibitive.

Administration

We asked participants to consider which areas of administration may be poor and how these might affect the fair treatment of policyholders. The key areas identified were the difficulty policyholders and their advisers encountered when requesting information in relation to the MVR, the arrangement of a sale of an endowment in the secondary market, and the arrangement of an open market option purchase of an annuity for a maturing pensions policy.

Participants said that in some cases it was very difficult to get the information in a complete and timely manner. Call centres for advisers were not always well run and particular problems appeared to relate to closed and consolidated funds, although participants recognised that in the case of recent consolidations it could take time to establish appropriate standards.

There was a broad consensus that all policyholders should be treated equally, whatever the status of their fund. It was noted that there were differences in administration and communications with policyholders in closed and open funds.

Communications

Participants agreed that communications literature was a key metric for the measurement of fair treatment for policyholders. However, there was a general consensus that with-profits policyholders did not read communications literature and that therefore was it cost effective for these documents to be improved and consumer-tested? Customers who chose with-profits policies frequently did not want to engage actively in investment decisions and preferred an expert to do everything for them.

While there is a danger of 'dumbing down' too much – to the point of being potentially misleading – regular communications, such as the annual statement, should state clearly what has happened since the last communication and what the options and prospects are for the future. Communications about specific issues – for example MVR-free exit dates and maturity – should be sent out in advance and cover clearly the customer's options and any implications of these, for example in relation to guarantees.

Communications can be tested at two levels. First, was the necessary information provided? This would give a 'yes'/'no' result. Second, can policyholders understand and act on this information? This is more difficult to test. Consumer testing might be helpful, although it was noted that testing in group discussions is not very effective and that actual policyholders should be used.

Participants also noted that simpler communications was impeded by regulatory requirement for what documents should include. Also, it is not always clear whether communications are aimed at policyholders or at their advisers. Where a customer has an adviser he/she is likely to pass communications to the adviser.

Communication needs to be more proactive. Participants said that informing a policyholder at the point of closure or consolidation was too late to assess fairness. Most communication at this stage currently aims simply to inform.

Verbal communications, such as those provided by call centres, should also be assessed

Governance

We did not ask any specific questions on governance but this issue was raised by several participants as critical to the fair treatment of policyholders. Participants noted that most policyholders 'bought on trust' and said that if improvements could be achieved within the governance framework of with-profits providers then this would enhance the fair treatment of policyholders. The With-Profits Committee (WPC) was identified as the appropriate mechanism on which to build better governance. The role of policyholder advocates was also considered important and could be extended to more funds.

The workshop was followed up by further research and interviews to explore the issues that arose, particularly in relation to governance.

Appendix 5: Terminology

AVCs - Additional voluntary contribution schemes are offered as a supplement to most defined benefit occupational pension schemes. Most AVCs in the private sector work on a defined contribution basis.

Annual Management Charge (AMC) – the annual fee charged on a policy.

Appropriate Personal Pension (APP) – the name given for a personal pension designed for contracting out of the second state pension.

Asset share – the premium paid by the policyholder, less deductions for expenses, tax and other charges, accumulated at the rate of investment return achieved.

Bonus – an addition to any guaranteed benefits provided by the insurer. This might be a contractual addition (regular or annual bonus) or a discretionary addition (final or terminal bonus) representing the policy's share of surplus the insurer has decided to distribute.

Closed fund – a fund that has stopped taking on new business.

Conduct of Business rules - COB rules are the requirements, set by the FSA, that relate to the business processes involved in selling and administering insurance and investments, including marketing, sales, consumer literature, and claims handling.

Consolidator – company set up to acquire and aggregate closed life assurance funds.

Conventional with-profits policy – a policy with fixed guarantees, including a guaranteed sum assured and annual bonuses, which, once allocated, cannot be taken away. The final or terminal bonus is discretionary.

Consumer Friendly Principles and Practices of Fund Management (CFPPFM) - a version of the PPFM, which has been written in simpler terms to make it easier for consumers to understand.

Defined contribution - DC schemes invest contributions to build up a fund. At retirement the individual can take a tax-free cash lump sum and must use the rest to buy an annuity or to generate an income directly from the fund.

Equity-Backing Ratio (EBR) – the percentage of the with-profits fund asset mix invested in growth assets such as equities and property.

Guaranteed Annuity Rate (GAR) – a defined minimum rate at which an insurer has guaranteed to convert a pension policy fund at retirement into an annuity.

Industrial Branch (IB) – insurance business based on door-to-door sales and premium collection practices. This no longer exists.

Inherited Estate – the excess of assets maintained within the with-profits fund over and above the amount required to meet liabilities.

Limited or Focused Advice – financial advice which is focused on analysis of a particular product rather than on a complete analysis of the individual's financial requirements.

Market Value Reduction (MVR) – the reduction made to the unit value under a unitised with-profits policy in certain circumstances provided for in the policy conditions. The purpose is to restrict losses to the fund as a result of policyholders electing to have their policy benefits paid at a time when unit values exceed their asset share.

Mutual company – a life company owned by its policyholders.

Ordinary Branch (OB) – insurance business generated through channels other than industrial branch, for example direct sales and through independent advice channels.

Open Market Option - The OMO, defined in the Finance Act 1978, confers the right to buy an annuity from an insurance company other than the existing pension provider.

Principles and Practices of Financial Management (PPFM) – a document, required by FSA regulations, setting out the insurance company's approach to managing a with-profits fund.

Proprietary company – a life company owned by shareholders.

Policyholder's Reasonable Expectations (PRE) - PRE required insurance companies to consider any reasonable expectations that policyholders may have as to how they would be treated by the insurance company. Such expectations could be formed and influenced through, for example, policy terms, promotional and publicity material, the past practice of the company and practice within the life assurance industry generally. This has been replaced by TCF.

Realistic Balance Sheet (RBS) – the assets and liabilities of the insurance company reported on a realistic basis, as specified by the FSA.

Treating Customers Fairly (TCF) - an FSA initiative to ensure that firms meet the requirements of FSA principle 6 to 'pay due regard to the interests of [their] customers and treat them fairly'.

Traded Endowment Policy (TEP) – an insurance policy that has been sold on the secondary market and is no longer owned by the original policyholder.

Total Expense Ratio (TER) – the annual cost of an investment product including the annual management charge and any other expenses applied to the fund.

Reduction in Yield (RIY) – the cost of an investment product expressed in terms of the impact of the charges on the annual investment return achieved.

Unitised with-profits policy – where a with-profits fund is subdivided into units for the purpose of determining benefits under policies.

With-Profits Actuary (WPA) – an actuary appointed to perform the with-profits actuary function specified in the FSA rules.

With-profits bond – a unitised whole of life policy sold on a single premium basis.

With-Profits Committee (WPC) - a committee set up by an insurer to oversee the management of its with-profits fund and to ensure that it is being managed in accordance with the PPFM.

Appendix 6: Bibliography

The Actuarial Profession 'Briefing Note: With-profits endowment payouts', February 2007

AKG Actuaries & Consultants

- 'Closed UK Life Office with-profits Report', September 2006
- 'Open UK Life Office with-profits Report', September 2006

Association of Independent Financial Advisers Stakes in the Ground: With-profits Uncovered, April 2007

Association of British Insurers

- 'ABI Review of Yearly Statements: Making information work for customers', 2006
- Closed funds: A fact sheet, December 2005

Cazalet Consulting, 'Polly Put the Kettle On: Pensions Profitability', January 2006.

Financial Services Authority

- 'A Review of Retail Distribution', June 2007
- 'Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholders', May 2007
- 'Risk management in insurers', November 2006
- 'Treating customers fairly – towards fair outcomes for consumers', July 2006
- 'Initial review of CFPPFMs', May 2006
- 'Update on closed with-profit funds', November 2005
- 'Principles and Practices of Financial Management, October 2005
- 'Delivering the Tiner Insurance Reforms', April 2005
- 'The Regulation of Closed With-Profits Funds', September 2004
- Consumer testing on consumer-friendly PPFMs, August 2004
- 'Treating with-profits policyholders fairly', December 2003, with feedback August 2004
- 'With-profits governance, the role of actuaries in life insurers, and certification of insurance returns', January 2003
- Issues for with-profits business arising from the Sandler Review, February 2003
- 'A new regulatory approach to insurance firms' use of financial engineering', July 2002, with feedback December 2002 and August 2003

FSA reports in relation to with-profits are available at:

http://www.fsa.gov.uk/Pages/Library/Other_publications/Profits/index.shtml, which provides links to further publications.

'Sector' material can be found at

<http://www.fsa.gov.uk/Pages/About/Teams?Insurance/publications/index.shtml>.

FSA TCF 'frequently asked questions' page is at:

<http://www.fsa.gov.uk/Pages/Doing/Regulated/tcf/faqs/index.shtml>

Hewitt, AVC Survey 2007

HM Treasury Select Committee, Fifth Report, 'Endowment Mortgages', February 2004.
Money Management

- 'New business trends survey', July 2007
- 'Updated with-profits endowment survey', June 2007
- 'With-profits endowment survey', April 2007
- 'How strong is strong', May 2007
- 'Consolidators get it together', March 2007
- TERs vs. RIYs, January 2007
- 'Financial strength of with-profits offices survey', August 2006

O'Brien and Diacon, Centre for Risk and Insurance Studies, 'Closed life funds: causes, consequences, and issues' CRIS Research Report 2005-2.

Staple In Actuarial Society, 'Management of Closed Funds', November 2005.

The Pensions Advisory Service, 'Advising on pensions: A review of activities', June 2007.

The Pensions Institute

- 'Delivering DC?', 2004
- 'Accessible Annuities', 2006
- 'Dealing with the Reluctant Investor', 2007

Pension Institute reports are available at www.pensions-institute.org.

Thoresen Review of Generic Financial Advice, Treasury announcement, January 2007.

Appendix 7: About the authors

The Pensions Institute

Debbie Harrison is a Senior Visiting Fellow of the Pensions Institute at Cass Business School, a consultant to the Department for Work and Pensions on personal accounts, a consultant to the OECD on pension research, and a consultant on pensions and investment management issues to financial institutions. She is also a contributor to the *Financial Times* and a trustee of the Financial Inclusion Centre, a research charity.

Alistair Byrne is a Senior Lecturer in Finance at the University of Strathclyde in Glasgow, a Fellow of the Pensions Institute and a consultant on pensions and investment management issues.

The objectives of the Pensions Institute (www.pensions-institute.org) are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, to establish an international network of pensions researchers from a variety of disciplines, and to provide expert independent advice to the pensions industry and government.

The views in this report are those of the authors and not of the Pensions Institute, which takes no policy position.

IFF Research

Tim Britton is the Managing Director of IFF Research.

Karen Bunt is a Director of IFF Research.

IFF Research has been working with the FSCP for over ten years on a wide range of studies, notably on investor knowledge and behaviour. The company has also carried out work for the FSA on policy development and evaluation.

Appendix 8: Acknowledgements

The authors would like to thank *AKG Actuaries & Consultants, *Barrie & Hibbert, the Centre for Risk and Insurance Studies (CRIS) at Nottingham University, Cazalet Consulting, and **Money Management* for providing access to their research and data. We are also very grateful for the cooperation and assistance of the Financial Services Authority.

In addition we would like to thank the following organisations for their help:

The Actuarial Profession
*The Association of Independent Financial Advisers
*AEGON
Alexander Forbes Financial Services
*Annuity Direct
*The Association of British Insurers
*Aspen plc
Beachcroft Regulatory Consulting
Cazalet Consulting
CMS Cameron McKenna
*Deloitte
The Financial Inclusion Centre
*Hargreaves Lansdown
*HBoS
*Hewitt Associates
Independence Financial Planning
Irwin Mitchell
*Milliman Consultants
*Norwich Union
The Office of the Policyholder Advocate for Aviva
The Office of the Policyholder Advocate for Prudential
*Origen Financial Services
*Pearl Group
The Pensions Advisory Service
PolicyPlus
*Prudential
*Resolution Life
*Royal Liver
*Royal London
*Severn Consulting
*Standard Life
Staple Inn Actuarial Society
Syndaxi Consultants
*Telos Solutions
Wesleyan
*Which?

* Indicates organisations represented at the closed fund workshop