



ABI RESPONSE TO FSA WITH-PROFITS REVIEW ISSUES PAPER NUMBER 4 – DISCRETION AND FAIRNESS IN WITH-PROFIT POLICIES

1. ABI is supportive of the proposal that companies should set out high level Principles of how they intend to manage their with-profits funds and Practices giving examples of how these Principles are currently followed. While the Principles cannot be expected to be unchanged forever, they should be devised so as to be long-term in nature and capable of surviving changing economic and other circumstances. The Practices are more likely to change in response to changes in the shorter-term economic, fiscal, regulatory and legislative environments. The Principles might change in response to significant events affecting the structure of the fund or the company, such as closing the fund to new business, a merger or an acquisition.
2. Changes to the Principles should be approved by the Board, possibly in consultation with the FSA and the actuarial peer reviewer, whereas changes to the Practices should be approved by the Company's Board alone. There will also be a need for some form of annual certification of compliance, possibly as part of the FSA regulatory returns.
3. The Principles should be made widely available – perhaps published on the company's website. It is possible that different sets of Practices would apply to holders of different classes of policy, eg bonds and pensions, and appropriate practices should therefore be notified individually to policyholders, probably initially as part of the pre-sale disclosure. Changes to Principles and Practices should also be notified individually, probably with regular annual mailings such as bonus notices or annual statements. This will need further consideration, recognising the "less is more" principle.
4. It needs to be recognised that many funds already have 'Principles of Financial Management' that have been established by Courts in demutualisations or attributions of inherited estates. It would be difficult for these to be re-written, as this would risk disadvantaging current policyholders. FSA needs to ensure that any rules or mandated headings allow sufficient leeway to accommodate such existing Principles.
5. Principles or Practices should not be incorporated into policy documentation. While we can see apparent advantages in collecting all key data in one document we believe it is important for Principles and Practices to be written in plain language and to be reasonably straightforward to change when necessary. Policy documents are legal contracts and do not lend themselves easily to plain

language and it is not easy for their terms and conditions to be changed. Companies' other literature, such as leaflets and key features documents, can also be deemed to contain contractual conditions in some circumstances and yet are separate from policy wordings. We believe Principles and Practices can be better accommodated in other documents than policy wordings, their status can be more easily and better made clear and they are more likely to be informative.

6. The FSA acknowledges that the interpretation of fairness changes over time. It is vital that such Practices are applied prospectively and not retrospectively. Changing the definition of fairness with retrospective effect is itself unfair to those on whom the burden of the new interpretation falls. We are keen to work with FSA to develop a regime whereby innovative new Practices and products can be introduced without the application of hindsight to those that went before and an associated assumption of previous unfairness. Without some comfort for product providers in this area it is hard to see how a regime of stated Principles and Practices could work.
7. Whilst we can give some support to the suggestion that 'unpleasant surprises' may be indicative of underlying unfairness, we believe considerable caution is needed before pursuing this philosophy absolutely. A holder of a unit trust would be unpleasantly surprised if its value fell suddenly, particularly if it contained his pension fund and he was just about to retire. It would be unfortunate but not necessarily or automatically unfair. We believe a route through this problem is to ensure policyholders are regularly reminded of the nature of their investments, the risks to which they are exposed and the returns or growth the investment is achieving. This will help reduce the risk of unpleasant surprises but not eliminate it completely. The Raising Standards requirements for an annual statement go some way towards providing this information. Regular mailings of the Principles and Practices, with annual statements or bonus notice, might also help achieve this, although information overload is also a risk. An alternative might be to notify changes to Principles and Practices in this way, referring back to original documentation and the company's web site.
8. In particular we do not believe that the imposition of a Market Value Reduction (MVR) should constitute an unpleasant surprise or evidence of unfairness any more than a fall in the market does for holders of tracker funds. We accept that the use of MVRs can and should be clearly explained to policyholders at point of sale and regularly thereafter to gain better acceptance of the fact that these operate to ensure fairness to all policyholders. It is unfair to those who remain in the fund if those who leave take more than their fair share. It is also unfair if astute policyholders can 'play the fund' by moving out when asset shares have reduced without suffering any reflection of the underlying fund performance. We believe that if this Principle is regularly stated, in times of good and bad market performance, it will soon come to be rightly understood to be fair. With-profits funds are pooled investments where investors agree to share their fortunes, not

to compete against each other. If investors want to try to beat the market they should not be in with-profits.

QUESTIONS

Q1 Do you agree with the descriptions in paragraphs 15 to 29 of the general issues arising over discretion and fairness in with-profits policies?

- 1.1 ABI welcomes the fact that the paper recognises that careful consideration needs to be given over rules on discretion, as too rigid specification may be limiting and too light specification over discretion might serve no purpose. Discretion exists to allow the Directors to balance the competing interests of different groups of policyholders, and (in the case of proprietary companies) the interests of policyholders and shareholders. This needs to be retained if with-profits is to provide the smoothing of benefits that policyholders seek. It needs to be possible to draw up Principles and Practices that do not unnecessarily constrain the company by limiting its ability to adapt to changing circumstances so as to benefit both policyholders and shareholders. It is difficult to cover all circumstances that may arise and the danger is that the more one seeks to circumscribe the exercise of discretion the less flexibility there is to adapt to changing circumstances.

Unfairness

- 1.2 We have concerns about the development of the concept of 'unfairness' arising when a consumer has been 'unpleasantly surprised' by an event or a decision. 'Unpleasant surprises' regularly arise because customers have not read, or remembered, facts that were clearly presented in the literature when they bought the contract. We believe the regular provision of the Principles and Practices with annual mailings might help address this problem if the risk of information overload is managed.

Paragraph 21

- 1.3 Paragraph 21 recognises that elements of 'fairness' need to be considered as a whole, and since 'fairness' is a two-way concept, a balance struck between the parties. With-profits works on the basis of a pooled investment where companies aim for fairness between different cohorts of policyholders.

Paragraphs 17, 18 and 26

- 1.4 The implication in paragraphs 17, 18 and 26 is that the FSA consider that the discretion of Directors in determining investment strategy and bonus and smoothing policy is unconstrained. We disagree, as there is an existing legal framework that constrains the discretion of the Directors.
- 1.5 We agree that the operation of a with-profits fund relies on the exercise of discretion by the Directors. However, we believe that it is not possible to inform policyholders of all circumstances in which discretion might be used. Rather we agree with the proposition that policyholders should be informed of the Principles that will be used in the exercise of discretion, and kept up to date with how that discretion is being used as it affects their investment.
- 1.6 We also agree that setting out these Principles will enable consumers to better understand how a with-profits product operates, and will help reassure consumers that funds are being managed 'fairly'.

Paragraph 31

- 1.7 Clarification is needed on the point made in paragraph 31 that as far as possible information on discretion Principles and Practices should be included in policy documentation. We believe this may pose problems in that the Practices are likely to be change over time, and yet being part of policy documentation they will be contract terms. The Principles (as more qualitative) may act to restrict the ability of companies to respond to changing business needs (merger and acquisitions). Laying out Principles and Practices in policy documentation may make the operation of the with-profits fund too restrictive. This is discussed further in the answer to question 16.

Q2 Are there any other issues arising besides those mentioned in paragraphs 15 to 29?

- 2.1 Although covered to some extent in paragraph 48, the issue of information overload is not considered in the selected paragraphs. While the paper seeks to increase transparency through plain language in communications with consumers or further information and enhanced product disclosure, the balance between the benefit of supplying this information and the risk of too much detail must be considered. Less bulk of paper can have more impact – the “less is more” principle. It is are not clear as to how Principles and Practices could best be communicated. Many of the example Principles and Practices suggested would seem to rely on considerable prior knowledge of with-profits on the part of the reader. Even taken together, the examples would not constitute a rounded description of what with-profits is about. This means that a statement of Principles and Practices could not replace explanatory guides, and that it would have to be accompanied by a reference to other information such as a guide. There would be a clear risk of information overload for policyholders if such statements were to be added to information already being routinely provided.

2.2 Specific areas where there could be potential information overload are:

- the suggestion that bonus reviews should be undertaken half-yearly, and
- consideration of when and how often policyholders are to be informed of a change in Practices.

Q3 Does the list in paragraph 28 represent the key areas of discretion retained by insurers over the management of with-profits funds? Are there any others?

The paragraph covers the key areas. Other significant areas are picked up elsewhere in the Issues Paper, including new business policy and exit strategies.

Q4 Do you agree that a distinction needs to be made between Principles and Practices as set out in paragraph 30?

4.1 ABI supports the structure suggested where there are overlying, high-level Principles that will create a framework under which more flexible and more detailed Practices can operate. The Principles will be wide-ranging and qualitative, while the Practices will be more measurable and often quantitative. This is reflected in the examples shown in paragraphs 33 to 38.

4.2 We do not agree that notice should be given of proposals to change either Principles or Practices. This would introduce a delay that could be harmful to all policyholders. If insurers had had to give notice of changes to asset allocations as a result of September 11 2001 it would have taken a long time before changes would be made. Market participants would be alerted to the insurer's intentions, which would obviously have an effect on price, and thus investment performance. Other eventualities can be envisaged that would cause immediate changes to Practices. We believe notification and explanation in the next annual statement is the most cost effective method of notifying changes.

Q5 Are there any particular Principles or Practices that universally apply to all with-profits funds? If so, what are they and should all insurers be required to adhere to them?

5.1 We can imagine Principles at least that could be drawn up in such a general way that all insurers with with-profits fund could happily promote them. We do not believe this is what the FSA is seeking. We think it would be helpful if Principles and Practices were to be set out in a way that allows customers to compare one company with another. We believe the answer is for the FSA to propose

headings – probably those used in this paper or similar – under which each company states its Principles and Practices. If the heading is not relevant for a company it should briefly explain why. The templates given in the paper indicate the length of statement that would be suitable, although we have concerns about the overall length of the documents and the potential for information overload.

5.2 If the purpose is to be to enable customers to compare companies, companies might have to include a very full list of the principles and practices - including those they know to be more or less universal - in an attempt to ensure that as far as possible the overall impact of the list of principles and practices gave a sufficiently complete and undistorted impression of what with-profits is about. We are doubtful of the extent to which individual customers would be able to make sense of the list.

Q6 Do you agree that Principles and Practices such as those in paragraphs 33 to 38 could be set out to help explain, and qualify, the way in which discretion will be operated by an insurer?

6.1 Yes, although we could take issue with some of the examples given. We believe most of the headings and level of detail to be given are about right. We would be happy to discuss specific areas of concern if that would be helpful, possibly using paragraph 37 as an example.

Q7 If you do not agree, what type of Principles and Practices do you think could or should be set out?

7.1 We think the headings suggested provide a good basis. However 'Application of MVRs' should be replaced by a heading of 'Exit Terms' and should cover surrenders and transfer values as well as MVRs. There should also be a category for over-arching or general Principles that do not fit any of the separate categories.

Q8 Do the examples of Principles and Practices set out in paragraphs 33 to 38 provide sufficient detail to gain transparency? What other factors do you think need to be included?

8.1 Transparency will certainly be improved by these proposals, but only if risks of information overload can be managed.

Q9 Do you agree with the issues in paragraph 39 to 42 about the terms to vary charges?

Q10 Do you agree that consumers should be able to surrender without incurring surrender charges where a firm increases its charges but without relating this to an objective point of reference or by imposing a cap?

Q11 How do you propose consumers should be notified of any variation in their charges and what do you consider to be an appropriate notice period?

- 9.1 These three questions about charges do not address issues that are unique to with-profits investments. All companies offering all types of investments should disclose their terms regarding charges (including rights to vary charges) so that investors can choose between them. It should be made clear at the outset what the terms are, including terms on exit after charges have been increased.
- 9.2 If FSA are minded to impose limits going beyond disclosure there will be a need to look across the board at the whole issues of charges in a more systematic way than this Issues Paper does. It would be a significant step to move from ensuring that there is full disclosure to regulating this aspect of the product and careful analysis of all the issues would be needed.
- 9.3 ABI generally agrees with the issues in paragraphs 39 to 42 about how companies should disclose to consumers when they vary charges. We particularly support the Raising Standards recommended approach (quoted in Paragraph 41 of the paper) that imposes a cap or external rate (such as inflation) that will limit any 'unexpected surprises'.

Q12 Do you agree with the issues raised in paragraphs 43 and 44 about the surrender of with-profits policies?

- 12.1 The operation of the MVR on surrender of the with-profits policy is fundamental to the operation of with-profits funds. We agree with the suggestion that it would be preferable that this process is explained clearly to the policyholder and that the extent of discretion is laid out in the Practices of the fund, so the process on surrenders cannot be construed to be unfair.
- 12.2 The best place of all for explanation of the use of the MVR would seem to be in a with-profits guide such as that for Raising Standards. One reason for this is that such a guide can explain the office's approach to the underlying concept of fair shares (smoothed or otherwise) in a way that is beyond a list of Principles and Practices.

Q13 Do you agree there is a need to clarify the scope of the terms relating to fund closure in with-profits contracts?

- 13.1 We assume this refers to the closure of the fund to new business, rather than any suggestion that existing investments have to be moved elsewhere. Information on the right to close the with-profits fund to new business is disclosed to policyholders in the contractual terms, ie in the policy document, by some companies. Customers usually enter into a contract believing that the fund will continue to operate over the term of their policy. Most with-profits policies are for the long-term and circumstances can change over the duration. Policyholders

should therefore be aware that this could happen, and if companies do not include this information in the policy terms it should be included in the Principles.

Q14 What type of information do you think should be included in policy documents on the right to close the with-profits fund to new business?

14.1 As explained earlier we do not agree that Principles or Practices for operating the fund should appear in contractual documentation. However, policyholders should be made aware of the company's right to close the fund to new business.

Q15 How desirable and practical is it to seek a greater degree of consolidation of information relevant to the terms and conditions of a with-profits contract into one key reference policy document?

15.1 It would not be realistic for the Principles, Practices, policy terms and conditions and key features to form one document. We support the Raising Standards route of using headline information for key points with signposting to where more detailed information can be found.

Q16 To what extent should the Principles and Practices applied to the operation of with-profits funds be set out in the policy document? What details might be better provided in supplementary material, with appropriate cross-references?

16.1 The Principles and Practices should not be incorporated into policy conditions. The policy document will inevitably use legal language and inability to alter these terms may restrict the ability of companies to respond in their consumers' best interests to changing business needs (eg demutualisation, mergers and acquisitions) or a changing environment.

16.2 There is also the problem that Principles and Practices will need to change over time, which would not be possible if they are part of policy documentation and therefore contractual terms. Also using legalese is unlikely to aid clarity and transparency.

16.3 One possibility would be for the Principles and Practices to be described in clear terms in the "with-profits summary" or with-profits guide, as well as in information provided to consumers with annual statements or bonus notices. They are more likely to be informative than in policy documentation

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