

Appendix 13

Equity between with-profits policyholders and shareholders

A report for the policyholder advocate in connection
with the reattribution of the inherited estates
of the CGNU Life and CULAC with-profits funds

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Note: This paper is academic research and does not necessarily reflect the views of the Policyholder Advocate

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1.00 Introduction

Equity has long been an important issue in insurance and, in particular, with-profits life insurance. The names of insurers such as Scottish Equitable, Equitable Life and Equity & Law are evidence of the significance of equity in the operation of life insurance. The actuarial profession has been instrumental in addressing, and suggesting solutions to, questions such as what way of valuing assets and liabilities is suited to measuring profits in with-profits life insurers, the balance between retaining and distributing profits, and the structure of bonus rates, being the means for distributing profits to policyholders. While the references to the relevant body of work would be too long to list here, we can mention the book by Cox and Storr-Best (1962) on “Surplus in British life assurance”, which summarises much of the earlier literature. But Cox and Storr-Best did not address the issue of equity between with-profits policyholders and shareholders in proprietary life insurance firms. This is a question that has had relatively little attention in actuarial literature, although it did feature in a Presidential Address to the Faculty of Actuaries (Wallace, 1973).

The equitable treatment of with-profits policyholders and shareholders has, however, become a more important issue for three reasons.

First, 70 life insurance firms demutualised in 1990-2001 (Sandler, 2002), so we now have a much higher proportion of the business being carried out by proprietary firms as opposed to mutuals.

Second is the increasing emphasis within proprietary companies on shareholder interests. The globalisation of and competition in capital markets is associated with the greater focus on increasing shareholder value; in a life insurance context we can see this reflected in the considerable effort devoted to finding suitable ways of measuring the value of life insurers to their shareholders, in particular using embedded value reporting (O’Keeffe et al, 2005). The issue is that, according to some authors (Froggatt & Iqbal, 2002), policyholders’ importance is now secondary.

Lastly, regulators have become more alert to problems about whether with-profits business is operated fairly. The Financial Services Authority (“FSA”), which acquired its formal regulatory powers in 2001, established a review of with-profits business, the outcomes of which have included firms issuing Principles and Practices of Financial Management (“PPFM”) documents, new FSA conduct of business rules on the operation of with-profits business (for example, on capital management and payouts), “realistic balance sheets”¹ for major with-profits insurers, and changes in governance that have seen the appointed actuary system replaced by with-profits actuaries and, in many cases, the establishment of with-profits committees. The airing of these issues has also made some policyholders and their representatives more concerned about the problems (Which?, 2008).

This is therefore an appropriate time to review issues of equity between with-profits policyholders and shareholders. We do not, however, consider the specific issues arising in a reattribution of the estate.

The rest of the paper is organised as follows. In section 2 we consider why equity is a relevant issue and what it means. In section 3 we review why this is particularly important for with-profits business. We then consider, in section 4, some practical issues regarding the equitable treatment of policyholders and shareholders, including how insurers interpret the “90:10” rule, whereby normally 90% of distributed surplus is allocated to policyholders and 10% to shareholders (in a 90:10 fund we take it as given that shareholders are entitled to 10% of the profits, being a term of the contract).. The conclusions are in section 5.

2.00 Why is equity relevant and what does it mean?

2.01 Why is Equity Relevant?

The question arises as to why we should be concerned by equity between with-profits policyholders and shareholders. Surely the latter take 10% of the profits, and the policyholders know this at the outset, so assuming the policy is operated on the basis that was agreed, questions of equity do not arise. Consider unit trust investors, who purchase units

¹ The realistic balance sheet involves major with-profits life insurers reporting their assets and liabilities on a broadly market-consistent basis; with liabilities based on how the business is operated, using asset shares.

with a view to receiving some investment return minus a fund management charge that they know in advance. Investors can compare such charge with the charges made by competitor providers, so equity, it appears, is irrelevant. We therefore need to assess whether the relationship, in with-profits life insurance, between with-profits policyholders and shareholders needs to have reference to ‘equity’.

It is the characteristics of with-profits life insurance contracts that distinguish them from unit trust and other contracts, which mean that equity is important. In particular, the terms of the contract are not well-defined, not well-understood by policyholders (FSA, 2002a) and leave significant discretion to management. Policyholders are therefore in a weak position (Sandler, 2002) and there is concern that discretion may be exercised in a way that disadvantages policyholders (FSA, 2003). While the advent of PPFMs has helped define how with-profits life insurers operate their business, we find that, in practice, there is still considerable management discretion.

The need to consider issues of equity between with-profits policyholders and shareholders has already been acknowledged by regulators and some insurance practitioners. Wallace (1973) felt that a life insurance actuary has the duty “to ensure to the best of his ability that the respective relationships of shareholders, with-profits and without profits policyholders are as equitably and fairly arranged as possible” (p. 2). The discretion open to the management of with-profits firms is typically wide, regarding investment strategy, smoothing policy and bonus rates in particular. This discretion may lead to conflicts, and this discretion may be constrained by the courts (O’Brien, 2004) and by regulators.

2.02 What does Equity mean?

We still need to decide what equity means, and we can gain some insights from the FSA’s views about “fairness.”

The FSA has, as one of its principles for businesses, “A firm must pay due regard to the interests of its customers and treat them fairly.” It said (FSA, 2002b) that fairness is a powerful concept about which people have deeply intuitive but varied notions, with natural

justice, ethics and morality all potentially playing a part. Honesty, openness, transparency and good faith may be indicators that a firm is acting fairly.

The FSA's "Treating Customers Fairly" (TCF) initiative has generated much activity, and has been somewhat more precise in expressing the desired outcomes of TCF, such as retail products being designed to meet customer needs and targeted accordingly; and customers receiving the product performance they have been led to believe from firms they deal with (FSA, 2006).

The author's starting point is that firms' obligations are contractual ones, deriving from the policies they have issued and the representations made about those policies. However, there are two possible problems: first, the contract may contain terms that are unfair; second, the contract may have 'implied terms'.

The first problem can be addressed because life insurers are subject to the Unfair Terms in Consumer Contracts Regulations 1999, which contains the following test of fairness (regulation 5(1)):

"A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirements of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer".

Fairness requires that insurers do not include any such terms in their contracts.

Core terms, i.e. those which describe the main subject matter of the contract and the adequacy of the price, are exempted from the Regulations, provided they are expressed in plain and intelligible language.

The second problem is addressed by the fact that the courts are willing to imply terms in contracts (Beale, 2005). They may do this if:

- There is an inference (from the contract and the circumstances in which it was agreed) that the parties must have intended; or

- The contract does not fully set out the terms, and the courts must therefore determine what they are.

Fairness requires that insurers (and policyholders) act in accordance with any such implied terms.

- The author's view is that an insurer acting fairly will:
- Comply with its obligations under the contract;
- Not seek to impose any terms that would be unfair under the Unfair Terms in Consumer Contracts Regulations 1999; and
- Comply with any terms that would be implied by the courts.

While there are other perspectives on fairness, the above approach is put forward to help us determine the fairness or otherwise of insurers' behaviour and we shall use it in section 4.

Incidentally, one can argue that TCF is an unnecessary principle, as what firms are required to do can be deduced from contract and related law: however, the record of financial services firms in dealing with their customers suggests that an industry gets the regulation it deserves. Indeed, the nature of the with-profits life insurance industry is that there are deficiencies in competition and there are clear conflicts of interest: regulation is a faster and cheaper way of addressing these issues than using the law.

3.00 Equity and with-profits business

Ensuring that policyholders in with-profits firms are treated equitably may not be straightforward. The FSA identified four aspects of the business that might give rise to unfairness issues (FSA, 2003):

- The discretion the firm has in managing its business;
- The discretion the firm has in deciding how much payouts will be under a new policy, both on maturity or surrender;

- The imbalance between what the firm knows and what policyholders know (which can lead to the firm doing things without the policyholders knowing); and
- The imbalance between the firm's decision-making powers and those of the policyholders (which can lead the firm to do things without policyholders having a say).

The FSA has acted to address these by changes in its rules, including new governance arrangements for with-profits funds, putting responsibilities on with-profits committees and with-profits actuaries. The new rules were additional to the FSA's general principles, which included the requirements to treat customers fairly and to manage conflicts of interest fairly; both being important issues for proprietary with-profits funds.

In this paper, we take it as given that surplus is divided 90:10: that is (assumed to be) the basis on which customers effected the contract. However, this still leaves room for questions of equity to arise, which we address in the next section.

This paper suggests that some aspects of the operation of with-profits business in proprietary companies can be, or have been, unfair for policyholders. In discussing questions of equity, it is natural for the paper to concentrate on problem areas. However, we do need to recognise that many with-profits policyholders have been well-served by with-profits policies issued by proprietary insurers.

4.00 Discretion And Equity

4.01 Introduction

In this section, we consider some specific areas where firms can exercise discretion, which raise questions regarding whether they are acting fairly. We consider whether these practices are consistent with the notion of fairness as defined (in broad terms) at the end of section 2.

4.02 Investments

Sandler (2002) was concerned about conflicts of interest between policyholders and shareholders, and the possibility that there could be investments in ventures which have strategic value for the business as a whole, but do not themselves earn an adequate return. He was also concerned that money could be invested in a venture from which the extraction of profits favours shareholders.

He went on to recommend that with-profits funds should not be used to finance other parts of the provider's business (for example, banks or estate agents run by the provider's management). His proposals would also constrain mutuals. However, he was aware that these restrictions may be inconsistent with the requirements of the First Life Directive; if so, he would recommend disclosure of such investments, along the lines of a related parties disclosure statement.

This is a difficult area, as there are potentially a number of conflicts. For example, policyholders may prefer risky investments to give a good opportunity for the asset share to be high, knowing that they are protected by the guaranteed benefit if the investment risks are unsuccessful; whereas shareholders may prefer less risky investments in order to avoid the potential for the asset share to be less than the guaranteed benefit, and having to use the inherited estate or, possibly, shareholders' funds, to pay the policyholder. Or an insurer may invest part of the fund in a unit trust run elsewhere in the group: this may have advantages to the with-profits fund, although there are questions of conflicts, governance and disclosure.

The FSA's rules contain provisions on with-profits funds' investments, with reference to the conflicts when connected parties are involved. The FSA (2007b) has confirmed that its rules permit 'strategic investments' to be held within a with-profits fund, provided this is fair to with-profits policyholders. However, its rules do not contain an explicit statement about the extent to which it is fair to choose investments for the benefit of shareholders rather than policyholders. The author suggests that the FSA considers this, and suggests this can be addressed by devising an underlying principle on what are acceptable investments for a with-profits fund.

FSA rule INSPRU 1.5.30 goes some way towards this by requiring insurers to use long-term insurance assets only for the purposes of their long-term insurance business. Those purposes include the investment of assets (INSPRU 1.5.32). However, it may be argued that the investment of assets is a means to an end, and that the real objective of the business is to pay claims (guaranteed benefits and bonuses). On this basis, the principle would be that investments would be chosen as part of managing the fund in order to pay claims to policyholders.

If that principle is accepted, it would form the basis for considering:

- Is it appropriate for some assets to be chosen to be to the long term benefit of shareholders and, if so,
- what constraints should there be and what limit to the assets to be chosen in this way?

4.03 Management service companies

Several life insurers have entered into management services agreements (“MSAs”) with management services companies (“MSCs”) in their group, whereby the latter provide administration, and sometimes acquisition and investment services for the life insurers, for a specified charge. These MSCs are usually 100% owned by the shareholders. The expenses used in calculating asset shares are then the charge paid by the insurer to the MSC; if the MSC incurs a lower (higher) expense than this, there is a profit (loss) to the MSC, i.e. to the shareholders.

Concerns have been expressed that MSCs may be a means of transferring value from policyholders to shareholders (Brindley et al, 1990). For example, Brindley et al (1998) questioned whether charges, while supposedly based on market costs, took full account of discounts that may be available.

An insurer may arrange an MSA on market terms; however, there are still issues about whether it is in policyholders’ interests to start an MSA, especially if this relates to carrying out mainstream policy administration, and if this continues to be done by the same staff and

systems. The main issue is that market terms include a profit margin above costs, so that using an MSA can be expected to reduce the insurers' profits and policyholders' bonuses. This can lead to 'milking' the fund, which has been a concern of regulators, who have been especially concerned about whether with-profits funds are treated fairly: this was referred to in the Government Actuary's Department Insurance Supervision Manual, included in Parliamentary and Health Service Ombudsman (2008, part 4, p.674-676). That manual indicated that supervisors looked to ensure that the MSA charges were based on costs; and that there were no penalty clauses on termination of the agreement. This provision has not been incorporated into the rules of the FSA.

However, an MSA may bring advantages to the insurer and its policyholders. A 100% shareholder-owned MSC has clearer incentives to reduce expenses than a with-profits life insurer, where only (about) 10% of any expense saving accrues to the shareholders, the remainder of the gain benefiting policyholders' payouts in a way that is not easily visible (Brindley et al, 1998; Sandler, 2002). MSCs also give security to policyholders about future expense charges, which may be particularly important in closed funds, where declining business volumes may lead to an increase in unit costs. However, the gain from security of costs may be small compared to other risks to the level of policyholders' payouts, especially if the MSA relates only to renewal costs, which may be less variable than acquisition costs.

There are a number of advantages and disadvantages of MSAs; whether using one is sensible depends on the charges that are agreed. Determining the charge can raise problems, such as where the MSC gains, for no specific fee, the goodwill of trained staff and developed systems. Another case is if a life insurer uses its parent to provide some services (e.g. investment), then the parent may effectively have a guaranteed contract with the life insurer, which should be reflected in the charge.

The author suggests that life company directors should, before entering into an MSA, consider the alternatives of providing the services themselves, or having an arrangement direct with an outsourcing firm, and should be prepared to disclose to policyholders their reasons for and the implications of entering into a MSA. One problem area is where the MSC

uses an outsourcing firm, but the policyholder is charged more than the fee paid to the outsourcing firm. Surely it would be better for policyholders if the life insurer dealt directly with the outsourcer?

MSAs typically indicate the price charged for these services when the agreement begins and the rate at which these prices will increase over the period of the agreement. The author suggests that a starting point is that the prices would be expected to increase at around the same rate as other prices. In closed funds, the perspective may be different: the price may be expected to increase more quickly as a result of diseconomies of small scale. However, we would expect insurers' management to seek solutions, such as outsourcing, to minimise this effect.

There are a number of practices regarding the price increases included within MSAs and it is common, in open as well as closed funds, to find price increases being set at a rate that is expected to be above the level of general inflation.

This discussion suggests that more regulatory scrutiny of management services agreements is necessary. Some current agreements may be favouring shareholders over policyholders. The FSA (2008c) has examined intra-group investment management agreements, but there are issues beyond this.

In practice, insurers will have governance mechanisms in place, intended to ensure that the operation of MSAs is consistent with treating policyholders fairly. Under the previous regulatory regime, the Department of Trade and Industry (DTI) normally expected a majority of the directors of the insurance company to be independent of the MSC (Parliamentary and Health Service Ombudsman, 2008). The author suggests that the FSA reviews current governance practices, which may not be consistent with the old DTI rule, and considers whether they are operating satisfactorily.

4.04 Taxation

The taxation of life insurance companies is complex, but the main points are:

- On pensions business:

- the investment income and capital gains of companies are not subject to tax;
- the part of the surplus attributable to shareholders (which is typically 10% for with-profits business) is subject to tax at the usual corporation tax rate (28%).*
- On life insurance business:
 - the investment income and capital gains of companies are subject to tax at a lower policyholder rate of 20%;
 - and further tax is payable on the part of surplus attributable to shareholders, because the usual corporation tax rate applies to this, and exceeds the lower rate for policyholders. *

* The asterisked parts of the tax bill are known as “shareholders’ tax” (Needleman & Roff (1995) referred to it as the “shareholders’ tax on transfers”).

The above tax regime reflects several changes in tax law, including important changes in the Finance Acts 1989 and 1990. In particular, under the previous tax regime:

- it was common for with-profits life insurers, in their tax computation, to increase their provisions for pensions business by reserving profits for the benefit of annuitants: this meant that firms paid little, if any, tax on the surplus attributable to shareholders (i.e. their pension profits). From 1990, reservations of profits were no longer effective, and the tax on the transfers to shareholders on pension business generated a tax bill that had to be paid; and
- There was only one tax rate, not two, applicable to life business.

The question then is who pays this shareholders’ tax? The tax could be paid from:

Shareholders;

Asset shares; or

The inherited estate.

If it is paid by shareholders, they receive a transfer of surplus, net of the tax. As an illustration, say there is £100 surplus, and a shareholders' tax rate of 18% (the rate indicated by Keefe, Bruyette & Woods, 2008), then the policyholders receive £90 (in the form of bonuses), shareholders £8.20, and £1.80 tax is payable.

If it is paid from asset shares, this means that the accumulated asset share is less than otherwise, so that (assuming the guarantees do not bite), bonuses are lower, and 90% of the tax is paid for by policyholders in the form of a reduced payout, 10% by shareholders. In the above example, policyholders receive £88.38 (£90 minus 90% of the £1.80 tax) and shareholders receive £9.82 (£10 minus 10% of the £1.80 tax).

If it is paid by the inherited estate, the strength of the fund is reduced, and the future rights to distributions are lower. If the interests in future distributions are in a 90:10 ratio, this means that, effectively, 90% of the additional tax is paid by policyholders (which includes future policyholders) and 10% by shareholders. We mention here that the FSA (2008a) has agreed that policyholders have a non-zero interest in the inherited estate.

In the above example, we can think of assets of £101.80 being used to pay policyholders £90, shareholders £10 and a further £1.80 tax. Indeed, this can be regarded as using (possibly past) profits of the fund to distribute an additional £1.80 for shareholders' benefit (see Which? 2008). This means that, on a gross basis the shareholders are receiving £11.80 from the profits distributed of £101.80, i.e. 11.6%. Policyholders are receiving only £90 out of £101.80, i.e. 88.4%.

Or, using figures on a net of tax basis, shareholders receive £10 out of £101.80 (9.8%). Policyholders receive £90 (88.4%), but quite possibly less when we deduct the tax they pay on the additional benefits from their bonus (which depends on the type of policy and their tax position).

As regards who *has* paid the tax, Paul (1996) reported some limited research that concluded that it was more common for the tax to be paid by policyholders: "The position had probably

arisen more by chance than through a specific corporate position” (p. 659). However, in the case study of a fund merger that he reported, it was decided that the shareholders should pay the tax. This was partly because, for one of the companies involved, the shareholders already paid the tax, but also for two other reasons: it improved the competitive position of products in the future, and it was less likely to be affected by future changes in the tax regime.

A survey by Tillinghast Towers-Perrin (2001) found that shareholders often did not pay shareholders’ tax. Around half of offices made some deduction of this tax from asset shares in 1995, although this had diminished substantially by 2000 (see Table 1).

Table 1. Is shareholders’ tax on transfers deducted in the asset share?

	1995	1997	2000
Yes for both life and pensions business	5	5	3
Only for life business	1	2	0
Only for pensions business	4	2	0
No	10	9	13
Other	1	3	0
Total	21	21	16

Source: Tillinghast Towers-Perrin (2001)

In particular, this implies that some insurers were charging pension policyholders, in their asset shares, for tax on shareholder transfers – notwithstanding much marketing literature having highlighted the tax-free nature of the business.

The survey also indicated that, in 9 cases, the shareholders’ tax was charged to the inherited estate. In only 3 cases was the tax paid directly by the shareholders receiving a net transfer for both life and pensions business. In 1 case they received a net transfer for life and a gross transfer for pensions business.

We conclude that, historically, it has been the exception for the shareholders to pay shareholders’ tax; in many cases it has been paid from the inherited estate and, in some cases, from asset shares.

The position changed in 2004 when the FSA introduced a rule (now rule COBS 20.2.20), which indicates that a firm may not attribute such a tax liability to asset shares but may attribute it to the inherited estate if the firm can show that this is consistent with its established practice and it is explained in its PPFM.

We move on to consider who *should* pay shareholders' tax (shareholders, asset shares or the inherited estate). Some previous writers have considered this for pension policies. Iqbal (1990) concluded that it should not be paid from asset shares, because pension policyholders have often been advised, either in writing or orally, of the tax-free nature of the investment, a feature often emphasised in marketing. He went on to say that "the reasonable expectation of the policyholder is likely to be that he will not suffer the tax payable on shareholders' profits... The Revenue clearly believe that if the shareholders receive 10% of the surplus arising during that year, tax should be paid on a minimum one-ninth of the surplus distributed to (pension) policyholders." Brindley et al (1998) concluded, "Charging the amount to pension policyholders seems almost certainly wrong as they expect 'gross' earnings."

There was less clarity over whether the tax should be paid by shareholders or by the inherited estate. Iqbal (1990) went on to say that the option of charging the tax to the estate can be justified in the short term "but it is not a long term alternative.... They will soon run out of estate." Brindley et al (1998) commented, "Charging it to shareholders seems fair to policyholders. Charging the amount to the estate seems debatable." The Actuarial profession (2008) indicated that the FSA rules "reflect a compromise view between those who view the tax on a pure unitary basis and those who would see the marginal additional tax as being effectively an imposition on shareholders"; however, it did not present detailed arguments supporting alternative views.

It may be argued that it is fair for the tax to be taken from the inherited estate:

- This could be a term of the contract, - provided it is not unfair as discussed in section 2.2;
- It may be sanctioned by a scheme of financial management approved by the High Court (Office of Fair Trading, 2008) - although the author would ask

whether the information and advice provided to the High Court about the rights of policyholders was presented fully and fairly;

- It may be the means to ensure that shareholders actually receive the £10 (in the above example) which is their 10% share of surplus (Norwich Union, 2008).

However, there are arguments for the tax to be paid by the shareholders. In particular, if the insurer uses the inherited estate to receive its £10 transfer, this means that policyholders receive less than the 90% share of profits they were expecting.

Research (on closed funds) by the Pensions Institute et al (2007) indicated concerns about PPFM documents being used to justify shareholders' tax being paid from the inherited estate:

“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” (p.29, italics added).

We now consider whether charging shareholders' tax to the inherited estate is consistent with:

- The 90:10 division of profits, which expressly underlies with-profits contracts;
- What may be implied terms of the contract; and
- How we would expect a well-functioning competitive market to operate, in the absence of which, we expect market distortions to arise.

First, the author suggests that charging shareholders' tax to the inherited estate is inconsistent with the 90:10 division of profits. This is because:

- As illustrated in the example, it means that policyholders receive less than 90% of profits, whether this is assessed gross or net of tax; this being consistent with

the argument in Which? (2008), who obtained counsel's opinion that it was difficult to see how paying the tax from the inherited estate was consistent with the contractual obligations of 90:10 companies;

- Alternatively, we can regard the £1.80 tax as reducing the inherited estate, which would otherwise potentially be distributed or reattributed, with a proportion being allocated to policyholders. Policyholders' interests are therefore being reduced. Indeed, the depletion in the inherited estate reduces policyholders' security and may lead to a more conservative strategy than otherwise, potentially to policyholders' detriment;
- Specifically in the case of pensions policies that have been marketed as providing a tax-free return to policyholders: it is difficult to see an argument for policyholders' share of surplus to be reduced from 90%.

Second, the tax calculation has features that relate to shareholders rather than policyholders, leading the author to propose that it may be an implied term of the contract that tax of this type should be paid by shareholders:

- The tax is payable as a direct result of, and calculated on, part of the surplus being transferred to shareholders (and is not payable by mutual life insurance companies); and
- The tax rate applied is the usual rate of corporation tax payable by companies, not the rate applied to policyholders.

Thirdly, the author suggests that paying shareholders' tax from the inherited estate is inconsistent with how we would expect a well-functioning competitive market to operate. Using the inherited estate to pay shareholders' tax means shareholders' rewards are more favourable than in other firms where tax directly depletes the firm's profits. In particular, it favours life insurers with a large inherited estate and provides an advantage not available to those writing non-profit business. We could regard this as meaning with-profits life insurers have a lower cost of capital. Alternatively, we may say that the product terms are being subsidised by using the inherited estate to pay the tax. It is difficult to understand why the

FSA are content with this, when they say (FSA, 2008a), “we do not allow new business to be subsidised... we are not supportive of subsidising new business out of funds.” The outcome is a distortion of competition.

As noted above, the FSA permits shareholders’ tax to be paid from the inherited estate if this is past practice and is referred to in the firm’s PPFM. However, the author would say that if a practice is inappropriate, the fact that it has been past practice does not justify it. It may also hinder competition by giving an advantage to established firms. As regards the PPFM, while a with-profits contract could be established on the contractual basis that shareholders’ tax is paid by the inherited estate, the author does not believe that this is achieved by a comment in the PPFM:

- many contracts began before PPFMs came into being in 2004;
- PPFMs were drawn up by management without an opportunity for policyholders to comment;
- most policyholders have not read the PPFM (they do not ordinarily receive a copy) and, if they have, may not understand the significance of the references to tax;
- some policyholders will have read the customer-friendly version of the PPFM, but FSA rules do not require this version to explain that the inherited estate pays shareholders’ tax, if that is the case;
- therefore, mentioning shareholders’ tax in the PPFM is not the same as disclosing this clearly to the policyholders concerned, which the FSA (2003), in its consultation, set as a requirement for the tax to be payable from the inherited estate;
- the author’s conclusion is that comments about shareholders’ tax in the PPFM cannot properly be regarded as a fair term of the contract between policyholder and insurer.

The FSA (2007b) confirmed that its rules can permit shareholders' tax to be paid by the inherited estate. The FSA's reasoning is not given in the consultation documents (FSA, 2003, 2004). However, it has commented more recently, as follows.

The FSA (2007b) refers to "preserving the shareholders' position following a change in the tax law." However, it does not say which change it is referring to. We note that the changes in the Finance Acts 1989 and 1990 were described by the government as "a revised approach to the allocation of investment income, capital gains and profits between shareholders and policy holders for various tax purposes" (Lilley, 1989). This was therefore a deliberate policy of government to bring about change. The author suggests that the FSA clarifies which change in tax law it is referring to.

The FSA (2008a) appeared to suggest that it was reasonable for shareholders' tax to be paid by the inherited estate in a fund that was open to new business, enabling the policyholders to benefit from a vibrant and successful fund. However, the reasoning was not explained in detail. The author suggests that the FSA clarifies whether it is suggesting that shareholders' tax should be paid by shareholders in closed funds.

The FSA (2008b) indicated that it believed its position is "reasonable in the context of the wide-ranging review [they] undertook and the overall framework of policyholder protection which was introduced". However, the FSA does not give the reason for that view: the author believes that there is no coherent explanation for the regulator's position.

The FSA (2007b) referred to it having consulted on this subject in 2003 and 2004. In an annex to this paper, the author reviews the FSA's consultation process and suggests that it may not have been consistent with what the Financial Services and Markets Act 2000 requires. Indeed, the FSA (2004) has described its decision as a "concession" [to the industry]: the author asks what happened to the interests of policyholders, who expected the FSA to be protecting them?

This issue is one where the views of consumers and insurers differ. The Treasury Committee (2008), having concluded that the FSA's current rule furthers shareholder interest to the detriment of policyholders, asked the FSA to consult again. Without a consultation, there is

the potential for a policyholder complaint leading to a court case to test the legality of insurers' practice.

There remains the problem of some insurers' past practice of charging shareholders' tax on pensions business profits to asset shares: is that consistent with their obligations to policyholders? Consider, for example, a policyholder who effected a policy in 1995 and who is due to retire in 2012. If the insurer deducted shareholders' tax from the asset share from 1995 until the FSA changed the rules in 2004, the payout in 2012 would not give a tax-free return. The question is, have any such insurers committed themselves to providing a tax-free return, on the basis of marketing literature or other relevant documents? If so, the insurer would appear to be giving a lower payout to policyholders than they should. The author suggests the FSA investigates this and reports its conclusions.

4.05 The impact of the statutory solvency basis

The statutory solvency valuation establishes how much surplus is available for distribution, and it is carried out in accordance with the FSA rules (previously the Insurance Companies Regulations).

Standard practice in the UK is that proprietary with-profits life insurers transfer 10% of their distributed surplus to shareholders, 90% to policyholders. In some firms that is written into their Articles; in others, it has been the practice for many years. However, the way in which the actuarial basis in the statutory solvency valuation is applied for conventional with-profits business means that the shareholders typically receive a proportion that exceeds 10% in "real" terms. While this is a matter of concern (which we explain below), the excess over 10% is now much reduced compared to the 1980s and 1990s.

The importance of the actuarial basis is as follows. The distributed surplus is received:

- for shareholders (10%): as cash at (or shortly after) the valuation date;
- for policyholders (90%): in the form of a bonus, i.e. additional benefits payable whenever the claim is made, usually on death or maturity.

If surplus is in reality being divided 90:10, the way we value the shareholders' and policyholders' benefits should be consistent. Since the shareholders' benefit is valued as cash, this requires the policyholders' benefit to be valued on a market-consistent basis. The policyholders' benefit is the additional benefits on death and/or maturity and as these are guaranteed, so valuing them on a market-consistent basis means discounting the benefits at the gilt yield for the relevant duration of the policies concerned (it could alternatively be argued that a corporate bond yield is more appropriate, as the insurer is not certain to pay the bonus benefits when a claim arises).

In practice, however, most insurers use the yield that they use in their statutory solvency valuation. The FSA rules require the liabilities to be valued using prudent assumptions, which means using a rate of interest lower than the yield on gilts. This results in an increase in the amount the shareholders receive, compared to the position if the gilt yield was used.

We can see this by considering an insurer that declares a 3% bonus on a guaranteed benefit of £1000. The cost of that bonus is $30/(1+i)^n$, where i is the rate of interest used, and n is the term from the valuation date to the maturity of the policy (we ignore mortality). For example, in 1995, the average rate of interest used in the statutory solvency valuation by four major proprietary with-profits life insurers was, for pensions business, 4.56%. Let us assume $n = 10$. The insurer calculates the amount of surplus allocated to policyholders as the present value of the new bonus, i.e. $£30/(1.0456)^{10} = £19.21$. The 90:10 relationship means that the surplus distributed to shareholders is one-ninth of this, i.e. £2.13, being 10% of the total distributed surplus of $19.21 + 2.13 = £21.34$.

In some ways this is an understandable practice, as the surplus arises from having valued the liabilities in the statutory solvency valuation; where the regulations lead to insurers using an interest rate lower than that on gilts. Historically, a "net premium valuation" was required: the liabilities valued are the guaranteed benefits only, but there is an implicit allowance for future bonuses made by using an "artificially" low rate of interest to value the liabilities (i.e. leading to a higher figure). In any event the regulations require the rate of interest to be below the yield that firms are earning on the assets backing with-profits business; while this yield is the

redemption yield where the assets are bonds, it is the dividend yield (or, from 1996, the average of dividend yield and earnings yield) on shares. Since with-profits funds typically have a substantial equity content, this has again meant that the rate of interest used is significantly below the gilt yield.

Using the interest rate in the statutory solvency valuation when calculating the transfer to shareholders is a long-established and widespread practice, and when insurers make calculations for policyholders of projected payouts on policies, they take into account that the shareholders' transfer is, in practice, worked out in this way. Furthermore, regulators have been aware of what is happening and have allowed it to continue, subject to some conditions mentioned below.

An insurer using the gilt yield to calculate the transfer to shareholders would derive a different answer. Using the 10-year gilt yield in 1995 of 7.47%, the cost of bonus is $\pounds 30 / (1.0747)^{10} = \pounds 14.60$, leading to a transfer to shareholders of $\pounds 14.60 / 9 = \pounds 1.62$. In this example, the shareholders receive $\pounds 2.13$ instead of $\pounds 1.62$ by using the statutory solvency valuation rate of interest rather than the gilt yield: a 32% increase.

This 'distortion' (as we may call it) does not apply to all payments received by shareholders. Some unitised with-profits business does not involve discounting in the valuation, hence no distortion arises. Also, for terminal bonuses on both traditional and unitised business, there is no discounting as payments to shareholders and policyholders are made at around the same time, hence again no distortion.

The issue has been recognised for some time in the actuarial literature. For example, Redington (1981) noted that the shareholders receive considerably more than 10% of surplus where the policyholders' bonus is valued at an artificially low rate of interest.

Kennedy (1981) believed that shareholders were claiming an excessive level of surplus, receiving more than 10% because the policyholders' share was being valued at the interest rate in the statutory solvency valuation, which he regarded as artificial. He went on to say: "can we as actuaries feel happy about that? Is it right, if the articles of association state that

not more than 10% of the profits should go to shareholders, that we as actuaries should use an artificial method of calculation that gives them substantially more than 10%? Clearly that is not right. As actuaries we have a duty to use a method that ensures that shareholders are getting no more than a genuine 10%, or whatever percentage is appropriate”. He went on to say that the appropriate rate to use was the rate of return expected on the fund, including capital gains on equities.

Frankland (1989) referred to the argument that using a low rate of interest ensures that the transfer to shareholders is greater than it need be, and unfairly penalises policyholders. However, he went on to say such a stringent valuation basis provides an additional benefit to policyholders by way of security, and the smoothing in with-profits is possible only with this stringency. On the other hand, as he notes, the stronger the fund, the less likely is there to be a call on shareholders’ funds to support the portfolio.

Bangert (1973) said that the shareholders would receive 11-15% of surplus rather than 10% because of the use of the statutory solvency valuation basis. Brindley et al (1992) referred to the concern that strong valuation bases increased the effective shareholder rate of participation. Hare et al (2004) said that the transfer to shareholders “may be much greater than the cost on a realistic basis”.

The FSA (2003) proposed that proprietary with-profits life insurers should calculate the transfers to shareholders arising from reversionary bonus based on the long-term gilt yield (net of tax if appropriate). This would correct the distortion described above. The industry was however concerned that the FSA proposals may unduly reduce the value of shareholder interests in with-profits funds (FSA, 2004). The outcome was that the FSA withdrew its proposal, and the resulting rule indicated that the transfer to shareholders could be calculated in a different way (e.g. using the “low” rate in the statutory solvency valuation) if the firm could show that this was consistent with its established practice and if it is explained in its PPFM.

The FSA indicated that it continued to have reservations about the fairness of a method of calculating bonuses which can result in shareholders’ receiving more than the 10% of

distributed surplus over time that they claim to receive. It commented, “We accept, however, that the beneficial effects for policyholders of making a rule now addressing this would be limited as it would affect only reversionary bonuses allocated to conventional with-profits business, which is now a minor part of all surplus distributed to policyholders” (FSA, 2004).

The author’s view is that, if an insurer states that surplus is distributed 90:10:

- The value of the benefits to policyholders of the new bonus and the (cash) transfer to shareholders should be in a 90:10 ratio;
- It is an implicit term in a 90:10 contract that the shareholders’ and policyholders’ shares will be valued consistently and without a distortion;
- It is therefore fair to calculate the value of the benefits to policyholders using a gilt yield (net of tax as appropriate) since this is the market price of the additional guaranteed benefit;
- While the PPFM may indicate the firm’s practice of using the statutory solvency valuation rate of interest to calculate the transfer to shareholders, it is inappropriate to rely on this (as in section 4.4 about shareholders’ tax); most policyholders would not be aware of this or understand the implications, and we would not ordinarily expect a reference to this practice in the customer-friendly version of the PPFM that some policyholders will have read.

The distortion is, however, now much less than it was, because

- reversionary bonus rates have reduced (in some cases to zero);
- the average term to maturity, of business in force, has been reducing, with little new with-profits business being written: the discounting is therefore over a shorter period and the distortion correspondingly less;
- the statutory solvency rules now permit a gross premium valuation to be used, in which the rate of interest is higher than in the net premium valuation method, leading to the distortion being reduced; and
- most with-profits business now is unitised, where, in most cases, discounting does not arise and hence there is no distortion.

For a traditional 10-year policy now maturing, approximate calculations indicate that the distortion means that shareholders typically received about 11% of the surplus arising from reversionary bonuses; when we also take into account terminal bonus (where there is no distortion) the proportion would be a little less than 11%. For longer term policies the true proportion for shareholders is greater, because discounting at an artificially low interest rate over a longer period produces a greater distortion and because reversionary bonus rates were higher more than 10 years ago.

Given that the impact of the distortion is now relatively low, the effect on shareholder value of moving to a gilt yield basis would be quite modest. It is nevertheless disappointing that the FSA has permitted the continuation of a practice which it admits involves shareholders receiving more than they claim. It is suggested that the FSA review this, in the context of the conclusion above that the practice is contrary to what is implied by the contract.

4.06 With-profits business with a lower than 10% allocation to shareholders

Some insurers have developed products where they specified that the proportion of distributed profits payable to shareholders will be less than 10%. This may reflect competitive pressures:

- Many policies have lower guarantees than policies issued in the past, so bonuses are expected to be higher than otherwise, and the shareholders' share, at 1/9th of the value of bonuses, would be correspondingly higher - perhaps uncompetitive; and
- It has perhaps become easier to compare products on the market, especially for single premium policies such as with-profits bonds, and competition may have put pressure on what shareholders can take.

However, some insurers who have written policies on this basis have still calculated the overall transfer to shareholders as 1/9th of the value of bonuses. This is consistent with documents that restrict the shareholders to receiving not more than 10% of the distributed surplus. However, if a policy is written on the basis that 5% of surplus is distributable to

shareholders, this means that the remaining 5% is paid to the shareholders from the inherited estate.

If policyholders have effected policies where they have been told that shareholders will receive 5% of the profits, then the author's view is that it is an implicit (if not explicit) term of the contract that the shareholders will receive 5% of the profits, instead of the 10% that some are receiving.

Indeed, this is a mechanism that transfers part of the inherited estate (which is the source of the additional 5%) to the shareholders. The author regards this practice as unfair as:

- by reducing the strength of the fund, it reduces policyholders' security and may lead to a more conservative investment strategy than would otherwise be the case, potentially to policyholders' detriment; and
- it reduces the level of policyholders' future distributions

4.07 Relationships with other companies

It is common for with-profits companies to be part of a group. This can lead to issues: for example, if a cost is borne by the with-profits company then only 10% of that cost is effectively charged to the shareholders, whereas it would be 100% in other companies. There have been concerns that cost allocations for projects could be made in ways which are favourable to shareholders (Brindley et al, 1993; Sandler, 2002).

Brindley et al (1998) referred to an issue being development costs that are charged to a with-profits fund, when the benefits are entirely or mainly directed to shareholders. For example, the cost of new computer developments or establishing new distribution channels might be borne by a with-profits fund, but where the outcome was that a sister unit-linked company (where all profits were for the benefit of the shareholders) gained from lower administration expenses and higher new business profits. They suggested a principle of best practice that the risk bearer takes a similar proportion of the profits (and losses) from developments as the proportion of the development capital that they provided.

Other situations where conflicts may arise are:

- where new non-profit business of a type previously written in a with-profits fund is subsequently written in a fund all of whose profits go to shareholders: this may result in the transfer of goodwill (Brindley et al, 1990); and
- there can be concerns about the treatment of reinsurances between funds or companies with different shareholder and policyholder interests in profits (Brindley et al, 1993).

We would expect the FSA rules on treating with-profits policyholders fairly to help ensure insurers recognise the conflicts and manage them fairly.

4.08 Regulatory action to correct unfair practices

The FSA has had concerns that with-profits policyholders as a class should not be disadvantaged compared with shareholders in distributions, and in 2007 implemented a rule to address an issue acknowledged as operating to the detriment of policyholders (FSA, 2007a).

The issue was the relative treatment of policyholders and shareholders when surrender of a unitised with-profits policy involves a “market value reduction” (MVR) being deducted from the face value of units, so that the result does not exceed the asset share. O'Brien (2003) described the position which applied in some (not all) firms:

“Say the policyholder’s basic entitlement – the face value of the units (FVU) on his policy – is £8,000 and the asset share at the time a claim is to be paid is £9,320 (we shall ignore smoothing). Then the £1,320 profits are divided 10% (£132) to shareholders, and 90% (£1,200) to the policyholder, who therefore receives £9,200 (a terminal bonus rate of 15% would be declared to top up the basic benefit of £8,000 to achieve this). Now say adverse investment conditions cause the asset share to reduce to £7,000. The firm may apply a 12.5% market value reduction (MVR) so that the payout is $8,000 \times (1 - 0.125) = £7,000$.

“However, this would be unfair as the MVR is essentially (at least in most cases) a negative terminal bonus, and an equitable outcome would be to reduce the payout by £900 to £7,100, and reduce the transfer to shareholders by £100. In other words, the pain of the MVR should

be borne 90% by policyholders, 10% by shareholders. Firms should not be giving policyholders only 90% of the upside (terminal bonus) but clawing back from them 100% of the downside.”

The FSA’s new rule was designed not only to rule out this unfairness, but also ensure with-profits firms “do not indulge in practices that could lead to a declared distribution ratio drifting in favour of shareholders and so against the interests of policyholders at the point of an annual distribution and over time” (FSA, 2007a).

The FSA (2008b) has also reviewed mis-selling compensation costs, and proposed that, in proprietary funds, such costs should be met by shareholders. This would give more specific incentives to the firm to avoid mis-selling, and avoid the depletion of potential payouts to policyholders in a distribution or reattribution of the inherited estate. The FSA’s proposal is consistent with the stance that payments should not be made from the inherited estate if they are not to be made from asset shares.

On the other hand, it may be argued that policyholders share in both profits and losses, so that the shareholders’ fund should not be required to meet these specific costs. Some mis-selling may be expected to arise in the ordinary course of events, and such costs should not be singled out for special treatment. We await the result of the consultation.

In concluding this section, we draw attention to FSA rule COBS 20.2.1, which asks firms to “give careful consideration to any aspect of its operating practice that has a bearing on the interests of its with-profits policyholders to ensure that it does not lead to an undisclosed, or unfair, benefit to shareholders.” The author suggests that the FSA reviews the other practices described in sections 4.2 to 4.6, in the light of the evidence and arguments presented, to assess whether they are fair.

5.00 Conclusion

This paper has considered a number of issues relating to with-profits business operated by proprietary life insurers. The business is characterised by very limited transparency. The products themselves are complex, poorly understood by consumers, and leave considerable

discretion to management; and there can be problems where with-profits firms are managed in conjunction with sister firms where all the profits can be allocated to shareholders.

The paper suggests that an insurer acting fairly will:

- Comply with its obligations under the contract;
- Not seek to impose any terms that would be unfair under the Unfair Terms in Consumer Contracts Regulations 1999; and
- Comply with any terms that would be implied by the courts.

The paper suggests a number of practices that may be considered unfair to policyholders.

The FSA has done a great deal of work to address issues around with-profits business.

However, the paper suggests further areas for it to review.

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Annexe: The FSA's consultation process on shareholder tax

Purpose

This appendix considers whether the FSA's decision to make a rule that permits, in certain circumstances, shareholders' tax to be charged to the inherited estate, was made after carrying out a consultation process which was fair and complied with the requirements of the Financial Services and Markets Act 2000 (FSMA).

What FSMA requires

Section 155 of FSMA contains certain requirements on the FSA, when proposing to make rules, including:

- (i). it has to publish a draft of the proposed rules in the way appearing to it to be best calculated to bring them to the attention of the public;
- (ii). the draft has to be accompanied by an explanation of the purpose of the proposed rules;
- (iii). the draft has to be accompanied by an explanation of the FSA's reasons for believing that making the proposed rules is compatible with its general duties under section 2 (which sets out, inter alia, the FSA's regulatory objectives, which include the protection of consumers);
- (iv). it has to give notice that that representations about the proposals may be made to the FSA within a specified time [subsection 2(d) of the rule] and, before making the proposed rules, the FSA must have regard to any representations made to it in accordance with subsection (2)(d);
- (v). if the FSA makes the proposed rules, it must publish an account, in general terms, of the representations made to it in accordance with subsection (2)(d) and its response to them.

The above requirements do not apply if the FSA considers that the delay involved in complying with them would be prejudicial to the interests of consumers. This is not relevant in this case.

What consultation took place: CP207 (2003)

The FSA's rule (briefly) is that shareholders' tax may be charged to the estate (but not to asset shares) if that is consistent with past practice and is referred to in the PPFM.

This was first proposed in Consultation Paper 207 (December 2003).

The proposal was, in the main document, merely mentioned in a two-line footnote² (footnote 10 on page 14). The precise proposed rule wording was included on page 11 of Annex 8: the reader needs to appreciate both rule 6.12.54, which would rule out charging the tax to the estate, and then rule 6.12.55, which allows insurers to charge the tax to the estate (subject to certain conditions).

Comparison of what took place and what was required

Condition (i) is met if the FSA thinks what it did is the way best calculated to bring the proposal to the attention of the public.

However, the point is a technical one, where the public has little background information about life insurers' practices or the issues involved.

The author's view is that, to bring the proposal to the attention of the public required the proposal to be given more prominence and with a better explanation of the issues. Indeed, if there was little response on this matter in the consultation process, this may reflect it not having been brought to the public's attention in an appropriate way.

The author therefore believes that if the FSA did think this was the way to comply with condition (i), it was mistaken, and its actions in this respect were unreasonable.

Conditions (ii) and (iii) require the FSA to explain the purpose of the rules and why they are compatible with its general duties. However, there was no explanation of the purpose of the proposed rules, and no explanation as to why it was compatible with the FSA's objectives, including the protection of customers.

² "The cost of a firm's tax liabilities on transfers to shareholders would not be borne by the with-profits fund unless this is already the established practice of the firm and has clearly been disclosed to the policyholders concerned."

It may be argued that (ii) and (iii) were met in the sense of the proposals in CP207 together being meant to ensure that with-profits policyholders were treated fairly, and annex 3 to CP207 (on compatibility of the proposals with the FSA's general duties under the Act) covered several issues in the document. However, the shareholders' tax proposal was not covered there. While the proposal meant that insurers who had been charging shareholders' tax to asset shares could no longer do so (a change which was regarded as treating customers fairly), the author (and some others) would argue that this proposal was, in other respects, unfair to customers, in the sense that their interests in the inherited estate were being reduced by a tax that was properly attributed to shareholders.

In such circumstances, the author regards the FSA's failure to set out more fully the implications of its proposals for each of policyholders and shareholders, and the reason why it came to its conclusion, as inconsistent with conditions (ii) and (iii).

Some insights into the FSA's thinking can be obtained from the feedback to CP207, contained in CP04/14 (August 2004). A separate proposal consulted on in CP207 was that transfers to shareholders should be calculated by using the gilt yield as the discount rate (rather than the yield used in the statutory solvency valuation, which resulted in the transfer being inflated). The FSA withdrew its proposal, resulting in shareholders gaining compared to had the proposal in CP207 been implemented. The FSA stated, "(We proposed in CP207 a similar concession with respect to tax liabilities on transfers to shareholders.)" (Annex 4, page 4).

So, the shareholders' tax proposal was a concession to the industry.

It therefore appears as if the FSA had decided to concede, to the industry, the ability to charge shareholders' tax to the inherited estate, before it consulted in CP207. If this had been admitted, and the grounds for the concession stated, then perhaps conditions (ii) and (iii) would have been met for this proposal, and the fact that the FSA was proposing a concession to the industry would have brought the matter to the attention of the public more effectively.

However, the FSA did not, in CP207, admit that this was a concession. The author therefore believes that the consultation process was inadequate and unfair.

Condition (iv) requires the FSA to have regard to representations made to it. At least one representation was made, arguing that the proposals on shareholders' tax were unfair. There are no grounds for saying that the FSA did not have regard to representations.

Condition (v) requires the FSA to publish an account, in general terms, of the representations and its response to them. However, the feedback, in CP04/14, made no mention of representations on this issue and so we do not know the FSA's response to the criticism of what it proposed. The FSA may argue that its overall feedback in CP04/14 was in general terms. However, it remains the case, in the author's view, that condition (v) was not met in relation to the rules proposed on shareholders' tax.

Further consultation: CP04/14 (2004)

CP04/14 included some new proposals, and the FSA decided to consult again. They said (para 2.10, page 11): "We therefore see this consultation as an opportunity for all stakeholders to focus on the detail of our revised TPF proposals rather than the points of principle, which we now regard as having been established."

The author's view is that it is fair to regard the shareholders' tax proposals as a matter of detail (after all, they only merited a footnote reference in CP207). There was, though, no explanation of the reason for the proposals (which were not changing materially from what was in CP207) or their compatibility with the FSA's general duties.

Feedback was in Policy Statement 05/1 (January 2005). There was, however, no feedback on the representation(s) made on this issue

Summary

The author's view is that the FSA's consultation on its shareholders' tax proposals was inadequate:

- The proposal was not brought to the attention of the public in an appropriate way;
- The consultation did not explain the reasons for the proposal and why it was consistent with the FSA's general duties, including the protection of policyholders;
- The proposal was admitted later to be a concession [to the industry] but the fact that this was a concession was not flagged when the proposal was put forward; and
- No mention was made in the feedback documents of the objection(s) and why they had not been accepted.