IT'S TIME NOW TO TACKLE A SCANDAL

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1. Executive summary

This note is about a scandal: some life insurance companies aren't paying policyholders enough on their pension and other policies; and the regulator, the Financial Conduct Authority (FCA), has not yet taken action. This note sets out my views and why I think the issue should be tackled now.

What's it about?

Life insurance companies pay tax on the profits that their shareholders make. I would expect that this tax should deplete the shareholders' profits accordingly. But, in many companies writing with-profits business, it doesn't. Instead, the policyholders bear the burden: hence the payouts they receive are less than they should be.

Why are policyholders losing out? There are two issues:

- (A) an FCA rule, originally a Financial Services Authority (FSA) rule, allows companies to pay the tax from the surplus in the fund. Many companies do that.[2]

**** but around 90% of that surplus is usually allocated to policyholders (both life and pensions), who therefore suffer:* ***many policyholders' bonuses are and/or will be less than they should be.***

- (B) up to 2005 some companies paid the tax from the share of the fund's assets they allocated to policyholders ('asset shares'). That stopped when regulators prohibited it.

**** so consider someone whose policy started before 2005, whose company had paid the tax from policyholders' asset shares. Bonuses are again less than they should be.* ***In particular, many pension policyholders, retiring now, who expect a tax-free return, are receiving a payout after tax has been deducted.***

How much have policyholders lost?

*** *Since 1990, when the tax rules changed, it could well have cost policyholders over* ***£2 billion****, money that instead has gone to shareholders. And the problem is continuing.*

Why are regulators allowing this?

(1) The FSA gave a concession to the insurance industry in 2004. It admitted this in Consultation Paper 4/04. This presumably followed industry pressure.[3] The FCA has continued the concession.

*** *I thought the regulator was meant to protect customers!*

**** I also believe the FSA evidence to the Treasury Committee was misleading by not admitting this.*[4]

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[2] Many of the companies that have shareholders (but not mutuals, which do not have shareholders).

[3] Financial Services Authority (2004). Treating with-profits policyholders fairly: further consultation, feedback on CP207 and near final text. Consultation paper 04/14, annex 4, paragraph 11.

[4] The Treasury Committee suggested that the FSA had been too ready to make concessions to the life insurance industry. Mr Sants (then chief executive of the FSA) replied that he rejected that. House of Commons Treasury Committee (2008a). Inherited estates. London: The Stationery Office, Q109.

(2) The FSA said their rule, now an FCA rule and the subject of issue (A), was to preserve the shareholders' position after a change in the tax law.[5]

*** *but the government specifically wished to make a change in how tax was paid.[6] The FCA appears to be flouting the will of Parliament.*

(3) The FSA amended its rules in 2005 but inadequately; they still mean that many pension policyholders retiring now get less than the tax-free return they expect.

****** the FCA is failing to address issue (B): many customers with pension policies starting before 2005 are not getting the tax-free return they expect.*

(4) The regulators know that there is an issue. In 2011 the FSA admitted that its rule, (A), attracted a considerable level of opposition (an example was the Treasury Committee). It said it would review the position in a forthcoming consultation.[7] It hasn't done so. But the FCA says this is a discretionary matter with low priority.

*** *the 'low priority' argument no longer stacks up. The FCA used its discretion to examine the fair treatment of long-standing life insurance customers in a thematic review.[8] It reviewed, for example, whether communications to customers were clear: fine, but surely ensuring customers get the right payout is at least as important and must also be a priority.*

Why should the FCA tackle this issue now?

The FCA's recent thematic review included draft guidance for life insurers on how they treat customers. This included a review on charges. My response to the thematic review was that the guidance should cover the issue of charges made for tax.

I believe the guidance should be extended so that insurers ensure that pension policyholders receive a tax-free return (as expected from the product literature and/or representations from salesmen) without a deduction made pre-2005 for tax on shareholders' profits. This covers issue (B). I believe that this can be incorporated in the FCA's response to the consultation on the thematic review.

And while I want new guidance, and indeed a rule, to prohibit insurers from charging tax on shareholders' profits to the inherited estate, the FCA will need to consult on this. The FCA should confirm in its response to the consultation on the thematic review that it will issue the consultation that was first flagged in 2011 in order to address issue (A).

Tackling these issues will help provide policyholders with value for money, which has been a feature of the government's pension policy.

The thematic review on the fair treatment of long-standing life insurance customers provides the impetus for the FCA to tackle these tax issues. I believe its response to the consultation on the thematic review is a suitable way to progress these long-standing issues and bring them to a conclusion.

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[5] Financial Services Authority (2007). Reatttribution of inherited estates. Letter to Clare Spottiswoode and Mark Hodges.

[6] Lilley, P. (1989). Reply to question in the House of Commons on life assurance taxation, *Hansard*, 20 Dec.

[7] Financial Services Authority (2011). Protecting with-profits policyholders. Consultation Paper 11/5, para 2.69.

[8] FCA (2016). Thematic review TR16/2: Fair treatment of long-standing customers in the life insurance sector.

2. Plan

Section 3 describes the background to the issues.

Section 4 considers who pays the tax on shareholders' profits and who should.

Section 5 refers to regulators' comments, and the review (announced in 2011) that hasn't happened.

Section 6 highlights how the FCA rules for new business favour shareholders over policyholders.

Section 7 refers to some pension policyholders receiving payouts less than they should.

Section 8 explains why this issue is important.

Section 9 briefly concludes and what is needed.

3. Background: The problem of tax on shareholders' profits

3.1 How do life insurers work out what payout they will provide for with-profits policyholders?

With-profits policies provide policyholders with a guaranteed payout, but there is an expectation that the insurer will earn profits: I assume a standard type of policy where 90% of the profits are for policyholders, being used to add bonuses to produce an increased payout; 10% represents the shareholders' profits. I illustrate below, in a simplified way, the calculation that insurers typically make to determine the payout.

First, the insurer calculates a policy's 'asset share'. This is the amount to which the policyholder's premiums have accumulated, with investment returns, minus an allowance for claims and expenses/charges.[9] The investment return on pension policies is tax-free; on life insurance policies it is after basic rate tax. The asset share therefore represents what the policyholder's premiums have earned.

Second, the insurer carries out 'smoothing'. For example, if share prices are low when the payout is due, the insurer may use some of its surplus assets, known as the 'inherited estate', to provide a payout higher than the asset share. If share prices are high, it may pay less, transferring some assets to its inherited estate.

Third, the payout is topped up if it is less than the guaranteed amount. The insurer would use its inherited estate to do this.

Fourth, the insurer may distribute some of its inherited estate, thereby increasing the payout. This can happen if the insurer decides that its inherited estate is larger than it needs to be. Also, if the insurer decides not to offer any new with-profits policies, it distributes the whole of its inherited estate over time, in accordance with FCA rules. When the inherited estate is distributed it counts as profits, so 90% is for policyholders as bonus, 10% for shareholders.

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[9] Those charges include the profits that shareholders take when bonuses are added over the lifetime of the policy. When a life insurer adds a bonus, that represents 90% of the profits being distributed; the 10% remainder is for shareholders.

In summary: Payout = asset share, plus or minus effect of smoothing, plus amount to top up to guaranteed amount if applicable, plus any part of the inherited estate that is distributed.

Even if an insurer's management says it has no plans to distribute some or all of the inherited estate, there must be some possibility that it or a future management will do so. Hence policyholders have some expectation of benefitting from the inherited estate. The FSA (2009) was also clear in its view that with-profits policyholders have an interest in the inherited estate.

3.2 What is the tax on shareholders' profits?

The tax system for life insurers is complex and there continue to be changes. This brief description notes differences between life assurance business and pension business:

(i) Life assurance business is subject to tax at the basic rate on the fund's profits,[10] meaning that policyholders' profits (and bonuses) are lower than otherwise, as are shareholders' profits. Hence shareholders effectively bear tax at the basic rate on their life assurance profits;

(ii) Pension business profits are not taxed where attributed to policyholders but are taxed, at the main corporation tax rate, where attributed to shareholders; and

(iii) Shareholders' profits on the life assurance business are taxable at the main corporation tax rate so, prior to the Finance Act 2015 reducing that rate to 20% from 2016, there was additional tax payable on the shareholders' share of life assurance profits, based on the excess of the main corporation tax rate over the (then lower) basic rate.

Item (i) is not an issue, and the rest of this paper concerns who pays (ii) and (iii).

These issues are not new. If we go back to the Finance Acts of 1989 and 1990, these changed how tax was calculated for both life assurance and pensions business. In particular, many with-profits life insurers previously paid little or no tax on pension profits as they were allowed to reserve profits for policyholders (Iqbal, 1990). The Inland Revenue (1988, paras 6.26-6.27) wished to reform this, and the Finance Acts of 1989 & 1990 had measures to stop firms from avoiding tax (Iqbal, 1990). Thereafter, an explicit tax bill had to be paid.

4. Who does pay and who should pay the tax on shareholders' profits?

4.1 The possibilities are three:

- ***shareholders*** pay the tax, meaning that the net amount they receive is a 10% share of total profits, minus tax on shareholders' profits. The payout that policyholders receive is unaffected;
- insurers deduct the tax when calculating ***asset shares***, which are therefore lower than otherwise, as are profits and bonuses. Since policyholders receive 90% of the profits, this means they are paying 90% of the tax, and shareholders 10%;
- the tax is paid by the ***inherited estate***, which is thereby depleted. Since policyholders have a potentially higher payout when some or all of the inherited estate is distributed, this means that the payout expectations of policyholders are reduced.

[10] Calculated as the excess of the investment income and gains of the fund over the expenses.

4.2 Restrictions that regulators impose

Although the new tax rules were introduced in 1990, the then regulators, Lautro and the Securities and Investments Board (SIB), took no action. Intervention came only in 2003, when the FSA was reviewing with-profits business (the FSA became responsible for insurance regulation in 2001).

Can the tax be paid by ***shareholders***? Yes; regulators have never restricted this.

Can the tax be paid from ***asset shares***? The FSA (2004) proposed not, in Consultation Paper 04/14 and this was implemented in 2005. Before then, there was no regulatory restriction.

Can the tax be paid by the ***inherited estate***? In Consultation Paper 207, the FSA proposed yes, if this was the firm's established practice and it had clearly disclosed that practice to policyholders, including in its Principles and Practices of Financial Management ('PPFM') (FSA, 2003, para 4.13 footnote 10; and draft rules 6.12.30-31). The requirements were slightly weaker under revised proposals in 2004: the established practice had to be disclosed in the PPFM but "clear disclosure to policyholders" was no longer needed (FSA, 2004, annex 8, rule 6.12.55). The current FCA rule is COBS20.2.20.

The FSA described the approach of allowing insurers to use the inherited estate to pay the tax if it was established practice and had been clearly disclosed to policyholders as a "concession" (FSA, 2004, annex 4, para 11). Yes, the FSA admitted in a consultation paper that this was a concession.

4.3 Who pays the tax in practice?

In practice, do shareholders pay the tax? A paper by Paul (1996) found that this was not common.

More formal is a survey by Tillinghast Towers-Perrin (2001). They found that, in 1995, 10 out of 21 insurers charged the tax to asset shares, for life insurance and/or pensions business, that number reducing to 9 out of 21 in 1997 and 3 out of 16 by 2000. They also showed that most other insurers charged the tax to the inherited estate although, in some cases, the shareholders did pay the tax. While there is no more recent formal survey available, the PPFM documents of insurers indicate that it is now common to charge the tax to the inherited estate.

4.4 Who should pay the tax on shareholders' profits?

I believe that tax on shareholders' profits should be paid by shareholders, for three (and possibly four) reasons:[11]

First, the tax would not be paid if there were no shareholders making a profit. This suggests that if there are shareholders making a profit, the tax being a consequence, as is the case, the shareholders should pay the tax.

Second, according to the Finance Act 2008, the tax rate applied to the policyholders' share of profits in life assurance business is the basic rate of income tax:[12] I believe this suggests that policyholders should not have their benefits reduced as a result of the additional tax on shareholders' profits,

[11] A paper in the *British Actuarial Journal* discusses this issue (O'Brien, 2012).
[12] Paragraph 47 of Schedule 17; section 88(1) of the Finance Act 1989 was similar, referring to the savings rate of income tax.

applicable prior to April 2015, based on the (then higher) ordinary corporation tax rate applicable to companies. Further, pension business is regarded as gross roll-up business, which I believe again suggests that policyholders' benefits should not be reduced by tax charged on shareholders' profits.

Third, if shareholders do not pay the tax, this distorts competition by giving an advantage to with-profits insurers over those who write unit-linked business, who cannot avoid the tax as with-profits insurers do.

There is a possible fourth argument, that if shareholders do not pay the tax, then the proportion of profits distributed to policyholders is lower than the 90% that they are entitled to: Which? (2008) obtained counsel's opinion that this is the case. There is a counter-argument that surplus is after an insurer's liabilities, of which tax is a part, so shareholders should receive their 10% after tax has been paid. The position on this point therefore requires clarification.

If, as an alternative, the tax were paid from asset shares, this would reduce policyholders' payouts, meaning that 90% of the tax is paid by policyholders and only 10% by shareholders; I believe this is unfair to policyholders and inappropriate.

For pension policies a further point adds to the argument. These policies were typically promoted as being in a tax-free fund, or something similar (see section 7): so it is wrong to deduct tax when calculating asset shares and hence the payouts that policyholders receive.

Indeed, a group of senior actuaries suggested that best practice was that tax on shareholders' profits from pensions business should be charged to the shareholders rather than to asset shares or the inherited estate (Brindley, Nowell & Thomson, 1998).[13]

If, the further alternative, the tax were paid from the inherited estate, this would mean that policyholders' payouts can be reduced if some or all of the inherited estate is distributed; again, I believe this is unfair to policyholders and inappropriate.

The FCA's rules allow an insurer to use the inherited estate to pay the tax, subject to two conditions. One is that this is the past practice of the insurer. However, if the past practice is wrong, the FCA should not let it continue. The other is that the practice is described in the insurer's PPFM document. But this is irrelevant: many policies were issued before the FSA began to require insurers to issue PPFM documents in 2004; after then, the PPFM was not typically supplied to policyholders; and the contents of the PPFM cannot be considered to be terms of the contract with the policyholder.

The regulators have never explained why they now stop insurers depleting the benefits of policyholders by charging the tax to asset shares but allow them to deplete policyholders' benefits by charging the tax to the inherited estate.

Insurers may say that charging the tax to the inherited estate does not breach the rule that policyholders are entitled to at least 90% of the distributed surplus (the point above that requires clarification), and that it is within their discretion to do this. However, with-profits contracts lack transparency, with policyholders having little bargaining power compared with insurers. This means

[13] Unless a specific explanation was given to policyholders in the prospectus. The authors mentioned, in passing, that they thought that the argument for charging the tax on shareholders' profits to the shareholders, as opposed to the inherited estate, was less strong for life assurance business.

that it is appropriate for regulators and/or the courts to limit the way in which insurers exercise their discretion in order to protect policyholders.[14] The FCA accepts that this is an area where they can properly intervene but I believe that their current rules do not go far enough, and that they should require the tax to be borne by the shareholders in accordance with the arguments expressed above.

One way of considering the issue is that while with-profits contracts are not explicit about how the benefit to policyholders are calculated, there is an implied term that the tax on shareholders' profits should be borne by shareholders. The courts have the ability to rule that contracts have implied terms; they did so, of course, in *Equitable Life v Hyman*, resulting in the insurer having to change its practices. In the case of tax on shareholders' profits, the regulators have begun to consider the matter; it would be appropriate for them to pursue this further.

5. Later comments, the Treasury Committee conclusion and the regulators' review that hasn't happened

5.1 Comments leading up to and in connection with the Treasury Committee inquiry

The FSA (2007) confirmed its stance, adding: "This rule [to allow the tax to be paid from the inherited estate] was introduced to avoid policyholders suffering any deductions from their benefits, whilst preserving the shareholders' position following a change in tax law". However:

- The rule does not avoid policyholders suffering a deduction from their benefits, as their payouts can be reduced if some or all of the (then smaller) inherited estate is distributed;
- The changes in tax law were described by 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): so why should the FSA wish to preserve a position that the government had wanted to change? By continuing to apply the FSA rule, the FCA appears to be flouting the will of Parliament.

In 2008 the Treasury Committee carried out an inquiry into inherited estates, and questioned Hector Sants, then Chief Executive of the FSA. His attempts to justify FSA rules that allow tax on shareholders' profits to be paid from the inherited estate were imprecise; he relied on saying that tax was tricky and that they made a judgment "in the round" that was reasonable.

Mr Dunne suggested "perhaps the FSA has been a bit too ready to make concessions to the industry and has not acted firmly enough to protect the interests of policyholders?" (House of Commons Treasury Committee, 2008a, Q109). Mr Sants replied, "I completely reject that." But the FSA has admitted that allowing insurers to use the inherited estate to pay tax on shareholders' profits <u>is</u> a concession! Mr Sants failed to make this point to the Committee; I believe he should have done so.

The House of Commons Treasury Committee (2008a, p.4) report concluded:

"The charging of shareholder tax to the inherited estate is, in our view, a striking example of how certain life firms are able to use their discretion in a way that furthers shareholder interests to the detriment of policyholders. It seems unfair that policyholders should pay anything towards this

[14] This argument is discussed in O'Brien (2012).

charge… We urge the FSA to consult on the charging of shareholder tax to the inherited estate by the end of 2008."

The FSA declined to consult. It said that it did not agree that its decision was wrong in principle (House of Commons Treasury Committee, 2008b, para 23).

5.2 The consultation that FSA agreed to – but which didn't happen

In its February 2011 consultation, CP 11/5, on protecting with-profits policyholders, the FSA (2011, para 2.69) recognised that its rule allowing tax on shareholders' profits to be charged to the inherited estate attracted a considerable level of opposition, and that it would review the position. It would do this in a further consultation in connection with Solvency II (the new EU-wide regime for the prudential regulation of insurers); this was because Solvency II would lead to tax changes for insurers.

I believe it would have been better to consult without waiting to address the issues of Solvency II, the introduction of which was put back to 2016.

The FSA (2012b) issued its consultation paper on Solvency II in July 2012 (CP 12/13). However, it made no mention of tax on shareholders' profits; a more transparent approach would have made clear that the issue had not been addressed. A subsequent presentation at the Institute and Faculty of Actuaries said this is a matter for future review (Hicks & Field, 2013).

Section 9 suggests that the FCA's (2016b) thematic review on the fair treatment of long-standing life insurance customers is the impetus to carrying out the consultation now.

I believe the FCA's review of this matter should also consider the position of schemes to merge or re-arrange insurance businesses, some of which have been arranged so that the tax on shareholders' profits can be charged to the inherited estate. Courts have approved these without the objections that I believe the regulators should have made.

It may not be possible to make changes to Court-approved schemes even if it is concluded that their provisions on tax were improperly generous to shareholders. However, the FCA may suggest to the insurers in question that they no longer use the inherited estate to pay the tax on shareholder' profits. An example from the water and sewerage industry, regulated by Ofwat, can be used to illustrate that (House of Commons Committee on Public Accounts, 2015). Ofwat had produced a generous price review settlement for the industry, and contacted companies in October 2013 to suggest they voluntarily consider foregoing a proportion of bill increases they were entitled to in 2014–15, taking account of affordability pressure on households as well as the generous settlement. Six of the ten largest water and sewerage companies did so. Hence, the FCA may be able to secure a better settlement for policyholders notwithstanding Court-approved schemes.

6. The FCA favours shareholders over policyholders in its rules on new business

The need for action is clear as there is also an ambiguity in the FCA's rules when applied to new business; and the FCA has interpreted its rules in a way that favours shareholders over policyholders.

The FSA was concerned that with-profits life insurers should not use (and thereby deplete) the inherited estate in order to subsidise new business. This is because it would reduce the benefit

expectations of with-profits policyholders, who may gain from future distributions of the inherited estate. In CP11/5 the FSA (2011) proposed a new rule to strengthen the prohibition of subsidies, with some minor changes made in the consultation process before implementation.

So FCA rule COBS20.2.28 requires that an insurer should only write new business on the basis that there is likely to be no adverse effect on the interests of with-profits policyholders. Accompanying guidance refers to, for example, lines of business being expected to be financially self-supporting.

Say an insurer writes new business, with expected cash flows being self-supporting, and shareholders pay the tax on their profits: there is no subsidy and it complies with the FCA's rules. I refer to this as situation (A).

If the insurer used (i.e. depleted) its inherited estate to provide a higher benefit to a policyholder, the policy would not be self-supporting. It would reduce other with-profits policyholders' benefit expectations and contravene the FCA's rules. The FCA would therefore not permit this situation, (B).

Situation (C) is where the policyholders receive the same payout as in (A), but the insurer uses (depletes) its inherited estate to pay the tax on shareholders' profits, so that the shareholders receive more than in (A). Do the FCA's rules permit this?

One answer is 'no' because the new business is not self-supporting: the inherited estate is depleted. Another is 'yes' because an insurer can use the inherited estate to pay tax on shareholders' profits.[15]

The FCA rules appear ambiguous. The FCA interprets its rules to answer 'yes'.

So the FCA allows the inherited estate to be depleted to benefit shareholders in (C) but not to support subsidies that would benefit new policyholders in (B). This is surely inconsistent. The FCA admitted to me that "this uncertain position is less than desirable".[16] I did tell the FCA that its proposed rules were ambiguous, in my response to CP11/5, but it took no action.

This problem would not have arisen if the FCA had stopped insurers from using the inherited estate to pay tax on shareholders' profits, as I have suggested.

7. Insurers who deducted tax from asset shares on pension policies: FCA action is needed

A particular problem relates to pension policies, because of the way they were typically described as being in a tax-free fund, or something similar; some insurers may be providing payouts to policyholders that are less than they should be.

When the new tax rules were introduced, Iqbal (1990, p.40) wrote, "Policyholders' reasonable expectations are formed primarily by the representations made by the company, before or shortly after the point of sale, either in its promotional literature or orally by its salesmen. Expressions such as (a) 'Your money is invested in a tax-free fund', (b) 'the fund is free of tax on income and gains', (c)

[15] Assuming this is consistent with its established practice and is explained in the Principles and Practices of Financial Management document.
[16] Email dated 3 May 2014.

'Tax free' and (d) 'Tax exempt' are also often used. Thus the reasonable expectation of the policyholder is likely to be that he will not suffer the tax payable on shareholders' profits". [17]

Therefore, we usually expect pension policies to provide a payout that is tax-free up to the point of retirement. This implies that firms should not deduct tax on shareholders' profits from asset shares. However, some did so before the FSA banned this from 2005.

Say a policyholder retires in 2016. Following the above argument, he or she should receive a payout at retirement without the insurer having deducted tax. If the insurer did deduct tax from asset shares before 2005, this would imply that the policyholder receives less than he or she should (although the underpayment may be quite low). The solution is for the insurer to use other assets to offset this so that it can declare bonus rates consistent with a tax-free return. I have not seen evidence that this is happening.

There is also the question of pension policyholders who retired previously and where the payout was after charging tax on shareholders' profits to asset shares pre-2005. The FCA will need to consider whether any such policyholders have valid claims for additional payments if firms have not paid bonuses consistent with policy conditions and representations and, if so, what action is appropriate.

It is worth adding that when HM Treasury (2015) consulted on tax relief on pensions, it described the current tax regime as "EET" (Exempt-Exempt-Taxed), the second E referring to pension savers benefitting from there being no "personal tax charged on investment growth from pension contributions while in accumulation, subject to the lifetime allowance" (para 2.1). However, the regime is not fully "E" on accumulation: some pension savers holding with-profits policies have, as described in this section, had their pensions reduced because the asset shares used to determine their pensions have borne corporation tax.

This matter concerns firms who appear to be not fulfilling their contractual obligations to policyholders, and is independent of the review requested in section 5. I believe that the FCA's (2016b) thematic review is also the impetus for addressing this issue.

8. Why the regulators should take action

I would expect the FCA to investigate these matters, for five reasons set out below.

First, the FSA recognised in 2012 that with-profits life insurance still raises issues. It said, "We will continue to engage with firms as necessary to establish that with-profits policyholders and members are treated fairly. We will ensure that firms meet their contractual obligations and manage any conflicts of interest within their with-profits funds appropriately" (FSA, 2012a, p.50). Tax on shareholders' profits is a prime issue here but the FSA and FCA haven't yet acted.

Second, the FCA recognises that there is concern about this particular subject. In 2011 the FSA accepted that there was a considerable level of opposition to its rule. The House of Commons Treasury Committee (2008a) had expressed its opposition as had the Policyholder Advocate (2009).

[17] Some insurers may have issued policies where the terms permit the deduction of tax. However, the validity of such terms is debatable, given the oral representations that salespersons may have made, the low transparency of with-profits contracts, and (from 1995) the Unfair Contract Terms in Consumer Contract Regulations.

The FCA also accepts that its position on new business referred to in section 6 is less than desirable. This suggests that the FCA ought to be taking action - but it isn't.

Third, the FCA is meant to be consumer-oriented. Its Annual Report 2013/14 indicates, "we have always kept the focus on helping consumers get a fair deal" (FCA, 2014, p.8), while the Chairman wrote, "we want to use the eyes and ears of millions of people who use financial products and services to help inform and direct our work" (p.5). Good intentions, but is it consistent with the FCA's not yet having addressed the tax issues?

The fourth point is that this issue has implications for the financial position of insurers if the suggestions in this note are accepted. While the effect would not be expected to be major, the Prudential Regulation Authority should be keen to ensure that this issue is resolved without delay.

The fifth point concerns the size of the issue. The FSA (2012a) stated that, in assessing our success in delivering consumer protection, it sought to avoid major consumer detriment events (defined as above £250m or 50,000 people).[18] How does this issue compare?

There are well over 50,000 policyholders in with-profits funds whose interests are affected (there are far more). Therefore, for shareholders not to pay tax on shareholders' profits appears to be a major consumer detriment event unless, of course, the regulators' concession is actually fair. As for the amount involved, my view is that it is almost certain that the detriment to policyholders since 1990 exceeds £250m, likely by a sizeable margin: it depends on the tax position of the insurers involved, so cannot be estimated directly.[19] However, it does appear that the total effect could well exceed £2billion, possibly by a significant amount, and this is increasing as time goes on.[20] This is therefore an important matter.

The FCA indicated to me that while the FSA said it will *seek* to avoid events generating major consumer detriment, there was never a commitment to always *act*. We are still awaiting the FCA to FCA act? The longer the issue is deferred, the more problems there will be in putting it right.

For a matter of this size, the Treasury may call for the FCA to report on this as a regulatory failure: the FCA (2013) stated that such a report may be triggered if customer detriment exceeds a threshold of £30-150m. It is surely simpler for the FCA to tackle the issues.

The FCA confirmed in 2014[21] that work in connection with tax on shareholders' profits is not in the FCA business plan and with the volume of non-discretionary work coming from Europe and the UK (e.g. on pension reform) they have no time for anything discretionary.

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[18] The FCA confirmed to me (email dated 3 May 2014) that it would be fair to expect that the FCA would adopt a similar approach to that laid out previously by the FSA although it would not be bound by any commitments.
[19] The FCA would be in a better position to estimate this.
[20] There have been two one-off transactions where a substantial part of the inherited estate was reattributed to shareholders. In the case involving AXA, Which (2008) reported that the FSA allowed the company "to make an allowance of £400m (23%) from the inherited estate to cover the shareholders' tax bill". In the Aviva reattribution, an amount of over £100m was calculated as the benefit to shareholders from the tax concession in the FSA rules (Policyholder Advocate, 2009). In addition to these transactions the shareholders have gained from profits each year not being net of tax: this is quite likely over £1billon and may exceed £2billion. It certainly does appear that the total effect could well exceed £2billion.
[21] Email dated 13 October 2014.

A reply from the FCA dated 2 June 2015 on behalf of Mr Wheatley, then Chief Executive, confirmed that this is not a priority.

An email from the FCA dated 10 June 2016 stated that while the issue is one which remains open for the FCA to address, its primary focus has been to ensure that non-discretionary priorities are addressed.

But the FCA does undertake work in connection with many subjects that are not driven by regulatory imperatives: examples are concerns about levels of consumer engagement and their treatment by general insurers at renewal (FCA, 2015b); and a discussion paper on the ageing population and financial services (FCA, 2016a). These doubtless reflect work very relevant to the FCA's responsibilities, but they suggest that the FCA is wrong to say it has no time for discretionary work.

So I wonder if the work will ever get done. Does the FCA need more resources to achieve its objectives? Of course, as with-profits business continues to decline, the problem will go away – but without proper investigation of whether shareholders are gaining hundreds of millions of pounds at policyholders' expense.

A more recent development provides evidence that the FCA's 'non-priority' argument does not stack up. In March 2016 it issued a thematic review on the fair treatment of life insurance customers (FCA, 2016b). It drew attention to a number of issues, such as whether communications to customers at the time of key policy events are clear and accurate. If the FCA has time for such discretionary work, which appears to have occupied significant resource, and can regard it as a priority, surely it has time for the issue of whether the payouts being offered by life insurers are being adversely affected by their tax treatment and this must also be regarded as a discretionary priority.

Indeed, the thematic review did refer to charges and to with-profits policy payouts. It is surely the case that the tax issues referred to in this note are within the scope of the fair treatment of long-standing life insurance customers. It is therefore suggested (see section 9) that this provides the opportunity for the FCA to tackle the tax issues.

It is worth mentioning another point. A life insurer which has issued personal pension schemes or stakeholder pension schemes has to establish an independent governance committee (FCA, 2015a). Those committees have to assess the ongoing value for money of the pension schemes, including the charges borne by policyholders. It is reasonable to think that the committees should assess whether pension policyholders' value for money is unfairly affected by the way that tax on shareholders' profits has, in some firms, been charged to asset shares pre-2005, so that the payouts are not tax-free as expected. Committees may also be interested in the way that payouts are adversely affected by the charging if tax on shareholders' profits to the inherited estate.

It is clear that, at least for some committees, they welcome comments, and are keen to demonstrate their independence from company management, and achieve better value for money for customers. The committee members may currently be unaware of what has been happening, and I suggest would be surprised that they are being asked to take action where the FCA has not.

9. Concluding comments: the way ahead

The thematic review on the fair treatment of long-standing life insurance customers provides the impetus for the FCA to tackle these tax issues. I believe its response to the consultation on the thematic review is a suitable way to progress these long-standing issues and bring them to a conclusion.

First, I believe that the FCA's guidance, included in its thematic review, should be augmented to require firms to ensure that pension policyholders receive a tax-free return. This is what they would expect from the product literature and/or representations from salesmen. This implies that some firms will need to re-calculate policyholders' asset shares to remove a deduction for tax on shareholders' profits re-2005. I believe that such action, covering issue (B), can be incorporated in the FCA's response to the consultation on the thematic review.

Second, the FCA should recognise that charging tax on shareholders' profits to the inherited estate is still a contentious matter, and should consult on a change to its rules to prohibit this. This consultation would need to address the problem of court-approved schemes that have given firms the right to charge tax on this way (see section 5). I believe that the FCA should announce, in its response to the consultation on the thematic review, that the consultation will be going ahead and should specify the date that it will be issued.

In conclusion, I believe that some life insurance companies are paying policyholders less than they should.

This has been a tale of regulatory failure. From the outset when Lautro and SIB failed to address the issue in 1990; to the FSA giving a concession to the industry; and the FCA failing, so far, to carry out the review that the FSA said would be undertaken. The thematic review on fairness for long-standing life insurance policyholders provides the way ahead to tackle the issues.

I believe the FCA needs to get to grips with the issues; policyholders deserve it.

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