

CP11/5: Protecting with-profits policyholders

Royal London's response to the Consultation Paper

About Royal London

Royal London Mutual Insurance Society Limited (Royal London) is the UK's largest mutual life and pensions company, with funds under management of £42.2 billion¹. Founded in 1861, initially as a friendly society, Royal London became a mutual life insurance company in 1908.

Royal London Group businesses serve around 3.1 million customers and employ 2790 people. Royal London has around 1.0 million with-profits customers.

The Royal London Group's specialist businesses provide pensions, protection and investment products. Products are distributed through intermediaries.

Royal London is a founder-member of the Association of Financial Mutuals (AFM). We have contributed to, and support, AFM's submission in response to the FSA's Consultation Paper CP11/5 "Protecting With-Profits Policyholders" (CP11/5).

We set out below Royal London's response to CP11/5.

General Comments on Policyholder Interests

We fundamentally disagree with aspects of the FSA position as outlined in CP11/5. In particular, we have significant concerns about the FSA's approach to "fairness" in paragraphs 2.2-2.6 and 2.10-2.32 of CP11/5 and about the application of proposed changes to COBS 20.2 to mutually-owned long-term insurance funds. The FSA's approach represents a direct challenge to the ongoing viability of the mutual sector, to the ultimate detriment of competition, consumer choice and diversity in the financial services sector

Much of what the FSA says about "fairness" falls outside the questions that consultees have specifically been asked to address. The importance of the FSA's views lies, however, in how rules and guidance currently contained in COBS 20.2 are to be applied in the future and in how the FSA's proposed changes can be expected to apply. It is therefore crucial that those views are challenged, where necessary, in addition to answering the specific consultation questions.

Fair treatment of with-profits policyholders

Royal London wholeheartedly supports the principle that insurers should treat all of their policyholders, including with-profits policyholders, fairly. We believe that the FSA's approach to fairness, as discussed in CP11/5, is fundamentally flawed. Further, we particularly disagree with comments made by the FSA in paragraph 2.22 of CP11/5, which in our view misrepresent the approach adopted by mutuals to the determination of policyholder benefits and interests.

Interests of with-profits policyholders in the with-profits fund

All assets held in the with-profits fund are the property of the insurer. Policyholders do not have a legal or beneficial interest in the assets, or in any part of the assets. This being the case, the FSA's failure to begin its analysis of policyholder interests by acknowledging where ownership of the assets lies is misleading and risks creating policyholder expectations that go far beyond those that can be

¹ All figures quoted in this section are as at 31 December 2010.

justified in law or under established practice. A proper understanding of policyholder interests is central to considerations of "fairness" under COBS 20.2 and it is therefore essential that any description is complete and consistent with the law.

Fair treatment of with-profits policyholders in a mutual

For mutuals, the FSA's views on fairness appear to mean that, once the with-profits fund is no longer selling a material volume of new with-profits business, with-profits policyholders can expect that all surplus will be distributed over time to the then current generation of with-profits policyholders. In such cases, the FSA's analysis continues, the inter-generational transfer of surplus, including the use of the with-profits fund to support the writing of new business, is no longer fair and must stop unless with-profits policyholders' consent is obtained.

As this consent is in most cases unlikely to be forthcoming (see our comments below in relation to this), mutuals in this position would be forced in due course to stop writing all new business and to go into run-off. Ultimately, they may have to be wound up. The FSA's views in this regard are particularly worrying - they threaten the ongoing viability of the life mutual sector and, we believe, do not reflect either the current legal position or established industry practice. We note the following in particular:

- Conflict with directors' duties - Directors of firms must reconcile the FSA's regulatory approach with their common law and statutory duties. For some mutuals, including Royal London, that are subject to the Companies Act 2006 (CA 2006), these duties would include acting in the way that "*would be most likely to promote the success of the company for the benefit of its members as a whole*" (section 172(1) CA 2006).

Meeting this requirement would be particularly difficult for mutuals where, as is the case for Royal London, membership is not confined to with-profits policyholders (and not all with-profits policyholders are necessarily members). For example, when presented with a choice between favouring with-profits and non-profit policyholder members, the FSA's approach to "fairness" would require the interests of the with-profits policyholders to be preferred even though this may put the directors in breach of their CA 2006 obligations (or equivalent common law rules for those mutuals not subject to the CA 2006). This places directors in an impossible position.

We are advised that members are key to the legal ownership of a mutual. How the directors of a mutual should reconcile their conflicting duties to policyholders and members is, therefore, a legal issue of utmost importance that we (and others) have asked the FSA on a number of occasions to address in the context of Project Chrysalis. Prior to concluding its review of the operation of with-profits funds and finalising COBS rule changes, we believe that the FSA needs to provide properly reasoned legal arguments, which deal fully with these conflicts, to support its case for extending the rules in the way it proposes.

- Creation of new interests - The FSA's approach to achieving fairness appears to extend beyond the recognition and protection of the interests of with-profits policyholders to the point of creating new interests. Specifically, the FSA has converted a with-profits policyholder's expectation of participating in any distribution of excess surplus that a mutual decides to make into an expectation that, once the insurer ceases to write material volumes of new with-profits business, a distribution will be made of the entirety of the surplus.

We are advised that the FSA's view is inconsistent with case law in this area establishing that distributions of excess surplus should properly be regarded as (and they are indeed described elsewhere in the FSA Handbook as) "windfall" benefits and not as policyholder entitlements giving rise to an "interest" in assets held in the with-profits fund. It is also relevant that the current generation of with-profits policyholders has not contributed to the surplus, which was primarily built up through caution in the level of distributions to past generations of policyholders. This being the case, we simply do not understand the FSA's determination to ensure that delivery of such benefits to the current generation of with-profits policyholders is so necessary that the undesirable consequences of the FSA's position, namely the probable demise of the mutual insurance sector, should be accepted.

- Same treatment as proprietary policyholders - The FSA justifies its position on the basis of ensuring that with-profits policyholders in a mutual are treated no differently from (and no less

favourably than) with-profits policyholders in a proprietary firm. The reality is, however, that mutual with-profits policyholders will be treated differently if the FSA's position is allowed to prevail. This is the consequence of the FSA's failure to recognise the special characteristics of many mutuals, including the need to write all of their business into a "common fund".

Unlike proprietary firms, the mutual has no other funds (like non-profit and shareholder funds) to provide support for any non-profit business that it writes and to provide the capital to support the entity's ongoing business, which must inevitably have implications for policyholder interests in the common fund. No policyholder in a proprietary firm has any interest or expectation of participation in the surplus assets of the firm which support non-profit business conducted outside the separate with-profits fund or in the ongoing members' capital held outside the long term fund.

- Policyholder expectations - Consistent with the previous paragraph, it is clear that our with-profits policyholders could not reasonably expect all surplus to be distributed to them should the company cease to write new with-profits business. Our Principles and Practices of Financial Management state as follows:

"Royal London expects to remain open to new business. If it is decided that the fund should be closed to new with profits business then appropriate changes to the principles would be notified to policyholders as part of a wide-ranging process. If the fund is closed to new with profits business part of the Estate would need to be retained to write new non participating business. If the fund is closed to all new business one possibility is that the fund would be run off over the future lifetime of the business in force at the date of closure to new business, with an appropriate distribution of the Estate" (see section 2.5).

It is clear from this wording that, should Royal London cease to write new with-profits business, it intends to continue writing new non-profit business. The Estate would be used to support that new business and it would not, therefore, be distributed in its entirety to with-profits policyholders. This does not mean that with-profits policyholders would not benefit from a partial distribution in such circumstances; whether they did would, of course, depend on the extent to which the Estate needed to be retained. The FSA places great emphasis on the need for clear communication by insurers with their with-profits policyholders, a requirement that has clearly been met by Royal London on this point.

- Treating all policyholders fairly - The FSA's approach fails to give proper recognition to the requirement for firms to treat all policyholders (including potential policyholders) fairly and not to favour one class or generation over another. To prefer the interests of with-profits policyholders in the way proposed by the FSA puts insurers in an impossible position as they will be forced to try to reconcile competing regulatory obligations which may not be capable of reconciliation.
- Policyholder consent/ affinity groups – Once a material volume of new with-profits business is no longer being sold or where it is likely that such a position will be reached in due course we believe it is unrealistic for most mutuals that with-profits policyholder consent might be obtained for the continuing use of the with-profits fund to support the writing of new non-profit business - there is little, if any, incentive to policyholders to provide such consent and it seems difficult to imagine the Board of a mutual recommending that with-profits policyholders do so. The only circumstances in which it may be possible to obtain such policyholder consent are, in our view, where a mutual has been established for the purposes of providing services and products to a particular affinity group.

Even if our concerns in this regard are overstated, we believe the policyholder consent mechanism raises certain questions. For example, given that under Royal London's articles of association voting rights are given to members (only approximately half of whom, in Royal London's case, are with-profits policyholders) rather than with-profits policyholders, it is unclear what rights members would have in relation to such a proposal and why it is appropriate that a decision of this nature, which is of a type which in a mutual would historically have been put to the members (as has been the case, for example, with votes on demutualisation proposals), should instead be dependent on a decision of with-profits policyholders.

FSA's rule-making powers – The scope of the FSA's rule-making powers is established by section 138 FSMA. We are advised that it is highly questionable whether, as a legal matter, the FSA is able to exercise those very general and non-specific rule-making powers in such a way as to interfere with the private law rights held by members of a mutual in their capacity as members.

The “similar interest” requirement

We note that the FSA accepts that intergenerational transfers are an “intrinsic part” of the operation of with-profits funds. However it is not clear from the wording of paragraph 2.18 (nor indeed from the draft rules) what is meant by the phrase “transfer should occur between generations of with-profits policyholders with *similar interests*”.

The suggestion in 2.18 that an inter-generational transfer should only take place between policyholders with similar interests appears to have no foundation in existing rules or historic practice and, if it is applied too narrowly, will unduly stifle the natural progression of participating products. While we have no doubt that the terms for inter-generational transfer should be fair, we have concerns in this regard over the potential interpretation of the word “similar”. It is clear from any analysis of the historical development of with-profits funds that the interests of successive generations of policyholders have evolved over time and could not have been categorised at all times as “similar”.

Attempting to impose too narrow a “similar interests” test would stifle the development of with-profits business to meet the changing demands of the market and would not be in the interests of consumers. For example, we assume that the application of the “similar interests” test in the past would not have prevented the natural and logical progression from conventional with-profits to unitised with-profits policies? Likewise, the characteristics of Deposit Administration are very different from those of a “traditional” with-profits product, but they are both viewed under the current rules as with-profits.

Other General Comments

The focus of regulatory intervention

Throughout the dialogue with FSA on with-profit policyholder protection we have had concerns about the specific behaviours or conflicts of interest that the Regulator is trying to prevent. A careful reading of the Cost Benefit analysis (Annex 2) highlights the issues that FSA is trying to address in the tightening up of the rules around with profits policyholder protection. Frequent reference is made to the AXA and Aviva reattribution exercises and the benefits that accrue from limiting such exercises in future. Indeed paragraphs 78 to 81 contain estimates of the transfer of value from policyholder funds to shareholders during these reattribution exercises.

In the same Annex paragraph 10 makes reference to the Treasury Committee report of the “conflicts of interest on the part of the management of life funds by proprietary companies leading to concern among some holders of with profits policies that their interests have not been adequately served”.

Royal London has been engaged with FSA in the debate over with profits governance over a number of years, latterly as part of the group of companies sponsoring Project Chrysalis. This Chrysalis debate and paragraphs 2.10 to 2.32 focus on the ultimate ownership of the assets of the with profits fund within a mutual. It has not centred around firms seeking market share by writing loss-leading new business; nor has the debate focussed on the fairness of firms boosting returns to shareholders through re-attributions of the estate which are loaded against the interests of policyholders.

Royal London continues to hold the opinion that the rules as currently drafted try to address some specific concerns that have arisen in the past with some very general rules that apply regardless of the ownership and governance structure of the firm. These general rules have some potentially undesirable consequences for mutual businesses trying to balance the interests of with-profits policyholders with the interests of other stakeholders.

With-profit committees

In a mutual, the issues to be addressed by any with-profits committee that is created are almost exactly the same as the issues considered by the Board. There is therefore enormous scope for duplication and overlap in this governance structure. The FSA should reconsider the necessity of a with-profit committee in mutual organisations, and the required scope of its terms of reference, and not attempt to impose a “one size fits all” solution on firms with widely differing governance requirements.

Answers to the specific questions

Q1: Do you agree with the proposal to include guidance setting out our view of some of the interests of policyholders in with-profits funds?

Guidance on policyholders' interests in the with-profits fund is only appropriate if it provides a complete explanation of the position, consistent with law. As stated above, the FSA's description of policyholder interests in the with-profits fund in paragraphs 2.2-2.6, which it aims to carry over into the guidance, fails to recognise that assets held in the with-profits fund are the property of the insurer. This is despite the fact that ownership of the assets is of fundamental importance to determining policyholder interests in the fund and that the legal position is, as far as we are aware, generally agreed.

Guidance in the terms currently proposed by the FSA risks misleading future users of the FSA Handbook into thinking that it is an authoritative and complete statement of the nature of policyholders' interests, so that they overlook the fact that assets in the with-profits funds belong to the insurer. Absent text that reflects the interest of insurers in assets representing the with-profits fund more accurately and completely, COBS 20.2 should remain silent on this issue.

Finally, we assume that the phrase "(including but not limited to the amounts required to satisfy their reasonable expectations)" in COBS 20.2.1(3) is merely intended to reflect the application of the TCF concept to a broader range of issues than have historically been reflected in "PRE". If this is not the case, the position should be made clearer in the guidance and an explanation provided.

Q2: Do you agree with our proposal to convert elements of COBS 20.2.1G into mandatory requirements in a rule and to clarify the types of conflicts that may arise?

We believe that Principle 6 and the existing guidance in COBS 20.2.1G are more than adequate in determining a firm's responsibilities in dealing with conflicts of interest and the introduction of COBS 20.2.1A is not necessary or helpful. Otherwise, the FSA's proposed change raises a number of concerns.

First, the proposed new rule in COBS 20.2.1AR requires a firm's management to give particular consideration to the interests of with-profits policyholders, but makes no mention of the interests of other policyholders. Whilst this can be explained by the fact that COBS 20.2 is solely concerned with safeguarding the position of with-profits policyholders, singling out with-profits policyholders in this way might be taken as suggesting that conflicts must always be resolved in favour of the with-profits policyholders (we note paragraph 1.7 of CP11/5 which suggests that this is the FSA's intention). This cannot be right, given that the need for firms to treat customers fairly is not selective and therefore applies to all policyholders; it necessarily follows that sometimes it will be appropriate to settle conflicts in a manner which is to the detriment of with-profits policyholders.

As stated in our General Comments above, a regulatory obligation to place the interests of current with-profits policyholders above the interests of all other policyholders and potential policyholders and above the interests of members risks putting directors in an impossible situation if they are unable to reconcile meeting their regulatory obligations with their common law and statutory duties.

The proposed language in COBS 20.2.1AR refers to there being no "*undisclosed, or otherwise unfair, benefit*". This suggests the FSA now takes the view that undisclosed benefits are automatically unfair, which we do not believe to be right.

Q3: Do you agree with our proposed approach to the use of COBS 20.2.17R and to the clarifying amendments to the definition of 'required percentage' that we propose to make? Do you consider the guidance that we propose to make in this area to be adequate and clear?

We disagree with many of the arguments put forward in paragraphs 2.10-2.32, as set out in the "General Comments" section of this response.

We do not accept that the concept of the 'required percentage' is a relevant or useful one for mutuals. In mutual organisations, explicit distributions in the form of bonuses have historically been on a 100/0

basis since the prevalence within mutuals of traditional with-profits policies has meant that there has been nowhere to distribute surplus to, other than to with-profits policyholders.

However the evolving nature of mutuals and the change in the amounts of capital that various classes of policyholder contribute to the mutual means that historic practice may not be appropriate or fair. It may well be that it is appropriate in the future to recognise non-profit members' interests by making a distribution to them. We strongly believe that the rules around distributions should not be framed, as the current proposals are, in a manner which prevents the fair treatment of all policyholders.

The default 90:10 split which is effectively being embedded in the rules is derived from historic practice in the shareholder-owned sector. The 90:10 split was effectively given formal status by the 1995 Ministerial Statement on "Orphan Estates" but this was introduced to moderate excessive re-attributions in favour of shareholders by shareholder-owned companies. The former Minister has confirmed to us that the statement was not intended to apply to the management of mutuals, nor was it intended to create a baseline by which to judge the fairness or otherwise of distributions by mutuals.

Q4: Do you agree with our proposal to strengthen our rule and guidance on the terms of new business written into a with-profits fund?

We support the principle that one set of policyholders should not suffer unfair detriment in order to support volumes of new business. However, we do have concerns about whether the proposed changes to COBS 20.2.28, including the introduction of COBS 20.2.28A, are necessary or appropriate.

In particular, we believe that the "no adverse effect" test that it is proposed should be introduced into COBS 20.2.28(1) is unnecessarily onerous and that the current materiality threshold should be retained. First, the proposed rule disregards the fact that there may be circumstances in which loss-leading business is justified, albeit perhaps only in the short-term, in which case with-profits firms should be equally able as other firms to take advantage of opportunities.

Second, the meaning of the phrase "no adverse effect on with-profits policyholders' interests" is not clear, in particular as it purports to cover both current and potential with-profits policyholders. Demonstrating that a test written in such absolute, but uncertain, terms has been satisfied would be extremely difficult and we doubt whether an external professional adviser would be happy to advise a Board of Directors without any qualification that it has been met.

Finally on the "no adverse effect" test we note that, absent COBS 20.2.28A, it may have been arguable that the introduction of the "no adverse effect" rule would always mean that new business failed the test in COBS 20.2.28 merely because it would have the effect of deferring distributions to the current with-profits policyholders which would otherwise have taken place from excess surplus. We therefore welcome COBS 20.2.28A, which makes it clear that this is not the intention of the new requirement. If our understanding is incorrect on this point, we would welcome clarification in any feedback.

The drafting of COBS 20.2.28 should also be clarified or amended in the following respects:

- A requirement for "all" appropriate analysis to be obtained creates a very onerous obligation, which may be difficult for any firm to satisfy (and for the FSA to enforce). The word "all" should be deleted as the requirement for the Board to be satisfied "so far as it reasonably can be" should be sufficient by itself to achieve the FSA's purpose.
- Clarification of the concept of "loss leading business", which is effectively prohibited by the proposed COBS 20.2.30G, would be helpful.

Q5: Do you agree with our proposal that a firm should discuss with us what actions may be required to ensure the fair treatment of with-profits policyholders if it experiences sustained and significant falls in the volume of new business?

Yes. In the case of *sustained* and *significant* falls in the volume of new with-profits business, we agree that it would be appropriate to discuss action plans with the regulatory authorities. However, where a firm continues to write a material volume of new with-profits business despite such a fall, we note from

proposed COBS 20.2.41BG(2) that there would be no question of the firm being taken to have ceased to write new contracts of insurance for the purposes of COBS 20.2.54R(3).

However, as described in our General Comments above, we have considerable concerns about the FSA's approach to "fairness" in circumstances where a firm experiences declining levels of with-profits business and, it follows, with the application of the proposed rule changes. In particular, insurers that find themselves in discussions with the FSA over declining levels of with-profits business will, in our view, find it difficult (at least after a short time) to demonstrate that expected future profits on any non-profit business that continues to be written will become available for distribution during the lifetime of the with-profits business. It seems unlikely, therefore, that firms in this position will continue to be able to write non-profit business in the fund.

As regards the drafting of this provision, it is unclear what timeframe constitutes a "sustained" period. We would expect to be able to take corrective action to recover business volume before involving the regulatory authorities in discussions on the distribution of surpluses, which could take some considerable time. The meaning of "significant" in this context is also unclear; nor is a starting point specified for the assessment of whether the fall is significant or sustained. We assume that the starting point should be when the rules come into force.

As drafted, the guidance at COBS 20.2.41BG indicates that a firm might be treated as having ceased writing new business if it is not writing a material volume of non-profit business in the with-profits fund (seemingly even if significant volumes of new with-profits business are being written into the fund). The rule at COBS 20.2.41AR uses the same formulation. We assume this is not the intention and that a change will be made.

Q6: Do you agree with our proposal to require firms to have fair distribution plans appropriate to their reasonable/sustainable new business projections?

We believe that a distribution plan is part of the proper management of a mutual firm, but that it is only required where a firm has identified or anticipates an excess surplus.

Furthermore, where distribution plans do exist they need to be flexible enough to deal with future regulatory uncertainty, such as that caused by Solvency II, and the content should not be prescribed in regulation.

Q7: Do you agree with our proposal that firms prepare, maintain and update a management plan containing contingency arrangements in the event they experience sustained and significant falls in new business volumes?

We believe that it is prudent to maintain contingency plans for foreseeable eventualities and this includes sustained and significant falls in new business volumes. However, we do not believe that it should be a regulatory requirement.

Q8: Do you agree that the with-profits funds that closed to new business before the current rules came into effect in 2005 should have run-off plans?

Yes, although we would expect that the precise content of such run-off plans, particularly those resulting from Court Schemes, could be less rigid than those in respect of funds closing after the 2005 regime came into effect.

Q9: Do you agree with our proposal to change the rule so that an MVR can be applied only where there could otherwise be a payment in excess of the value of the assets underlying the policy?

Yes, we agree with the main thrust of the argument being put forward here. However, on a practical note there is often a degree of smoothing involved in setting MVRs – in the same way there is for setting Final Bonus rates. We do not think it would be appropriate to judge a firm guilty of breaching this rule where it had set MVRs as described and a sudden upturn in market values led to payouts below asset share. Provided that MVRs are set according to this rule and monitored at appropriate intervals this should be sufficient to evidence compliance.

Q10: Do you agree with our proposal to clarify our rule relating to MVRs and distribution ratios?

Yes.

Q11: Do you agree with our proposal that the existing guidance on strategic investments should be strengthened into a rule and that the guidance formerly in COB 6.12.86G (amended to take account of the new rule) should be restored?

No, we are not persuaded that this needs to be strengthened into a rule. However, it is appropriate that strategic investments when entered into should have no expected long-term adverse impact on the interests of policyholders. The wider fiduciary duties of the Board should be sufficient in light of the guidance. In many cases strategic investments are by their nature long term and illiquid so any disposal plans need to recognise this feature.

Q12: Do you agree with our proposal to amend COBS 20.2.23R to prevent value being extracted from a with-profits fund by other group companies making charges in excess of their costs?

We do not agree with this proposal as drafted.

We believe that such a rule will act to prevent potential transfers of with-profits funds as part of any future industry M&A. An acquiring firm would only be interested in taking on an additional with-profits fund if there was the potential for profit. This rule would largely deny such profits in the case of 100/0 funds. This would seem perverse if the terms of such a transfer had been judged fair by both firms involved, as well as by the relevant with-profits actuaries and by an independent expert, and then approved through a court (or the equivalent Friendly Society Act) process. We consider that there are already ample safeguards in place with regards to fund transfers and therefore any rule of this nature should be disappplied in the context of transfers of business.

More generally, "costs" is too ill-defined a concept to apply within such a rule. In-house service and investment management companies might well be taking on expense or other operational risk which would otherwise fall on the fund. For the management company to make a profit from such a services contract may be no more than providing an adequate return for the risk incurred. Such companies may be exploiting economies of scale within the broader group that would not be available to the fund in isolation; again, it is not necessarily reasonable for the whole of the benefit of such economies of scale to accrue to the with-profits fund.

Whilst it is appropriate to ensure profits for shareholder are not disproportionate, we consider that limiting charges to a with-profits fund to costs is too crude an approach and that any rule in this area should be drafted in a way which allows for the fairness of specific cases to be considered on their individual merits. When such group arrangements exist, it would be better to proceed by way of the approach of benchmarking against third party charges in order to limit profit margins to reasonable levels.

Q13: Do you agree with our proposal to remove the ability of firms to reattribute excess surplus?

No. In a mutual, reattribution between policyholders and shareholders is not relevant. Moreover, we are concerned that this proposal could adversely impact on the establishment of a Mutual Capital Fund as suggested in the Chrysalis discussions and referenced at 2.20. We would appreciate confirmation in the amended rules that this is not the intention.

Q14: Do you agree that a firm that proposes a reattribution should, prior to that proposal, be required to pay particular attention to identifying and distributing excess surplus?

No. As for Q13 we do not see any need to differentiate between surplus and excess surplus in the context of a mutual. The ultimate beneficiaries in either case are policyholders – a reattribution in the mutual context is purely a mechanism for allocating surplus to different generations/types of

policyholder, rather than between shareholders and policyholders which is what the majority of this section is concerned with. We are concerned that the proposals may hinder the legitimate creation of a Mutual Capital Fund or increase still further the barriers to the creation of such a fund.

Q15: Do you agree that the policyholder advocate should have control over the content of communications provided by the policyholder advocate for policyholders?

Yes, provided the policyholder advocate is acting reasonably. However firms should be accorded sufficient notice to correct any factual errors, to challenge the reasonableness of what the Advocate wishes to communicate and to prepare responses for anticipated policyholder queries. Where the sides cannot agree on the content of communications sent to policyholders the Independent Actuary should assume the role of arbitrator.

Q16: Do you agree that it would be unfair for a firm proposing a reattribution to seek to bind the minority, against their wishes, by means of the reattribution scheme?

Not necessarily – we believe there must be a level at which you bind a small minority, in order to avoid potentially disproportionate administrative burden.

Q17: Do you agree that a with-profits committee should be required for all with-profits funds except small funds, and that the threshold suggested is the right one?

Royal London chose to go the “independent person” route and over a period of almost 10 years of considerable change in the industry and turmoil in the markets has found this to be an efficient and effective means of governance alongside the With-Profits Actuary.

We strongly believe that all mutuals, whatever their size, should be able to continue with an Independent Person, should they so wish. The establishment of a with-profits committee by Royal London would, in our view, merely serve to increase the company's costs, for no obvious improvement in governance and perhaps even deterioration.

In a mutual, because of their particular structure, the issues that the FSA believe a with-profits committee should consider (as listed at 3.23) are almost identical to those that would be considered by the Board. The only real difference between the remit of the two bodies would be that the Board would be required to act in the interests of all members and policyholders; whereas the with-profits committee would be solely concerned with the interests of with-profits policyholders. The overlap could easily lead to delay and inefficiency rather than adding to the governance structure. We would add that, in the case of a closed with-profit fund the degree of overlap could be even more pronounced if the closed fund was established to operate with a supervisory committee, as numerous such funds are when established by means of a Part VII transfer, and then is required to supplement this governance with a with-profits committee in addition to the Board.

If the FSA chooses to require that a with-profit committee be established for mutuals, we believe the Terms of Reference for a with-profit committee in a mutual should be capable of variation from the issues listed in 3.23 in order to minimise unnecessary and potentially damaging overlap, provided that does not compromise the governance surrounding the with-profit business.

Q18: Do you agree that the members of a with-profits committee should be independent and completely external to the firm whose with-profits fund(s) they are considering?

No, the lack of at least some internal input is likely to lead to inefficiency and delay.

In a mutual a committee of external appointees would in effect be a shadow Board, giving rise to significant duplication of effort, to the detriment of members and policyholders.

We challenge the basis for the estimates in the CBA (Annex 2 paragraph 92) of £3.2m a year for a wholly independent committee (£2.3m a year for a majority independent committee). A key element of the cost of the committee is the availability of suitably qualified people. An expansion of with-profits committees on an industry-wide basis would increase the fees for committee members.

Q19: Alternatively, should we continue to allow directors and non-executive members of the governing body to sit on the with-profits committee, subject to its having an independent majority?

Notwithstanding our answer to Q.17, if it is decided to make a with-profits committee compulsory for all funds (subject to size) we would have a very strong preference for the presence of executive directors and non-executive directors to complement an independent majority on the with-profits committee. A balanced committee with internal members would have far greater insight and understanding of the firm than a committee made up wholly of independent members. It would also reduce the potential for conflict.

Q20: Do you agree with defining independence using the same criteria for independence as the Financial Reporting Council's current Code?

This seems appropriate.

Q21: Do you agree with the proposal to have terms of reference published on the firm's website?

Yes.

Q22: Do you agree that the conclusions of the with-profits committee and the governing body's decisions to accept or to reject those conclusions must be clearly recorded?

Yes, although as indicated above, we do not accept that it is beneficial to require a with profits committee in a mutual, given the potential overlaps of responsibilities with the Board.

Q23: Do you agree that with-profits committees should have the right to make a reasonable request to obtain external advice and in shareholder-owned firms request that this is at the shareholders expense?

Yes, we agree with the proposal as the with-profits committee should have the right to obtain external advice and to request (but not require – it would be a matter for discussion and agreement having regard to the Board's duties and the particular circumstances) that the advice is obtained at the shareholders' expense, in particular where a firm is looking to do something that may be more for the benefit of shareholders than policyholders.

We hope that the circumstances where such a request would be necessary would be limited as we believe that any responsible Board would make legal advice which the Board has already obtained available to the with-profits committee, and that such advice should generally consider the particular proposal from all relevant perspectives, not just that of shareholders.

Q24: Are these the right areas for a with-profits committee to consider and on which to provide advice?

Yes, although see answer to Q17.

Q25: Do you agree that the with-profits committee should be able to raise issues proactively that it thinks the governing body needs to consider?

Yes, although see answer to Q17.

Q26: Can with-profits committees or other independent persons as described operate effectively alongside the with-profits actuary?

Yes, we have considerable experience of the independent person working efficiently with the with profits actuary.

We fail to see the purpose or the merits of the additional requirement (at 20.5.3(2)) for the with-profits committee to have regard to "issues which a knowledgeable with-profits policyholder might reasonably

expect". With-profits committees must operate with regard to the interest of all with-profits policyholders and this requirement could easily act to undermine and conflict with the role of the with-profits actuary. Without a definition of a "knowledgeable with-profits policyholder", it is in any case unclear how this rule should be applied.

Q27: Is it right to introduce a notification mechanism for alerting the regulator to significant issues where there has been disagreement?

Yes, it is appropriate to have a notification mechanism in place whether governance is provided by a committee or an independent person.

Q28: Do the proposed changes for the with-profits actuary provide sufficient support for his independence and how practical is the arrangement for setting his remuneration?

We are not sure we understand the second sentence of 3.26 'not reporting to...'. It is clearly desirable for the With-Profits Actuary's remuneration to be determined in a way that does not give rise to a conflict of interest and this seems perfectly possible to achieve. It is not clear how appraisal of the WPA's performance by the WPC supports the WPA's independence.

Q29: Are there any other matters that you think are relevant to this consultation?

Yes, we have very serious concerns about the implication of these proposals on mutuals. These are covered in the "General Comments" section.

Q30: Do you think that the CBA has identified the relevant costs and benefits and that the costs have been appropriately estimated?

No. The CBA indicates that the costs in respect of the fair treatment of policyholders in mutuals will be minimal. However, our view is that many of the proposals endanger the very existence of mutuals – with significant costs to the companies concerned and material detriment to the industry as a whole from the loss of a diversified insurance market.

We believe that the establishment and maintenance of a with-profits committee for a mutual would involve significant cost for almost no benefit. The indicative figures in the CP of £175k pa seem unrealistically light given that virtually everything that a mutual does has a with-profits impact so it is likely that more than 4 meetings per year would be required. The recruitment process is likely to involve significant additional up-front costs and additional spend as and when a member stands down.

Finally, we note that the Compatibility Statement completely fails to address the adverse impact on competition which would result if the consequence of the FSA's proposals were the demise of the mutual sector.