



With-profits business

Principles and Practices of Financial Management



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Introduction

The Financial Services Authority (FSA) launched a review of with-profits business in 2001. Afterwards, it announced certain measures to improve the governance and transparency of with-profits.

Among the changes, insurers will have to be more open about how much discretion they hold over with-profits funds and will be more accountable for how that discretion is exercised. They must publish a set of guidelines called Principles and Practices of Financial Management (PPFM) that describe how they manage their with-profits funds. They must also put in place arrangements to check that PPFM are applied. These arrangements could include the appointment of a with-profits committee. Finally, insurers will need to report annually on whether they have complied with PPFM.

This guide looks at the FSA's requirements, focusing on the relationship between PPFM and the need to treat customers fairly and on the likely consequences for insurers that act in breach of PPFM. It also questions whether discretion can continue to play a real part in with-profits once the new rules take effect. Finally, the guide highlights the need to review PPFM from a legal perspective, as well as ensuring that the guidelines pass actuarial scrutiny.

Background

In strengthening governance arrangements for with-profits business, the FSA had the following aims.

- More information should be available about how much discretion insurers hold over with-profits funds and how that discretion will be exercised.
- Improvements should be made in how the interests of policyholders are taken into account in managing with-profits funds.
- Clearer mechanisms should establish that, in exercising discretion, directors have balanced competing interests and fulfilled their responsibility to treat customers fairly.

In January 2003, the FSA put out various proposals for consultation.

- Transparency – insurers must publish guidelines describing how they manage their with-profits funds (PPFM).
- Governance – insurers must put in place arrangements (eg a with-profits committee) to monitor whether with-profits funds are run in accordance with PPFM. The company would have to report annually on how it had complied with this obligation, including how it had dealt with the various rights and interests of policyholders.
- Actuarial function – the role of the appointed actuary would be divided in two. The ‘with-profits actuary’ would advise the board on the use of discretion in the with-profits business.
- Annual returns – there would be a more streamlined approach to certification of annual returns. Directors would be required to certify, where relevant, that a life company had complied with its PPFM.

The FSA later confirmed that it would adopt these changes. Also, the with-profits actuary would be required to report annually to policyholders on insurers’ compliance with PPFM. Most of the amendments that needed to be made to the FSA Handbook of Rules and Guidance (Handbook) to implement these proposals have already been made or are expected shortly. More recently, though, the FSA issued a consultation paper (CP207), suggesting new requirements to protect with-profits customers from unfair treatment. Some of these proposals will mean changing the current rules and guidance on PPFM.

PPFM in more detail

An insurer's PPFM should describe how its with-profits funds are managed. In particular, they should explain how much discretion the directors hold and how they will apply that discretion. The FSA has said that PPFM should provide 'a clear and objective set of guidelines as to how the insurer conducts its business and how it addresses the differing interests of different groups and generations of policyholders'.

Principles and practices

The 'principles' element of PPFM will describe the long-term aims and guidelines of the with-profits fund. The current application of those principles will make up the 'practices' element.

So, principles must:

- be enduring statements of the overarching standards adopted by the insurer in managing its with-profits funds; and
- describe the business model used by the insurer in meeting its duties to with-profits policyholders and in responding to longer-term changes in the business and economic environment.

FSA guidance establishes that principles should contain enough information for directors, any actuary appointed by the insurer and any with-profits committee, among others, to decide whether existing or potential with-profits practices are appropriate.

Practices must:

- describe the insurer's approach to managing its with-profits funds and how it will respond to changes in the business and economic environment in the short term; and
- contain enough detail for a 'knowledgeable observer' to understand the material risks and rewards in taking out or maintaining a with-profits policy with the insurer.

Practices, unlike principles, are expected to change over time.

Content of PPFM

Despite early indications that PPFM should be directed at policyholders, it is clear that the final guidelines will be long and detailed and not, therefore, particularly suitable for individual consumers (CP207 contains the FSA's proposals for a consumer-friendly version). So, an insurer's PPFM must cover 'any issue that has, or it is reasonably foreseeable may have, a significant impact on the firm's management of with-profits funds', including:

- amounts payable under a with-profits policy, including the insurer's approach to setting bonus rates and smoothing – under proposals

contained in CP207, insurers will need to specify target ranges as a percentage of asset share for policy payouts and smoothing;

- investment strategy;
- the exposure of the with-profits business to business risks;
- charges and expenses;
- management and use of any inherited estate;
- volumes of new business and arrangements on stopping taking new business; and
- achieving a balance between the interests of with-profits policyholders and any shareholders.

Rules and guidance establish what PPFM should cover in each case and how to divide information between principles and practices. PPFM should also cover any other areas that are significant to how an insurer manages its with-profits funds and that may affect amounts payable to policyholders.

Finally, insurers with more than one with-profits sub-fund must consider whether they need separate PPFM for each.

Publication of PPFM

In consultation the FSA stressed the importance of making PPFM available to policyholders, their advisers and market commentators. However, accepting that PPFM would be too long and detailed for most policyholders to understand, it dropped its proposal that all new policyholders should receive a copy of the guidelines with their policy documents. In CP207, the FSA describes its proposals for the 'consumer-friendly delivery' of PPFM instead. Insurers will be required to:

- extract key information from their PPFM;
- present it in clear and plain language; and
- provide the information on request by potential or existing with-profits policyholders free of charge.

The FSA will also advise insurers on how they might signpost the availability of information, including in annual statements, and suggest that it is published, together with full PPFM, on their websites. Current guidance on how to advertise the availability of full PPFM will be replaced by this new guidance.

Changes to PPFM

Principles are expected to be enduring and should not change often. Importantly, an insurer must give three months' written notice of any proposed change. However, the FSA expects an insurer to vary

its practices every few years or so. In this case, written notice must be given to policyholders, either before or after changes take effect.

CP207 contains further proposals restricting an insurer's ability to change its PPFM unless justified by the need to:

- respond to changes in the business or economic environment;
- protect the interests of policyholders; or
- change the practices element of the guidelines in order to meet the principles element.

Territorial scope

All insurers authorised by the FSA will fall within the new rules. EEA insurers that carry on insurance business in the UK under the insurance passport will also be caught, subject to limitations in the insurance directives. This extension of the rules is unlikely to be important as there is little, if any, passporting of with-profits business into the UK.

Compliance and certification

Insurers must establish controls to ensure that they comply with, maintain and record PPFM. They must also report annually to policyholders on how they have met their obligations. In particular, the report must show how competing or conflicting rights, interests or expectations of policyholders and, if relevant, shareholders have been addressed. It must also describe how the insurer has exercised, or failed to exercise, its discretionary powers.

Insurers will have to send the FSA a copy of their annual report to with-profits policyholders. By doing this, the FSA aims to make sure that reports get into the public domain. Although addressed to policyholders, insurers will not need to send copies to them. It will be up to each company to choose how to make the report available. Options include providing copies on request, publishing the report on websites and including it in annual financial statements.

Finally, directors will have to certify each year (as part of the directors' certificate in the annual regulatory return) that the with-profits business has been run according to PPFM.

Timing

Insurers must publish their PPFM by the end of March 2004. Changes to governance arrangements must be made by the same date. First annual reports to with-profits policyholders will need to be prepared for financial years ending on or after the date the Integrated Prudential Sourcebook takes effect for life insurers. This is expected to be summer 2004. However, first annual reports need only cover the period from 31 March 2004.

Most of the changes proposed by CP207 do not come into effect until the end of March 2005 because the FSA envisages that insurers will need to amend PPFM to meet the new requirements. However, proposals for the consumer-friendly delivery of PPFM are expected to apply from 30 November 2004.

A governance or policyholder document?

It was initially assumed that an insurer's PPFM would aim to describe for policyholders how its with-profits policies worked and the risks and rewards associated with such an investment. To do this, the guidelines would need to contain relatively general levels of disclosure expressed in simple language.

However, the FSA was attracted to the part that PPFM could play in improving senior management accountability. It therefore established rules requiring insurers to produce a set of guidelines that are likely to be too long and detailed to be read and understood by policyholders. In doing so, the FSA may inadvertently have made it difficult for insurers to hold on to the discretion that characterises with-profits business and that is needed to operate with-profits funds efficiently.

First, life companies will make sure that PPFM are drafted so that directors can confirm compliance without fear of being challenged. Almost inevitably this means accepting restrictions on their discretionary powers. The more discretion directors can exercise the more exposed they are likely to be, especially once the benefit of hindsight comes into play. Similarly, the introduction of target-setting into with-profits may make senior management more reluctant to hold wide discretionary powers, the use of which can be challenged if targets are not met.

The emphasis placed by the FSA on the link between 'realistic reporting' and PPFM also underlines the importance of PPFM to insurers' governance arrangements. Key to the calculation by an insurer of its realistic liabilities is the ability to vary bonus payments. So, the more discretion retained by directors over with-profits funds, the more flexibility there will be in the calculation of realistic liabilities and the more vulnerable directors are to later questions about reserving levels. Taking discretion out of PPFM will reduce the chances of getting the calculation wrong.

Finally, the FSA has recently published proposals for the consumer-friendly delivery of PPFM. To meet those requirements, insurers will almost certainly look to simplify the description of their business in PPFM. Again, this is likely to result in limits on discretion.

Drafting issues

Considerations affecting how PPFM are drafted include the following.

FSA Handbook

PPFM should usually satisfy both the FSA's rules and guidance. Breach of a rule will expose an insurer to regulatory action. The position on guidance is more difficult. Although guidance does not have the force of a rule, it tends to act as a benchmark against which best practice will be judged. In practice, therefore, it is difficult to ignore FSA guidance without a very good reason. Insurers must also be wary of assuming that following the guidance is enough to satisfy the rules.

Treating customers fairly

The FSA's Principles for Businesses include requirements that firms pay due regard to the interests of customers and treat them fairly. These requirements are fundamental to the new PPFM regime and insurers will need to ensure that PPFM reflect the FSA's views on the fair treatment of policyholders. PPFM will also go a long way, together with other documentation issued by an insurer, towards determining what is fair for policyholders of that company once its contractual obligations have been met. So, deviations from PPFM inevitably risk being regarded as 'unfair'.

Guidance on the requirements of fairness in with-profits can be obtained from a number of sources, including:

- previous FSA discussion papers, notably its papers on discretion and fairness in with-profits policies issued as part of the with-profits review and on treating customers fairly after the point of sale;
- unfair contract terms legislation;
- policyholders' reasonable expectations (PRE) – although satisfying PRE is no longer a specific legislative or regulatory requirement, it will form an essential element of the FSA's assessment of fairness; and
- CP207 – the FSA argues that its proposals reflect current good practice in with-profits.

Flexibility

PPFM must be flexible enough for insurers to manage their with-profits funds efficiently and in the best interests of policyholders. However, it is clear that requirements of fairness dictate that insurers must not reserve unqualified discretion to themselves. Otherwise, PPFM must not be 'bland' and must contain sufficient detail to enable a knowledgeable observer to understand the possible risks and rewards of taking out a with-profits policy with that

insurer. The line between acceptable and unacceptable levels of disclosure will be difficult to draw in practice.

In theory, both principles and practices may be changed, subject to proposals contained in CP207. However, the characterisation of guidelines as one or the other will carry certain consequences with it, both in terms of policyholder expectations about how the fund will be operated and in terms of the formalities of change. Either way, an insurer wishing to amend its PPFM will need to check carefully that any changes are consistent with requirements of fairness including, in particular, PRE. In practice, an insurer is likely to need to carry out active and routine reviews of PPFM to make sure that the guidelines still reflect the company's activities and other company literature. Failure to do so will inevitably mean that companies store up problems for the future.

Finally, it is clear that silence is not a satisfactory method of preserving flexibility. An insurer that says nothing probably exposes itself to regulatory intervention if a chosen course of action allowed by its PPFM turns out to be less beneficial to policyholders than an alternative permitted course. The FSA might argue (again with the benefit of hindsight) that the company must compensate its policyholders for having failed to take the better option. A similar outcome is possible if the insurer uses overly cautious wording eg stating that in certain given scenarios it will 'seek to optimise' the position for policyholders.

Commercial sensitivity

If an insurer includes detailed information about its investment strategy in its PPFM, the market may use this information to the detriment of policyholders. Insurers will need to find a balance between providing enough information to satisfy FSA requirements and not allowing the market to anticipate patterns of investment activity and even force insurers into investment changes. Otherwise, concern has been expressed about whether the publication of detailed information in PPFM may facilitate selection against the fund.

Contractual terms and past statements

PPFM must reflect an insurer's contractual obligations, including terms implied into policies during pre-contractual negotiations. PPFM should also reflect non-contractual statements made about the management of with-profits funds. The FSA has noted that PPFM should not change policyholder expectations, but should reflect existing expectations.

Consequences of PPFM

As to what consequences will follow on from a failure to abide by, and act consistently with, PPFM, there are likely to be two key aspects. Both are centred upon questions of fairness. This is because an insurer's PPFM, together with other documentation it issues, will go a long way towards determining whether a particular course of conduct is fair to policyholders once any contractual obligations have been met.

First, if an insurer does not apply the guidelines set out in its PPFM, it is likely to be regarded by the FSA as acting in breach of its regulatory obligations. It will therefore be liable to be fined and censured accordingly. The reputational damage associated with such a decision could be severe. The insurer may also be liable for compensation to policyholders that it has not treated fairly as a result of the breach and the FSA is likely to seek to achieve compensation for such policyholders at the same time.

Second, in cases that do not go so far as regulatory intervention, policyholders will rely on any communications they have had with their insurer and on PPFM when making a complaint to the Financial Ombudsman Service (FOS). Even if they do not refer to PPFM, the FOS will look at the guidelines to decide what is, in their opinion, fair and reasonable in all the circumstances of the case.

Of course, if the FOS decides a case in favour of the policyholder in this type of situation, it raises further questions about how many policyholders have been treated in a similar way. At his recent appearance before the Treasury Select Committee John Tiner, chief executive of the FSA, referred to a need to look at the relationship between the FSA and the FOS when it comes to dealing with issues that have implications beyond the individual case being decided by the FOS. PPFM are an obvious area for consideration in this regard.

Whatever the outcome of the joint FSA/FOS consultation, it is clear that PPFM have the potential to cause great difficulty for insurers both in the enforcement context and in the context of claims and compensation. It is essential, therefore, that PPFM are reviewed not only by actuaries but also by firms' in-house or external counsel from the viewpoint of different categories of policyholders. This is to ensure that, upon issue, PPFM are consistent with current practice and will not cause immediate difficulties. That is achievable with a document being issued for the first time. What is more difficult, and therefore more important, is to ensure that PPFM are reviewed regularly and in the same way, and to check that they remain consistent with current practice and that the practices within them are amended as necessary, in advance of changes that affect policyholders.

Conclusion

The FSA believes that consumers must take responsibility for their own financial affairs. To do so, however, they must be properly informed. New requirements on PPFM are intended to help consumers make better choices.

Only time will tell whether the regulator has been successful in this respect. However, a number of issues remain about how PPFM should be drafted and how much real value they will provide, even with the FSA's proposals for consumer-friendly delivery.

From a commercial perspective, insurers must protect their ability to conduct their businesses efficiently and in the best interests of policyholders. This could often best be achieved by maximising how much flexibility companies have over the use of with-profits funds. However, as has been shown above, it is likely that the new requirements will lead instead to a significant reduction in the role of discretion in with-profits.

An insurer must look particularly carefully at its legal and regulatory exposure in relation to published PPFM. At a minimum, it must make sure that PPFM accurately reflect how the company's with-profits business is conducted and it should actively and routinely review its PPFM to check that this remains the case. An assessment is also needed of whether PPFM satisfy FSA requirements of fairness to policyholders. Ultimately, it is important to recognise that disgruntled policyholders will rely on PPFM in proceedings against insurers. It is vital, therefore, that in addition to passing actuarial scrutiny, lawyers are brought in to review the guidelines and identify possible problem areas.

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