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With Profits Review
The Financial Services Authority
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2 April 2002

Dear Eleanor

With-Profits Review: Issues Paper 4
Discretion and fairness in with-profits policies

I am responding on behalf of the Consumer Panel to the questions raised in Issues Paper 4; I apologise for the delay in so doing.

The Consumer Panel welcomes the opportunity to respond to the consultation paper on discretion and fairness in with-profits policies.

We give below our comments on the questions asked in relation to discretion and fairness. The paper appears to deal with fairness only in relation to the exercise of discretion. However, we believe that there are issues of fairness which arise in with profits policies which are not related to discretion. These are aspects of the design of the product which appear to us potentially unfair and which cannot be remedied simply by making the exercise of discretion fit into the principles and practices set out in the consultation paper. We deal with these in section B of this response.

SECTION A

Our replies to the questions in the paper are as follows:

Q1 and 2 Do you agree with the description in paragraphs 15 - 29 of the general issues arising over discretion and fairness in with profits policies? Are there any other issues arising besides those mentioned in paragraph 15 - 29?

The paper does not make clear the extent to which the requirements to explain how discretion will be exercised will apply both to existing and to new policies. While the Unfair Terms in Consumer Contracts Regulations apply only to contracts made after 1995, the FSA's principles of fairness do not have a time restriction. We think some thought should be given to this.

We think that because of the variety of kinds of policies, in extreme cases it may be necessary for the FSA to take action on a particular type of policy to challenge its terms under the legislation, rather than simply relying on restricting the exercise of discretion.

We also think there may be issues of fairness when the insurer has to make discretionary decisions in circumstances where different consumers have different interests, beyond the

differences between policyholders at different stages in the life of their product. An example would be the Equitable Life case where GAR and non-GAR policy holders had differing interests in the same fund.

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

In the FSA paper 'A description and classification of with profits policies' there is an area of discretion mentioned which we think need some consideration. This is in the calculation of asset share. The ways in which asset share is calculated appears to vary considerably and yet we see no reason why it should. This is an area where standardisation would promote fairness, since it would help in making these policies plain and intelligible, an aspect of fairness under the regulations. We do not think this can be dealt with as satisfactorily by making the basis of calculation of asset share more transparent. We do not think that the phrase 'management of the inherited estate' encompasses all the discretion involved in the inherited estate, since decisions on its application as well as its management are taken by the insurer.

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

We agree that this is a useful way of distinguishing between matters which should be fixed and matters which may vary during the life of the product, but where discretion should be fettered. We think the principles should be part of the policy document, since it is intended that they should not change.

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

We do not know of any which currently apply to all, except for some very general ones. We think, however, that the headings used in the paper are useful to identify the general areas where discretion applies and might be used in communication with policyholders.

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

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

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

Investment strategy

We agree that the discretion given over the strategy has to remain a matter of discretion and that the principles and practices set out are fair.

Exposure to business risk

We are concerned that principles a and b are fairly loose and do not necessarily mean that a consumer would be any the wiser about how an insurer approaches business risk. We also think that the mixture of investment risk and business risk in funds is in itself not a desirable feature. This in itself may not be fair although it does not relate to discretion. We deal with this further in section B.

Bonus policy

With one exception, we agree that the discretion over the bonus policy has to remain and that the principles and practices outlined should help with greater understanding and fairness. This one area is concerned with surrender values and we deal with it below under Surrenders.

While the addition of a terminal bonus at the end of the policy is discretionary, we think it should be made clear that it is the amount that is discretionary and that only in very exceptional circumstances - given the way bonuses are structured at present - would there be no terminal bonus. Fairness is affected by the way products are advertised and by sales talk. If products are sold on the basis of terminal bonuses, then a term which allows none to be paid needs to be very circumscribed. That this is a possibility must be made clear in advertisements and Key Features documents.

Practice 'e' says that the rate of terminal bonus will be set so that payouts will be close to the asset share of the policy. For this to be meaningful, the way asset share is calculated should be standardised, as we suggest above in reply to question 3.

Application of MVRs

We agree that the application of an MVR has to remain within the discretion of the insurer, especially as there are differing interests between policyholders exiting and remaining in the fund.

We are, however, concerned that the application of an MVR is likely to come within the definition of an 'unpleasant surprise', and attempts to explain it in advance are likely to fall on stony ground. It may not be possible to remedy the potential unfairness simply by explaining the policy behind the exercise of discretion. This is because the word guarantee will have been used in a way that runs counter to the understanding of most ordinary people. We think some standardised way of explaining when the 'guarantee' will operate (and when it will not) must be found. Consumers need to be told that until maturity it will always be possible for amounts they think of as 'banked' (annual bonuses) to be reduced if they want to exit early. The annual statement should perhaps show how much the current reduction would be, even if this is regularly 0%.

Variations pursuant to the terms of existing policies

While we accept that terms may have to change during the life of a product, we are not at all clear that this should be made too easy, particularly in relation to charges. In particular we have difficulty with the sentence 'the percentage of profits received by shareholders will not increase, except in exceptional circumstances, and not beyond y% of the total distributed

profit.' We cannot think what the exceptional circumstances could be which should allow this. If there are any they should be mentioned explicitly.

Management of the Inherited Estate

We note that the term 'inherited estate' is not a statutory term. We think there is an argument for making it one. If it is not, discretion can be exercised outside the principles and practices set out by assigning funds in or out of the inherited estate.

We have said in response to a previous consultation paper that we think that there are issues about who the inherited estate belongs to (shareholders or policyholders) which arise before any attribution. This might typically be the case where there is a question of using the estate to pay for compensation due to mis-selling or to gain new business. In proprietary companies where the consumer does not carry any of the business risk, expenses connected with the business risk should not come out of the inherited estate. Where consumers do share the business risk, it is still not clear that the inherited estate should bear all these costs. We think that the principles should cover the permissible use of the fund to cover business risk expenses.

Charges

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

We think there is a distinction to be made between charges that are based on a percentage of the current value of the fund and charges that are of a fixed amount. Charges that are a percentage grow when the fund grows without there being necessarily any more work to do. We think percentages set should not vary except in very exceptional circumstances: the shareholders have to take the upside with the downside. If the fund does not grow, then the charges will not grow. That is a risk that shareholders take.

Where charges are a fixed amount, they should be related to costs and increases fixed to an index.

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

While we agree with this proposal, it is not satisfactory for consumers to have to exit to avoid unfair increases in charges, thus incurring further early years charges on a new policy. We hope that the standards set by the Raising Standards initiative will develop into regulatory requirements.

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

We think individual notices should be sent out, with personalised calculations of the effect on the consumer's policy. Firms should not be allowed to rely on newspaper notices. The length of notice period should allow all consumers who wish to move to do so. Where there are delays in replying to consumers' requests for information or for a transfer, the effect of the increase in charges should be delayed until all have been dealt with.

Surrenders

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

We support the approach taken in paragraphs 43 and 44. We have a more fundamental view on the fairness of surrender value at times other than maturity, which we deal with in section B.

Opacity and multiple documents

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

Yes

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

No comment

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

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

Our response to the questions on disclosure in reply to the previous consultation paper gave our views on these matters. We have stated above that we support the proposal that at very least the principles on which discretion is exercised should be presented as part of the policy. We also think that in some cases how discretion will be exercised should be part of the key features document.

SECTION B

We have dealt above with questions of fairness where there are elements of discretion which are essential to the nature of with profits policies and which can only be dealt with by describing the limits within which and the principles on which discretion will be exercised (as proposed by the consultation paper). We have also referred to areas of discretion where we think there should be standardisation: eg in calculation of asset share and definition of inherited estate.

In this section we deal with the elements of with profits policies where there appears to be evidence of substantive unfairness, which cannot be cured by fettering discretion and making its exercise more transparent, and which may have nothing to do with discretion. The unfairness may not fall neatly within the statutory or regulatory description, but nevertheless the question is raised.

Early surrender

One of the major problems in with profits policies is the fact that large numbers of consumers cash in their policies long before the maturity date. This reduces their rate of return on the whole product, because it is designed to 'work' for those who keep it to the end. If the numbers were, in practice, limited to a small proportion, the issue of fairness might not arise, since some changes in circumstances are to be expected. However, the Consumers' Association argues (Profits at the Consumers' Expense, February 2001) that extrapolating from the PIA persistency figures over the previous five years it can be estimated that only 30% of policyholders with 25 year contracts will maintain payments to maturity. Nearly half of those surrendering do so within ten years. It is possible that these figures reflect sales before the current training and competence regime came in and that later figures should be better. However, there does not seem much evidence of great improvement.

A later table (chart 3) in the report shows Consumers' Association calculation, based on figures given in Money Management in April 2000, of the return on 25 year policies surrendered early measured against the returns on other investments and savings. It is only at the 15 year mark that the with profits surrender values significantly outperform instant access savings returns, and even at 15 years gilts outperform with profits.

The FSA research into why people surrender early (Persisting: why consumers stop paying into policies, FSA, December 2000) showed that around a quarter of those surrendering did so because of product related issues. These may or may not indicate they were sold to those for whom the product was unsuitable. In a further 58% of cases there were affordability and income based reasons. Again not all of these could be attributed to factors that might have been foreseen at the time of sale. The researchers estimate that, roughly speaking, about 36% of those surrendering might have fallen in the 'difficult to predict category' and 22% in a category where the reason for stopping might have been predicted at the time of sale.

The big question is whether those who exit early benefit those who stay to full term or shareholders, ie the penalties they suffer amount to more than the costs of selling to them and the lack of time to make their investment grow. If they do, then there must be an issue in the fairness of the design of the product.

We think serious consideration must be given to fixed rules on the calculation of the value of policies where they are surrendered before term. We are opposed to the non-contractual discretion over payments when a policy is surrendered other than at maturity. We understand that the practice of paying a surrender value at less than the target of the policy's fair share is declining but still occurs. We question whether this is fair, especially as the practice enriches those participating in the business risk.

If large numbers of consumers are surrendering early, whether or not there was mis-selling, it looks as if there should be a market for shorter life products. Consumers who want medium term products are adapting themselves, often unsuccessfully, to the product rather than vice-versa and are presumably doing so on the basis of the returns they think they may make or because there is nothing else on offer. We think there is an issue of fairness in marketing long life products with high terminal values to consumers who are unlikely to keep them long enough to achieve these returns. The evidence seems to be that consumers know about not surrendering in the early years and that they know that investments are better held for five years or more (Consumer understanding of personal illustrations and its influence on

buying behaviour, FSA August 2000). But on the Consumers' Association evidence they should be given the message that they should be thinking of at least 10 years, if not 15.

Smoothing

Similarly, with profits policies are sold on the basis that they have the advantages of smoothing. But many investments held on a long term basis have the same advantage without the artificial smoothing. According to the figures in the Consumers' Association report (chart 5, source as above), unit trusts in UK All Companies sector would outperform 25 year with profits policies held to term by over 2%. So simply by holding a spread of investments for 25 years, the effect of smoothing is achieved, potentially at a lower cost than for a with profits policy. However, at the end of the term, there is an advantage in smoothing if the product is needed at a particular date, for a pension or to repay a mortgage. So those who surrender early are sold a product on the basis of a feature which is of no use to them. Once again this might not be a matter of fairness if there were comparatively few surrendering early.

The FSA research (With profits review: Issues paper 3, appendix B) showed that very few people were aware of the term 'smoothing' or recognised the concept once described. There was general recognition of balancing out good and bad performance but this was seen to be due to the long term nature of the policy rather than artificial smoothing. When explained, the smoothing concept raised concerns over manipulation and holding back of funds. Consumers see the potential for unfairness when it is explained to them.

Charges

We understand from the FSA's paper ' A description and classification of with profits policies' that the basis of profit sharing between policyholders and shareholders in some proprietary companies is 90:10, but in mutuals, and in other proprietary companies, it is 100:0. In the former case, the expenses of running the fund are charged at cost to the fund; the net profits are then divided in a ratio of 90:10. In the latter case, the business risk in proprietary companies is retained by shareholders; the shareholders get their profits on running the fund through a charge on the fund for management expenses. This charge includes a profit element for shareholders. The policyholders get 100% of the investment returns. The policyholders in mutuals share in the business risk by virtue of being owners of the company.

In reply to a question at the With Profits Open meeting in June 2001, an insurer said that the additional profit made for policyholders through sharing in the business risk was around 0.5%. We think uniting business and investment risk in proprietary companies, for an average 0.5% return, is not worth the confusion of interests that it can cause. We think there should be an over-riding aim to achieve transparency in charges. This is a requirement of the regulations. As a core term, the charges are required to be in plain intelligible language.

If all funds were based on sharing returns of the with profits fund 100:0, with shareholders making profit out of running the fund through a management fee, the distinction between the interests of policyholders and shareholders would be clearer. Consumers would know that they were only taking an investment risk, rather than the other business risks which normally fall to shareholders. The research by the FSA into consumers understanding of with profits policies shows very little understanding of this feature, and yet it is a significant difference both in the type of risk undertaken and the method of charging. Contract terms

which act to cause an imbalance between the parties to the detriment of the consumer can be considered unfair. If the term sharing business risk is a part of the main subject matter of the contract, this potential unfairness can be cured by stating it in plain and intelligible language; but there seems little evidence that these terms are understood.

The future

We recognise that there is a problem with redesigning with profits policies given the fact that large sums are currently invested in products with their own history. Changing the history mid-stream may disadvantage those who are currently invested. Closing funds to new business to allow new customers to start with clearer and fairer products has similar problems.

Nevertheless, we do not feel that these products, which are sold as a halfway house between investing directly and deposit accounts, are always 'fit for purpose'. We do not have easy answers but we think the review should go wider than simply fairness in the exercise of discretion.

Yours sincerely,

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Chairman

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