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Response re Financial Services Authority's Consultation Paper 08/11, With-profits funds – compensation and redress

The City of London Law Society (CLLS) represents over 13,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response to the Financial Services Authority's Consultation Paper 08/11 has been prepared by the CLLS Insurance Law Committee. The Committee is made up of a number of solicitors from City of London firms who specialise in insurance law. The Committee's purpose is to represent the interests of those members of the CLLS involved in this area.

Introduction

The following are the comments of the City of London Solicitors Company in relation to the FSA's proposals put forward in its Consultation Paper 08/11.

The proposal will affect proprietary life insurance offices carrying on with profits insurance business. Currently, compensation or redress may be paid out of the inherited estate of the with profits fund of such an office to a policyholder or former policyholder of that with profits fund. The FSA propose to change their rules so that it will cease to be permissible to pay compensation or redress (of any description or to any person) from a with profits fund.

General Observations

Hitherto, the FSA has regulated the conduct of with profits business through the promulgation and enforcement of a set of detailed rules which regulate the basis upon which with profits business is sold and administered. The proposals in CP08/11 suggest that the FSA does not believe these rules (and their enforcement) are having the desired effect. The proposals have the effect of removing the problem from the with profits fund and imposing it instead on shareholders' interests. The proposal is radical – it relates to all compensation and redress becoming payable to a policyholder after the proposed new rule comes into force, howsoever it may arise, and whenever the circumstances giving rise to the claim arose. And it conflicts fundamentally with the long standing approach that all assets and liabilities associated with the carrying on of the with profits business should be allocated to the with profits fund.

So the two general features we would draw out are these:-

A. the proposals suggest that the FSA do not believe that their present conduct of business rules (and the way they are enforced) is adequately addressing potential failings; and
B. rather than addressing the reasons for this, the proposals instead leave the rules as they are, but attribute the compensation and redress costs arising from breach of the rules to be met from the shareholders' interests through a structural reallocation of the liability to make the compensation and redress payments.

We believe this proposal will, if implemented, represent a fundamental change (and certainly establish a fundamental precedent) in relation to the basis upon which with profits business has historically been conducted. In addition, the proposition that the FSA should regulate with profits business by reallocating liability for the consequences of breaches of its rules from one investor constituency to another is, we believe, sufficiently radical that strong justification would be required to adopt such a course.

<u>The FSA's rationale for the proposal</u>

The FSA provide two reasons for making this change:-

A. to increase the incentive for proprietary life insurance offices to address failures of systems and controls; and
B. to constrain the firm so that it cannot unfairly use the assets retained in the inherited estate of its with profits fund as working capital in ways that are detrimental to the interests of with profits policyholders.

We shall review each of these justifications in turn.

<u>Incentivisation</u>

The FSA point out that shareholders' interests already bear the risk of compensation and redress payments in relation to non-profit business that is not written in a with profits fund. This is, of course, consistent with the fact that the profits (or losses) of business written outside the with profits fund is entirely for the account of the shareholders' interests. Conversely, the shareholders' interests in the profitability of business written within the with profits fund is very substantially more limited.

The FSA justify the proposal in CP08/11 on the basis that the rules as they stand do not (they say) provide sufficient incentive for proprietary firms to address failures of systems and controls. It is therefore reasonable to infer that the FSA believe that there will be a greater incentive upon proprietary firms to address failures of systems and controls, as those failures affect business written in a with profits fund, if the liability for the consequences of those failures rests with shareholders' interests directly, rather than being met within the inherited estate of the with profits fund. Unfortunately, the Consultation Paper contains no evidence to suggest that reallocating the cost of compensation and redress to shareholders is likely to have this effect.

There are two important, but unanswered, questions in this context which come out of the Consultation Paper:-

A. is it the case that the level of mis-selling and mismanagement giving rise to compensation and redress is significantly less marked in the case of non-profit business written outside with profits funds than in the case of business (whether non-profit or with-profit) written within the with profits fund?

B. is there any evidence suggesting that the level of mis-selling and mismanagement by mutual life offices is materially less, on a relative basis, than that of proprietary firms? Given the parallels which the FSA draw between the powers of shareholders of a proprietary firm and the members of a mutual life office, it would be reasonable to suppose that the FSA would have made this comparison in arriving at its conclusion that its proposal in CP08/11 would reduce the incidence of compensation and redress payments by proprietary life offices.

Unfortunately, although relevant to the first leg of the FSA's justification of the proposed rule change, neither of these questions is addressed and the requisite evidence is thus not provided. Instead, the inference in paragraph 2.5 of the Consultation Paper is that the level of mis-selling and mismanagement in mutually owned life offices is, in relative terms, as bad as in proprietary firms. The FSA note the concerns that their proposals may be seen as a possible incentive for policyholders to switch from mutually owned firms to proprietary ones. Presumably, there would be no incentive for policyholders to do so, if the level of mis-selling and mismanagement by mutual firms was immaterial.

If the FSA is concerned that the present rules do not achieve their objective, we cannot see how that difficulty will be resolved by imposing the obligations to meet any resultant compensation and redress costs on a different constituency of investors. We think it is unrealistic and disingenuous to suppose that management would be more inclined to protect one investor constituency than another. We doubt that selling and administration procedures within authorised firms differ according to whether or not the long term business in question is written within or outside the with profits fund.

In any event, we do not understand what, in practice, shareholders in a proprietary firm (any more than members in a mutual life office) can insist management should do in order to reduce compensation and redress costs. Shareholders are not likely to be experts in regulating and preventing mis-selling or mismanagement; and at least in the case of listed companies are unlikely to be in a position to influence management to any meaningful extent. At best we would suggest that shareholder action might be prompted by what the paper refers to as "systematic" wrongdoing, which most likely arises from a failure of relevant systems and controls. But the FSA produces no evidence to show that, under the regulatory regime as it currently exists, such "systematic" wrongdoing is a serious problem.

Nor has the FSA produced any evidence to support the proposition that shareholder pressure has reduced the prospect of compensation and redress payments becoming due in the context of life insurance business sold and managed outside the with profits fund. So the justification for extending the proposition to life insurance business sold and managed within the with profits fund is, at best, unproven. And such a justification has, in any event, no bearing at all in relation to those cases where the circumstances giving rise to the compensation or redress have already occurred, yet to which the proposals in CP08/11 will also apply if the compensation or redress has not yet been claimed or paid. The proposals speak generally of exempting existing "guarantee schemes" but it is unclear what these are and the detailed amendments to the rules make no allowance for them in any event.

<u>Fair treatment of policyholders</u>

Currently, firms are entitled to charge compensation and redress costs incurred towards holders of policies in the with profits fund to its inherited estate. It is also the case that, if a with profits fund has a disproportionately large inherited estate, the FSA will expect the firm in question to distribute the excess if the firm cannot properly justify retaining it. The FSA frame this approach within their overall requirement for firms to treat their customers fairly. Against this background, the FSA state in the Consultation Paper that a key purpose of their rules in COBS 20 is to constrain firms so that they cannot unfairly use the assets retained in the inherited estate as working capital in ways that are detrimental to the interests of with profits policyholders. So the second justification for the proposal that compensation and redress payments should no longer be met from the with profits fund through its inherited estate is that this will potentially increase the prospective interest which with profits policyholders may have in the inherited estate.

It is axiomatic that all of the assets in a with profits fund belong to the firm itself, a point which the FSA accepts in the Consultation Paper. But policyholders (including with profits policyholders) only have contractually based rights and expectations. They have no proprietary interest in the underlying assets of the with profits fund. Broadly, their contractual rights and expectations are that they will receive, in terms of their maturity benefits, their "smoothed asset share" as derived from the with profits fund.

This is supported by the High Court decision in re AXA Equity and Law (2001 BCLC 447), where Evans-Lombe J said:-

> *"In my judgment, however, an AELLAS policyholder would not have, prior to the promulgation of the scheme by AXA, a reasonable expectation that the whole or any part of the inherited estate would be distributed to him as a bonus or otherwise during the currency of his policy. In particular, it would not be a reasonable expectation for him to hold that the directors of AXA would promote a scheme of reorganisation which involved a distribution of the inherited estate."*

If the firm chooses to distribute surplus beyond that measure, then the distribution must be made, as between the interests of with profits policyholders and shareholders, in accordance with the formula laid down in the relevant instrument (the policy document, the articles of association, the scheme document etc.). But we do not think that with profits policyholders have any legal right to require that such a distribution be made. Nor is it part of their reasonable expectations that the use of the inherited estate as working capital for the purposes of the with profits business should be constrained with a view to increasing the prospect that the firm might choose to make a distribution out of the inherited estate beyond the "smoothed asset share" measure. Indeed, how can a firm sensibly price for the business risk it is assuming if the premiums for that risk are received into one fund and some of the risks are borne in another, differently constituted, one?

COBS 20.2.22 (albeit drafted on a circular basis) is, we assume, intended to impose on firms an obligation to justify the retention of any "excess surplus" if the firm chooses not to carry out a reattribution or a distribution in relation to such "excess surplus". The effect of the proposed rule change will be to increase the prospect of there being an "excess surplus" – indeed, that appears to be the FSA's motivation in suggesting the change – and thus the focus on a reattribution or distribution of that "excess surplus". This goes well beyond the limits of with profits policyholders' contractual rights and reasonable expectations as commonly understood.

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We think these are fundamental points in the context of the FSA's second justification of its proposed rule change. The FSA conceives that with profits policyholders have rights and expectations in relation to the inherited estate which go beyond those conferred by the contractual relationship between firms and their with profits policyholders.

Under section 138 FSMA 2000, the FSA has power to make rules to "protect" the interests of consumers to an extent which is "necessary or expedient". It seems to us that the FSA's present proposal stretches the concept of "protecting" the interests of policyholders, in the sense in which the term is used in section 138. In our view, the interests of with profits policyholders must be determined for the purposes of section 138 against the background of the rights and reasonable expectations which with profits policyholders enjoy by reason of their contractual relationship with the firm in question. As we have said, this does not extend to any distribution out of the inherited estate, except for the purposes of securing that the with profits policyholders receive their "smoothed asset shares" from the with profits fund.
It seems clear to us from the Consultation Paper that the FSA conceives that the interests of with profits policyholders extend prospectively to the inherited estate in a more general sense. They therefore justify the proposed rule change on the basis that it will potentially increase the likelihood and extent of "excess surplus" distributions from the inherited estate.

In our view, such an approach must, from a legal perspective, necessarily involve an enhancement (rather than a protection or safeguarding) of the interests of with profits policyholders and, as such, is arguably outside the power of the FSA under section 138 FSMA 2000. Indeed, the FSA themselves expressed the view, in section 5.1 of CP 207, that:

> *"This part of the CP, which carries forward a policy commitment made in the WPR FS, is not about distributions from the estate or changing the ownership of the estate, which would be outside our powers."*

We would be interested to know whether the FSA have now changed their view and in what sense. In particular, do they consider that section gives them carte blanche, if they consider it necessary or expedient, to override the ordinary legal and contractual rights of authorised firms? The implications of such a view seem to us potentially far reaching and certainly not evident from the terms of section 5 FSMA. Notwithstanding the FSA's general duty to consult, we think it would involve an unreasonable degree of uncertainty for authorised firms and indeed consumers themselves. We also think that the limitation in section 138 to rules which appear to the FSA to be "necessary or expedient" for the purpose of protecting the interests of consumers calls up the very criteria which we mentioned in relation to the incentivisation argument, namely first, whether there is any factual basis for exercising the power and, secondly, whether the rule which is being proposed is proportionate to that end. It seems to us very doubtful whether either of these criteria are met in the present circumstances.

We would also be interested to know what view the FSA have taken on the compliance of the proposed rule with the Human Rights Act 1998, specifically the protection of property under Article 1 of the First Protocol to the ECHR. Always recognising that public authorities must enjoy a margin of appreciation in relation to the application of that Article, it nevertheless seems to us that the potential reduction in the value of shareholders' interests in insurers affected by this rule is one that needs to be fully justified, and as we have indicated we do not believe that the CP meets that test.

7. Other implications

It is perhaps also worth pointing out that, contrary to the assertion in the Consultation Paper, the proposed rule change will have a very significant economic effect upon shareholders' interests in a number of life office companies. This is because, as we have explained above, all compensation and redress payments made after the proposed rule is to take effect will be covered, regardless of when the circumstances giving rise to the compensation or redress payment actually arose. Life offices have, for example, committed to making significant compensation and redress payments in the future in respect of the pensions mis-selling imbroglio, which occurred many years ago.

This effectively amounts to retrospective regulation. The FSA have made it clear that a good principle of regulation is not to act retrospectively unreasonably. In its oral evidence to the Treasury Select Committee Inquiry into inherited estates, the FSA said:-

> *"We do genuinely also adhere to the point of not carrying out retrospective judgments, changing the rules on firms retrospectively or unreasonably."*

Changing the investor constituency which will bear the cost of meeting the liability for accrued compensation and redress payments to holders of policies written within the with profits fund where the liability to pay that compensation or redress has already arisen is, in our view, particularly suspect in terms of the FSA's power under section 138 FSMA and the Human Rights Act. Moreover, it is likely to be detrimental to another of the FSA's regulatory objectives – that of market confidence. If the FSA can make unpredictable changes to the rules in a way which reallocates significant accrued liabilities from one pocket to another with retrospective effect, investors' confidence in the regulatory framework in which they are investing as shareholders will be sorely tested. That does not seem to us to be consistent with the FSA's regulatory objective of promoting market confidence.

Doubtless this thought will be in the minds of the directors of proprietary with profits life companies as well. After all, if the FSA is to take to itself the reformulation of the contract between the policyholder and the company (and the business structure on which the contract is based), with potentially retrospective effect, it is very difficult to see how management can plan their business operations with any degree of certainty as to the future. We think it is quite possible that some, at least, of those companies currently providing with profits products will examine very carefully whether they should continue to do so.

8. Conclusion

In short, we believe that both of the reasons put forward by the FSA in support of their proposals are potentially flawed and we find neither of them in any way compelling.

We believe there is a serious risk that, if they were to implement these proposals, the FSA would be exceeding their powers under section 138 FSMA. And we consider that the retrospective nature of the proposals is fundamentally objectionable in principle and inconsistent with the FSA's statutory objective of promoting market confidence.

Paradoxically, the proposal may act as a spur, not to achieving better standards in the sale and management of business written in the with profits fund, but instead to the withdrawal of with profits products in the future. The FSA is on record to the Treasury Select Committee of the House of Commons as regarding the with profits product as a *"credible and worthwhile investment product that should remain in the savings market"*. The FSA has said that it would not be in the interests of the consumer for this product to disappear.

In our view, if the FSA is concerned about the prospective level of compensation and redress claims which may arise from the future conduct of with profits business, it is imperative that the grounds for those concerns are carefully considered and the necessary steps taken to address those problems. We do not believe the problems will be solved simply by reallocating them to a different investor constituency in the way the FSA contemplates doing with its present proposals.

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Annex

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James Bateson	Norton Rose
Michelle Bramley	Freshfields
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Catherine Hawkins	Berrymans Lace Mawer
Glen James	Slaughter & May
Stephen Lewis	Clyde & Co
Geoff Lord	Kennedys
Martin Mankabady	Lawrence Graham
Kenneth McKenzie	Davies Arnold Cooper
Michael Mendelowitz	Norton Rose
Terry O'Neill	Clifford Chance
Richard Spiller	Edwards Angell Palmer & Dodge
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