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## Consultation response

Myners Review of Governance of Life Mutuals  
Room 4/16  
HM Treasury  
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DATE: 1 October 2004  
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**INDEPENDENT REVIEW OF THE CORPORATE GOVERNANCE OF  
MUTUAL LIFE OFFICES: CONSULTATION DOCUMENT**

**SUBMISSION BY WHICH?  
OUR REF: 04-070**

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for all consumers

## INTRODUCTION

Thank you for the opportunity to respond to the review. By way of introduction may we say that we were surprised at the Government's announcement of a review into governance in life mutuals. The issue of governance in mutuals is important of course but we believe it is much more problematic in the proprietary financial services sector.

There has been a substantial debate about the issue of corporate governance at UK, EU and international level over the past few years in the aftermath of the Enron and Worldcom and other corporate scandals. This is of course to be welcomed. However, most of this debate has been conducted from the shareholder perspective. Indeed more recently, the Department for Trade and Industry (DTI) has been consulting on the Operating and Financial Review (OFR) to improve the information provided to shareholders.

So far there has been no real debate about governance and accountability from the consumer perspective. There are a number of reasons for this, but we think the main reason is that the prevailing orthodoxy assumes that the interests of shareholders and consumers are aligned, that shareholders provide a disciplining effect to ensure that management and directors will treat consumers fairly – in other words what is good for shareholders is good for consumers.

However, this is not necessarily the case in financial services particularly in the life sector where a series of financial scandals suggest that shareholder and consumer interests are not aligned. Misselling scandals, and other detrimental practices such as front-end loaded charges and unfair contracts are manifestations of an underlying problem with governance, accountability and ethics in the sector.

Which? is in the process of developing a series of standards on governance, accountability and ethics for the financial services industry and will be publishing a discussion paper in November. The purpose of these standards is to institutionalise the consumer interest from the boardroom to the sales floor. We will then consult with the industry, trade bodies, regulators and others interested in governance on how to introduce these standards possibly as a code of practice.

Having said that, many of the necessary governance reforms apply to mutuals as well as PLCs. But we would stress that the failure of Equitable Life was not because of its mutual status. We put this down to a combination of management, regulatory and governance failures which are not unique to mutuals.

It is also important that any further governance reforms do not place mutuals at an even greater competitive disadvantage. The existing legal framework leaves mutuals vulnerable to carpetbagging activity. The regulatory and governance framework within the life industry very much favours shareholders. Unless reforms apply also to proprietary life firms, mutuals will be at a competitive disadvantage.

Governance and business practices need to be changed across the entire sector not just within mutuals to ensure consumers are treated fairly. Theoretically, improving governance in mutuals would improve the way consumers of mutuals are treated. However, in the life sector, firms who seek to introduce consumer friendly business practices can find it difficult to compete against more ruthless competitors who use aggressive business models (commission driven sales etc) and are pressurised to revert to similar practices to maintain market share.

The life fund industry manages some £300-400 billion on behalf of up to 20 million existing policyholders (depending on which estimate is used). The management of these existing books will be one of the key regulatory challenges over the next 10 to 15 years. Closed books are a particular issue. The financial welfare



of literally millions of consumers will be in the hands of an industry which operates within a weak governance, accountability and ethical framework.

The financial services industry already plays a huge role in consumers' lives. This role is expected to increase. There is a huge transfer of risk and responsibility under way from the state and employers onto individuals who are expected to use financial markets and providers to meet core welfare needs such as pensions and protecting against the risk of losing health or income.

Clearly, the industry must be fit for purpose if that transfer of risk is to happen safely and effectively. It is in the national economic interest for the government to conduct a fundamental examination of the governance, accountability and ethical framework which governs the relationship between the financial services industry and consumers.

The notion of effective competition and informed consumers exerting influence is such a long way off as to be an unrealistic ideal. Governance and restraint mechanisms are needed to ensure the consumer interest is properly represented and to deal with the chronic consumer detriment within the sector. We hope the Myners review of corporate governance in the mutual sector will be a spur to a wider investigation of governance, accountability and ethics in the financial services industry generally.

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## BACKGROUND: GOVERNANCE AND ACCOUNTABILITY IN THE FINANCIAL SERVICES INDUSTRY

There are many theories and definitions of corporate governance which have appeared in various reviews. For example, Cadbury describes governance as 'the system by which companies are directed and controlled'. Most of the reviews relate mainly to the governance of a firm from a shareholders perspective and are reflected in the Combined Code on Corporate Governance published by the Financial Reporting Council which is annexed to the FSA's listing rules.

However, we use a more fundamental approach which describes and sets out the purpose of governance, integrity and accountability and business ethics from the *consumer's* perspective.

Governance, integrity, accountability and ethics:

- identifies sources of power and influence within firms, which offices and officers have the power to make decisions which affect consumers. Crucially, the 'directing minds' within organisations must be identified and whose interests those directing minds represent; and
- ensures there are structures and checks and balances in place to ensure that the consumer interest is represented properly in business planning and decision-making processes particularly when directors have a legal duty to other more powerful and influential stakeholders such as shareholders.

For this to happen, a number of conditions have to be met:

- consumers needs are properly understood
- directors have an incentive to treat customers fairly
- conflicts of interests are identified and resolved fairly and transparently (where necessary separating duties and responsibilities to ensure transparency and accountability)
- those in positions of power do not exploit those positions either individually or collectively, deliberately or inadvertently
- when checks and balances don't exist, ethical standards are in place to ensure that directors and other company officers act with integrity and do not exploit absence of controls



- those in positions of power (and those they represent such as shareholders) are held responsible and accountable when abuse of control or position does occur

It is important to emphasise that opacity in and of itself does not cause corporate governance failings - it simply exacerbates poor corporate governance. It follows that relying on greater transparency alone will have limited impact in enforcing high standards of corporate governance in complex sectors where consumer influence and competition is very weak, and is unlikely to require firms to treat customers fairly.

However, greater transparency if properly deployed could be a useful spur to reform.

### *The life insurance sector*

As mentioned, one of the critical issues with regards to governance and accountability is identifying the 'directing minds' within organisations. Much of the debate about governance in the life sector has focused on the role of actuaries. This is important of course but we would argue that the actuaries are/ were not the directing minds.

The sector generally is characterised by major governance flaws. It is interesting to look at the structure of the life sector. Details can be found in Profits at the Consumer's Expense<sup>1</sup> and our responses to the FSA's with profits reviews. But briefly the structure can be summarised as follows:

- when consumers invest with a life firm the legal ownership of the assets resides with the firm not with the consumer, This in contrast with, say, unit trusts where consumers' assets are ring fenced and administered by custodians, or pension schemes which have trustees to look after scheme members interests
- consumers have a contract with the firm which undertakes to provide certain benefits. This coupled with the discretion afforded to directors to manipulate returns and bonuses puts policyholders in a vulnerable position
- directors have an explicit legal duty to maximise shareholders returns under UK company law with no corresponding duty to policyholders except a regulatory requirement to 'treat customers fairly' - although in practice directors have significant discretion to define and interpret what this means and monitor whether this requirement is met
- one of the biggest discrepancies is the significant imbalance between statutory protection given to shareholders under UK company law and that available to consumers

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<sup>1</sup> Profits at the Consumer's Expense, Consumers' Association, 2001



in relation to directors duties and legal rights of access to information. Under the listings regime, shareholders have legal right of access to information which is material to the share price. This is exacerbated by the unnecessary protection given to commercial interests in s348 of FSMA 2000. The Operating and Financial Review (OFR) provides shareholders with more rights of access to information

- nor are there any specific requirements for representing the consumer interest on main boards.

This structure means that actuaries working within firms must find it difficult to challenge directors on the running of the business. We believe that actuaries have been under pressure within firms to use unrealistic projected returns for marketing purposes and so on. Overall, the corporate governance structure provides very little opportunity for actuaries to act as a restraining influence on directors.

Indeed, the FSA's review means that even more power and influence is being placed in the hands of directors so further weakening the position of actuaries to exercise a restraining influence.

There are two key issues to consider when reforming the governance, accountability and ethical framework of life funds whether mutual or proprietary. These are:

- prudential supervision and
- treating consumers fairly.

We take the view that many positive reforms of prudential regulation life funds have been made. However, we also take the view that little progress has been made in terms of improving the governance of life funds to ensure that policyholders are treated fairly.

For this to happen requires new structures, checks and balances, principles and practices to be introduced.

## ANSWERS TO SPECIFIC QUESTIONS

***Q1. To what extent does the current guidance on corporate governance particularly the Combined Code provide an appropriate framework for mutual life offices? Would another approach be more effective?***

We think the governance provisions within the Combined Code do to some extent provide a framework for mutual life offices. The principles of good governance, accountability and ethics should in theory be transferable to any business model.

The application of these principles and supporting practices may vary depending on the extent of governance failures and consumer detriment in different sectors. For example, there are considerable differences between the savings and loans sector, and the life sector.

However, while the Combined Code contains many useful principles which could be built upon we do not agree with the comply or explain approach. The comply or explain approach makes the common mistake of assuming good governance equates to transparency and disclosure.

Transparency of course is a crucial part of good governance but it is not enough particularly in complex markets and in sectors where consumers exert minimal influence on director/ producer behaviour.

Comply or explain may be appropriate for governance in relation to shareholders who are in a much better position to challenge directors or understand explanations as to why requirements have not been complied with. Shareholders are in a much better position to show displeasure with directors/ firm by selling shares.

But it is not realistic to rely on this restraint for ensuring the consumer interest is given due consideration. Consumers may be trapped into long-term products because of surrender penalties and may not be able to exercise choice if dissatisfied by the standards of governance within a life firm. This assumes that consumers would be in a position to understand the implications of a firm not complying with a code.

Many of the principles in the combined code could be adapted. In particular, we are attracted to the principles relating to the board (A.1), board balance and independence (A.3), appointments to the board (A.4), information and access to independent professional advice for non-executives (A.5), re-election (A.7), dialogue with shareholders (D.1 and D.2) which could be adapted for communication with policyholders.

For governance to be effective some mechanism needs to be found to communicate to consumers whether firms are complying with a code and the implications of compliance or non-compliance.

The code could be embodied in regulation in the same way that listed firms are required to report on compliance with the Combined Code. We take the view that the best way to maximise the effectiveness of standards would be to have compliance with these standards overseen or validated by an independent third party. Given the level of detriment in the sector, we do not think that it is entirely appropriate that the board of firms undertake a formal and rigorous evaluation of its own performance (A.6) because of the potential for conflicts of interest.

In relation to remuneration (B.1) the requirement that a proportion of executive remuneration is linked to corporate and individual performance is in theory a good idea. However, in practice this can reinforce conflicts of interest between the firm and consumers. A better way of aligning corporate and consumer interests would be to ensure that performance indicators used to set remuneration contained an evaluation of



how well consumers were treated eg. complaints, satisfaction, persistency data, regulatory and compliance issues etc. As part of our standards on governance and accountability we are consulting on whether these performance indicators can be incorporated into remuneration strategies.

Similarly, the remuneration committee (B.2) should be independent and be made up of non-executives *and* policyholder representatives. As part of our governance proposals, we are proposing that shadow boards or consumer councils/ panels be established within firms to oversee the performance of the firm from a consumer perspective.

The provisions on financial reporting (C.1) could be adopted and modified to require the firm to publish a performance report which details how well the firm has performed from the consumer perspective, which identifies risks to consumers and how these are addressed. This should be published in a dedicated consumer section of the annual report along with the usual financial data. We have made similar suggestions to the Morris review of the Actuarial Profession and the DTI's review of the OFR.

***Q2. What is the best way of securing mutual life offices' compliance with corporate governance best practice?***

We would make the point that it would be unfair to secure mutual life offices compliance without also ensuring that proprietary firms also complied with improved governance standards. It is wrong to assume that the requirement for listed firms to comply with a form of governance leads to better outcomes for consumers. This model assumes that shareholder and consumer interests are aligned and shareholders provide a disciplining effect on management/ directors to ensure consumer welfare is given due consideration. As we know from experience, this has not always been the case in the life sector. Much of detriment in the life sector has come as a result of governance failures from the consumer perspective.

Unless mutuals and proprietary firms are required to comply with similar standards, this will put mutuals at a disadvantage.

There are a number of measures for ensuring compliance. Greater transparency and disclosure is important but has limits. We take the view that a combination of statutory and voluntary measures (such as Which?'s governance standards) and independent evaluation including accreditation is needed to ensure compliance with rigorous governance standards.

A general point we make is that section 348 of FSMA 2000 needs to be amended to allow the Freedom of Information Act to enable information to be disclosed if it is in the public interest.

***Q3. In your opinion, should the ownership structure or the nature of the business conducted by a life mutual affect the composition or structure of its board? If so, how?***

In principle the ownership structure and nature of business should affect the board structure. In the case of a PLC, there are two groups of stakeholders<sup>2</sup> – shareholders and policyholders. Within a mutual, theoretically there is usually one group - the policyholders who are the owners and consumers of the business.

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<sup>2</sup> Understandably, employee representatives will include employees as a separate group of stakeholders. However, in relation to governance and checks and balances we are concerned primarily with consumers as the key stakeholder group



In the case of policyholders, there are various classes and types depending on the nature of business. There are different interests to balance – between different generations of policyholders and different classes of policyholders depending on length of policy and so on.

However, we think it may be difficult to construct a board to reflect *precisely* the different balance of interests implied by the nature and ownership of the business involved. One possible way of doing so would be to ensure that elections to the board were weighted according to policyholder classification. This may be difficult practically but it should be remembered that pension fund trustee boards reflect different classes of beneficiaries and there are requirements as to the number of trustees which are employee nominated. Indeed, it is expected that the Pensions Bill will require that 50% of trustees of pensions schemes are employee nominated.

That is why we believe that a wider review of governance and accountability in life firms generally is important and the creation of standards and principles applicable to all life firms regardless of ownership status is necessary. Which?'s model of consumer representation, shadow boards, a consumer constitution provides a better more flexible model for ensuring that disparate interests are taken into account.

In relation to proprietary firms, we argue for a 'twin peaks' approach ie. a mutual fund within a PLC structure<sup>3</sup> with representatives of policyholders and shareholders overseeing the running of the firm.

If the governance of life firms whether mutual or proprietary is to be improved and for this twin peaks approach to work, we have also argued that professionals such as actuaries should be given an explicit public interest duty and a 'Hippocratic Oath' (see response to Morris review). Essentially, we argue that the actuary should have responsibility for representing the interests of the policyholders while the executive directors retain their duty to shareholders.

This model is not directly transferable to mutuals given that in many cases the owners and consumers are one in the same group. But there is an opportunity for non-executives to play a bigger role in representing the consumer interest and communicating with policyholders on the boards of mutuals and PLCs.

In relation to committee structures, we advocate the creation of shadow boards (or consumer councils) to oversee the activities and performance of the main board. In terms of the remuneration committee, rather than argue for the creation of a new type of committee we are evaluating whether performance indicators which measure how well consumers have been treated should be used in determining directors' remuneration. This is particularly important for PLCs where the most important factor in determining remuneration is financial performance and shareholder benefits.

***Q4. In your experience, is the information and advice (including actuarial advice) used by the non-executive directors of life mutuals sufficient – in terms of quality and relevance – to enable them to exercise effective oversight of the executive? In what ways might it be improved? If more information and advice is needed, what are the resource implications? Do similar issues arise for the non-executives of other complex businesses, such as wholesale banking or science-based businesses?***

The issue of non-executives knowledge is a difficult one. The review is right to identify that this is an issue faced by non-executives in other sectors which involve complex products – scientists, food safety, transport etc.

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<sup>3</sup> see Which? response to FSA With Profits Review Issues papers 4 and 5 for details and the Morris review (attached)



It is difficult to strike the right balance with information. It is advantageous for non-executives to have specialist knowledge of financial matters especially actuarial science. For non-executives to challenge boards effectively requires those individuals to understand the information on which decisions are based.

However, the downside is that the type of individual who may possess this type of knowledge may have a background in the life sector. Without casting aspersions, specialists may have been ‘institutionalised’ and may not question conventional wisdom on business practices.

There are limits to how much non-expert, non-executives can be expected to know. Again, the key issue for Which? is to ensure that those people who are in possession of specialist knowledge do not abuse that position of power or more relevant that the ‘directing minds’ of the organisation do not exploit that specialist knowledge to the advantage of producer/ shareholder interests.

This involves checks and balances, better disclosure and key officers having public interest duties (see response to Morris review). In our submission to the Morris review we argued that while actuaries quite rightly should share a great deal of the blame for the major financial scandals involving the life industry they were not necessarily the directing minds behind the events.

However, that is not to say that more could be done to improve the efficacy of non-executives. In the occupational pension fund sector, much has been done to provide access to training for employee representative trustees. In addition, Which? is considering whether it would be possible to create a register of public interest representatives who specialise in certain subjects.

In light of the existing FSA approach to governance within life firms, the role of the with profits actuary (WPA) will be crucial. The FSA proposals envisage the WPA producing a report stating whether the firm has complied with the principle of treating customers fairly. We think this is an unwise approach – firstly, the FSA’s proposals allow directors significant discretion to determine and interpret what treating customers fairly means so complying with these self-imposed principles should not be too onerous for firms. Moreover, we think that the WPA will feel under pressure to produce the ‘right’ report unless actuaries have a public interest duty and Hippocratic Oath to protect him/ her against director influence.

We have recommended to the Morris review that the regulatory and representational roles of the actuarial professional bodies be separated. We are advocating a statutory regulator for actuaries and that this regulator should conduct spot checks on the WPA’s reports. This new regulator could play a substantial role in providing guidance and advice on technical matters for non-executives.

***Q5. What is the role of the non-executive director in a complex or technical business? In particular what is their capacity to understand and to challenge the executive over technical aspects of the business?***

***Q6. What can the owners of a complex or technical business reasonably expect of its non-executive directors? How would you characterise the practical limitations of a non-executive director? What steps might be taken to codify what is reasonable and realistic in this context? Should executives and non-executives have the same legal duties to the company?***

From Which? perspective it is perhaps more important to ask what can the consumers of life business expect of non-executives.



Non-executives have a key role to play in ensuring that risks are identified and specialists are recruited who understand these technical issues. But again, it all comes down to the directing minds who run life funds and moderating the influences placed on specialists. Non-executives should ensure competing interests are balanced and aligned, directing minds are challenged, and consumers engaged.

But to reiterate this is unlikely to happen unless wider governance reforms occur. If non-executives and other public interest representatives are to make a difference they will need legal protection through the establishment of a public interest duty to counter the duty directors have to shareholders/ company.

It is unlikely that public interest representatives will make much practical difference without training and legal protection. Governance reforms can be codified with statutory and voluntary standards.

***Q7. What role should policyholders play in the running of mutual life companies? Are there practical barriers to policyholder participation in UK life mutuals? What action would be needed to allow more effective engagement?***

We have a number of recommendations on governance and policyholder engagement, including:

- better disclosure on how well the firm has performed from a consumer perspective. Shareholders have explicit rights of access to information which allows them to make informed decisions and exercise influence over the running of the firm. Policyholders need access to equivalent information if they are to engage (see above for details)
- arrangements should be made to allow policyholders to elect directors to the main board. This may be difficult but is not insurmountable
- elements of the Combined Code (D.1, D.2 Dialogue with Shareholders and use of AGMs) could be adapted for life firms. Similarly, as mentioned below building societies already have some of these provisions where members elect directors and vote on key issues. Greater use of consumer panels could be used to facilitate consultation with policyholders
- non-executive directors, consumer councils or shadow boards could be utilised to oversee policyholder participation
- legislation could be made to ensure boards contain an appropriate balance (broadly speaking) reflecting the nature of the products sold and different classes of policyholder in line with pension fund trustee legislation
- Which? is evaluating whether a public interest advocate register could be created to provide a pool of suitable non-executives.

These recommendations could apply to mutuals and proprietary firms.

***Q8. Lord Penrose says that in a life mutual "...it is the policyholders who are the source of the risk capital for the enterprise." (chapter 20, paragraph 51). What does this mean for the relationship between a mutual life office and its policyholders?***

This statement contained in Lord Penrose's report implies that shareholders are the source of risk capital for proprietary firms. In practice, policyholders are the source of risk capital in proprietary firms also. The governance arrangements mean that policyholder assets are used for the benefit of shareholders and conflicts of interest result between shareholders and policyholders.



Policyholders provide much of the development capital either directly or indirectly. Moreover, even though shareholders in life firms receive a share of bonuses generally in the ratio 90:10 (rather than conventional management fees) it is difficult to argue that they take on the same degree of risk and corporate responsibility as shareholders in other financial firms.

In the case of a mutual life firm the compensation costs for mis-selling must come from the life fund – so policyholders do share in the successes and failures of management. However, in the case of proprietary firms shareholders still receive share of bonuses yet are allowed by FSA to pay compensation costs from the with profits funds so protecting shareholder interests. Therefore in the case of proprietary firms shareholders can receive the benefits while avoiding many of the risks (there is also concern about the degree of cross-subsidy which goes on within a proprietary firm although others may be better placed to provide details). Policyholders bear the corporate and investment risk but also pay shareholders a share of bonuses.

We do not think that in the normal course of events that policyholders in mutuals face significantly greater prudential risks compared to proprietary firm policyholders. Equitable Life was a governance, management and regulatory failure not a failure of mutuality per se.

We take the view that directors of life firms should follow the highest standards of governance and risk management regardless of the corporate form involved. It could be argued that a mutual firm should adopt less risky strategies with policyholders' assets. However, this could prove too restrictive and constrain the ability of mutuals to offer real choice in the market place. This would place mutuals at a competitive disadvantage. Firms in life sector signal quickly new product development and business strategies. This reinforces need for governance reform to apply across the entire sector. Allowing PLCs to retain freedom to pursue aggressive market strategies would place mutuals at a severe disadvantage.

We make a distinction in relation to demutualisations. Assets in life firms are built up from previous generations and the governance structure should ensure that these assets are not used to further interests of directors who are seeking demutualisation for personal gain.

Perhaps, a more beneficial approach would be to evaluate the rules which govern mutuals ability to raise capital from external sources. This would carry a cost of capital. However, shareholders providing capital to policyholders demand a price for providing that capital. The difference is that the mutual directors have control over how the capital is used whereas in a PLC directors have control over shareholders and policyholders assets.

***Q9. Lord Penrose acknowledges that the FSA's work since 1997 "...has sought to anticipate many of the lessons that might be drawn by this inquiry, and it should come as no surprise that it has largely succeeded in that." (chapter 30, paragraph 3). In so far as corporate governance is concerned, do you agree?***

On balance, we strongly disagree with Lord Penrose on this. The reforms should bring some improvements to the prudential supervision of life funds. Even then, without improvements to the Financial Services Compensation Scheme policyholders will still be at risk from the inherent conflict of interest in the FSA's statutory objectives to protect consumers and maintain confidence in the financial system.

However, in relation to treating policyholders fairly we are of the view that the FSA's with profit's reforms have not addressed the fundamental absence of corporate governance and accountability framework in life funds. Indeed, the creation of the governing body and other proposals actually invest even more authority and

influence in the office of directors who have an explicit duty to shareholders. The FSA mistakes transparency for meaningful corporate governance and accountability.

More details can be found in the background and in our submission to the Morris review, and FSA with-profits review Issues papers 4 and 5, plus our response to CP207.

***Q10. Is there a further role for the FSA to play in improving firms' corporate governance?***

Yes. There are a number of measures the FSA could adopt. The FSA could ensure that firms comply with proper governance standards but it will be difficult for the FSA to change course now given its very public approach of favouring more transparency as the main means of introducing governance into the sector.

We are of the view that the FSA is too 'hands-off' and is delegating too much authority to directors to ensure consumers are treated fairly. The FSA could play a greater role in holding directors to account for breaches of governance and unfair treatment of policyholders. We fully agree with Lord Penrose that FSA should consider how powers can be exercised to address unbalanced or ineffective boards, and ensure it has the powers to require changes to the board to address gaps or imbalances in board skills and experiences.

We have suggested that a new actuarial regulator undertake public spot checks on directors' compliance with treating customers and the with profits actuary's report. The results of this spot check should be published and if this spot check uncovers issues of concern the FSA should have the power to appoint from a panel of experts to the board of the life office to produce a plan of action for addressing the areas of concerns.

While Lord Penrose recognised that 'There would be resistance to direct involvement of regulation in management for understandable reasons (chapter 20, para 55), we do not think that this should be reason enough to prevent the necessary governance and accountability reforms.

The scale of detriment caused by the life industry should be remembered. This level of intervention is entirely appropriate and proportionate. Which? is of the view that the sector has probably been the single biggest source of consumer detriment of all sectors we investigate – we estimate that the total detriment has amounted to £30 billion over the past two decades due to misselling and other detriments such as front end loaded charges and manipulation of returns. We believe the FSA has a degree of faith in directors of life firms and its own version of governance which is not warranted by previous experience.

Section 348 of FSMA is a major barrier to governance and accountability in the sector and is an unnecessary restriction on disclosure of information. This undermines both corporate and regulatory accountability.

***Q11. Listed companies are subject to the influence of their shareholders, particularly large shareholders, and the risk of takeover. What market forces are most relevant for mutual life offices? How effective are they in promoting good performance and how might they be enhanced?***

There seems to be an assumption implicit in debates about governance and accountability that the existence of shareholders and institutional shareholders act as a positive disciplining force on firms. This is not the case from the consumer perspective given the lack of real competition and consumer influence in the market. Indeed, it could be argued that because directors have an explicit duty to shareholders this has led to substantial consumer detriment – particularly when conflicts of interest arise.

Mutuals are affected by the usual market forces in the life sector. Competition is primarily for distribution and for the custom of intermediaries not for the business of the end-user. Unless a mutual operates in a

particular niche, mutuals will have to follow the prevailing commercial models such as relying on commission or other remuneration strategies to achieve volume of sales. Changes in the market place are signalled very quickly so that if a major player adopts an aggressive distribution strategy relating to a particular product eg. raising commission to sell with-profits bonds, other major players will feel pressurised to follow suit regardless of whether it is a mutual or PLC.

***Q12. Do specific barriers exist to the success of mutual businesses in the UK? If so, how might they be addressed?***

The main barriers to long-term success are potential restrictions caused by restricted access to external capital and vulnerability to take over or conversion.

The legislation relating to building societies requires for example that a society raises 50% of its funds from individual members. Theoretically, this could restrict a society's ability to raise funds over the economic cycle. But, it is not entirely clear whether this has been a restriction in practice and the review team would be in a better position to establish from newly converted banks whether they have taken advantage of the 'freedom' conferred by a listing to change the balance of funding or to raise new capital. Having said that the fact that these restrictions exist may fetter mutuals ability to be flexible in changing market conditions and may be worth reconsidering.

The vulnerability of mutuals to takeover or conversion means that management can face severe disruption and distractions from the primary objective of running the business. More fundamentally the legislation relating to conversions and takeovers is anachronistic.

This was evident in the series of building society conversions in the late 1980's/90s. Directors of mutuals who were seeking to become banks were able to set terms of windfalls to make conversions attractive to large numbers of customers who had shown little commitment to the society. The essence is that members were able to obtain shares way in excess of the financial commitment to the society. A typical deal may have involved members with £200 savings getting £1,000 or more worth of shares in the new bank. This is a huge degree of leverage and meant that assets built up over years were unlocked for a small price. The equivalent for a listed bank would be if a customer was able to demand to buy shares at a market price prevalent fifty years or one hundred years ago. This is not a level playing field.

Similar barriers apply in the life sector in relation to access to capital funding.

A barrier we think specific to the life sector is the general lack of confidence and trust consumers have in the life industry and its products. In the savings and loans sector the products are less complex - comparatively speaking - which means that consumers are able to shop around with a higher degree of confidence. This means that savings and loans mutuals are able to communicate their proposition much more easily. And there is evidence that mutuals are starting to rebuild market share.

Products sold by life firms are more complex and it may take a number of years before consumers can evaluate whether the product represents good or poor value. This makes it more difficult for life mutuals to communicate their proposition.

Mutuals should be able to pass on the advantages of not having to pay dividends to policyholders either in the form of lower charges or higher payouts (all things being equal). However, it is not clear that the FSA rules on disclosure allow mutuals to communicate those advantages effectively.



Consumers face greater corporate risks (in terms of governance and accountability issues) with proprietary firms mainly because of the legal duty directors have to shareholders under company law.

As mentioned above, we do not agree with the implications of Lord Penrose's statements that shareholders are the source of risk capital for listed insurance firms. There have been some instances such as Equitable Life which were unusual but we do not think that this can be considered to be typical of the risks mutuals face. Equitable in our view was a management, governance and regulatory failure not a failure of mutuality. Yet policyholders face significantly greater corporate governance and legal risks with proprietary firms.

But there is nothing in the disclosure requirements which requires firms to disclose the comparative advantages and disadvantages of different corporate forms. This means that mutuals are not competing on a level playing field with proprietary firms.

***Q13. What are the forces that drive de-mutualization? What are the implications of demutualization for members and customers?***

There are a number of reasons put forward to explain the large number of demutualisations over the past decade or so. However, it is difficult to identify those reasons which are genuine and those which are used by vested interests seeking stock market listings for other reasons.

Access to capital has been put forward as a reason for seeking demutualisation though it is not clear whether this was a pressing reason for those mutuals who did convert to banks. However, we take the view that the main driver of mutuality was the opportunity directors had to structure deals to provide attractive incentives for members to vote for conversions. We also think that in some of the life firm takeovers the information was not laid out in a fair and clear enough fashion to allow policyholders to understand the real choices they were faced with – ie. a windfall payment against the likelihood of reduced returns due to the need to pay dividends to external shareholders.

The implications of demutualisation for members and consumers generally are significant.

Mutuality should help to compensate for the weak position of consumers. The presence of shareholders being able to capitalise on a weak corporate governance framework via directors is a source of major detriment for policyholders rather than a positive disciplining force for good.

In theory, mutuality as an alternative corporate structure should also provide competition for proprietary companies, particularly due to the fact that dividends are not payable to shareholders. This has been well documented in the banking sector where mutual building societies have consistently delivered better value than banks.

The widespread demutualisation which occurred in 1990s carries a very real cost for consumers.

For competition to thrive, what matters is not just ensuring that there are a certain number of market players, the existence of different types of institution is important. Pre-conversion the mutuals held around two-thirds of the savings and mortgage market, post-conversion this was reversed with banks now holding the bulk of savings and mortgages. Overall, the number of players in the market did not change considerably so conventional competition theory holds that

choice and competition ought to still work to benefit consumers. But of course the reality is that mutuals can operate on lower net retail margins than banks because they do not have to pay dividends to shareholders. So plurality of institution is important not just number of participants.

The dividend advantage mutuals have by not having to pay dividends to shareholders means that mutuals can operate on lower margins which is passed onto consumers through higher savings rates or lower borrowing costs. Research Which? published in 2001 estimated that post conversions consumers faced higher charges amounting to £3 billion a year as a result of higher margins banks operate on.

The cost of conversions is particularly borne by future generations of consumers and current generations who did not benefit from windfalls.

There is also some evidence to suggest that life mutuals offer an advantage. Research conducted by the Personal Investment Authority in 1998 found that in the personal pensions sector mutuals offered a clear advantage to consumers, both in terms of long-term maturity values and importantly transfer values.

Table 1, Comparison of Mutual and Proprietary Companies

25 year personal pension plan, £60 a month, average illustrative maturity value

	Proprietary	Mutual
Unit linked	£48,629	£49,562
With profits	£48,129	£50,228

25 year personal pension plan, £60 a month, average illustrative transfer value

	Proprietary	Mutual
Unit linked	£3,206	£3,454
With profits	£3,145	£3,410

As with the building society sector, any reduction in the number of mutuals will remove a major source of competitive pressure for PLCs leading to what we term a 'levelling down' of competition.



***Q14. What specific governance arrangements currently apply to other financial mutuals? In what ways do their governance arrangements differ from those that apply to life mutuals? Which, if any, of the options for life mutuals could be applied more widely in the financial mutual sector? What would the consequences be?***

The best known arrangements are in the building society sector. Legislation requires that building societies operate on a one member one vote basis. Members with £100 savings or £100 of debt have a right to vote at annual and special general meetings on the composition of the board and on special or ordinary resolutions.

***Q15. Do small, affinity group-based, mutual life firms face different governance issues from the largest firms in the sector?***

On the face of it, while the principles of governance should be the same, in practice smaller mutuals or affinity group-based mutuals should face different governance issues primarily in relation to their size and relationships with members.

This is also reflected in the requirements for listed firms where some of the requirements of the Combined Code do not apply to smaller firms.

***Q16. Are you aware of effective governance regimes for life (or other) mutuals in other countries? Is this the result of a formal (regulatory or government) requirement or is it voluntary, driven by the industry? Are there aspects of the arrangements in other countries that it would be desirable and practical to adopt in the UK?***

We have no information on this.

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Morris Review of the Actuarial Profession

Submission by

The Consumers' Association

which



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*Morris Review of the Actuarial Profession - Consumers' Association Submission*  
*Introduction*

CA is pleased to submit a response to the Morris Review. The role of the actuarial profession at the heart of some of the most serious financial scandals of recent times in the UK certainly warrants such a wide ranging review.

Much of the review focuses on technical issues which we are not in a position to respond to. Therefore, we have concentrated on the structural and governance issues relating to the role of the profession. Many of the issues covered by the review such as the regulatory framework for actuaries are so fundamental to the public interest as to warrant policy reports in their own right. We have provided summaries of our views but would be more than happy to discuss these in more detail with the review team.

Actuaries have come in for some justified criticism about the role they have played in financial scandals such as pension and mortgage endowment misselling and pension scheme deficits. We believe the actuarial profession failed to protect the interests of consumers.

However, in defence of the profession it would be wrong to lay the blame entirely at the door of actuaries. Although actuaries played a role in these scandals we attribute most the blame for these failures to wider corporate governance and systemic failures in the sectors in which they operate.

The main recommendations we make are:

- the regulatory and representation roles of the professional bodies should be separated
- a new regulatory framework is needed with two key overriding objectives:
  - to ensure that the profession is legally required to act in the public interest (primarily to provide a counterbalance to the explicit duty directors have to shareholders under company law); and
  - ensuring the quality of the science and the market practitioners. This would include professional competence and standards for actuaries; overseeing standards and development of actuarial practices; monitoring, complaints and enforcement/ disciplinary responsibilities.



- this would be best achieved through the establishment of a separate regulator akin to the General Medical Council. This would need to be underpinned by the appropriate governance, public representation, and disclosure provisions. We would be happy to discuss further with the review team our preferred model for this regulator.

This submission was prepared by Mick Mc Ateer, Principal Policy Adviser, Consumers' Association. For further information please contact Emma Bandey, Senior Public Affairs Officer tel: 020 7770 7821, email: emma.bandey@which.co.uk

### *Background*

In the two main areas where there has been major consumer detriment - the life insurance sector and the occupational pension fund sector (mainly defined benefit schemes) - with the exception of a few high profile cases it is difficult to argue that actuaries have been the 'directing minds' which deliberately caused or recklessly allowed financial scandals to develop.

The role of the auditors must also be questioned. As Lord Penrose pointed out in his report (Penrose 19.148) '*the auditor has been in some instances over reliant on the appointed actuary .....*'. In our estimation, these major failures have occurred as a result of a combination of governance, regulatory and professional shortcomings. Reforming the actuarial profession will go some way to addressing some of the root causes of detriment but we are convinced that wider reforms are needed to ensure that actuaries are not put in the same position in future where the profession and its practices are exploited by vested interests.

#### **What is corporate governance?**

There are many theories and definitions of corporate governance which have appeared in various reviews. For example, Cadbury describes governance as 'the system by which companies are directed and controlled'. Most of the reviews relate mainly to the governance of a firm from a shareholders perspective and are reflected in the Combined Code on Corporate Governance published by the Financial Reporting Council which is annexed to the FSA's listing rules.

However, we use a more fundamental approach which describes and sets out the purpose of governance, integrity and accountability and business ethics from the *consumer's* perspective.

Governance, integrity, accountability and ethics:



- identifies sources of power and influence within firms, which offices and officers have the power to make decisions which affect consumers and
- ensures there are structures and checks and balances in place to ensure that the consumer interest is represented properly in business planning and decision-making particularly when directors have a legal duty to other more powerful and influential stakeholders such as shareholders
- consumers needs are properly understood
- directors have an incentive to treat customers fairly
- conflicts of interests are identified and resolved fairly and transparently (where necessary separating duties and responsibilities to ensure transparency and accountability)
- those in positions of power do not exploit those positions either individually or collectively, deliberately or inadvertently
- when checks and balances don't exist, ethical standards are in place to ensure that directors and other company officers act with integrity and do not exploit absence of controls
- those in positions of power (and those they represent such as shareholders) are held responsible and accountable when abuse of control or position does occur

It is important to emphasise that opacity in and of itself does not cause corporate governance failings - it simply exacerbates poor corporate governance. It follows that relying on greater transparency alone will have limited impact in enforcing high standards of corporate governance in complex sectors where consumer influence and competition is very weak, and is unlikely to require firms to treat customers fairly. However, greater transparency if properly deployed could be a useful spur to reform.

### *The life insurance sector*

The life insurance sector is a prime example of how the actuarial profession was exploited by firms. The sector is characterised by major governance flaws. It is interesting to look at the structure of the life sector. Details can be found in



Profits at the Consumer's Expense<sup>4</sup> and our responses to the FSA's with profits reviews. But briefly the structure can be summarised as follows:

- when consumers invest with a life firm the legal ownership of the assets resides with the firm not with the consumer, This in contrast with, say, unit trusts where consumers' assets are ring fenced and administered by custodians, or pension schemes which have trustees to look after scheme members interests
- consumers have a contract with the firm which undertakes to provide certain benefits. This coupled with the discretion afforded to directors to manipulate returns and bonuses puts policyholders in a vulnerable position
- directors have an explicit legal duty to maximise shareholders returns under UK company law with no corresponding duty to policyholders except a regulatory requirement to 'treat customers fairly' - although in practice directors have significant discretion to define and interpret what this means and monitor whether this requirement is met.

This structure means that actuaries working within firms must find it difficult to challenge directors on the running of the business. We believe that actuaries have been under pressure within firms to use unrealistic projected returns for marketing purposes and so on. Overall, the corporate governance structure provides very little opportunity for actuaries to act as a restraining influence on directors.

We are of the view that unless these fundamental governance and structural flaws are addressed then reforming the profession per se will have limited impact. Indeed, the FSA's review means that even more power and influence is being placed in the hands of directors so further weakening the position of actuaries to exercise a restraining influence.

#### *Occupational pension fund sector*

Similarly, we are of the view that actuaries operating in the occupational pension fund sector face similar pressures to produce results which suit powerful vested interests. The investment system encourages actuaries to satisfy these interests.

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<sup>4</sup> Profits at the Consumer's Expense, Consumers' Association, 2001



One of the key criticisms levied at actuaries in the sector is that they have encouraged overly aggressive or optimistic assets allocations (biased towards equities) which has contributed to pension fund deficits. The bias towards equities allowed employers to justify lower contributions which left funds exposed when the investment climate took a dramatic turn for the worse (ie. the fall in stockmarket values and reduction in expectations for investment and bond returns). The investment markets reward firms which make high profits and clearly it is in firms/ director's interests to minimise pension costs which feed through to the bottom line. Even with the trustee structure, employers exercise major influence on actuaries (larger schemes have 1/3<sup>rd</sup> member nominated trustees).

Historically, there has been little incentive for actuarial firms to be conservative in the assumptions as this would have pushed up pension costs for employers. Firms which attracted a reputation for conservatism would have suffered in business terms. Peer group pressure or the herd instinct must not be underestimated in the actuarial sector. In the UK pension fund sector we had a situation where the herd instinct of fund managers was exacerbated by the instinct to conform within the actuarial sector as well.

In addition, the consolidation in the investment consultancy sector may have played a role as well. The concentration of market share in the hands of such a small number of major players must encourage conformity of behaviour.

Furthermore, this tendency to conformity we think has been compounded further by the dual role played the professional bodies ie. the regulatory and representative role.

Finally, the lack of training and expertise of pension fund trustees contributed to the problem as few were in a position to challenge the 'experts'.

Overall, the dynamics of the investment market and ineffective regulation created a dangerous cocktail. Clearly, actuaries played a major role in allowing these problems to develop but the wider environment must be factored in.

Hopefully, some of these pressures may be alleviated by recent reforms. Changing to the funding regimes for pension schemes, the creation of a new proactive regulator and improved training for trustees should provide some checks and balances if implemented properly. However, a sense of pragmatism is important. There are limits to the extent to which 'lay' trustees can be expected



to challenge experts such as actuaries. So there is still a very real need for the profession to be reformed and to accept responsibility.

### *Actuarial 'science'*

Actuarial science and practices are neither good nor bad in and of themselves. As with any other science or technical speciality the detriment or benefits derived depend on how it is applied and what checks and balances are in place so that those who use the science act in the public interest and are not compromised.

There are striking parallels with other consumer sectors. The key point is that actuaries are specialist professionals just like scientists or doctors. Consumers face the same issues with the role of professionals in the pharmaceutical industry, doctors in the health system or the role of scientists in the BSE scandal. There is a need to separate out the person from the science/ discipline to ensure that the science is good quality and is updated, and there are checks and balances in place so that the professional person uses those specialist skills in a way that benefits the consumer or public interest.

### *Reforming the profession*

Despite the comments above, the profession should not escape criticism and is in need of reform. We take the view that the combined role played by the professional bodies must change to avoid compromise and to restore confidence in the profession. We think the dual role introduces conflicts of interest and makes it difficult for the profession to act objectively.

We would prefer to see a separation of duties. The question is how best to regulate the profession. There are three key issues to be addressed:

- the quality of actuaries and practices used by the profession. This relates to professional standards and ethics training and competence of the individuals; the quality of the science itself which should be subject to greater peer review and external scrutiny by investment and legal specialists
- how that science and advice is used and regulated. This requires new forms of governance and checks and balances to ensure that actuaries and their



advice and recommendations are not subject to manipulation and undue influence by vested interests<sup>5</sup>.

- finally, if we are to see real transparency in the life insurance markets we need a reform of the protections given to commercial information under Section 348 of FSMA 2000. This statutory prohibition is unnecessarily protective of commercial interests given that the FOI Act due to take effect in 2005 already protects commercial interests but with a public interest override. FSMA 2000 undermines corporate and regulatory accountability. We suggest that section 348 of FSMA 2000 be referred to the Department for Constitutional Affairs to be amended or repealed to allow the intention behind the FOI Act to take force. As the saying goes, 'sunlight is the best disinfectant'.

There are two possible models for regulation. The separate groups of professionals ie. scheme actuaries and life insurance actuaries could be regulated by their respective regulator - namely the new pensions regulator which will replace OPRA and the FSA.

Alternatively, a single separate regulator akin to the General Medical Council could be established. On balance we prefer the single regulator approach which could continue to work with the profession on standards and competence.

This would need to be underpinned by the appropriate governance, public representation, and disclosure provisions. We would be happy to discuss further with the review team our preferred model for this regulator.

## RESPONSE TO SPECIFIC QUESTIONS

### 1 *The role of actuaries, the profession and the actuarial services market* Q1.1

Actuaries play a hugely important role from the consumer perspective particularly in the life insurance and occupational pensions sector. It is a specialist and necessary function particularly when identifying assets and liabilities.

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<sup>5</sup> The irony is that CA believes there is a case for a stronger role for actuaries within life funds for example rather than a weaker role which results from the FSA's with profits review. We argue that they should be given greater independence and legal protection to act in the interests of policyholders rather than their position being compromised by directors of firms who have an explicit legal duty to maximise shareholders returns.



Actuarial science is not an exact science - it deals to all intents and purposes with the future which by definition is difficult to predict. Actuaries are subject to the same weaknesses and pressures that other specialists are - eg. food scientists, doctors etc.

However, as mentioned above the main weaknesses stem from wider systemic and governance flaws. We are of the view that unless there are wider governance reforms particularly to the life insurance industry then we will face the same problems. This is not to say that the profession should escape reform.

We are not in a position to comment on whether the training and qualifications for actuaries are sufficient to ensure they are equipped for the roles they perform. The level of technical knowledge required is outside our competency. However, again the main issue is to ensure there are suitable structures and processes in place to ensure that:

- actuaries are qualified to fulfil those roles
- importantly, safeguards in place to ensure actuaries are not subject to undue influence and act in the public interest and
- sufficient peer group review by actuaries and other market practitioners to ensure the 'science' and practices evolves to cope with a changing environment.

#### Q1.2

We have no real comment on this question except to say that we believe there could be more collaboration between market specialists. Clearly, it must be possible for auditors to challenge actuarial conventions used in the calculation and presentation of financial data. In practice, most large firms within occupational pension fund sector will employ and use investment specialists for advising on investment strategy.

#### Q1.3

We certainly believe there are roles which must be reserved for professionals who have demonstrable competencies in those specialist technical skills and knowledge which make up the actuary's job. Whether this needs a particular type of person called an actuary is perhaps not the main point. Actuarial science involves understanding a number of disciplines and actuaries must consult more



widely with experts in these disciplines. But the actuarial discipline is a distinct enough speciality to require a specialist who is trained in actuarial science.

We also think that these roles are important enough to be reserved for specialists who have this particular degree of expertise - in particular within insurance markets and the occupational pension fund sector.

Q1.4

It is not clear whether the existence of the reserved role per se has affected relationships between actuaries and non-actuaries. Again, we think this is more to do with the wider regulatory, legal and governance structures which put the role of actuary in such an influential position and paradoxically in such a vulnerable position open to manipulation by vested interests.

Q1.5-1.6

Yes, we do think there is a need to introduce greater peer review and external scrutiny. We do not think that this perceived problem associated with the reserved role would be best dealt with by downgrading the role of actuary. Rather this would be best dealt with by improving the checks and balances surrounding the reserved role.

#### *Accountability of actuaries*

Q1.7

As mentioned above, actuaries should accept a share of responsibility for the litany of misselling scandals which has left a legacy of mistrust in the financial system. But to reiterate, our firm view is that the main cause of the financial scandals such as misselling and poor value products (which were designed to suit firms' commercial models rather than consumers' needs) was the almost complete lack of a corporate governance and ethical framework. This ensured that when conflicts of interest arose actuaries naturally sought to satisfy those in positions of power and influence - namely directors of firms (and their shareholders) and employers.

Actuarial science is an important discipline but like any other science or technology it can be used for good or bad. Like any other science or technology it is also used by human beings who are subject to influence. This is compounded by a professional arrogance which again is not unique to the actuarial profession.



The challenge now is to learn the lessons of the past and ensure that the science is 'good' as it possibly can be and that the specialists who use it deploy this in the proper interests. In this case, we would argue that actuaries must be given a clear duty to act in the consumer or public interest or at the very least ensure that the consumer/ public interest is given the same consideration as other powerful interests such as shareholders or employers.

Q1.8- 1.9

Not surprisingly, perhaps, we take the view that actuaries are not accountable for their actions. Rather, to be more precise, the wider governance framework means that those 'directing minds' which use the services of actuaries are not accountable for how they use actuarial services.

We do think actuaries should be accountable to the wider public interest and be required to protect consumers/ members interests as well as maintain stability. Perhaps there is a case for a 'Hippocratic oath' for actuaries to represent this duty to act in the public interest.

Some may argue that FSMA 2000 and pensions regulation means that directors are supposed to take consumer interests into account. We do not agree with this argument. The legal duty to shareholders overrides this regulatory duty to treat customers fairly given that directors retain significant discretion to interpret how this applies. If anything we would have preferred the role of actuaries to be strengthened and for them to be given a specific duty to represent policyholders' interests within a life fund. Instead directors are being given an even more powerful role.

Specifically, we think pension fund actuaries should have a duty to pension scheme/ scheme trustees although we have reserved judgment on whether schemes/ trustees and employers should be required to use different actuaries until we see further analysis of costs.

In relation to life funds, we have argued previously that actuaries should be given the responsibility for ensuring fairness:

- between different classes of policy holder,
- between generations of policyholder and
- most importantly between policyholders generally and the board/ PLC.



Effectively, this would mean that life funds would be run as mutual funds within the wider corporate entity closer to the model used by unit trusts. The idea would be that the firm would receive an explicit commercial fee for managing the assets in the life fund and for marketing and other activities but the allocation of benefits would be the domain of the actuary.

Q1.10

Again, we think that the liability incurred by actuaries should be paid for the employer for whom the actuary is acting eg. the life firm or the actuarial firm providing services to an occupational pension scheme.

*The profession*

Q1.11-1.14

From experience the industry has increased efforts to engage with Consumers' Association, and should be given credit for that.

The key problem is the dual role of regulator and representational role. We take the view that the public interest would be best served by removing the regulatory role from the professional bodies (similar to GMC and BMA relationship).

In the short term, the governance structure would certainly benefit from greater lay input into the key decision making bodies. It is a specialist subject area - and some may question the added value of lay members in such a professional arena - but this is an argument which has been used by professionals in other sectors to maintain exclusivity. Lay members can add a different perspective and value - particularly if provided with suitable technical support.

*Entry into the profession*

Q1.15 - 1.21

We have no comments on these questions.

*The market for actuarial services*

Q1.22

It is difficult to say with certainty what the main drivers have been for actuarial services or indeed how demand has changed. However, regulatory and legal



developments along with the reorganisation of many major occupational schemes must have played a significant part in the development of the market.

For example, trustees of pension schemes face a considerable change to their responsibilities as a result of changes to pensions legislation. Clearly, they must rely on the expert knowledge of the actuarial profession to comply with duties under regulation and legislation. This is not a criticism of increased regulation of pension schemes merely a reflection of how the demands placed on trustees have changed.

Q1.23

It all depends on how the 'consumer' is defined. As the review suggests there would appear to be a great many providers of actuarial services in the UK. However, just because there are numerous providers or individual actuaries operating in the market does not automatically mean that the market is functioning in the consumer or public interest.

Looking at the life insurance market for example, we would argue that the actuarial profession does not serve the end-consumer ie. the policyholder, because of the legal and governance structure of the sector. The main theme of our response is that the office and profession of the actuary has been in effect 'corrupted' to some degree in the service of producer/ supplier interests (pensions misselling, mortgage endowments, product design etc).

Similarly, there are concerns that actuarial advice has been used to serve the interests of employers whether inadvertently or complicity seeking to cut pensions costs exposing scheme members to risks.

Therefore, we would argue that the actuarial market is indeed constrained, not in terms of classical competition models eg. limited supply etc but because of the wider governance and systemic flaws.

There are some specific areas of concern. As mentioned in the review document there is significant concentration in the investment consultancy market where four consultancies account for 2/3rds of the market in 1999. Interestingly, this does not appear to have led to high margins as might normally be expected in a market with such a degree of concentration. Rather the concern is more to do with the potential concentration of risk in the sense that the consumers of actuarial services are playing safe by choosing one of the big four.



This can have adverse effects if it leads to the big four and their clients following the same strategies and those strategies turn out subsequently to have been ill-judged. This concentration would have been caused to a large degree by mergers and acquisitions but we suspect that a key driver has been the inability of consumers of services (pension schemes and trustees) to evaluate the 'quality' of strategic advice provided by actuaries hence leading to an understandable human desire to play safe.

Consumers' Association encountered a very specific example of market constraint during the Axa case. Axa decided to undergo a reattribution of the inherited estate within its life fund. CA found it extremely difficult to find an actuarial firm to work on our behalf. It was made clear to us that firms would not risk upsetting the life industry as it would be 'biting the hand that feeds it.'

Again, this situation is likely to happen again without wider reform of the legal and governance structures of life funds. The actuarial firms as with any other commercial entity understandably will seek to satisfy its paymasters (directors who represent the producer/ shareholder interest). This means that, when a conflict of interest arises between producer/ shareholder and consumer interests (policyholders), it must be wise to assume that the actuarial profession will be deployed in the service of producer/ shareholder interests.

Q1.24-1.25

It is not particularly easy for consumers such as pension schemes/ trustees to switch service provider for a number of reasons. One of the key reasons is to do with the sheer complexity and volume of information relating to scheme operations. Understandably, scheme trustees and administrators build up a relationship with the scheme actuaries. Switching provider is not a task to be undertaken lightly given the amount of familiarisation required and the possibility of upheaval given that new providers may want to change the way things have been done with all the associated costs. Switching providers requires the involvement of the trustees and given that most schemes trustees meet infrequently this is not an easy option.

This barrier to switching is likely to a permanent feature of the market unless significant improvements are made to scheme administration generally through real pensions simplification. A major source of administrative complexity is the ridiculous fragmentation of the UK pension system. Radical simplification of the pension system plus developments in technology may alleviate this particular problem.



The other major barriers to switching relate to 'consumer' confidence in and capacity for comparing actuaries. This is an oversimplification of course, but actuaries should be judged on quality of service (communication and administration skills etc), fees, and quality of advice. Clearly, trustees are able to judge for themselves whether they are satisfied with service quality, and are able to compare fees. However, comparing quality of advice is rather a different matter. Trustees for the most part are not experts in the key areas actuaries specialise in - calculating liabilities etc and investment consultancy (asset allocation and fund manager selection).

This could be addressed by improved trustee training so that trustees are better able to judge quality of advice. However, there is a more fundamental question of how far should trustees be expected to become experts in their own right. It is unlikely they would ever be capable of becoming experts to such a degree that they could challenge confidently advice on liability modelling for example - after all what are they paying actuaries for?

There is undoubtedly an informational gap and a confidence gap. This gap is unlikely to be closed completely. This does cause problems in the sense that there is a tendency to play safe by choosing the biggest providers (the IBM syndrome). This has potentially significant risks if this conformity leads to concentration of risk eg. if the advice of the major players turns out to be detrimental.

Also, concentration in the hands of a small number of providers can lead to undue influence in the market. Others follow the market leader as we have seen with the increasing involvement of actuaries in strategic and tactical asset allocation decisions.

However, there are a number of measures which could be introduced which could help consumers. The first relates to performance measurement. There is a huge performance management industry grown up around pension funds. Fund managers are scrutinised in minute detail on performance. We think more could be done to scrutinise the performance of actuaries in relation to their investment consultancy services for example. It is difficult to see how actuaries' advice on liability modelling could be rated objectively. However, we believe the standard of their investment consultancy services could well be. For example, actuaries advise on asset allocation and fund manager selection. There is no reason why actuaries' advice could not be rated so that consumers can judge the quality and skills of different firms.



Another effective method for improving the market would be for actuarial firms to move towards a performance related fee basis for asset allocation and fund manager selection advice. Institutional fund managers are accustomed to the idea of working on a performance related basis particularly given the rise of passive management techniques.

The involvement of actuaries in the asset allocation and fund management selection markets can lead to a double layer of charges for pension schemes - once the actuaries set the broad parameters for asset allocation to match liability profile it is not clear what value actuaries add in terms of detailed asset allocation. Given that the available evidence suggests that past performance is no guide to future performance and low cost passive management techniques are available for asset allocation (through consensus funds) and stock selection (through index tracker funds) the involvement of actuaries in asset allocation adds to overall pension funding costs unless their advice leads to better performance against the market consensus.

We think actuarial firms have exploited consumer ignorance and low levels of confidence in these markets to create a need for investment consultancy advice creating two layers of specialists advising on asset allocation and fund management - actuaries and fund managers themselves.

Clearly, one of the best ways to align the interests of actuarial firms and consumers would be for actuaries to work on a performance related basis where fees were levied according to the success or failure of actuaries' recommendations against benchmarks such as index tracker funds or consensus asset allocation funds. However, this is unlikely to happen unless the bigger consumers in the market ie. the biggest pension schemes adopt this strategy.

Q1.26-1.27

We have no comments on these questions.

Q1.28

We think there are two different questions here. Firstly, does the actuarial services function in the consumer interest and, secondly, what degree of competition is there in the market?

We make a distinction here because often there is an assumption that if the indicators of competition exist (choice of supplier, informed consumers,



sufficient information etc) then the market must function in the consumer or public interest. As in so many cases relating to the financial services industry, this is not necessarily the case. It is not enough to assume that if the conditions for competition are created then the benefits of that competition will feed through to serve the consumer/ public interest.

It of course depends how the 'consumer' is defined. In this case the immediate consumer of services is the employer or the life insurance firm, not the employee or policyholder. And it could be argued that the actuarial market has served the immediate consumer very well indeed. The problem is of course that the immediate consumer was not always acting the interest of the end consumer (policyholder/ employee).

There are some specific competition concerns relating to the concentration of suppliers in the investment consultancy market which could be addressed by some of the suggestions we make above in Q1.24-1.25.

It is not clear that the existing professional rules or conventions act as barriers to entry. We do not believe that reducing barriers to entry or introducing other measures which would encourage competition will necessarily result in the profession serving the consumer/ public interest. The bigger challenge is to ensure that the profession takes sufficient account of the end-users (employees/ policyholders) by reforming the wider environment actuaries operate within.

Q1.29

We have no comment on this question.

#### *International comparisons*

Q1.30 - 1.33

We do not have access to information to comment on these questions except to say that there are obvious benefits to learning from experiences in other countries.

#### *Other professions*

Q1.34

We agree the review can learn lessons from developments in the accountancy profession. We support the carving out of the regulatory role of the actuarial professional bodies. There are two possible approaches:



- a dedicated regulator similar to the Financial Reporting Council (FRC) or the GMC. A single regulator would be responsible for standards, compliance with regulatory requirements and other statutory eg. FSMA 2000, qualifications in conjunction with Institute and Faculty, complaints and discipline, ethics etc, or
- regulated separately according to different functions ie. pensions and scheme actuaries regulated by the new pensions regulator, with life insurance actuaries regulated by FSA.

On balance, we prefer a dedicated single regulator. This allows for transferability and would not prevent actuaries working in life insurance having to meet FSA requirements if undertaking a controlled function.

Q1.35

We have no comment on this question.

*Law*

Q1.36-1.37

Perhaps the most appropriate model is that of the General Medical Council and the British Medical Association. The GMC has a clear remit to oversee professional and ethical standards within the medical profession. This is not to say that the GMC is a perfect model as we have some concerns about the GMC in relation to governance, representation and funding mechanisms. However, in principle this model could be appropriate for the actuarial profession allowing the Institute and Faculty to continue with their representation roles similar to the BMA.

## 2 THE CURRENT REGULATORY FRAMEWORK OF THE REGULATORY PROFESSION

Q2.1

We think the regulatory framework should have two key overriding objectives:

- to ensure that the profession and practitioners are legally required to act in the public interest (primarily to provide a counterbalance to the explicit duty directors have to shareholders under company law); and



- ensuring the quality of the science and the market practitioners. This would include
  - professional competence and standards for actuaries
  - overseeing standards and development of actuarial practices
  - monitoring, complaints and enforcement/ disciplinary responsibilities.

As mentioned, we think this would be best achieved through the establishment of a separate regulator akin to the GMC. This would need to be underpinned by the appropriate governance, public representation, and disclosure provisions. We would be happy to discuss further with the review team our preferred model for this regulator.

#### Q2.2-2.4

We do not think the existing regulatory regime serves the public or consumer interest. It is difficult for the professional bodies to act as representatives and regulators of the profession. There is nothing wrong per se in self regulation - indeed self regulation can be an efficient and responsive mechanism for ensuring standards and good practice.

However, the central role of actuaries in various scandals calls in to question this self regulation of such an important profession. This dual role goes against the very principle of good governance which takes on a greater significance in light of the lack of governance and particular dynamics in the markets actuaries operate in - namely life insurance and pension funds.

We have no problems with it being a reserved function and indeed would argue that such key positions should be the reserve of professionals with the specialist expertise actuaries have. The problem is that as we explain above is that the office of actuary and actuarial science is exploited by vested interests to the detriment of consumers.

#### Q2.5 2.6

No. We are of the view that the FSA's proposals risk institutionalising even further the corporate governance flaws within life insurance companies. There is of course an advantage to preventing the actuarial function holder and with



profits actuary from acting as chairman or chief executive. Separating key functions and offices is an important part of good corporate governance. But this is not enough in itself. Good governance as we define it involves identifying where decisions are made and recognising and dealing with conflicts of interests those in positions of power face. The FSA's proposals do not address the fundamental conflicts of interest faced by directors of life insurance firms.

As we say in the introduction, actuaries are not blameless but where detriment has been caused we would argue that this is because commercial imperative and pressure from directors has put pressure on actuaries to conform to the will of the directing minds in the life insurance firms.

The FSA would argue that the requirement of the WPA to publish a report assessing how the board/ firm has exercised discretion will introduce transparency and therefore improve corporate governance and accountability. But this will have little restraining effect in our view.

To begin with, it mistakes transparency for proper governance - which goes much deeper than transparency. Nor does it address the fundamental concern that without some public interest duty, legal protection, or wider governance reforms, actuaries within life firms are unlikely to question the decisions made by the directors. The pressure actuaries will face to conform will still remain as strong as ever.

Moreover, the FSA's reforms still allow substantial discretion in the way asset shares, surrender penalties, reattribution of inherited estates and so on are calculated (these are the issues which determine in practice whether consumers are being treated fairly or under the previous regime whether policyholders reasonable expectations were met).

More needs to be done. Wider governance reforms are needed. Indeed we are of the view that the FSA's reforms institutionalise conflicts of interest. More power will be vested in the hands of directors through this governing body and we think the potential for actuaries to represent the policyholders' interest will be compromised further by these reforms. Furthermore, the already weak provisions on discretion published in CP207 have since been relaxed even more in CP04/14 following fierce lobbying by the industry.

We think it is self-evident that actuaries will come under more pressure from the governing body and directors to make recommendations which suit the firm and its shareholders rather than policyholders. The aim should have been to balance



the duties provided to shareholders with a clear duty and responsibility to policyholders. This is not achieved by FSA reforms which actually vest more responsibility in the hands of directors to interpret what treating customers fairly means.

We were of the view that structural reform of the sector was needed with:

- assets ring fenced within the firm and the actuary being responsible for mediating how different classes and generations of policyholders are treated (in effect a mutual within a PLC entity) and
- actuaries provided with a public interest duty under a new regulatory structure
- an explicit commercial relationship set up between the fund and the corporate entity (as with unit trust structure) and a move away from the 90:10 arrangement to an explicit annual fee for services provided by the corporate entity
- greater policyholder representation on boards of life firms, plus greater resources provided for training lay directors
- tighter fettering of the discretion afforded to directors to manipulate returns<sup>6</sup>
- we are particularly concerned at the FSA's move towards a high level principles approach to regulation which delegates even more responsibility for directors to ensure consumers are being treated fairly. This obviously institutionalises conflicts of interest even further given that the same officers who have an explicit legal duty to maximise shareholders returns will have almost total discretion as to how consumers are being treated. This places a degree of trust and confidence in directors of life firms which frankly isn't warranted given the previous behaviour of firms and the lack of governance reform within life firms. We think at the very least the new

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<sup>6</sup> An example of how firms can manipulate returns and profits in life funds can be seen in the Money Management article attached, where an expert estimates that possibly £1 billion a year is being transferred from surrender values to enhance maturity values to boost the marketing efforts of firms. Given that it is estimated that only a minority of regular premium policyholders maintain payments on long-term contracts for the full duration this exposes significant numbers of consumers to detriment.



regulator<sup>7</sup> should be charged with carrying out spot checks on firms to see if the WPA report is objective and written free of influence from directors.

- all of this needs to be underpinned by reforms to the protections given by section 348 of FSMA 2000 which allows information relating to commercial interests to be withheld.

#### Q2.7

The ability of non-executive directors to challenge experts in firms which sell complex products applies not just to life insurance firms - it applies to any firm which produces a complex product eg. pharmaceutical firms, engineering, biotechnology firms etc.

The issue is one of ensuring that the experts present the information in a transparent and unbiased fashion so that non-executives can exercise their responsibilities. Again, unless actuaries feel protected enough and/or feel obliged to under a legal or regulatory duty to present information fairly and objectively this is unlikely to happen. Even then, given that directors/ governing body will have more authority to interpret what it means to treat customers fairly, we have little confidence that they will use this information objectively.

#### Q2.8

Yes, this should help - but see comments above on need for training and expert support for lay people.

#### Q2.9

Yes, we take the view that the scheme actuary should be reserved for actuaries. Or to be more precise, reserved for an individual who has the same technical skills and experiences as an actuary.

Actuarial science is a specialist enough function to warrant a separate role. In practice, many of the bigger firms will employ investment specialists to advise on specific investment issues.

#### Q2.10

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<sup>7</sup> Not the FSA given that it would be preferable to have an external validator rather than the same regulator which is responsible for the high level principles approach to regulation



It must be said that it is unlikely that most trustees would be able to challenge completely the advice of scheme actuaries given the specialist technical nature of the profession. Hopefully, some of these imbalances may be alleviated by recent reforms. Changing to the funding regimes for pension schemes, the creation of a new proactive regulator, better information disclosure and improved training for trustees should provide some checks and balances if implemented properly. However, a sense of pragmatism is important. There are limits to the extent to which 'lay' trustees can be expected to challenge experts such as actuaries. So there is still a very real need for the profession to be reformed and to accept responsibility.

Again, the key issue is that corporate governance only works when those in possession of and understanding of the implications of technical information act in the consumer interest and do not face unmanageable conflicts of interest.

Q2.11-2.14

It is probably fair to conclude that there is insufficient peer group review or audit of Scheme Actuary's advice. Certainly, in terms of valuing scheme deficits more could be done in cooperation with auditors to ensure realistic valuations of liabilities are produced and appropriate funding mechanisms so that future shocks are avoided.

We agree with the view that the introduction of the scheme specific funding strategy for funding pension commitments and funding deficits does introduce potential conflicts of interest if the same Scheme Actuary is advising the scheme and the employer. The MFR may not have been that effective as a measure for valuing liabilities and deficit funding requirements, but it did have the advantage of introducing a standard which meant the valuation was to a degree mechanical - which removes some potential for conflict of interest.

We are in a difficult position in relation to separation of duties. In principle, we strongly support the separation of duties as having the same actuary acting for both parties under a more 'discretionary' regime goes against the very fundamentals of good governance. Indeed, it would need to ensure that actuaries were from different firms not just different actuaries from within the same firm.

However, we add a caveat to this. We are concerned that this could add significantly to scheme costs and would be reluctant to support anything that might jeopardise employer sponsored final salary schemes unnecessarily. It may



well be that this might not require an increase in costs if actuarial costs were absorbed within the audit function. But we are not able to say definitively where we stand until we further detailed cost/benefit analysis of separation of duties is produced.

It would seem fair to assume that actuarial advice has contributed to the way occupational schemes are funded. However, to reiterate, we take the view that while the profession must share in the blame, the greater share of the problem must be attributed to wider system in which actuaries operated. Actuaries operating in the occupational pension fund sector have faced pressures to produce results which suit powerful vested interests. We share the view that the changes to pensions legislation particularly the scheme specific funding requirement will increase the power and influence of the scheme actuary and heighten concerns about governance and accountability.

Q2.15 - 2.19

No comment.

Q2.20 - 2.23

We are not in a position to say whether there is the right balance between the Profession issuing practising certificates and regulators giving their approval. However, we do think that under a reformed regulatory regime the new regulator would play the central role in ensuring that standards were appropriate and actuaries complied with these standards. The profession could still play a key role in working with and advising the regulator on development of standards and qualifications.

Q2.24-2.26

Overall, we do not believe there are appropriate legal and professional duties and safeguards to protect the public interest (or indeed any actuary who seeks to act in the public interest). The publication of the WPA report is unlikely to lead to disclosure of contentious issues given the pressures on actuaries to write favourable reports on how directors are exercising discretion.

As the review document mentions, the FSA has received ten 'whistleblowing' reports yet given the difficulties associated with disclosing the contents of these reports it will be difficult to establish whether the FSA has responded properly.

Major reform is needed including:

- a public interest duty for actuaries (including a form of 'Hippocratic Oath' for actuaries),
- more transparent and effective approach to enforcement and disclosure on the part of the FSA,
- governance reforms in the life sector,
- crucially, amending of the statutory prohibitions on disclosure of regulatory information in FSMA 2000

Further details can be found in our response to Q2.5 and 2.6.

Q2.27-2.32

We agree with Lord Penrose's view that professional guidance did not protect policyholders' interests. However, we do not think it is appropriate to lay the entire blame for poor standards or inconsistent standards on the actuarial profession. After all, the avoidance of a general rule or practice on reasonable expectations suited very well the interests of the life insurance firms who were able to use the substantial discretion available to manipulate returns to the detriment of vulnerable policyholders.

This reinforces the argument for an independent standards setting regulator accompanied by meaningful regulatory intervention in the form of fettering the discretion available to directors to manipulate returns. The impact of the FSA's approach to reforming with profits invests more power and authority in the hands of directors and retains a significant element of discretion on asset shares and issues such as inherited estates.

In terms of governance this is not appropriate as actuaries in life firms will still come under huge influence to put a seal of approval on directors' decisions. The existence of a public interest duty (plus an independent regulator that sets standards which must be complied with) would provide a very strong defence for actuaries to resist pressure.

Q2.33-2.37



We agree with the view that the lack of transparency and openness of the life industry (including the actuarial profession) has contributed significantly to consumer detriment. The language used by the industry compounded this opacity. Certainly, more could be done to make the terminology employed by the life industry more user friendly.

We stress that greater transparency, while welcome, will not in and of itself lead to meaningful corporate governance or improvements in the quality of with profits products. There is little evidence to suggest that information solutions have significant impact on making complex markets such as life and pensions work in the consumer interest<sup>8</sup>.

It is unlikely that the WPA report or the PPFM will act as a restraint on corporate behaviour unless these transparency measures are accompanied by governance reform. We find it highly unlikely that WPA employed by a life firm will feel emboldened to challenge a firm's exercise of discretion. Moreover, the FSA's approach still allows firms significant discretion in relation to treating customers fairly. In most cases it will not be too difficult for the WPA to report in all good faith to policyholders that firms are complying with their obligations. To reiterate, the FSA's approach is largely a regime where firms:

- are able to define what treating customers fairly means,
- interpret compliance with those self-defined standards, and
- report on compliance with those standards.

It is difficult to think of a model which is so at odds with the very principles and practices of good corporate governance and accountability.

However, it is fair to say that the reviewing actuary should provide better scrutiny of liabilities and other prudential issues, which is to be welcomed.

Similar criticisms of governance in the occupational pensions sector could be made - but not to the same degree as the life insurance sector.

We are of the view that as a general principle actuarial opinions should be addressed directly to policyholders and scheme members. It is not clear under

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<sup>8</sup> for example, disclosure of charges and commission for the life and pensions sector was introduced in 1995 yet this had little downward pressure on prices until the arrival of stakeholder pensions.



what circumstances opinions should not be communicated to policyholders/ scheme members. There is the issue of legibility but that needs to be addressed. At least with scheme members, trustees can play a role in ensuring the information is clear, transparent and meaningful. Unfortunately, no such intermediating body exists within the structure of a life firm.

In terms of widening the scope of peer review and scrutiny there are a number of major issues which need to be addressed. In particular, we would mention the issue of genetic information and insurance (particularly the effect on the underwriting process) and a more general review of the insurance business to evaluate whether firms are being too backward looking when calculating risk premiums.

Q2.38 - 2.43

It is genuinely difficult to say whether the record of 17 complaints over 15 years is sign of success or failure. On the face of it, it would seem to us that given the amount of consumer detriment and market failure in the life sector alone these figures would suggest that few people are being held accountable - an average of just over 1 a year when set against the sheer scale of detriment<sup>9</sup> is rather a contrast.

However, the theme of our response is that the firms/ directors who have been primarily responsible for the detriment and who should be held accountable, not the actuaries. We are not aware of any examples where directors of major life firms were forced to resign as a direct result of a misselling scandal.

Having said that, we couldn't agree more with Lord Penrose that a more direct intervention approach where it was thought the administration of life funds was likely to threaten the legitimate interests of policyholders would improve the image of the profession. More to the point, this would be an effective way of protecting the public interest.

The question is: how best to achieve this proactive interventionist approach? We are of the view that this should be achieved by carving out the regulatory functions into a separate regulator who would be responsible for setting, monitoring, and enforcing ethical and professional standards and discipline.

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<sup>9</sup> we estimate that the total consumer detriment attributable to the life sector alone in the form of pensions, endowment and other misselling, poor value products and unfair treatment of inherited estates/ orphan assets amounts to some £30 billion over the past two decades.



Again, the crucial point is that unless actuaries have a public interest duty to counter the duty directors have to shareholders to improve governance in firms - set within a robust regulatory framework - the key objectives of raising standards and protecting the public interest are unlikely to be met.

In terms of funding the regulator, a number of options could be used including levy on firms or professional fees paid by individual actuaries. It is difficult to say what the best option would be without further cost/benefit analysis.

We are not in a position to say with certainty whether regulators make appropriate use of actuarial expertise. There has always been a concern that regulators cannot match the resources or do not have access to the same expertise available in the private sector.

### 3 ROLES AND RESPONSIBILITIES OF THE GOVERNMENT ACTUARY'S DEPARTMENT

#### Q3.1-3.8

Many of the activities of GAD which concern us have been transferred to the FSA. However, we still see a case for a separate entity to provide truly independent and objective advice to government on social security and pensions matters. Indeed, CA is lobbying for the creation of a new institution which would fulfil a similar function to the Monetary Policy Committee plays in economic policy. We are concerned that there is too much political interference and at the same time neglect of pensions, social security, health and long-term issues.

Future generations of workers do not have a real say in determining policies today. So any reforms must consider the interest not only of today's generations of consumers, but future generations, too, as they will be faced with the responsibility of picking up the bill as a result of demographic pressures. Pensions cannot be considered in isolation, as they are part of a complex web of issues which determine an individual citizen's quality-of-life and living standards in retirement - including access to affordable health care, access to work, the housing market and debt. This complex interaction means that pensions cannot be considered a pure consumer issue: it is a public policy issue, meaning that the market cannot determine and deliver a solution in isolation.

However, the UK lacks a coherent, integrated public policy framework to meet the demographic challenge. New institutions and policies are needed to introduce accountability in government, employers, industry and consumers. Pension and other public policy needs to be shielded from short-term political



influence - both today and in the future. Today's generations of consumers need to be held accountable for the intergenerational transfer of risk that will be loaded onto future generations if they don't provide for the future. As the elderly constitute an ever increasing share of the UK population, it seems unavoidable that public policy questions will increasingly coalesce around age related issues. Politicians must think outside the four to five year election cycle and instigate reforms aimed at delivering long-term sustainability, or else we face major social tension in the UK.

To deliver this long-term vision, a new independent Financial Futures Commission<sup>10</sup> should be established. This would combine the skills and expertise of the DWP, Treasury, GAD and others to oversee the formulation and implementation of public policy and prevent short-term political decisions interfering unduly with what are long term public policy challenges.

It is not possible to remove the politics from pensions entirely - after all what constitutes a fair and decent pension or amount of public spending committed to health care is a matter for society through its elected representatives to decide. However, it is possible to introduce greater political accountability and scrutiny into public policy.

This marks the end of Consumers' Association submission.

**Consumers' Association**  
**September 2004**

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<sup>10</sup> This is just a working title to reflect the purpose of this proposed body



## DTI COMPANY LAW - DRAFT REGULATIONS ON THE OPERATING AND FINANCIAL REVIEW AND DIRECTORS REPORT

*Consumers' Association Submission ref: 04-086*

### *Introduction*

Thank you for the opportunity to respond to the DTI consultation on this important issue. We have not commented on the specific questions contained in the consultation document. However, we have submitted some general comments on corporate governance and accountability. The main subject of our response is the *code of practice on corporate governance and business ethics* we are developing for the financial services industry. We are not suggesting that the DTI take responsibility for introducing this code of practice, however, the standards contained in the code provide a useful template for the information which should be included as part of the reforms outlined in the OFR consultation.

Our key recommendations in relation to the consultation are:

- consumers should have statutory rights of access to information to counterbalance the powerful rights and protections shareholders have under UK company law and listings regime. Consumers should have access to the information which would affect their decision to use (or stop using) a firm's products and services
- firms should be required to report on the impact their activities have on major groups of stakeholders not just shareholders (including risk and impact assessments). This information should be contained within the annual report and accounts or within the OFR.
- a dedicated consumer report containing consumer information and an impact assessment should be compulsory for firms in all sectors. As a bare minimum, this report should contain information on consumer risks, service quality, complaints and redress handling, and compliance with regulations (statutory and/or self regulation).
- however, financial services firms are a priority given the chronic consumer detriment which has led to a collapse of confidence and trust in the sector with huge repercussions for consumers and the wider national economic interest. Major reform of governance and accountability structures are needed to restore confidence and trust in the sector. The interests of shareholders and consumers in key financial sectors are not aligned. Better reporting in annual reports/ OFR would be a powerful spur to that reform. Financial services firms should be required to report on a wider range of



criteria to reflect the higher level of risk consumers face. Consumers' Association code of practice provides a list of standards/ template against which firms impact on consumers can be assessed and monitored.

- it would not be appropriate for directors of individual firms to retain the discretion to determine appropriate information and reporting issues to be included in the OFR/ annual report. The information should be prescribed and the level of disclosure/ content should be determined according to the level of consumer detriment/ risk in different consumer sectors. Preferably, these reports should be independently audited.

If you have any queries about this response, please contact Mick Mc Ateer, Principal Policy Adviser, Consumers' Association, tel: 0207 770 7609, email: [mick.mcateer@which.co.uk](mailto:mick.mcateer@which.co.uk)



### *Section 1: the need for reform*

#### *Background*

We very much support the government's initiatives on corporate governance for UK firms but think that so far the consumer interest has been largely ignored. This may be because there is an assumption that shareholders provide a disciplining effect which means that firms will treat consumers fairly - in other words what is good for shareholders, is good for consumers. This may be the case in consumer sectors where there is real competition rather than the illusion of choice and customer focused firms. Unfortunately, this is not generally the case in some of the major financial sectors such as pensions, insurance, investment and banking where the interests of the firm/ shareholders are not aligned with the consumer and wider public interest.

There are major problems with corporate governance and accountability in the UK financial sector, from a consumer perspective. Many of the issues such as:

- the significant imbalance between statutory protection given to shareholders under UK company law and that available to consumers in relation to duties of directors and access to information,
- the corporate and legal structures or
- the absence of mechanisms for representing the consumer interest

apply to all consumer sectors but are particularly important in financial services because of the complex nature of the market, absence of real competitive pressures and the chronic detriment in the sector.

The imbalance between shareholder and consumer rights in the UK is quite striking and surprising given the influence shareholders already exert in the markets through institutional fund managers etc. Indeed, the current regulatory regimes in the UK actually reinforce the information asymmetries between shareholder and consumer interests in financial services. The OFR (with its intention to empower shareholders even further) if implemented in its current form could actually tilt the balance even further towards shareholders unless counterbalancing measures are introduced to hold firms to account in relation to their treatment of consumers.

The reputation of the UK retail financial services industry has been severely damaged by financial scandals and corporate abuse. Fundamental reform of the way UK financial corporations do business with their consumers is needed to



restore confidence and trust in the industry. The culture of the industry needs to change and the consumer interest needs to be institutionalised from the board room to the point of sale. If confidence is not restored this will further damage consumer interests and the wider national economic interest.

The scale of reform needed is challenging. However, we do think the consultation on the OFR provides the ideal opportunity to provide some counterbalance to the powerful protections and rights afforded to shareholders in complex markets such as financial services. Better reporting would focus directors' minds on how consumers are being treated and allow for scrutiny and oversight by consumer and public interest representatives.

*CA's code of practice/ standards on corporate governance and business ethics*

The issue of corporate governance and accountability is a hot topic in a post Enron and Worldcom, Equitable Life world. We have also seen a wide ranging debate about CSR with regards to the environment or employees. There are some financial firms we know who are genuinely trying to change the way they do business with consumers, but so far they remain a minority. We do not believe there has been a meaningful debate about governance and accountability from the *consumer perspective* within industry, government or regulatory circles.

Why has this been the case? We think this is mainly because the prevailing orthodoxy (the Anglo-US model of corporate behaviour) assumes that the interests of shareholder/ firm are aligned with those of the consumer and that liberalisation and 'natural' market forces will work to meet consumers' needs. That is why most corporate governance initiatives so far have focused on empowering shareholders further in the assumption that shareholders will put pressure on directors/ firms to satisfy consumers' needs. However, as we explain below that model is limited in financial services and another approach is needed to align consumer and corporate interests, act as a proxy for competition and ensure consumers are treated fairly.

The causes of detriment in retail financial markets remain. Issues such as pensions and endowment misselling, front-end loaded charges, unfair terms and conditions, commission bias etc are outward manifestations of underlying flaws in the corporate governance and accountability structures within the financial services industry. The risk of detriment therefore remains unless new checks and balances are introduced to persuade directors of firms exploiting the absence of governance and accountability mechanisms.



FSA regulated firms already have a regulatory duty to treat customers fairly and to be open and transparent. However, given that directors have significant discretion to interpret what that means it does not provide a meaningful counterbalance to the legal duty owed to shareholders. Moreover, many of practices which cause detriment in the market do not fall outside the regulation (see below - responsible practices).

Therefore, CA has developed a set of standards on corporate governance and business ethics which we believe if adopted would change the relationship between consumers and the financial services industry.

We are about to publish a consultation document on our code of practice and will be discussing with the financial services industry how best to turn this in to a meaningful set of standards for guiding company performance in relation to consumers and measuring performance. We are of course keen for firms to voluntarily sign up to a code of practice as a sign of willingness to put consumers at the heart of business planning and decision making at the highest level. However, even if firms do not sign up we will use these standards as a template for assessing business practices and where appropriate expose bad practice.

Greater transparency alone does not provide meaningful corporate governance and accountability - it requires better regulation and change in legal and corporate structures. But transparency and better reporting is an important part of the menu of solutions. Publication within the annual report and accounts (or specifically as part of the OFR) of an objective and open assessment of how firms have performed against the relevant standards would be a useful mechanism for introducing a degree of proper corporate governance and accountability from the consumer perspective. Section II of this submission outlines how CA's code of practice could apply to the OFR.

#### *Application of the code to DTI regulations on OFR and Directors reports*

We recommend that annual reports and accounts (or the OFR) should be required to have separate sections dedicated to reporting on the impact firms have made on the main groups of stakeholders. Clearly, until now most attention has focused on information important to shareholders and creditors. More recently we have seen an increase in reporting from a CSR perspective. However, we have not seen the same attention given to consumers as a dedicated stakeholder group.

In terms of reporting format and structure, we suggest two alternatives.



The annual reports and accounts could be split into two clearly defined broad sections containing performance information:

- The standard financial information and data relating to financial performance, profit and loss, balance sheet information etc of interest mainly to shareholders and creditors
  - This should be complemented by a risk assessment which identifies the key external risks and commercial factors which will affect financial performance. It is appropriate for directors to determine which factors will affect financial performance and therefore shareholder interests. After all, if it becomes clear that directors have not understood the business environment or withheld information from shareholders they can be held to account.
- Information relating to relationships with wider stakeholders other than shareholders which may be broken down into separate sub sections, for example:
  - a CSR report relating to environmental and community issues
  - treatment of employees
  - treatment of suppliers
  - a dedicated consumer report.

Alternatively, the OFR itself could contain separate sections relating to shareholders and other stakeholders.

Other stakeholder representatives will have views on whether the parts of the report relevant to them should be compulsory. We are certainly of the view that the dedicated consumer report section should be compulsory for firms in all sectors particularly those which are regulated –either statutory or self regulation. At a bare minimum this should contain a report on complaints handling and compliance with regulation (whether statutory, self or standards based).

However, given the level of detriment retail financial services firms are a priority and should be required to report on the wider list of standards in CA's code of practice.



It would not be appropriate for directors of individual firms to have discretion to determine the appropriate factors for inclusion in the report. Given the imbalance in rights of access to information and information asymmetries in the market between shareholders and consumers, consumers are not in a position to judge whether information is correct and relevant. This needs to be prescribed and preferably independently evaluated.

Shareholders are already privileged by the UK regulatory and legal regime. Directors have an explicit duty to shareholders under UK company law. In addition, under the UK listings regime shareholders have legal rights of access to information which would affect their decision to invest or continue to invest in a firm.

The irony is of course is that the bulk of shares are held by institutional investors in long-term pensions and investment markets (albeit on behalf of ordinary consumers) and these institutional investors should be in a position to evaluate risk from a professional standpoint. Yet ordinary consumers who may have a long-term relationship with financial services firms are given nowhere near the same rights of access to critical information as institutional or professional investors.

Even if the theories about market failure being due to information asymmetries were valid, the current regulatory regimes in the UK actually reinforce the asymmetries between shareholder and consumer interests. It is not surprising that the overwhelming advantage shareholders have in terms of access to performance information combined with governance conflicts in relation to directors' remuneration leads to a shareholder interests taking precedence over consumers' interests. Again this is a particular problem in complex markets such as financial services.

In terms of producing meaningful information for stakeholders, the OFR would need to be tailored to be suitable for different sectors. The type of information which is important (or the risks the firm is associated with) will understandably differ depending on which sector of the economy the firm operates in.

The standards in CA's code provide a template for allowing directors to report to the wider public on a firm's relationship with its consumers. The code also allows for performance to be objectively and transparently evaluated. It allows for consistent measures of performance and reporting to be used. It allows for risks to be identified, especially reputational or regulatory. The measures within the



code allow non-execs and public interest representatives to perform their duties more effectively and confidently.

#### *Relationship with other reviews*

Importantly, we were campaigning for the Financial Services Authority to introduce meaningful standards of governance and accountability to the life insurance sector as part of its with profits review and treating customers fairly reviews. However, it is clear that the FSA's initiatives are unlikely to lead to meaningful improvements in governance and accountability in the financial services industry or a fundamental change in the relationship between financial firms and their consumers. Indeed the FSA is moving towards a regulatory system based on high level principles with more responsibility and discretion as to how consumers are treated being devolved to directors. In financial services this entrenches rather than improves the existing governance flaws.

Similarly, as a result of the Penrose report into Equitable Life, Paul Myners is reviewing corporate governance of mutual life offices and Derek Morris is reviewing the role of actuaries within life insurance companies. These reviews are to be welcomed of course but do not provide the overarching assessment and review of governance in the financial services industry needed to align the industry with consumer and national economic interest. The remit of the Myners review is somewhat surprising given that governance is much more problematical issue in proprietary life firms than in the mutual sector. Similarly, the role of actuaries is important but needs to be seen in the context of overall governance of life firms as the relationships between actuaries and the boards are crucial.

#### *What is corporate governance and accountability?*

There are many theories and definitions of corporate governance which have appeared in various reviews. For example, Cadbury describes governance as 'the system by which companies are directed and controlled'. Most of the reviews relate mainly to the governance of a firm from a shareholders perspective and are reflected in the Combined Code on Corporate Governance published by the Financial Reporting Council which is annexed to the FSA's listing rules.

However, we use a more fundamental approach which describes and sets out the purpose of governance, integrity and accountability and business ethics from the *consumer's* perspective. Governance, integrity, accountability and ethics:

- identifies sources of power and influence within firms, which offices and officers have the power to make decisions which affect consumers and



- ensures there are structures and checks and balances in place to ensure that
  - the consumer interest is represented properly in business planning and decision-making particularly when directors have a legal duty to other more powerful and influential stakeholders such as shareholders
  - consumers needs are properly understood
  - directors have an incentive to treat customers fairly
  - conflicts of interests are identified and resolved fairly and transparently
  - those in positions of power do not exploit those positions either individually or collectively
  - when checks and balances don't exist, ethical standards are in place to ensure that directors and other company officers act with integrity and do not exploit absence of controls
  - those in positions of power (and those they represent such as shareholders) are held responsible and accountable when abuse of control or position does occur

It is important to emphasise that opacity in and of itself does not cause corporate governance failings - it simply exacerbates poor corporate governance. It follows that relying on greater transparency alone will have limited impact in enforcing high standards of corporate governance in complex sectors where consumer influence and competition is very weak, and is unlikely to require firms to treat customers fairly. However, the OFR if properly deployed could be a useful spur to reform.

#### *Potential outcomes*

The intention of our code of practice is to align corporate and consumer interests - the OFR could also help align those interests. If an alignment results we would expect to see a number of positive outcomes including:

- directors and managers of firms put consumer interest at the heart of decision making, consumers interests are put on a par with shareholders



- customers are treated fairly
- the market moves to an attitude where quality sales are prioritised not just volume of sales
- existing customers are given the same attention as attracting new customers
- real competition is introduced, firms who do want to treat customers fairly have confidence to do so
- training and competence standards rise in the industry
- responsible practices are adopted by the industry
- sustainable, consumer friendly business models which are aligned with consumers' needs are adopted
- ultimately, mutually beneficial long-term relationships develop between consumers and FS industry

*Why is the financial services industry a priority for improving standards of governance and accountability?*

The conventional model of Anglo-US corporate behaviour which describes the circular relationship in the market between shareholders/ pension funds/ trustees, firms/directors and consumers works well for certain sectors of the economy. This model can be described in a simple fashion:

- pension funds/ trustees, investment funds allocate capital to firms in the market which offer 'best' return on investment for investors
- directors have legal duty to represent interests of shareholders by making profit so that share price can rise/ dividends can be paid. To do so, directors have to allocate capital provided by investors to activities (products and services) which generate highest return on capital employed
- the theory goes that to generate that necessary return for shareholders firms have to compete to satisfy consumers in the market. If shareholders are not happy they can take their capital elsewhere by selling shares to invest in firms which offer better return. This model assumes that what is good for shareholders must be good for consumers.



- competition and a functioning market generate economic activity and savings for consumers who in turn provide further capital via long-term savings and investment.

And so it goes on. This circular model of markets holds that shareholder/ firm and consumer interests are aligned to promote competition in markets and long-term value for investors and consumers (who are often one and the same person). So far, the theory and practice of corporate governance has focused on improving governance from the shareholders perspective in the assumption that they will provide the necessary disciplining effect to ensure that consumers' needs and wants are met effectively by firms.

Of course, in reality this model has major limitations particularly in complex sectors such as financial services. The model assumes that:

- a high degree of consumer sovereignty exists in a market, consumer influence is strong and can switch easily to better providers of goods and services
- there is a mutuality of interests between shareholders/ firms and consumers
- there is real competition rather than illusion of choice and competition eg. there is genuine competition for the end-user rather than intermediaries/ distributors (who may not pass this on to consumers)
- new entrants can innovate and compete against established rivals.

In the case of key financial services sectors these conditions are not met. Conventional models assume for example that firms can innovate to gain a market advantage and other firms then compete away that advantage to spread the benefits to consumers. In financial services, because consumer influence<sup>11</sup> is weak, firms compete for distribution which can lead to greater consumer detriment rather than welfare through higher distribution costs or unnecessary proliferation of products which exacerbates the effects of confusion marketing practices.

The pity is that in the past firms that have tried to adopt consumer friendly business practices have not been successful or have actually found that they have lost market share and have quickly reverted to the prevailing commercial

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<sup>11</sup> Due to many factors such as complexity, financial literacy, confidence, pressure sales tactics, etc



models. The nature of competition and absence of proper corporate governance in certain sectors entrenches detrimental practices and we believe some external mechanism in the form of an independent code or set of standards is needed to incentivise good practice and 'protect' firms who genuinely want to treat customers fairly. We take the view that the current financial regulatory framework (and the FSA's approach to regulation) will not provide that spur to improvement.

#### *Application to other sectors*

Corporate behaviour in all consumer sectors is a key issue for Consumers' Association. We are evaluating whether this model for improving governance and accountability could be adopted for other sectors where corporate behaviour is not aligned with consumer and wider public interests.

Clearly, ensuring that firms deliver value for money products and services is important but is only one part of a wider set of objectives. Certain consumers markets may be working well to deliver value for money products to consumers but may not be aligned with public policy objectives such as healthy eating, or dealing with issues of access and exclusion.

The practices of food manufacturers and marketers in relation to the diet and health crisis may deserve further attention - similarly the practices and behaviour of pharmaceutical firms in relation to promotion and safety of medicines is a cause for concern.

But for now we are concentrating on the financial services industry as this is the sector where market based consumer detriment is greatest and can be addressed by governance reforms.

#### *Statutory amendments and freedom of information*

One of the biggest barriers to better corporate governance and accountability is the unnecessary level of protection given to commercial interests in UK legislation. The Freedom of Information Act which takes effect from 2005 will be seriously undermined by these existing protections given to corporate interests - information which is subject to an existing statutory prohibition such as s348 of the FSMA 2000 will be protected by a class exemption under the FOI. We are maintaining our lobbying to persuade the government to amend these rules so that consumers can have access to information which can affect their choices and decision making, and hold firms to account.



*Section II: Consumers' Association Code of practice/ standards on corporate governance and accountability*

CA's code of practice and standards covers the following areas:

- a consumer constitution with guiding principles and practices
- representing the consumer interest
- directors' remuneration
- sales/ business cultures
- disclosure of information and performance indicators
- fair and responsible practices
- risk management procedures
- ongoing relationships with consumers
- redress and complaints handling
- training and competence

We have set out the issue each part of the code is intended to address and how the code could be monitored.

*Constitution and principles*

Issue: directors of firms have an explicit duty to shareholders under UK company law. However, firms have no corresponding overarching duty to consumers. There are a number of statutory and self-regulatory measures which are meant to provide some balance to that duty to shareholders. However, we do not believe that these are effective enough. For example, FSA regulated firms do have a regulatory duty to 'treat customers fairly'. However, this is an undefined principle which is to all intents and purposes left to directors to interpret. This would not be major problem if we had a functioning market where there were strong competitive pressures on firms to treat consumers fairly. Moreover, many of the issues which we believe are unfair and cause detriment are not actually covered by regulation anyway (commission bias, unfair pricing, remuneration strategies etc). The code we are developing is intended to build on the

foundation provided by statutory legislation and regulation to improve business performance.

Another example is industry codes of practice. Many of these initiatives are worthwhile and can play an important role in making markets work (Banking code, Raising Standards etc). But again we do not think these codes go far enough and do not address the fundamental governance relationships and conflicts of interest between consumers, firms (and their directors and shareholders). Other codes of practice fall short in terms of the standards set and compliance and enforcement.

Overall, we are of the view that the existence of this clear and powerful legal duty to shareholders is **not** counterbalanced by market forces or existing regulatory mechanisms which are intended to protect the consumer interest. We believe this leads to an imbalance of interests in favour of shareholders especially whenever a conflict of interest arises.<sup>12</sup>

**Code of practice:** to provide a counterbalance to the duty to shareholders firms should produce a constitution and a set of guiding principles and practices which:

- defines and governs business operations,
- sets out the relationship or 'contract' between firms and customers, and
- provides the framework for governance and accountability.

This should be more than just a mission statement or token charter. This constitution should be underpinned and implemented by the elements of the code. This will define the relationship between firms and consumers and provide the basis for a dedicated report setting out firms have treated customers in annual reports and AGMs. This constitution would form the basis of the reporting requirements in the OFR.

The principles and practices set out in the constitution should cover:

- pricing policies
- responsible practices

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<sup>12</sup> the attribution of inherited estates (orphan assets) in life insurance funds etc



- redress and complaints handling
- customer satisfaction
- consumer representation and other governance issues
- service levels
- other factors specific to the business

As well as providing financial performance information, annual reports and accounts should include a dedicated section which assessed how the firms performed against these standards and where performance has fallen short what is being done to rectify the situation. We are currently working on ideas on how this could be verified.

This reporting format dovetails well with the approach set out in the consultation paper on OFR.

#### *Representing the consumer interest*

**Issue:** one of the main corporate governance flaws is the lack of direct mechanisms for representing the consumer interest at board level of firms. As mentioned, directors have an explicit duty to shareholders; in addition only shareholders may elect directors and shareholders approve strategic decisions by voting.

**Code of practice:** aim of this element of the code is to ensure that consumers/ policyholders interests are factored in to decision making and planning at the highest level in the firm. Another important factor is that, as explained below, there are concerns that management information is often 'sanitised' before it reaches the highest level which means that directors may have little idea of what is happening in the further reaches of the business and may have a 'rose tinted' view of how the firm is treating its customers.

We would like to see an improved role for non-executive directors representing the consumer interest in challenging the board and acting as a conduit for information relating to performance.

In addition, we would like firms to evaluate whether provision could be made for consumers/ policyholders to nominate directors for election.



A further measure is that we would like firms to set up shadow boards, or consumer councils/ panels who would have a specific public interest objective to evaluate and advise on business strategy and practices from the consumer perspective eg. product development and pricing policies etc.

To facilitate these measures, we are evaluating whether a register of approved public/ consumer interest representatives can be developed.

Directors should set out in the OFR what steps they have taken to ensure the consumer interest has been properly represented in decision making process and the mechanisms for addressing conflicts of interest between shareholders/ directors and consumers.

#### *Directors' remuneration*

**Issue:** the processes for calculating director's remuneration mean that the interests of the firm/ shareholders and directors themselves are sometimes severely misaligned with consumers' interests. Director's bonuses and share options are generally linked to financial performance and do not factor in sufficiently measurements of how well consumers are treated/ compliance with regulation etc. Not surprisingly, human nature being what it is, directors will devote more attention to satisfying shareholders interests or when it comes to conflicts of interest will side with shareholders. This along with commercial models used by firms has led to for example more attention being paid to volume of sales rather than quality of sales in the life and pensions sector.

**Code of practice:** the aim of this element of the code is incentivise directors to truly put consumers at the heart of business decisions and to pay more attention to consumer protection. We take the view that if directors knew that treating consumers unfairly or allowing compliance failures to occur would hit them directly in the pocket, attitudes would change.

Directors remuneration should be linked to a range of performance indicators which measure how well consumers are being treated, not just financial performance. We are currently developing a range of meaningful performance indicators which to judge performance. This is likely to include factors such as number of complaints, response times, compliance failures, customer satisfaction surveys etc

One practice that has been suggested to us is that directors should have their bonuses reduced if regulatory enforcement decisions or fines are incurred.



Evaluation of performance criteria should be overseen by an independent remuneration committee/ shadow boards/ consumer councils who would recommend directors' remuneration.

This is an area where performance against criteria could be published in the OFR/ annual report.

### *Sales/ business cultures*

**Issue:** one of the biggest sources of detriment we have identified is that the prevailing business models used by firms to compete for business result in conflicts of interests between firms and consumers. The prime example is the use of commission and other remuneration strategies which link staff remuneration to volume of sales. This not surprisingly has led to an emphasis on volume of sales rather than quality of sales particularly in sectors such as life and pensions where consumer influence is weak. In many cases, the best option for the consumer may have been no-sale at all but the use of these commercial models incentivise practices such as churning.

**Code of practice:** the business models need fundamental reform. The scale of the reforms needed is outside the scope of this code of practice and the OFR and we are campaigning for wider changes to selling practices to align distribution strategies with consumer interests.

For example, we would like to see IFAs and other distributors move to charging a simple, transparent tariff which would decouple the relationship between commission paid by product manufacturers and product recommendations by distributors.

We are also lobbying for FSA to make a rule for retail markets preventing firms using remuneration strategies which conflicts with duty to treat customers fairly. There is a precedent in the institutional investment markets where conduct of business regulations require that remuneration paid to investment banking staff should be i) consistent with impartial assessment of a company's prospects and ii) cannot be tied to a specific deal. Again, it is ironic that the regulators recognise the need to make rules to prevent potential conflicts of interest caused by commercial models in the institutional markets - markets where 'consumers' are meant to be relatively sophisticated and exert a powerful influence - yet there is no real equivalent in the retail sector.

It may take some time for CA to persuade FSA to regulate for changes in sales practices and we are lobbying firms to adopt voluntarily remuneration strategies



which reward staff according to overall financial and corporate performance rather than just sales volumes.

However, as an interim measure, it would be very helpful if directors as part of the OFR requirements were required to identify the risks to consumers caused by remuneration and sales strategies and what steps they are taking to address those risks.

#### *Disclosure of information/ performance indicators*

**Issue:** linked to the imbalance between shareholders and consumers arising from the explicit legal duty directors have to shareholders, is the issue of rights to information. Under UK listings regime, shareholders have rights to immediate disclosure of all information which is material to share price (with a few closely drawn exceptions). Consumers' rights are much weaker under UK law and regulation - this is exacerbated by the unnecessary protection given to commercial interests in s348 of the FSMA 2000. In addition, sophisticated financial indicators exist which allow investors/ shareholders (and their expert representatives and advisers) to judge financial performance of firms and directors). The current regulatory regimes in the UK actually reinforce the information asymmetries between shareholder and consumer interests - the OFR if implemented in its current form would tilt the balance even further towards shareholders.

**Code of practice:** in keeping with the protection afforded to shareholders consumers should have equivalent rights of access to information which could affect their decision to invest/ continue to invest (or save/ borrow). We are developing performance indicators which would allow consumers to make properly informed decisions which should cover issues such as:

- disclosure of real charges,
- complaints data,
- persistency data (or some other measure of customer retention which demonstrates quality of sales),
- regulatory information such as enforcement data or misselling cases,
- claims handling and other service standards,
- complaints handling/ redress.



This information should allow consumers and their representatives to assess whether the principles and practices set out in the consumer constitution above are being complied with and targets being met.

This should be a key part of the OFR. Access to critical information needs regulatory underpinning and we are lobbying to amend the unnecessary protections in s348 of FSMA (see above) as access to this type of information should be a statutory right for consumers. However, for now we are trying to persuade firms to voluntarily disclose this data as part of the code of practice.

This information should be included in the dedicated consumer section of the annual report and account. Directors should be required to report on performance.

#### *Fair and responsible practices*

**Issue:** FSA regulated firms already have a regulatory duty to treat customers fairly and to be open and transparent. However, in practice this does not work very well in terms of consumer experiences. Firms operate within regulations and have become skilled at pushing the boundaries of regulation. There are particular problems with communications, marketing, advertising, responsible lending and so on. Indeed, many of the practices which cause so much detriment are not against regulatory requirements - issues such as front-end charges, discretionary penalties, exclusions in insurance policies, overdraft charges and so on.

**Code of practice:** firms should set out and incorporate into constitution and guiding principles demonstrable and measurable practice standards which are responsible, transparent, fair, and honest. We will be working with industry to develop relevant practices which are commercially viable, and to take into account existing industry codes of practices.

Compliance with these fair and responsible practices should be overseen by shadow boards/ consumer councils (see above). Directors should be required to report in the OFR on how firms have performed against these standards, and where compliance failures have occurred what is being done to rectify the matter.

#### *Risk management procedures and stress testing products*

**Issue:** the financial services industry is not responsive enough when financial scandals happen or when consumers are exposed to risks. There are general problems with risk management within the sector. One particular manifestation



of irresponsible practices outlined above is unsuitable or inappropriate products being sold to consumers. Regulation covers this to some degree but we want to pre-empt problems and consumers may not be aware that they have been sold unsuitable products.

**Code of practice:** we want firms to adopt better risk management techniques similar to product recalls. It is difficult to recall financial products but selling practices can be amended, or literature revised and emergency training programmes implemented. In addition, firms should develop mechanisms for 'stress testing' products before and once they are launched onto the market to ensure products are understood by different groups of consumers, sales staff and intermediaries. Selling practices and literature should be revised in light of stress testing, and in extreme cases products should not be brought to market.

Again, this is an area which should be overseen by shadow boards/ consumer councils and reported on in dedicated section of report and accounts/ OFR as part of identification of risks which may affect company performance.

#### *Ongoing relationships with customers*

**Issue:** in certain financial services sectors, the commercial models adopted are geared up to getting a sale which can lead to churning of products and ongoing relationships with customers being neglected. There is a mismatch between short term horizons of shareholders and long-term horizons of consumers (who may be saving for a pension over 30 years, or paying a mortgage off over 25 years). Indeed one of the major reasons for the undermining of confidence in the insurance industry for example is the sudden shock syndrome. Consumers were not aware of the scale of the mortgage endowment problem because insurers did not keep them fully informed about progress of their endowment policy. There are also concerns about treating of existing consumers who may be cross subsidising new business acquisition - a particular problem in the insurance sector where directors have significant discretion to levy punitive penalties to keep policyholders trapped within funds. This of course is detrimental for competition generally as consumers' ability to switch to better performing firms is restricted.

**Code of practice:** we are asking HMT to establish an independent investigation into ways of 'freeing the prisoners' in life insurance funds. However, there are a number of voluntary practices firms could adopt including pricing policies, improved communications with existing customers, transparent guidelines on how the interests of existing and new customers are balanced. These should be set down in the constitution and principles and reported on in the OFR.



### *Redress and complaints handling*

**Issue:** redress is one of the key consumer principles yet there are major issues in relation to the way firms treat redress and complaints with inconsistencies and different levels of commitment to get things right. If detriment occurs, that detriment remains unresolved unless consumers have access to redress.

**Code of practice:** we know genuine mistakes happen and perfection is not possible but new commitments and standards on redress and complaints handling are needed. Public commitments on time taken to process complaints should be set out in the guiding principles and practices (see above) and reported on in the annual report and accounts/ OFR. Firms should adopt responsible practices and alert consumers to possible risks/ misselling promptly.

### *Training and competence*

**Issue:** many firms think of training just in terms of achieving sales volumes with the result that the consumer focus is lost, consumer needs are not given priority and unsuitable or inappropriate products are sold.

**Code of practice:** firms should take training and competence and qualifications seriously and recognise staff as a resource not selling machines. Firms should demonstrate a commitment to higher professionalism and incorporate ethics and treating customers fairly into training programmes. Again, this should be scrutinised by shadow boards/ consumer councils and training and competence issues reported on.

### *Next steps*

Consumers' Association is about to issue a discussion paper on the code of practice which will be followed up by a series of discussions with the financial services industry. We will then decide on which elements should be voluntary and which require statutory regulation to enforce. We also have to consider in more detail how this code will interact with existing codes of practice (eg. the banking code of practice) and existing statutory regulation. We will try to persuade the industry to adopt the standards in the code but are determined that if cooperation is not forthcoming we will instead use this as a template for exposing bad practice and naming and shaming.

The intention is to launch the finalised code in the early part of 2005.

## **Consumers' Association**

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August 2004

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FSA CP207 - Treating with-profits policyholders  
fairly

Submission by  
The Consumers' Association

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*Consumers' Association response to FSA CP207 Treating with-profits policyholders fairly*

*Introduction*

It is fair to say that since CA published its report on with-profits 'Profits at the consumers' expense' in February 2001 which exposed the reality behind the myth of with-profits there have been significant improvements in the quality of with-profits funds from the point of view of *prospective* consumers.

However, this improvement has occurred as a result of fierce public pressure from CA and media exposure rather than any fundamental change in culture in the with-profits industry or an improved regulatory environment.

There are two key outstanding questions in relation to the with-profits sector:

- Is the improvement permanent rather than a defensive and belated response on the part of the sector; can consumers have trust in the sector going forward?; and
- What can be done to protect the interests of existing policyholders who remain very vulnerable to practices in with-profits funds?

So far, CA has been disappointed at the progress of the FSA's with-profits review. In some cases the FSA's approach has actually weakened the position of consumers in relation to corporate governance. However, we had hoped that even at this late stage of the review, given the importance of the subject matter, CP207 provided an opportunity to address those shortcomings. Unfortunately, the FSA's proposals in CP207 do not provide that reassurance.

Moreover, there are cultural and regulatory changes needed in the wider financial services industry (not just with-profits) on corporate governance and accountability, regulation and consumer rights.

Ultimately, based on our analysis of the sector and evaluation of the FSA's proposals we conclude that there is no guarantee of permanent improvement and policyholders remain vulnerable to significant future detriment.

This response is in two parts: part 1 provides the background to CA's response, part 2 our response to specific questions.



We would be pleased to discuss further with the FSA or other parties any points raised here. This consultation response was prepared by Mick Mc Ateer, Principal Policy Adviser. Comments and queries should be directed to the attention of Emma Bandey, Senior Public Affairs Officer, Consumers' Association, 2 Marylebone Road, London NW1 4DF (or e-mail: [emma.bandey@which.co.uk](mailto:emma.bandey@which.co.uk)).

*Part 1: The case for reform*

The need for fundamental reform of the with profits sector is overwhelming:

- The sector is one of the biggest retail financial sectors and affects the financial wellbeing of millions of consumers. The sector looks after consumer assets worth in the region of £300-400 billion.
- Consumers rely on the sector to meet core needs such as pensions<sup>13</sup>, long-term savings, investment, insurance, repaying mortgages. These are not disposable consumer goods. The behaviour of the firms in the sector can make a difference to consumers' standards of living and basic quality-of-life.
- Yet the sector has been probably the single biggest source of consumer detriment in the past two decades (not just in financial services). It has been the pre-eminent example of an industry where the principle of treating customers fairly has been ignored or abused. It has been at the centre of scandals such as pensions misselling, mortgage endowment misselling, prudential scares such as Equitable Life, rip-off products which levied huge charges on the mass market of ordinary consumers, corporate abuse such as using inherited estates (orphan assets) to pay misselling compensation to protect shareholder interests, raids on inherited estates to boost shareholder interests and so on.
- The legal, corporate and contractual nature of the products gives rise to huge conflicts of interests and potential for corporate malpractice. Yet the corporate governance and accountability structure is anachronistic and at odds with modern thinking and practices followed in other sectors where consumers are vulnerable eg. employers' pension funds and unit trusts/ OEICS. This absence of meaningful corporate governance is exacerbated by product complexity and lack of transparency<sup>14</sup>.

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<sup>13</sup> Consumers are expected to use the sector's products even more in future. There is a huge transfer of risk and responsibility away from the state (as the basic state pension falls in value) and employers (who are closing final salary pension schemes) to individual consumers who are expected to use the capital markets and products of the industry to meet core needs such as pensions. Yet the sector is not fit for purpose.

<sup>14</sup> it is important to emphasise that opacity in and of itself does not cause corporate governance failings - it simply exacerbates poor corporate governance. Real corporate governance relates to appropriate legal, corporate and contractual forms, and putting checks and balances in place to ensure that the consumer



- Perhaps the most disconcerting aspect of the way the sector functions is the long-term nature of the relationship consumers are expected to have with firms. Millions of endowment and pension policies will mature over the next few decades, consumers must keep their annuities for their remaining lifetimes. Many with-profits consumers now face a stark choice - either risk being exploited by directors who are unfettered by meaningful corporate governance structures, or seek a better alternative and face the prospect of paying punitive surrender or transfer penalties.
- No doubt there will be fresh consumer scandals involving the financial services industry. But we are of the view that the plight of existing insurance company policyholders<sup>15</sup> will be one of the key consumer and regulatory issues in the next few years. Government, regulators, industry and consumers alike face a huge legacy problem in the sector - how best to protect interests of consumers who are exposed to such long-term risks.

*Problems with with-profits funds*

Consumers face a number of risks dealing with with-profits sector when compared with other retail investment vehicles. These are detailed in our report Profits at the Consumers' Expense and in our previous submissions to the FSA's with profits review. However, it may be helpful to summarise these here to help judge how much progress has been made and to establish what needs to be done to ensure that with-profits are truly fit for purpose and consumers (existing and prospective) can have confidence that they will be treated fairly.

Type of risk	Description (pre-FSA review)	Impact of FSA's review
Corporate	directors have an express fiduciary duty to shareholders under	Basically unchanged.

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interest is properly represented and individuals in positions of power and influence do not abuse those positions either individually or collectively. It follows that relying on greater transparency will have limited impact in enforcing high standards of corporate governance in complex sectors where consumer influence and competition is very weak, and is unlikely to require firms to treat customers fairly.

<sup>15</sup> This applies to all insurance company policyholders but with-profits are a particular problem.



	company law with no corresponding duty to policyholders save un-prescribed regulatory requirements such as treating customers fairly <sup>16</sup>	
Legal	<p>beneficial ownership of policyholder assets rests with the insurance company not the policyholder. Major contrast with other corporate structures eg. unit trusts/ OEICS, employers pension funds</p> <p>policyholders' interests in inherited estate not been enforced by regulation. Vulnerable to Axa type raids. Deals effectively <i>fait accompli</i></p>	<p>Unchanged. No ring fencing of assets either legally or through regulation</p> <p>Unchanged. Undermines influence of FSA's policyholder advocate</p>
Contractual/ discretion	the contractual nature of with-profits allied to the discretion over payments and penalties	On balance unchanged. What limited improvement re: discretion negated by

<sup>16</sup> previously policyholder interests were balanced by policyholders' reasonable expectations (PRE). However, the interpretation and application of PRE was in the hands of directors on the advice of the appointed actuary. This discretion over PRE gave rise to major policyholder detriment. It is perhaps not surprising that directors of some firms used this opportunity to maximise shareholders interests at the expense of policyholders. For the position of policyholders to improve, this discretion on treating customers fairly must be fettered directly by regulation or law.



	<p>leaves policyholders vulnerable</p>	<p>corporate governance proposals. Proposals on target ranges in CP207 could have been advance if accompanied by corporate governance reforms. In practice, firms left with wide discretion particularly over asset shares. FSA relying on transparency and market forces to constrain behaviour. Existing policyholders remain vulnerable to manipulation, and cross-subsidy risks, raids on inherited estates</p>
<p>Corporate governance, accountability and consumer representation</p>	<p>No equivalent to trustee structure or direct consumer representation established in other sectors eg. employers' pension funds or OEICS/ unit trusts</p> <p>Firms can evade corporate accountability by</p>	<p>FSA's proposals provide more power and authority to directors. No explicit separation of duties or responsibilities within life fund company structure between management firm and policyholders funds. No requirement for explicit commercial fee arrangement between management firm and with-profits fund. No direct policyholder representation</p>



	<p>paying compensation from inherited estate. Weak deterrent against corporate malpractice.</p>	<p>Firms will still be able to pay compensation from estate so protecting shareholder interests and by definition directors interests</p>
<p>Investment and prudential</p>	<p>with-profits investors are meant to be protected from investment risk by smoothing - but this has not been delivered in practice. They also face additional risks because of the nature of with-profits including sharing in losses and other prudential risks (eg. Equitable Life).</p>	<p>Good in parts. FSA indicate tougher approach to solvency which may reduce likelihood of prudential failure.</p> <p>However, concerns remain over application of FSCS to with-profits.</p>
<p>Regulatory</p>	<p>Regulatory principles re: treating customers fairly and discretion are unprescribed which undermines accountability. FSCS unclear about protection given to with-profits policyholders in the event of collapse<sup>17</sup></p>	<p>See above. FSA's proposals unlikely to represent permanent change.</p> <p>See above. Concerns remain about FSCS</p> <p>New reporting regime is an improvement but</p>

<sup>17</sup> As it stands, the FSCS definitely applies to guaranteed benefits but it is not clear how it would apply to discretionary benefits such as terminal bonuses as it must be tested by courts. CA has suggested new way of



	Regulatory reporting problem in past	presumption of protecting commercial interests and restrictive attitude to freedom of information generally still applies
Transparency	<p>Structural and governance problems exacerbated by opacity of with-profits operations. Weak freedom of information provisions in UK financial regulatory system with presumption on commercial confidentiality to protect corporate interests rather than disclosure.</p> <p>Critical example is inherited estates where negotiations are conducted behind closed doors.</p> <p>Consumer rights to disclosure compare very unfavourably with shareholders rights under listings regime.</p>	<p>Firms required to publish more information re: PPFM. However, all this means is that firms must be more transparent as to the discretion they retain. May benefit prospective policyholders but of little use per se to existing policyholders.</p> <p>At general level, FSA reiterated stance on withholding information citing commercial confidentiality as justification (see Policy statement 04/04).</p> <p>No moves to level playing field between shareholders and consumers re: disclosure of information eg. to require firms to publish key information on</p>

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applying FSCS to with-profits to clarify this which would link compensation scheme directly to asset shares and policyholders reasonable expectations



		complaints, persistency and other information which may affect consumer decisions
'Environmental' risks	Existing with profits policyholders vulnerable to cross-subsidising new business acquisition. Depolarisation will reinforce competition for distribution increasing risks of cross-subsidies.	No meaningful protection. Firms will have to be mindful of impact of new business on existing policyholders. But ultimately decision on whether reasonable will remain with firm/ representatives, no direct independent oversight or prescription on what is reasonable. Failure by FSA to establish 'ownership' of inherited estate leaves policyholders interests in estate vulnerable.

In summary, the detriment and unfairness experienced by policyholders in with-profits is a function primarily of 1) weak corporate governance and accountability and 2) discretion afforded to directors in relation to contractual terms, penalties and bonus/ return manipulation. In other words, the corporate governance structures provide the framework for detriment while the discretion provides the actual mechanism for applying unfairness. These are compounded by lack of transparency and weak regulation. This is a particular problem in proprietary companies where shareholder representatives (i.e. directors) have an express fiduciary duty to maximise the shareholder interest.

*Has the with profits review addressed the flaws and risks in the sector?*

With regards to with-profits funds the objective of corporate governance is to introduce structures, controls and mechanisms which:



- enforce accountability and transparency,
- ensure that:
  - competing interests are balanced,
  - consumers are treated fairly, and
- overall that people in privileged positions of responsibility and power do not exploit those positions to the detriment of others.

For proper corporate governance to be introduced, it is clear that:

- the duties and responsibilities of those who represent with-profits policyholders and those who represent shareholders need to be clarified and redefined, rights need to be equalised
- mechanisms and structures (legal and/or regulatory) are needed to constrain the powers of directors in exercising their duties to shareholders, and at the same time enhance the power of policyholder representatives to maximise policyholder benefits.

Discretion is bound up with corporate governance - both issues needed to be addressed to deliver fundamental improvements in with-profits funds. Fettering discretion can enforce governance and accountability by requiring firms to treat consumers fairly, and preventing firms whose fiduciary duty is to shareholders from exploiting a strong position.

We think the FSA's approach allows directors to retain too much discretion and relies on transparency and market forces to act as a constraint on that discretion. This may have been acceptable if accompanied by deep seated reform of corporate governance, legal and contractual reform.

Many of the proposals emanating from the FSA with-profits review so far remain at heart a system of self-regulation coupled with a reliance on greater transparency. The with-profits reviews proposals on corporate governance actually represent a retrograde step in that these invest even more power and discretion in the hands of directors (see CA's response to Issues papers 4 and 5 for details).



The review further 'institutionalises' conflicts of interest within with-profits funds. This goes against the very essence of corporate governance and accountability which aims to ensure that there are structures and checks and balances in place so that individuals in positions of power do not abuse that authority. This is particularly important in proprietary firms where the conflict of interest faced by directors in respect of satisfying shareholders means that consumers are more likely to be treated unfairly.

The FSA has placed great faith in more transparency to encourage firms to treat customers fairly. This may or may not assist prospective consumers in making choices and avoid firms who treat consumers unfairly (even then this is not very likely given the limited impact of information solutions and transparency within complex financial sectors). Self-regulation and transparency do little for existing policyholders who may find that, even if they have access to more information, they are unable to act due to discretion retained by directors to impose penalties or manipulate returns.



*Part 2: response to specific questions*

**Q1: Are there other issues relating to the fair treatment of with-profits customers that we should have taken into account in framing the proposals on which we are consulting?**

We think that in general the FSA has identified many of the key specific issues relating to the operation of with-profits funds. However, so far the FSA's approach to addressing those issues and removing those detriments relies primarily on transparency and self-regulation. This negates the potential benefits of the proposals in CP207.

There are a number of specific issues which have not been addressed properly, namely:

- the need for an immediate attribution of inherited estates along lines of long standing government policy (ie. 90:10 attribution in favour of policyholders). The FSA's proposals on inherited estates remain weak and will do little to prevent a repeat of the Axa case nor prevent firms unlocking the benefits of estates for shareholders in other ways (see response to Q12 below)
- the need for policyholders (especially existing policyholders) to be accorded the same rights as shareholders in relation to disclosure of important information which can affect a decision to invest (this is connected to freedom of information generally). Robust reporting in relation to existing policyholders (especially closed funds) is a particular priority.
- perhaps the most critical issue at the moment is in relation to existing policyholders especially those within closed funds. We have made a number of recommendations below which would protect the interests of existing policyholders (see response to Q8).

**Q2: Do you have any comments on our proposals on the determination of amounts payable to policyholders, in particular the introduction of target ranges?**

As outlined above, the total detriment and unfairness experienced by policyholders in with-profits is a function primarily of:



- weak corporate governance and accountability and
- discretion afforded to directors in relation to contractual terms, penalties and bonus/ return manipulation.

In other words, the corporate governance structures provide the framework for detriment while the discretion provides the actual mechanism for applying unfairness. These are compounded by lack of transparency and weak regulation.

In relation to corporate governance and accountability, we are of the view that the FSA's with-profits review represents a retrograde step in that more power is invested with directors with no real independent oversight, or checks and balances (see CA's response to Issues papers 4 and 5).

In terms of discretion, when policyholders' returns are being determined, there are two key stages where unfairness can occur:

- I. the various adjustments and manipulations made to premiums, investment returns, fund values for expenses, transfers, and other deductions etc. to arrive at a figure for asset shares; and
- II. determining the actual return paid achieved by policyholders in the form of annual/ terminal bonuses and the impact of surrender and MVA penalties.

To ensure that policyholders are treated fairly, regulatory prescription is needed at both stages, not just transparency. The discretion at the second stage to decide level of payouts and proportions of terminal bonuses included in returns, or allocate arbitrary MVAs must be restricted directly to so that actual returns are as close to asset share as possible.

However, it is equally important that discretion and certain practices are fettered before the second stage. A company paying 100% asset share would not necessarily be treating customers fairly as various front-end loaded charges, and transfers, loading of expenses could have already been deducted from asset shares. This is why prescription of what constitutes asset shares is fundamental to fairness.

The FSA's proposals on target ranges could fetter discretion at the second stage if this control was exercised robustly. However, it does not address discretion at the first stage.



Moreover, it is not clear that the FSA's proposals will actually fetter discretion at the second stage to any meaningful degree. We consider the PPFM approach to be essentially another form of self-regulation by directors who will retain much of the discretion to manipulate funds. In relation to target ranges, firms and the governing body will define and determine whether maturity and surrender values fall within a specified target range around the policy's unsmoothed asset share.

So while the FSA's proposals could act as a control on the mechanism for applying unfairness *in the right hands*, this is undermined by the weak corporate governance framework. In operational terms, the directors and appointed governing body will determine how his mechanism is used. Indeed, we are of the view that corporate governance has deteriorated further in with-profits as a result of the FSA's review - particularly as a result of issues paper 5.

We can appreciate why the FSA wants targets to be expressed in the form of an objective rather than an obligation. However, the objective approach is only likely to work within the context of a robust corporate governance structure - which does not exist.

### ***Distributions and surpluses***

We support the proposals which would prevent distributions unless from realistic surpluses.

However, again we think this misses the important issues in relation to unfairness eg. inherited estates. The only way to ensure that policyholders are treated fairly in the case of inherited estates is for the FSA to effect an immediate *attribution* of the estate in the ratio of 90:10 according to established and stated government policy. Anything less leaves policyholders open to another 'Axa' (details can be found in our response to Issues paper 1). Moreover, the FSA's policy of allowing firms to avoid paying misselling compensation from shareholders funds is no incentive to good standards of corporate governance and business ethics.

Similarly, the requirement for firms to split surpluses using a fair, unbiased calculation method is undermined by the lack of transparency in regulation which compounds the weak corporate governance. In reality, policyholders are unlikely to know whether firms are using a fair, unbiased calculation method given the secrecy surrounding negotiations between firms and FSA, and the lack of any truly independent oversight. Moreover, it is difficult to see how allowing firms to continue to force the with-profits fund to bear the cost of a firm's tax



liabilities on transfers to shareholders just because it is accepted practice can be in keeping with the spirit of treating customers fairly.

Regardless of the limitations of target ranges, this is still preferable to other approaches such as that mentioned in para 4.21 which would be based on requiring firms to explain their approach to payouts in the PPFM. This approach would be even more subjective and discretionary.

CA favoured two approaches to improving with-profits - our own proposals which were set out in our responses to Issues Papers 1-5 and the Sandler proposals. It is unfortunate that the overall effect of the FSA's proposals do not go as far as either of those preferred options. We have little confidence that what the FSA proposes overall will result in a permanent improvement of with profits. Most of the risks and structural flaws have not been addressed.

**Q3: Do you agree that our proposals for the treatment of smaller firms and distinct categories of business strike an acceptable balance that protects policyholder interests without imposing an undue burden on the industry?**

Again, we are of the view that the FSA's approach to defining asset shares and PPFM mean that in effect firms will retain significant and unnecessary discretion as to how stage I of process by which asset shares and returns are calculated (see above). The FSA seems to be relying on transparency and market forces to constrain the manipulation of policies so evident in the past. This approach would be acceptable if combined with meaningful corporate governance standards. But the FSA approach reinforces conflicts of interests between shareholders and policyholders.

We appreciate that firms may need to have a waiver to provide time to improve quality of systems so that this asset share method can be adopted. However, there should be strict and taxing deadlines placed on this waiver. Moreover, we can see no reason for allowing firms to receive a waiver just to reflect the way they run their with-profits business.

Customers of smaller firms deserve as much protection as customers of larger firms. Therefore, we do not see why it should be down to the governing body to determine whether costs of system changes outweigh potential benefits or techniques deliver similar outcomes for policyholders. This should be a job for the FSA.



**Q4: Do you have any comments on our policy approach to the distribution of surplus or the draft Handbook text that reflects this?**

We have few comments on this. Fairness to policyholders in relation to surpluses can only be realistically met by the FSA effecting an immediate attribution of surpluses to asset shares of existing policyholders (see our response to Q12 below). The likelihood of policyholders gaining from a distribution of surplus in the near term seems quite low in this current climate compared to the risks of policyholders losing out to shareholders via some reattribution or other covert 'reorganisation' or 'clarification' of assets.

**Q5: Do you agree with our proposals for dealing with the issues surrounding surrender penalties and MVRs including for closed funds?**

We think the mechanism for dealing with surrender values and MVRs could be fair and reasonable if it was accompanied by proper corporate governance and regulatory oversight. On their own these proposals may have some short term impact on behaviour but we see little prospect of these introducing permanent change. In practice, firms and the governing body will retain almost complete discretion on what constitutes reasonable deductions and judgment on how to adjust for adverse market movements.

**Q6: Do you have any comments on our proposals on charges to with-profits funds?**

We have little confidence that the governing body as constituted will protect the interests of policyholders. In the specific example of bearing costs of compensation, it is unacceptable that compensation can be paid from the inherited estate. It is not the case that allowing compensation to be paid from the estate has no effect on payouts to policyholders. Anything that reduces the potential amount of assets which may be applied to policyholders' asset shares (either directly or indirectly) by definition affects long-term payouts.

There is a very real loss involved for policyholders, as every pound that is used by directors to protect shareholders' interests by paying compensation is an asset that is no longer available to boost solvency reserves or to free up assets to be used for either underwriting or enhancing bonuses. Being paid a return of say 5% when 6% could have been available is no different in its impact on policyholders than reducing returns directly by 1%. We would argue that policyholders who are finding it difficult to save for retirement or trying to pay off their mortgage

through an endowment policy would certainly consider that their reasonable expectation are being affected by this practice.

Moreover, there are wider issues in terms of corporate governance and accountability. Preventing firms from using the estate to protect shareholders' interests would be a powerful deterrent against corporate abuse.

**Q7: Do you have any comments on our proposals on new business?**

See comments on governing body, above. The potential benefit of the new guidance and rules in relation to cross subsidies and loss leaders is seriously undermined by the corporate governance structures. This will be exacerbated by the FSA's depolarisation reforms which will lead to a 'land-grab' for distribution - the risk is that this land grab will be paid for by existing policyholders.

The FSA should monitor new business directly rather than leave it to the governing body.

**Q8: Do you have any comments on our proposals for requiring the preparation of a run-off plan when a fund closes to new with-profits business, and for clarifying what information should be given to policyholders?**

Existing policyholders are particularly vulnerable to manipulation especially those in closed funds. The position of existing policyholders in with profits and other long-term insurance funds is one of the key consumer issues at the moment. The sheer number of consumers affected (10-20 million consumers depending on estimates and definitions) and the scale of the existing and potential detriment involved<sup>18</sup> is so great that CA is recommending to HM Treasury that the issue be investigated separately.

There are a number of forms the independent investigation could take. HMT could announce an inquiry along the lines of the Cruikshank review into competition in banking; relate the inquiry to the operations of FSA and FSMA under section 14 FSMA; or set up a dedicated working party/ task force.

The purpose of such an investigation would be to:

- evaluate the best way to protect consumer interests

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<sup>18</sup> Mortgage endowment policyholders, annuities, pensions etc



- produce guidelines for balancing the interests of different groups and generations of policyholders,
- assess whether the operation of with profits funds distort competition (especially in a post depolarisation world where competition for distribution will be reinforced); and
- investigate ways of 'freeing the prisoners' so that consumers can move to better value products.

At the very least, a number of immediate, interim steps are required:

- immediate attribution of orphan assets (see Q12)
- data about closed funds (including performance data, details of penalties and charges, options open to consumers) must be published on an individual fund basis to raise consumer awareness of how they are being treated
- run off plans for closed funds should be published, not just submitted to FSA
- the requirements for run off plans should apply to all existing closed funds not just future closures
- the FSA should undertake a major consumer awareness campaign to alert consumers to their rights and provide information on the options open to them.

**Q9: Do you agree that material on communications with with-profits policyholders should be included in COB 6.12 pending completion of our point-of sale and post-sale disclosure reviews?**

Yes, we agree with this approach.

**Q10: Do you agree with our proposal to require the with-profits actuary to take these rules and guidance into account in his annual report to policyholders?**

Yes. However, the main issue is to ensure that the information is presented in a consistent and standardised manner across all WP funds so that consumers can compare and make informed decisions.



**Q11: Do you have detailed comments on the draft rules and guidance in Annex 5?**

We have no specific comments on the draft rules and guidance as our concerns are set out above.

**Q12: Do you have any comments on the general approach, or the details of, our proposals for improving the process for reattribution of an inherited estate?**

The process outlined is unlikely to protect consumer interests during a reattribution because of the prior failure to establish policyholders' interests. Any reattribution proposal is likely to be a *fait accompli* as in the Axa case.

The comments made in paras 5.6 and 5.7 regarding the ownership of the estate are misleading. It follows that the FSA's approach to inherited estates will not protect policyholders from an Axa type raid on the estate or some other manipulation in favour of shareholders.

The value that policyholders would be asked to give up is not just in relation to what consumers might have expected to receive from a *distribution* of the estate. It is not clear what confusion the FSA is referring to in para 5.7. After all, the main weak point in with-profits is that *legal* ownership of the assets in a WP fund resides with the firm - that is the point. However, legal ownership and interests of respective parties in the estate (as determined by regulatory policy) are very different things. In any meaningful or practical sense, attribution is synonymous with 'ownership' of those assets and any income or other economic gain derived from those assets.

#### ***The value of the Estate***

There are a number of possible methods and reasons for realising or crystallising the value of the Inherited Estate for both parties to provide either current value or a recurring future value. These include distributions and buy-outs; or a legal or regulatory ring fencing of the Estate through declarations of ownership's, and attributions and amending the PRE replacement and/ or enhancing assets shares.

Shareholders' interests in the Inherited Estate are already set out in the 90:10 rule as per the 1995 Ministerial Statement. That means they are entitled to a 10%



share of the Estate with policyholders' share equal to 90%<sup>19</sup>. It is perfectly clear what that means in purely commercial terms. It is also comparatively straightforward to value a 10% share on a commercial or investment basis.

However, arcane actuarial debate and amorphous concepts such as policyholders' reasonable expectations have clouded the whole debate, so that the true value of the Estate to policyholders has not been fully explained or realised. While the technical issues may be complex, the outcome is simple to judge. The AXA deal was an example of a deal crystallising a value for shareholders greater than would be expected from a 10% attribution. The net result is that shareholders gain more than their entitlement (and by definition policyholders lose out<sup>20</sup>). This is an abuse of power and influence and is no different in its effect on policyholders than more obvious detriments such as pension or mortgage endowment misselling.

In the commercial world, it is common for one party to buy an asset from a second party. These are transactions between two equal informed parties. Although not a legal principle, the concept of 'seller beware' effectively applies, in the sense that the seller of the asset has the responsibility, means and the incentive to get the best price for the asset under the circumstances.

However, policyholders in with-profits funds do not have the same means to participate fully and fairly in any transaction - the main reason being that ownership rights to their 90% share of the Estate has not been established by the legal or regulatory system. Establishing ownership is critical for two reasons - it delivers to policyholders' significant economic value from the outset and in the event of a buy-out it strengthens their bargaining position (see lessons from AXA case in Profits at the consumer's expense).

In the second case, not establishing prior ownership has two effects:

- a) unlike the owner of an asset in the commercial world, policyholders do not 'own' the asset to sell in a legal or regulatory sense because their rights have not been established forcefully enough. The regulatory system has interpreted PRE/ attribution as meaning the right to future distribution i.e. the Estate only has value if a distribution occurs, ignoring the true value of attribution; and

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<sup>19</sup> Unless there are exceptional circumstances

<sup>20</sup> if the outcome of a commercial transaction results in a hitherto unrealised additional gain for one of parties then by definition this has patently deprived the other party of the same potential gain.



- b) it undermines the ability of policyholders to accurately assess any offer being made against the true value of the Estate.

Ownership needs to be established to ensure that any offer to buy out policyholder rights to the Estate constitutes a real choice for policyholders of a) accepting an offer or b) retaining valuable future rights.

The interests of policyholders who want to sell their rights would be protected by the disciplines of a market negotiation process involving two informed equal parties i.e. a fair price would be established which satisfied both buyer and seller in the circumstances. It may well be that even then policyholders could be induced to accept an offer which did not reflect the true value of their share of the Estate, but this could be safeguarded by the regulatory system including an independent negotiator.

Otherwise, if ownership rights are not established, buy-out deals in effect represent a back-door way of ensuring that shareholders obtain more than 10% attribution of the Estate.

If it transpires that by not first ring fence policyholders' ownership rights and realising the value, directors are subsequently able to maximise shareholders interests at policyholders' expense, then the regulatory system would have failed to protect policyholders' interests and treat them fairly and reasonably.

We would argue that it also follows that if it is possible to realise or crystallise the value of an asset for policyholders, then the regulatory framework should be used proactively to enforce policyholders' ownership rights.

#### CA recommendations on inherited estates

The FSA should:

- Publish a list of companies who have been or are currently in discussions with the FSA regarding any aspect of the Inherited Estate. This should include full details of any discussions or negotiations. This should also include valuations of the Inherited Estate in each case over the past 5 years. The FSA should publish both the shareholder value disclosed to policyholders during an attribution or re-attribution, and the value subsequently presented on the balance sheet to shareholders, with an explanation of the difference in any values where applicable.



- Issue a statement to the effect that the FSA considers any approaches or discussions by life companies to be inappropriate until the issues surrounding ownership and Inherited Estates processes have been resolved.
- Determine the most effective method of establishing or reinforcing policyholder ownership of the Inherited Estate in accordance with the 90:10 rule. This should take the form of a legal or regulatory ring-fencing of the Inherited Estate, so that any given valuation point, the economic value of the Estate to respective parties can be readily identified. The most effective method would be primary legislation. This would deliver significant economic value to policyholders. Moreover, it is only once policyholders' ownership rights have been established would buy-out deals represent a real choice for policyholders between accepting a one-off windfall payment now or retaining valuable interests in the Inherited Estate for future benefit. The current market conditions may have reduced the value of Estate, but this is a temporary situation.
- 'Novel' deals without establishing ownership, such as in the AXA case, are by their nature designed to benefit shareholders - otherwise there is no reason for proposing them. There are simpler more direct ways of clarifying shareholders interests. Until the ownership question has been resolved fairly and a new process for buy-outs agreed, these deals do not represent a meaningful choice for consumers and should not be allowed.
- Submit Section 348 of the FSMA (which prohibits release of commercially sensitive information) to The Lord Chancellor's Advisory Group on Implementation of the Freedom of Information Act, for review. Section 348 should be amended to restrict the prohibitions on disclosure and to allow the release of information in the public interest. By definition releasing most information relating to attributions or re-attributions of Inherited Estates would be in the public interest given the size of the assets involved and the need to protect the consumer interest. Greater transparency would of course 'prejudice' commercial interests as it would restrict the scope of directors' ability to maximise shareholders interests at the policyholders' expense. Greater transparency is more likely to ensure a fair price is paid during a buy-out or a clarification of ownership is conducted fairly. Withholding information unreasonably prejudices policyholder interests. However, we fully understand the need for discretion. For example, regarding truly commercially sensitive information relating to such matters as sales projections etc. which may jeopardise competitive positions.



**Q13: Do you have any comments on the implementation date for our proposals on reattribution of an inherited estate?**

See response to previous question regarding the need for immediate reattribution and greater transparency

**Q14: Do you have any comments on our proposals for firms to produce consumer-friendly information from the full PPFM and for the format of this?**

It is sensible and appropriate for firms to be allowed to extract information from PPFM. In addition, although we have general reservations about Raising Standards (in relation to the actual standards), some firms are genuinely trying to be more transparent and improve the quality of information provided to consumers. Therefore, we think firms should be allowed to use information produced as part of Raising Standards to avoid duplication of effort and costs.

**Q15: Do you agree that firms should provide consumer-friendly information from the PPFM on request instead of automatically?**

We take the view firms should be required to provide information automatically. We understand and share many of the concerns about information overload and have expressed on many occasions our doubts regarding the effectiveness of information as a tool for making markets work. Nevertheless, the effectiveness of the FSA's approach (based on transparency and information) would be further undermined if firms did not have to provide information automatically.

**Q16: Do you have any comments on our proposals for sign-posting of PPFM?**

For similar reasons, we see no reason why firms should not be expected to sign-post to the full PPFM.

**Q17: Do you agree with our proposal to remove the requirement on firms to produce with-profits guides?**

We have no particular attachment to any specific form of document. The critical point is that all the important information is disclosed and presented in an honest, transparent, clear and consistent fashion - and that this disclosure is monitored and enforced by FSA to ensure compliance. It goes without saying that factual information mentioned in para 6.22 relating to important issues such as past performance, solvency ratios, expenses etc must be disclosed. This is particularly important for existing policyholders.



**Q18: Do you agree with our proposal to consider the merits of requiring some or all of the factual information in with-profits guides to be produced as part of our wider reviews on point-of-sale and post-sale disclosure?**

Yes, we agree that the wider review should be used to assess the presentation of key information across all product ranges to ensure consistency and standardisation where possible. We appreciate some products do need tailored information. However, consistency should be the aim so that consumers can compare across different product groups and not just within product groups. Consistency and standardisation makes it easier for products to be assessed according to the consumer's needs and objectives.

**Q19: Do you agree that the implementation of our current proposals to improve the regulation of with-profits business, when taken together, adequately address the concerns about the operation of such business raised by the Sandler Review?**

No. Unfortunately, we do not think that the FSA's proposals provide the same degree of protection, or stimulus for market improvements, represented by the Sandler proposals. Further details regarding the reasons we supported the Sandler approach can be found in our submissions to FSA's DP20 and HMT's Proposed Product specification for Sandler Stakeholder products. But it may be helpful to summarise those reasons here.

The objective of CA's proposals for reforming with-profits funds was to try to replicate as far as possible the unit trust/ OEIC model within a life fund environment. Or as an alternative, the structures, governance and consumer representation models which exist in the employers' pension fund sector.

In terms of retail products, the unit trust model offers considerable advantages to consumers in terms of corporate governance, real transparency, legal and contractual form. The Sandler proposals were aligned to a fair degree with that objective - particularly the 100:0 structure and explicit commercial fee structure.

As outlined above the detriment consumers face in with-profits results in the main from

- a combination of weak corporate governance, legal and contractual risks, combined with

- discretion (exacerbated by opacity and misdirected regulation).

In other words, the corporate governance, legal and regulatory structure provides the framework for directors to treat customers unfairly while the discretion and contractual status provides the mechanism.

To be fair, some of the FSA's proposals on discretion and targets for asset share could have represented genuine improvement if *combined* with meaningful corporate governance reform.

However, these potential improvements are seriously undermined by the FSA's reliance on transparency and information as the key constraint on corporate governance abuses. Indeed, the net effect of the FSA's approach to corporate governance is to increase the imbalance between shareholder/ producer interests and consumer interests at board level. Real corporate governance and accountability 'institutionalises' the consumer interest from the board room to point of sale. Deep structural reform was needed to introduce the necessary corporate governance into the with profits sector.

Unfortunately, CA has to conclude that the sum of the FSA's reforms as part of the with-profits review do not add up to the radical overhaul needed to improve with-profits. As a result, we are of the view that for ordinary consumers, with-profits still represent a higher risk than other retail products in terms of governance, legal and contractual and regulatory risks and should carry a risk warning to that effect.

**Q20: Do you have any comments on the compatibility statement in Annex 3.**

*Market confidence*

We disagree with the view that these proposals will increase market or consumer confidence. To be precise, if confidence did increase, that confidence would be misplaced as the major risks and structural flaws remain especially in relation to the risks identified in Part 1.

*Public awareness*

Public awareness relating to some aspects of with profit's operations among certain groups of consumers and advisers may increase as a result of these proposals. However, transparency and information solutions per se have limited effect in complex sectors such as with profits. More to the point, making



consumers aware of the discretion held by directors is not much help to consumers if they cannot act on that information - as is the case with existing policyholders who can be trapped in funds because of this very discretion.

Moreover, the proposals relating to inherited estate do not represent a significant improvement in terms of transparency or consumer representation. The critical point during any reattribution or raid on estates is at the beginning when the firm enters secret negotiations behind closed doors with the FSA. By the time the proposals are made public for consideration by policyholders or the courts it is effectively a *fait accompli* as was evident during the Axa case.

At a general level, real public awareness requires a sea change in the FSA's attitude to freedom of information. There is no justification for the FSA's approach to disclosure of information under section 348 of FSMA as outlined by the regulator's statements in Policy statement 04/04 which provides feedback to DP23.

#### *Protection of consumers*

We think that the proposals will do little to improve consumer protection. There is an over reliance on transparency and disclosure as a controlling mechanism and no attempt to introduce real corporate governance reforms.

Existing policyholders are particularly at risk. We think the risks are such that a separate inquiry is needed to evaluate options for protecting existing policyholders. As an interim measure the FSA should undertake campaign to inform consumers of their options if they are trapped within a with profits fund.

Policyholders' interests in the inherited estates are also at risk by failure to effect an immediate attribution.

#### *Effects on competition*

We remain concerned that the FSA's reliance on transparency and discretion (coupled with FSA's proposals on corporate governance which place greater authority and responsibility with directors) allows for with-profits firms to gain unfair competitive advantage through the capital available in the with profits fund. This will be exacerbated in the environment created by depolarisation which will reinforce competitive distortions such as competition for distribution. This could be detrimental to existing policyholders (and consumers generally



because of competitive distortions) and should form part of the remit of the independent investigation outlined above.

#### *Treating customers fairly*

As outlined in our response to Q19 above, these proposals do not provide us with any real confidence that a permanent improvement will result in the way firms treat consumers. Existing policyholders remain very vulnerable.

#### *Reattribution of inherited estates*

As we explain in great detail our response to Q12, the FSA's approach to inherited estates will not protect policyholders from an Axa type raid on the estate or some other manipulation in favour of shareholders.

**Q21: Are there any areas in the CBA in Annex 4 where we have not identified significant new or additional costs or correctly identified the costs and benefits of the proposals in this CP?**

Public pressure from CA and the media has resulted in significant improvements in with profits. However, as will be clear from our response, we are not confident that the FSA's proposals *per se* will result in any permanent behavioural improvements on the part of firms.

In an effort to consolidate those gains, we are now in the process of developing a new code of practice on corporate governance and accountability and charter of rights for financial services consumers which will form the next part of our work plan for reforming the with profits sector in the consumer interest.

This marks the end of the Consumers' Association response to the FSA's CP207 consultation paper. We would be pleased to discuss further with the FSA or other parties any points raised here. This consultation response was prepared by Mick Mc Ateer, Principal Policy Adviser. Comments and queries should be directed to the attention of Emma Bandey, Senior Public Affairs Officer, Consumers' Association, 2 Marylebone Road, London NW1 4DF (or e-mail: [emma.bandey@which.co.uk](mailto:emma.bandey@which.co.uk)).

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