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# With-profits: from discretion to prescription?

By Peter Bloxham MA (Cantab), Solicitor

## Introduction

In February 2011, the Financial Services Authority published the first of its planned two consultation papers relating to the with-profits sector, entitled "Protecting with-profits policyholders" (CP11/05).

The consultation period on this first condoc closed on 24 May 2011. There is a series of 30 specific questions (Annex 4), as well as an Appendix with draft revised handbook text. The principal current rules and guidance specific to with-profits funds are contained in chapter 20 of the FSA's Conduct of Business (COBS) sourcebook and the revised text builds on that.

A second condoc will be issued at a later date specifically focusing on:

- client communications, as well as
- addressing changes to COBS 20 arising out of the implementation of the Solvency II Directive (2009/138/EC) which is expected to come into force on 1 January 2013.

The proposals in the condoc will of course be of interest to all those involved in the with-profits sector and are likely to be of particular interest to mutuals. These firms have been involved in a separate project with the FSA, Project Chrysalis, looking at the future of their with-profits funds. This was in part prompted by the desire of some mutuals to identify part of the capital of the with-profits fund as "mutual capital", available to be used to support further diversification into non-profit (and even non-life) insurance products.

Consumer groups will also take a keen interest, as they have done in this sector at least since the problems at Equitable Life and the Axa and Aviva reattributions.

Although there is no explicit reference to the impact of the FSA's Retail Distribution Review, there must be little doubt that the impact this may have on new sales of with-profits products has influenced the FSA's thinking, particularly in relation to fund closure and new business levels.

## Regulatory backdrop

The regulatory environment for with-profits funds has been under fairly continuous review since 2001. This is attributable to two circumstances in particular, namely the closure to new business of Equitable Life and the steep stock market falls in the early 2000s.

Previous initiatives have included:

- the requirement, since 2004, for most firms to set out, in a document entitled *Principles and Practices of Financial Management* (***PPFM***), the way that they run their with-profits funds (and also to produce a "customer friendly" version of the PPFM);
- The introduction in 2005 of a requirement to split the actuarial role into an *actuarial function holder* and a *with-profits actuary*, as well as to establish a degree of independent oversight, generally (for larger funds still open to new business) in the form of a *with-profits committee* . At the same time, new rules were promulgated for *reattributions*, following criticism of the AXA exercise in 2000;
- A review by the Treasury Select committee in 2008 (***TSC Review***). This was prompted principally by questions in relation to the *inherited estates* of with-profits funds arising as a result of the proposed reattribution exercises which Aviva and Prudential had embarked upon (the Aviva reattribution eventually went ahead, whereas Prudential decided not to go beyond the initial consideration stage). Nevertheless, some of the findings of the TSC Review were wide ranging in nature, notably in relation to lack of clarity, and the need for greater transparency and improved governance;
- Last summer's publication by the FSA of its *With-Profits Review Report* (***WPRR***), itself prompted by the TSC Review.

Many of the same topics were covered in each of these exercises, which may be an indication of how difficult it is to apply the current regulatory regime to with-profits products.

**Application of FSA General Principles to with-profits**

The two core FSA Principles for Businesses which seem to give most concern to those who regulate or observe the with-profits sector are principle 6, *treating customers fairly,* and principle 7, *communications should be clear, fair and not misleading*. At first sight, this may seem strange, at least in relation to general principle 6, since that principle should correspond to the considerations which underlie the exercise of the discretions inherent in a managing a with-profits product. It is less clear whether funds have in the past considered it necessary to be as open with their customers as regulators and an increasingly questioning customer base now expect.

It is also interesting how often the FSA comes back to its application of the *treating customers fairly* test in testing appropriate or fair conduct in relation to different aspects of the operation of a with-profits fund.

It will already be clear from the use of terms such as *Reattributions* and *Inherited Estates* (both explained below) that the with-profits world lends itself to arcane terminology. Indeed, part of the problem is establishing exactly what the rights of policyholders are in a with-profits fund. Subtle differences of emphasis can lead to a significant difference of economic outcome.

## The Commercial Context

Both the FSA and the Treasury Select Committee see with-profits products as a declining market. The FSA also anticipates continuing consolidation in the sector.

With-profits products are offered both by proprietary companies and by mutuals. In the mutual sector, as firms seek to diversify their businesses, there is a continuing desire to find ways of using the capital of the with-profits fund to support insurance products outside the with-profits sector.

## The Regulatory Challenge

In a sense, there are two main structural and policy issues which a regulator of the with-profits sector has to get to grips with:

- How do you apply the general principle of ***treating customers fairly*** to the operation of a with-profits fund; and
- What are the interests of policyholders in the capital of the fund and what can that capital fairly be used for?

In both cases, there are the associated questions of what governance structures should be required, how much transparency should be insisted upon and how best to achieve those objectives.

## Summary of scope of condoc and principal points

Paragraph 1.12 of the condoc enumerates the areas it covers:

- Conflicts of interest;
- Fair treatment of with-profits policyholders, notably in mutually owned funds;
- Terms on which new business is written;
- Material reductions in new business;
- Market value reductions;
- Strategic investments;
- Charges made to with profits funds;
- Excess surplus;
- Reattributions of inherited estates;
- Corporate governance.

Governance is considered sufficiently important or complex that it deserves a chapter (chapter 3) of the condoc to itself.

It will immediately be apparent that this represents a wide scope, although many of the issues are interlinked. Once the FSA has issued its second condoc, it will have reviewed all significant aspects of the operation of with-profits funds.

It will also be clear that the FSA is re-visiting a number of issues which have previously been the subject of guidance or rules. A theme running through the condoc is a measure of disappointment expressed by the FSA that previous guidance has not been properly understood or followed. This raises the wider question whether the rules and guidance have been unclear, or is there a divergence of views between firms and the regulator as to what is required to treat policyholders fairly?

A reading of the condoc itself suggests that the FSA proposals are designed to appear as the continuation of a gradualist approach towards enhancing regulation of the sector. It is, however, evident from a review of the changes proposed to COBS 20 that some of these changes are substantial and can be seen as a move towards a more prescriptive and potentially more intrusive regime.

***Rights of with-profits policyholders***

Before discussing the individual items listed above, the FSA reiterates the position it has previously adopted in relation to the interests which with-profits policyholders have in a with-profits fund. The FSA has taken advice from counsel on some of these issues. Not all firms would necessarily agree on all the propositions set out by the FSA. These include:

> "With-profits policyholders have an interest in the whole with-profits fund and in every part of it, which derives from the fact that the with-profits fund is a single, undivided fund of assets, from which any particular assets could be used to meet the fund's contractual obligations in respect of a with-profits policy written into that fund." (para 2.4)

and

> "With-profits policyholders also have a contingent interest in any surplus, which may exist prior to distribution." (para 2.5)

The FSA also indicates that a policyholder may in certain circumstances have some *expectations* (paragraphs 2.5 and 2.12). In this context, it also draws the subtle distinction between the with-profits policyholder not having any expectation that it may in the future receive a special distribution and the fact that, if there is to be a distribution, with-profits policyholders will have an expectation to have a share in it. Accordingly, the FSA makes the point that insurers need to consider issues of fairness to policyholders in exercising discretions, not just whether or not to make distributions, but also taking decisions which may render distributions less likely.

This interplay of different actual and potential policyholder "interests" serves to illustrate why some of the issues addressed in the condoc remain so hard to grapple with.

The FSA also considers that the rights of a with-profits policyholder in a mutual fund are the same as those in a fund managed by a proprietary firm. This leads to some of the conclusions the FSA has reached about the extent to which mutuals can use with-profits capital to diversify their businesses.

It is noteworthy that the FSA states (in paragraph 2.3) that these formulations quoted above describe **some** of the interests of with-profits policyholders, suggesting that a comprehensive enumeration of policyholder rights has eluded even the regulator.

Institutions operating with-profits funds have over the years increasingly used an "asset share" test at least as a starting point to describe the rights or interests of policyholders in a with-profits fund. The FSA seems to be putting down a marker that the "asset share" test should not be regarded as exclusive of other rights policyholders may have. It may be that a measure which initially was used, neutrally, to describe the minimum interest of a policyholder in a fund has come to be used as a limitation on policyholders' interests.

***Conflicts of interest (condoc paras 2.7-2.9)***

Conflicts of interest are inherent in the nature of a with-profits fund, particularly in view of the discretionary nature of many of the benefits which arise. The fact that many larger with-profits funds provide capital for different groups of policyholders or diverse businesses may also add to the scope for conflicts in decision making and allocating capital and investment returns.

Additionally, some funds have become complex, partly because a single pool of capital may be supporting a diverse range of insurance businesses. This increases the risks of conflicts and makes many of the decisions required in the exercise by firms of their discretions more challenging than may have been the case in the past.

The most commonly perceived conflict is between policyholders and shareholders, although it is fair to point out that in a typical 90/10 fund shareholders also have an interest in maximising distributions.

However the FSA points out that numerous other conflicts can arise, particularly when the capital of the with-profits fund is supporting diverse businesses.

Apart from the policyholder/shareholder conflict, there may be strains between divergent interests of different generations of policyholders, between different classes of with-profits policyholder and between with-profits policyholders and other policyholders. The firm's own interest in having an "open" fund may itself create conflicts with policyholders, if the firm is struggling to write business on an inherently profitable basis, after taking account of acquisition costs. The absence of shareholders in a mutual does not necessarily lessen the scope for conflict; indeed the reliance of a mutual on capital provided by the with-profits fund may exacerbate it.

Existing guidance is in COBS 20.2.1G. It is clear from that formulation that the FSA sees that discretion and potential conflicts of interest are linked. The FSA proposes to spell out some of the more common examples of conflicts in new COBS 20.2.1.

The FSA also proposes converting this guidance into a rule. Implicit in the current guidance (and therefore the proposed rule) is the need for firms to identify all the areas where there is scope for conflict.

***Fair treatment of policyholders generally (paragraphs 2.10- 2.32)***

The full heading of the next section is "Fair treatment of with-profits policyholders, with particular regard to mutually owned long term insurance funds". The section is principally aimed at mutuals, although the underlying principles as to policyholder interests on which the FSA's views are based will apply to all with-profits funds.

The main discussion in this section relates to the level of distributions which should be made to with-profits policyholders. In many cases, this will be determined at least in part by the articles of association or equivalent document of the relevant fund.

Some mutuals have suggested that they should be permitted to operate on a more flexible basis. The objective is to be able to create a capital reserve with which to write new business. The FSA, having regard to its conclusions that with-profits policyholders' rights are the same in mutual and proprietary funds, and also taking account of what is considered to be general current practice in relation to distributions, has decided not to adopt a different distribution rule for mutuals.

The FSA has already set out in existing COBS 20. 2.17 the principles to be followed by all firms in relation to distributions and in particular established the concept of a *required percentage*. It is proposing to retain the underlying principles already contained in COBS 20.2.17, but to expand the rules and guidance relating to the ability of a firm to rely on its established practice in relation to distributions. Such a firm will in future have to be transparent as to the policy.

***New Business (condoc paras 2.33-2.39)***

The FSA is proposing to refine the test to be applied by firms in deciding whether it is fair to write new business in a with-profits fund.

Implicit in the existing and proposed approach is an acceptance that new business may have start up or acquisition costs that could be detrimental to the immediate interests of some with-profits policyholders. The question is one of balance between short term costs and longer term benefit (provided that profit is adequately shared by the with-profits fund).

The existing test (COBS 20.2.28R) is as follows:

"If a firm proposes to effect new contracts of insurance in an existing with profits fund, it must only do so on terms that are, in the reasonable opinion of the firm's governing body, *unlikely to have a material adverse effect* on the interests of its with-profits policyholders." (emphasis added).

The Condoc indicates that the FSA has experience of some funds writing new business on terms which are loss leading and may therefore cause erosion of the value of the long term fund.

Accordingly the FSA proposes to strengthen the existing rule, so that the test is more positively expressed, ie there is *likely to be no adverse effect on with-profits policyholders' interests*. The FSA also want the outcome of the test to be demonstrable. At first sight, this may seem like just an adjustment of the burden of proof, but in practice proving the negative may be quite challenging.

Whilst it may be possible to demonstrate that there is **an** actuarial model and business plan which meets the "no adverse effect" test, the challenge will be to go on to demonstrate that this outcome is **likely**, not merely one of several possible results. It will be interesting to see to what extent with-profits committees and the FSA test firms' managements on these points.

It should be noted that the test remains a somewhat negative one- an assessment of no likely loss rather than that the new business may be expected to enhance value, which one might expect to form part of any normal business case.

It follows from the new formulation that, if it cannot be met, then the new business proposals will not be permitted (or not within the with-profits fund), which may tend towards the run-off or closure of a fund.

***Material reductions in new business (paras 2.40-2.49)***

This section begins with a discussion about the effect of closing to new business and making clear that the FSA regards it as essential for there to be communications with policyholders at the time of closure of a fund. Perhaps the FSA will revert to this point in its second condoc.

There are existing rules and guidance on this topic (COBS 20.2.53-20.2.60). The difficulty in this area is establishing what constitutes closure, recognising that a fund may have a continuing low level of "new" business, in the form of top ups or new members joining a with-profits based pension scheme, which does not really amount to the fund being in any active sense open to new business.

The consequences of being considered closed to new business are severe, in terms of a firm being obliged to prepare a run off plan and ultimately distribute surplus to existing policyholders. As a result, those running a fund may have an interest in avoiding the perception that they are closed. (This may of course lead to writing unprofitable new business as mentioned in the previous section of the condoc).

It would seem that the FSA recognises that its existing regime (which it describes as binary: see para 2.42) has not worked particularly well. Accordingly, the FSA is proposing replacing the existing rule with a new, more flexible one, requiring dialogue with the FSA and obliging a firm to show that its proposed actions are consistent with the overriding *treating customers fairly* principle in relation to existing policyholders. The FSA indicates in para 2.45 that it will be expecting firms to produce more realistic and robust new business plans which extend to addressing intentions in relation to distribution policy.

In this section of the condoc, the FSA introduces the proposed new requirement, to be inserted in COBS 20.2.22A, which will seemingly apply to all firms, to prepare and maintain a *distribution plan* and a *management plan*. These new instruments, unless drafted in very general terms, may reduce the element of discretion available to funds. They may provide additional transparency and give both the FSA and the with-profits committee an opportunity to exercise additional oversight of the fund. However there is a risk that these will end up being, rather like some PPFM documents, deliberately bland so as not to reduce the fund's room for manoeuvre.

***Market Value Reductions (MVRs) (condoc paras 2.50-2.57)***

When a policyholder seeks to redeem his policy early, a fund may apply an MVR. The FSA has for some time had rules as to how MVRs may be applied, but is proposing further to limit their use.

It is clear from the discussion in the condoc that the FSA approaches this policy from the perspective that early withdrawals should not be on terms which could jeopardise the interests of remaining with-profits policyholders. In other words, MVRs are not to "punish" exiting policyholders, but to protect those who remain invested in the fund.

The regulatory starting point is that a MVR is justified if the early payout would otherwise be higher than the current asset share allocated to the policy. This seems to be the only permitted justification for a MVR in the future. The FSA senses that MVRs may also be used to discourage early redemptions or to reduce outflows, if a fund sees a particularly large call for redemptions. The FSA makes clear that it does not consider these are adequate justifications for imposing a MVR. Accordingly, the FSA is proposing to remove the ability to impose MVRs solely on the grounds of volume of surrenders.

The FSA also tackles the perceived lack of symmetry between policyholder and shareholder impact of a MVR. A MVR may have the effect of reducing a bonus which had previously been declared on a policy. At the time of the distribution, there will have been a corresponding shareholder distribution. When the MVR is applied, existing FSA rules (COBS 20.2.17R (3)) require a corresponding adjustment, over time, of the shareholder distribution ratio. It seems that the application of this rule has proved to be unclear and so the FSA is preparing to re-write it, without intending to change the original intention.

***Strategic Investments (condoc paras 2.58-2.65)***

This is another example of circumstances where a proposed use of assets of the with-profits fund can create scope for conflict between interests of different policyholders and between policyholders and shareholders or management. They may also create complexity and lack of transparency because there may be commercial relations between the fund and the firm in relation to the investment.

The condoc begins by giving examples of such investments, notably a head office building or a business such as an investment manager or a general insurer.

The FSA proposes introducing new rules which will require that, where strategic investments are made or retained, the firm's governing body must be reasonably satisfied that the purchase or retention *is likely to have no adverse effect on the interests of with-profits policyholders*. The firm will need to be able to demonstrate the basis for this conclusion. This proposed test is consistent with that proposed for new business (see above).

The inclusion of a reference to retention of assets indicates that, where appropriate, firms may need to review existing strategic investments held in a with-profits fund, so there will be an element of retroactivity in the application of this rule.

The FSA makes clear it does not want the introduction of the new rule to lead to a fire sale. Indeed, it may be that any issue arising following a review of a strategic investment can be addressed by adjusting the terms of any commercial relationships between the fund and the investment entity, but without disposing of the investment itself.

***Charges to with profits funds (condoc paras 2.66-2.72)***

This is the subject of existing Rule COBS 20.2.23R. The rules and guidance in this area are designed to provide policyholder protection where central services and personnel are provided through a group's service company or other connected service providers or advisers.

Going forward, the FSA proposes to limit the charges to the with-profits fund to a fair proportion of actual costs including overheads, but not any profit element. The FSA seems to recognise this may be controversial but maintains that it will still be in shareholders' interests to use in house services, since it should maximise distributions, in which shareholders will participate.

***Excess Surplus (condoc paras 2.73- 2.76)***

*Excess surplus* is essentially any amount by which, on a regulatory capital measurement, there are assets available to a with-profits fund which exceed what is required to support the fund's liabilities, taking account of the support needed for new business.

Firms are already subject to a requirement, in COBS 20.2.21, to consider annually whether they have an excess surplus.

At the moment, FSA rules give a choice to any fund which identifies that it has an excess surplus. It can either make a distribution to policyholders (and, correspondingly, to shareholders) or it can propose a reattribution.

In a distribution, a firm which has identified an excess surplus can pay it out to policyholders and shareholders according to their shares in it. A distribution may be paid by increasing the value of policies or in the form of cash, and may be paid out at once or over a period of time.

In a reattribution, a firm restructures the with-profits fund so that it can use some of the money from the fund, such as an excess surplus, to support its activities outside the fund. The result is that the firm then has greater access to the funds from the inherited estate and more freedom as to how to use that money. Inherited estate is a wider concept than "excess surplus". It is an amount representing the fair market value of the with-profits assets less the value of liabilities of a with-profits fund. Unlike excess surplus it does not include provision for new business strain.

As part of the reattribution, the firm effectively buys out policyholders' interests in the inherited estate. Policyholders normally receive a one-off cash payment as compensation for the interests they are giving up.

In future, the FSA considers that there should only be one result. If excess surplus arises, this should lead to a special distribution.

There are currently a number of significant policy issues within the Solvency II project (referred to above) which have yet to be resolved. Agreement on these issues is expected later in 2011. One suspects that, until the implications for with-profits funds and annuities of Solvency II are much clearer, it would be a brave regulator who would suggest that any with-profits fund has an excess surplus, when its own actuaries were not persuaded of the fact. In the future, however, both regulator and with-profits committee will be entitled to scrutinise the calculations relied on by a firm to conclude that it does not have excess surplus and also to challenge constructively new business plans which propose to use capital which might otherwise form part of excess surplus. The new and more stringent tests described above for using with-profits capital to support new business may be expected, over time, to increase the likelihood of funds generating an excess surplus.

***Reattributions (paras 2.77-2.87)***

The FSA has made a number of proposals, in the light of further experience of reattribution processes. In addition the FSA has indicated that it proposes to issue further guidance in relation to reattributions.

A number of the condoc proposals revolve around the functions of the Policyholder Advocate, the role created by the revisions to the FSA's with-profits regime in 2005 and designed to overcome the perceived deficiencies of the AXA reattribution. The Policyholder Advocate is intended to protect the interests of policyholders, and negotiate on their behalf, during such a process.

*Excess surplus review*: As a preliminary exercise before a firm goes ahead with a potential reattribution, a firm should investigate whether there is any excess surplus in the fund and, if so, make a distribution. This is regarded as important because typically the percentage share paid to policyholders out of distributions is higher than from reattributions. This proposal may reflect a concern that reattributions might otherwise be used as a way of

achieving an extraction of surplus capital on terms which are more beneficial to shareholders than the normal distribution percentage. The discussion of this topic recognises the significance of a firm's new business forecasts in determining whether there is any excess surplus.

*Precise role of the policyholder advocate*: the FSA sees the need to expand its guidance to ensure that there will be agreement between the firm, the proposed policyholder advocate and the FSA as to the precise role of a Policyholder Advocate.

*Communications by the policyholder advocate*: it is proposed to clarify that the Policyholder Advocate should have control over the content of communications to policyholders.

*Retaining the opt out right*: in both recent completed reattributions, the legal structure adopted for the procedure has retained the right for individual policyholders to "opt out" of the reattribution process and retain their rights in the *inherited estate*. Under current rules, it is also possible to effect a reattribution by using a scheme of arrangement. This would allow the affirmative vote of a suitable majority of policyholders to bind all policyholders. The FSA has indicated it does not think this would generally be appropriate for reattributions and intends to make clear that policyholders should be given the right to opt out, unless it would be fair not to do so. This is reflected in proposed COBS 20.2.51A G.

The two reattributions completed in recent years involved very different exercises. Arguably the AXA process did not allow sufficient opportunity for interrogation of the underlying data and assumptions. Aviva was thorough but it was inevitably time consuming and has set a standard which may discourage smaller funds from embarking on reattribution. Any clarity from the FSA as to the scope of what should or should not be reviewed as part of the reattribution process would therefore be welcome; the involvement of the regulator in drawing up the Policyholder Advocate's terms of reference may assist in this regard.

The FSA has also floated the possibility that further thought needs to be given to the role of the with-profits committee when a reattribution is under consideration. Certainly there is merit in clarifying, in the terms of reference of the Policyholder Advocate, the degree of intended interaction with the With-profits committee.

***Governance (Chapter 3)***

The condoc includes a separate section (Chapter 3) on governance issues.

The FSA introduced in 2005 significant reforms of the governance of with-profits funds, including:

- Splitting the actuarial role between the *actuarial function holder* and the *with-profits actuary*;

- Requiring independent scrutiny of management of funds, notably by larger firms establishing with-profits committees;

This chapter proposes building on those structures.

Much of it focuses on the composition and roles of with-profits committees, the FSA's preferred method of ensuring, for policyholders' benefit, that there is informed and independent scrutiny and challenge of management decisions in relation to the management of a with-profits fund. The FSA seeks to address the perceived lack of effectiveness of some with-profits committee structures.

To date, the FSA has not required every fund to set up a with-profits committee. It is clear that in future, except for the smallest firms or funds, the FSA will expect all with-profits funds to have a with-profits committee.

These committees need to be, and be seen to be, independent. The condoc includes proposals for formalising the test to be used for establishing the independence of the committee, or at least a majority of its members, suggesting that as a base the principles in the Financial Reporting Council's UK Corporate Governance Code should be adopted.

Other recommendations in this chapter include:

- That the committee's terms of reference should be published;
- That arrangements should be entrenched to ensure that a with-profits committee receives, sufficiently in advance, the information it needs to assess proposed management actions;
- That there may be cases where the with-profits committee should be proactive and not just reactive;
- That the committee should in certain situations be able to seek independent external advice on issues arising, sometimes at the cost of shareholders;
- That there should be better record keeping of the debates which take place when a with-profits committee engages with a firm's management.

The condoc includes, in paragraph 3.23, an indicative list of issues with which with-profits committees should be engaged. This is a broad range, covering among others:

- compliance with PPFM;
- how conflicts of interest are addressed;
- policyholder communications;
- changes in strategy or business activity;
- costs; and
- bonus rate decisions

Taken together, these proposals could represent a significant strengthening of the role and powers of with-profits committees and may require members of those committees to become significantly more involved in overseeing the management and operation of their funds.

This chapter of the condoc also addresses points in relation to the role of the with-profits actuary and his interaction with the with-profits committee. The FSA seeks to ensure that the with-profits actuary operates independently of the firm by which he may be employed.

**Next steps**

The FSA's consultation closed on 24 May 2011. Following this the FSA will finalise the changes it is proposing to COBS 20.

It will also, at a later date, issue its second condoc, as mentioned above.

**Conclusions**

I have described the various proposals covered in the condoc as a series of separate items, but in practice there will be a degree of overlap and interaction between them. For example, it is to be expected that, going forward, with-profits committees will scrutinise in greater detail the bases on which management of firms have come to their conclusions that new business will not be likely to adversely affect with-profits policyholders' interests. Similarly, the stricter test to justify writing new business in a with-profits fund may eventually lead to some firms concluding that they have an excess surplus.

The FSA has clearly heeded the views of the Treasury Select Committee, in particular its recommendations for increased transparency in the management and operation of with-profits funds and for giving greater powers to the with-profits committee.

Taken together, the effect of the proposals is likely to be to introduce additional constraints on the discretions exercised by those managing with-profits funds and to oblige those managers to explain and justify decisions taken, and discretions exercised, more clearly than may have been the case in the past.

One senses that the FSA is still struggling to find (or perhaps impose) a suitable regulatory framework to ensure that the *treating customers fairly* principle applies, and is seen to apply, to with-profits funds. Interestingly, the TSC Review hinted at the view that with-profits might be inherently too complex to be capable of meeting FSA requirements. There are a number of places where the FSA expresses mild surprise that the existing regime has not achieved what the FSA had intended. Presumably therefore the FSA would argue that many of the proposed changes to COBS 20 are not intended to be innovations but simply to achieve what the FSA has always intended and what is already recognised as being best practice. However the extent of the proposed re-writing of the COBS 20 chapter suggests

that there remains a gulf between the FSA's interpretation of general principles 6 and 7 and that of the management of at least some with-profits funds. One interesting aspect of the condoc is the extent to which the FSA considers it necessary to convert what was previously guidance into formal Rules.

Solvency II will have an impact on the capital costs of with-profits businesses, as well as on the capital required to support non-profits business backed by the capital of the with-profits funds. This condoc, and the forthcoming document on policyholder communications and changes to COBS 20 to take account of Solvency II, will add to the regulatory burden on funds.

The with-profits industry will doubtless also point out that these proposals may saddle the sector with increased costs which will ultimately be borne by with-profits policyholders. This incremental cost pressure may further increase the trend towards rationalisation and consolidation.

The FSA's proposals apply equally to all with-profits funds, but may end up having greater consequences for mutual firms than for those with shareholder capital. Mutuals seeking to write a combination of with-profits and non-profits business have additional issues to consider, to ensure they are seen to behave fairly to with-profits policyholders in the way they use the mutual's assets to expand, or diversify into, other businesses.

*Peter Bloxham is a solicitor and was a partner in Freshfields Bruckhaus Deringer from 1983 to 2006, specializing in restructurings, including in the financial services sector. In 2007, he was nominated by Prudential Assurance Company (and approved by the Financial Services Authority) to be Policyholder Advocate in respect of the possible reattribution of the Inherited Estate of the Prudential Assurance Company's with-profits sub-fund. In June 2008, Prudential announced that, after very careful consideration, it had decided not to proceed with the proposed reattribution.*