

**Speech given to the Institute of Welsh Affairs on
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THE FUTURE REGULATION OF WITH-PROFITS BUSINESS

For the last 50 years with-profits policies have taken a large share of the long-term savings market in the UK. At the end of last year the capital value of with-profits funds stood at £320 billion, or around 35% of annual GDP. It may well be that the high watermark of with-profits investment has passed, but, nonetheless, 5.2 million new policies were taken out in the year 1999. Some types of with-profits policies are clearly growth areas – sales of with-profits bonds reached £12 billion in 1999; and with-profits annuities are an increasingly popular means of seeking to maintain the real value of pensions.

With-profits investment is therefore going to remain a hugely significant part of the savings landscape for the foreseeable future. So it is important to ensure that the regulatory framework within which this investment is marketed and managed is robust and fit for purpose.

Over the last few years a number of problems have emerged which have put the life insurance industry, and indeed its regulators, under some strain. With-profits funds are affected by these problems; and in some cases there are consequences specific to with-profits business.

A major problem has been, of course, the need to meet the costs of mis-selling of personal pensions – many of them with with-profits products. The pensions review has necessitated almost certainly the largest consumer compensation exercise ever conducted in this country, and perhaps in the world. We estimate that around 1_ million investors will, in due course, receive somewhere around £12 billion of

compensation for mis-selling. The review is scheduled for completion in June of next year, and it is proceeding well. But no one can take much satisfaction from this depressing episode. The management and salesforces who mis-sold systematically created misery for many savers, and the regulatory response was clearly too slow.

Initially, the main focus of public attention on pensions was on the distress and hardship caused to individuals who were persuaded out of employer funded pensions schemes into often much less attractive personal schemes. But as the compensation bill has grown, questions are increasingly asked about where this money comes from. And the answer, in the case of with-profits funds sold by product providers, is that it comes wholly or mainly from policyholders. How can this be? The simple answer is that policyholders in a with-profits fund share the ups and downs of that fund (entirely in the case of a mutual, and as to 90% in the case of a shareholder owned office). How can such enormous sums have been paid out without other policyholders seeing the cost to them? Largely because most of these funds have maintained large additional reserves, over and above those pledged to individual policyholders by way of annual bonus payments, typically known as orphan, or inherited estates.

That, and proposals by some life insurers to “attribute” their inherited estate, has led to increasing interest in the purpose and ownership of these estates. Precisely who does own them? In what circumstances may they be paid out, and to whom?

These questions may be seen as part of a broader set which have begun to be asked about the transparency of the funds and the ownership and distribution principles which guide those who manage them. Thus have been thrown into sharper focus by the recent problems experienced by Equitable Life. Here, it is the absence of a large inherited estate which has been questioned, together with the practice of selling guaranteed annuity policies, whose guarantees could only be met by reducing the bonuses available to non-guaranteed policyholders, following the House of Lords judgement last summer.

And on top of all this, holders of about one and a quarter million mortgage-related endowment policies - many of them with profits policies - have been told that, on

current projections of estimated future returns, their policies are no longer on track to pay out the capital sum needed to repay the loan.

These problems, which have somewhat different roots in each case, have come together to create a combustible mixture, leading to claims that with-profits funds are no longer appropriate savings vehicles for anyone, and that we need a sharper, more rigorous and more rigid regulatory environment. Some have argued for more direct controls over the nature and characteristics of the products sold and more precise and restrictive regulatory disciplines on the companies who manufacture and distribute them. There are calls for much clearer and direct accountability to policyholders for companies' directors and actuaries. Thus, in effect, act as trustees in relation to the funds policyholders invest in and exercise virtually unfettered discretion when it comes to deciding bonus distribution.

In this rather nervous and heated environment it is important not to jump too quickly to the conclusion that a radical overhaul of regulation is needed. There is always a risk, in the aftermath of a problem like that of the Equitable, which has created damaging uncertainty for many policyholders, of jumping to a panic response. The "dangerous dogs" approach to regulation can produce instant solutions which are then repented at leisure.

But there are, undoubtedly, serious issues to resolve, which will require co-operation between the industry, its regulators and, indeed, its customers.

Perhaps the best starting point is an assessment of the pluses and minuses of with-profits policies in today's environment.

No one can deny that the with-profits policy has allowed many investors to share in the rapid growth of the stock market over the last 25 years. Like other pooled investments, with-profits have enabled people to secure equity-related returns without picking a stock or meeting a stockbroker, both interactions which many people find uncomfortable or impossible. But there are two features unique to with-profits policies. One is the build up year on year of guaranteed amounts – so called reversionary bonuses which once declared cannot be taken away. The other is the way

in which final investment returns are smoothed over time. Together these features mean that with profit policies are less volatile than direct equity investments or other forms of collective equity investments such as unit trusts. According to Standard & Poors, over a period of ten years ending in August 1999 the variation in the returns between the best and worse performing unit trusts was between 18% and 4%. In the case of with-profits policies the variation was between 12% and 8%. So the range was about 14 percentage points in the case of unit trusts, and about 4 percentage in the case of with-profits policies. For many, this smoothing is a valuable feature, particularly where the investment has to be cashed in at a predetermined date. For example, a with-profits endowment is a less risky product than a unit-linked endowment as the final payment is not wholly dependent on the level of the stock market on the maturity date.

Over 25 years, many with-profits policies continue to provide quite high levels of payout relative to the actual investment returns achieved, because these policies share in the profits from other types of business written by the company, and in any distributions from their accumulated 'estate'.

But, set against these clear attractions, come some serious disadvantages. In the first place, the annual costs to the investor of with-profits policies can be high, certainly by comparison with, say, an indexed tracking fund. Investors typically pay 3.5% over ten years, and 1.5% over 25 years, in addition to dealing costs by comparison with around a 1% charge for an indexed tracking fund.

Furthermore, because of the nature of the returns to with-profits policies, with a large – and increasing – proportion of those returns in the form of a terminal bonus, coupled with the more general problem across investment products of high up front charges which need to be recouped, any investors who need to cash in early have typically earned a return well below the market average, and sometimes – if they cash in very early - even below what might have been earned on deposits.

This feature of with-profits policies has become more obvious as long-term interest rates have declined, and it has become more important as individuals' working lives and family circumstances have become more varied and more volatile. It has been

particularly true of with-profits endowment policies where an increasingly higher incidence of marital breakdown has taken a severe toll. Many many couples have had to disentangle their long-term investment strategies well before term, with damaging consequences for the returns achieved.

So while long-term investors, especially those who stay the full course of a fixed term contract, may receive the market return, or even better, those who fall by the wayside often receive considerably less.

These are not the only problems with the with-profits product. There are presentational problems, too. The funds are opaque, with investors getting little information about how their funds are invested, or indeed about the nature of the risks (whether risk of early surrender, investment risk, or risk by association as in the Equitable case) to which they are exposed. The annual statements an investor typically receives are often less than helpful in this regard. Even the terminology used seems designed to mislead. So while most funds allocate guaranteed sums to policies along the way, these allocations are described as “bonuses”. Not a usage of the term for which one would find support in most dictionaries. While the so-called terminal bonus remains determinedly unpromised and unclear, usually until the last possible moment. (There are some good reasons for this coyness, in terms of the reserving which is required when a bonus has been firmly promised, but it does not make for clarity for the investor.)

This lack of transparency has more than an irritant effect. It is one of the most important reasons why mis-selling has been so easy. It has been possible for salespeople to present these policies to investors in elaborate and confusing ways, causing many people to take out contracts whose characteristics were unclear and unsuitable to the investors’ needs.

These adverse indications are not brand new. And the market has been reacting to them for some time. There have also been regulatory pressures, particularly targeted at improving the suitability advice given to investors, and to enhancing disclosure, which have undoubtedly had an impact.

So, if we take mortgage endowments as an example, we can see that according to estimates from the Council of Mortgage Lenders the proportion of first time mortgages linked to an endowment product as the repayment vehicle has fallen from around a third only three years ago to less than 10% today. Looking forward, it is notable that, in the stakeholder pension market which will open in just over a month's time, most of the companies who have sought authorisation to offer stakeholder pensions have told us they plan to do so on a unit-linked basis, rather than as a conventional with-profits policy. Time will tell how big a share of the business is taken by with-profits products.

Undoubtedly the Government's ISA initiative, combined with stakeholder pensions and CAT-marks are changing the savings landscape. In the so-called "1% world", the traditional with-profits policy may become increasingly an endangered species unless it can evolve to meet the new challenges. There are signs that it is doing so. Conventional with-profits is steadily being replaced by more flexible "unitised with-profits", and both the industry and the actuarial profession are working on further changes. The industry is addressing standards through its "Raising Standards" project; and the actuarial profession is discussing a paper on "transparent with-profits" at a meeting of the Institute of Actuaries next week.

The FSA must and will play its part too. However the market develops from here, there will be many millions of policies in force for decades, and many billions of pounds or Euro under management. That is why, at the FSA, we have been working to improve the regulatory environment for with-profits policies, and plan to continue to do so.

We have five strands of work under way which, together, should significantly improve the way in which policies are described, managed and sold.

First, we must bring the pensions review to a successful conclusion. While there remain hundreds of thousands of mis-sold investors who are owed compensation the industry cannot hope to rebuild confidence in its selling practices. At the present rate of progress, we look on course to deliver substantial completion of the review by the

middle of next year, but there is still a lot of hard work ahead if that target is to be achieved.

Second, we press on with our work on endowment mortgages, both with profits and unit-linked. Millions of investors have now received letters telling them whether or not their policies are on track to deliver the capital sum required, and some 60% of those letters say they may not be. It is important that the industry as a whole ensures that those investors make sensible decisions for the future, and are not panicked into abandoning their policies, or otherwise led astray. It is important to bear in mind that lower interest rates benefit people with endowment mortgages just as much as borrowers in general, so that they can use the saving to put their mortgages back on track. But where policies have been mis-sold, compensation should be paid out quickly where savers have lost out as a result. For the worst cases, there will be vigorous disciplinary actions brought by the FSA. We have already dealt with a couple of particularly bad cases, and I am afraid to say that we can expect more before too long. It is sadly true that rebuilding confidence in the industry means, in part, tough discipline on those who have shown little regard for the regulatory environment in the past.

Third, we must improve the information available to investors on these policies, not only at outset but also throughout their life. The most important initiative in that area is our comparative information tables project, which is now well under way. This covers a range of popular investment products, including some with-profits. The results will be published in the summer of this year. That will greatly assist investors, and advisers on their behalf, to pick their way through the thicket of costs and charges surrounding life insurance policies and other long-term investment products. I believe that this, combined with our other work to help consumers ask the right questions of their advisers and salespeople, will over time produce much better informed purchasers of policies, which is probably the best way of improving the sales process and reducing mis-selling.

Fourthly, we have announced a review of some features of with-profits business itself. This project will, in turn, look at the prospects for change in four main areas:

The extent of the discretion available to management over the operation of with-profits funds, and how that discretion is exercised. Is it too wide? Or is it merely too opaque?

Improvements in the transparency of the published information about with-profits funds themselves, including how bonuses are set, and what is guaranteed. We have already published some updated proposals in the FSA Conduct of Business Sourcebook, and issued a Discussion Paper which addresses how to make product information more readable and understandable.

Better information for policyholders about the progress of their investments. That must, I think, involve significant changes in the language used to describe returns, much greater clarity about investment strategies and the way in which terminal bonuses are determined. Why can't the phrase 'reversionary bonus' be translated into English, for example?

The principles which underpin the reasonable expectations policyholders may have in relation to their pooled investments. One unsatisfactory feature of the old régime has been the phrase "policyholders reasonable expectations". Though central to insurance regulation, it has never properly been defined. We should also explore the possibility of finding a more transparent process for handling orphan asset cases, though one which recognises the need to ensure the orderly release of market sensitive information.

Fifth, and last, there are changes under way in the organisation of regulation within the FSA which will improve its effectiveness in the future. We are bringing together prudential and conduct of business regulation for many insurance companies. This should allow us to look more systematically at the interaction between the prudential position of a fund and its selling and marketing practices. In the old regulatory regime, responsibilities were divided between different authorities. Within a single regulator, in future, a more co-ordinated approach will be possible. We are introducing a rigorous, risk-based approach to regulation. That will result, for some insurance companies, in a much closer relationship with their supervisors than they have had in the past, and one which their boards are directly engaged, as has been the

case with banking supervision for some little time. This will involve a further increase in resources devoted to insurance regulation, which has been relatively thinly staffed in the past, again by comparison with banking supervision.

We will also under the new regime have some additional powers, such as a clear consumer education remit and the ability to consider action under the Unfair Contract Terms legislation, that will strengthen our hand.

All these regulatory initiatives do not, of course, take place in isolation. There are initiatives in the industry itself which will, if successful improve the standards of customer care which investors can expect. The so-called Raising Standards project has attracted considerable industry support. And the product changes stimulated by Government policy initiatives on stakeholder pensions and CAT-marks, with their charging caps, will also have a powerful impact on industry practice.

My suspicion is that the traditional with-profits business, in its present form, with its opaque superstructure, obscure marketing and high charges will not loom as large in the long-term savings environment in the next 20 years, as it has in the past 20. But some of the characteristics of with profits business bring significant benefits to savers and there could still be an important rôle for pooled savings in equity related funds. But this will only happen if the industry is prepared to put its house in order and react more imaginatively to changing customer demands and changing lifestyles.

Our aim as regulators is to support that necessary change, and to create an environment of confidence in which consumers and suppliers can come together in a more transparent and even-handed bargain in the future than they have typically done in the past.