

Steve Dixon Associates Update

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Conduct of Business Regulation

With profit mutuals

Jon Pain (Managing Director of Supervision of the FSA) has issued a Dear CEO letter to all with profit mutuals. This is part of the continuing campaign that the FSA have embarked upon to tighten up regulation of with profits. It could, however, be construed as being anti mutual and likely to lead to only shareholder firms continuing in business. This is against the government's stated policy to encourage diversity in the financial services market place.

Reason for the letter

The letter is a response to the replies received by the FSA as part of its response to Project Chrysalis. The original document from the FSA (about a year ago) enclosed some legal advice provided for the FSA that could be summarised as:

- On most demutualisations, only the with profit policyholders received any payout;
- Therefore, the whole of the current fund of a mutual belonged (after meeting contractual obligations) to the with profit policyholders;
- Membership did not, of itself, provide any ownership benefit nor cost to the member.

The FSA's conclusions to this was that:

- Mutuals can only continue to operate if the with profit policies are expanding and able to take the surplus from non-profit policies;

- New business is only justified if it is profitable to the existing generation of with profit policyholders;
- There is no estate or surplus assets for with profit mutuals - they are all part of the with profit policyholders' entitlement.

Mutuals responded vigorously. This letter now deals with this response.

Key points of Jon Pain's letter

The key points of Jon Pain's letter is as follows:

1. The FSA rejects all of the arguments made in favour of membership having a value;
2. The FSA are opposed to any distribution of surplus to non profit members and will require any Society doing so to explain this fully to with profit members and provide full disclosure to the FSA. Examples of these type of distribution may be discretionary optical / medical / dental benefits or discretionary legal support helplines. These can only be provided to with profit policyholders in future;
3. The FSA are creating a new concept of "at least as much as in a proprietary" to show the level of profit sharing appropriate for a with profit mutual. How this is going to work in practice is difficult to see. Does it mean at least 90% as most proprietaries (used) to be 90/10? Does it mean that a separate with profits fund needs to be established as it has been for most proprietaries? Are many proprietary offices still offering conventional with profits or have they all moved to fixed charge smoothed unit linked aka unitised with profits?
4. There will be a consultation paper out in late 2010 on this and other with profit

Inside

- 1 Reason for the letter
- 1 Key points of the letter
- 2 Our analysis
- 2 How to cope

matters (possibly the with profit review). This will be hard hitting.

Our analysis

We think that the FSA have, possibly, backed themselves into an impossible position to defend in the long term.

Stating that boards of mutuals are unable to provide discretionary benefits to policies that do not have traditional bonus distributions could be shown to be against Principle 6 of treating customers fairly. Boards only provide these distributions after careful consideration of the fairness of distribution.

Our understanding of mutuals is that they are similar to clubs where membership has ownership rights and responsibilities irrespective of whether the policies are with profits or not. With profits policies have a right to a distribution based on their fair share of the with profits fund.

Their analysis also makes no allowance for non-profit mutuals - who owns them?

We also believe that this work is intimately connected with the work carried out by the FSA on its with profit review. The analysis by the FSA of the ownership of with profit mutuals gives the starting point for the with profit review.

How to cope.

We would suggest that with profit mutuals need to analyse their rules and the terms and conditions on all their policies. The rule book is the foundation stone and must determine how the mutual is governed.

The firm needs, then, to be careful on its definition of with profits policies. Which policies normally share in material amounts of surplus (however it is distributed) needs to be clearly identified possibly by the Board and minuted. These are with profit policies even if the surplus is not given as a traditional reversionary bonus.

Next, the firm needs to provide some form of measure of fair distributions between members. The only method that the FSA will accept is a tight target based on historic asset shares.

This means that the asset shares used to determine policy payouts need to be carefully determined. The firm needs to make sure that all forms of surplus are found and attributed to the asset share. Some of the miscellaneous sources of surplus previously ignored by actuaries (say surrender profits or profits from risk benefits) need to be identified and shared by some form of proxy amongst members.

Firms and their actuaries should also note that any other data from the valuation process (for example the analysis of surplus or prospective realistic valuations) are of no value in determining bonus recommendations.

The firm must also be careful in its communication to members. It must explain these decisions on allocation of membership and, we would suggest, give time at its AGM for members to discuss them.

Finally, firms will have to stop the practice of providing free add on benefits as membership rights unless these are agreed by the with profit members.

S. Dixon

15th October 2010