Prising off the lid

Effective governance will help the millions trapped in closed with profits funds, says **Debbie Harrison**, senior visiting fellow of the Pensions Institute at Cass Business School

Since the turn of this century, the personal finance press has reported a mood of frustration and bewilderment among the 11m policyholders in 70 with profits funds, valued at £190bn. Of this figure, the consolidators – companies set up specifically to buy and aggregate closed insurance funds – have bought closed funds valued at about £80bn.

The tone of national press commentary is one of anger and cynicism, reflecting the commonly held view among personal finance journalists that the Financial Services Authority (FSA) can do little more than close the stable doors after the horse has bolted.

The horse that has bolted in this case is the management team of proprietary companies, which is responsible for establishing a governance framework within which closed with profits funds can be run in the best interests of policyholders as well as shareholders.

Management is the target of the FSA's treating customers fairly (TCF) regime and also the recipient of a series FSA 'Dear CEO' letters, the latest of which landed on the corporate doormat shortly after the Financial Services Consumer Panel (FSCP) published a measured but nevertheless damning report, '*Are customers in closed life funds being treated fairly*?'

The report was written by members of the Pensions Institute at Cass Business School, supported by IFF Research. The focus of the report is proprietary companies, as the potential for conflicts of interest between shareholders and policyholders is one of the most critical issues for TCF in the context of with profits funds.

The problem for policyholders is this. Investors in the 1980s and 1990s bought a household brand name product they did not understand but were led to believe would provide smoothed growth via a high equity backing ratio (EBR). Typically the funds invested 70% in equities and property.

What policyholders have now, in most cases, is a predominantly fixed interest product with a poor prognosis for future performance and what, understandably, consumers perceive as exit penalties in the form of the market value reduction

(MVR). The fact that for some 10m investors the brand name has disappeared following consolidation has done little to inspire confidence.

Governance

The report found that, within the life office structure, the governance mechanism to ensure policyholder representation and protection is frequently inconsistent and incomplete. The management of potential conflicts between shareholders and policyholders, therefore, does not necessarily reflect TCF.

In 2004 the FSA introduced guidance for firms on the necessity for some form of independent governance mechanism. Unfortunately the original guidance was watered down so that the company board was left to interpret 'independence' as it saw fit. Most firms established a with profits committee (WPC) but the majority of these are not genuinely independent.

The FSCP report proposes that a WPC should be a requirement for proprietary companies running with profits funds and that its primary purpose is to ensure that the financial management of the fund, which includes the inherited estate or any other form of surplus, is in the best interests of policyholders. To achieve this clear objective the WPC must be genuinely independent of the company board and not dominated by management, ex-directors and non executive directors, as in the case with about 60% of WPCs at present.

Critically, the WPC's remit should be TCF and not just the principles and practices of financial management (PPFM) document, which is written by the management and at present provides the frame of reference for WPC reports to policyholders. As one expert interviewed for the report put it, the PPFM "can be a charter for abuse" as it sanctions uses of policyholder capital that may not be in policyholders' best interests.

Disenfranchised from independent advice

TCF Outcome 5 includes the requirement that customers should be "provided with products that perform as firms have led them to expect". A with profits fund that has changed from a high EBR to a high fixed interest allocation cannot be expected to perform in the way that policyholders were led to expect at the date of purchase.

In these circumstances, the FSA says, customers can reasonably expect to be alerted to the change and to seek independent advice to determine whether it is appropriate to switch to an alternative product that matches more closely the original investment objectives. ('Quality of post-sale communications', May 2007.)

Fine words. The report found that in practice the 8m customers with small policy values (less than £5,000) are disenfranchised from the independent advice market. Fee based advice is costly relative to the value of smaller policies, while commission based advisers cannot provide an economic review service where the policy value is small for three good reasons: the complexity of the work required; the concern about the residual regulatory risk – the FSA may decide at a later date that a recommendation to switch was a case of churning; and the low level of commission that advisers would receive in return (but only where the recommendation is to switch).

The report proposes that "focused" or "basic" advice, which provides a detailed analysis of a specific investment but not a full financial planning service, is an initiative that should be developed further for with profits policyholders. Focused advice limits the scope of the service but not the depth. This type of advice would be of real assistance to customers with small policy values and to those who do not have a portfolio of assets that would make it economic for advisers to provide a full service, where the remuneration on other investment recommendations could subsidise the work associated with a with profits policy review.

Given the complexity of with profits policies, low cost focused advice requires smart with profits review software, as is available from Cazalet Consulting/ Towers Perrin and Barrie and Hibbert. Cazalet Consulting reports that analyser tools are now available to IFAs for all with profits bonds through the stochastic modelling tools available on the adviser websites for AEGON (Scottish Equitable), Clerical Medical and Fidelity Funds Network. Standard Life provides a review process on its adviser website, which was developed in conjunction with AKG. Meanwhile, Cazalet is in the process of extending its modelling services to cover pension contracts.

The FSCP report recommends that a central source of cheap reviews is made available, via an industry initiative, and that this should be noted prominently on all with profits communications literature. Inevitably this type of advice is limited and there will be some people who do not get the right results. The authors of the FSCP report acknowledge this point openly but argue that limited advice is better than no advice at all, which is the current position of the 8m disenfranchised.

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Box 1: Key findings of FSCP report

The governance mechanisms to ensure fair treatment of policyholders are weak and the company's use of policyholder capital is inconsistent.

8m policyholders are disenfranchised from the independent advice system.

Poor administration is detrimental to the policyholder's freedom and flexibility to exercise their rights in the traded endowment policy (TEP) market and to use the pensions open market option (OMO).

Poor communications literature undermines policyholder understanding and confidence so that they are unable to make informed decisions

The term 'closed' is confusing. Quasi-closed funds should close formally to provide better policyholder protection.

TEPs and OMOs

Liquidity is an important aspect of the with profits market and there are three ways in particular that a policyholder might end the contract with the original provider. These are the MVR-free period, the sale of an endowment in the secondary traded endowment policy (TEP) market, and the use of the open market option (OMO) at retirement to buy an annuity. The report found that poor administration is a significant barrier in all three areas.

With reference to TCF Outcome 3, "Consumers are provided with clear information and kept appropriately informed, before, during and after the point of sale", the FSA, in its 'Quality of post-sales advice' report, notes that three-fifths of advisers encountered problems in getting information from product providers, for example about market value reductions (MVRs) and

MVR-free periods.

The MVR is imposed where the policy's underlying value (the asset value) is lower than the unit value shown on the annual statement. The unit value usually only applies at certain dates, including maturity and death. MVR-free periods, therefore, provide an important element of liquidity in the market for policyholders, who do not wish to continue their policy to the maturity date.

Poor administration can further undermine the liquidity of the with profits endowment and personal pensions market. The traded endowment policy (TEP) market can, in many cases, enable customers who want to stop an endowment policy, to secure a better price than the surrender value offered by the provider. TEP market makers report that closed funds are particularly difficult to deal with and that it is often impossible to obtain information and duplicate policy documents, for example, in a timely manner to ensure customers are treated fairly. In these cases the sale may be impossible.

Annuity advisers report similar problems where they request a transfer of a client's maturing pension fund via the OMO. Where the transfer cannot be arranged within the 14-day annuity rate quotation period, annuity rates may change and the customer could receive a lower retirement income.

Administration standards provide a key metric for the measurement of TCF and in the three areas noted above there are serious problems that lead to customer detriment. The report recommends that the FSA, in conjunction with providers and advisers, should establish clear benchmarks for administration and a system whereby advisers can report breaches, which would be investigated thoroughly. Naming and shaming would be an effective spur in this cleaning up process.

Clear as mud

TCF Outcome 3 states that consumers should be provided with clear information and kept appropriately informed before, during and after the point of sale. In its post-sale report of May 2007, the FSA explained what this means:

"Post-sale information needs to be clear enough for customers (or their advisers) to understand how their investment is performing, so they can judge if the policy still meets their requirements. It should also remind them of the key benefits of that policy, particularly if they are about to take actions, which would result in them losing these benefits".

The report found that many communications documents, while adhering to regulatory requirements, do not set out the key information clearly and do not provide sufficient information to enable customers to make informed decisions.

There was a consensus among those interviewed for the Report that communications is a vital metric for the measurement of TCF. The Report states that the industry should work towards standard and simple formats for communications documents and that these should be assessed by regular consumer testing to establish whether the information is intelligible and sufficient to enable the customer to make informed decisions.

As mentioned above, all documents should highlight the availability of the focused advice centre. Key documents include the annual statement, the bonus statement, the customer friendly PPFM (CFPPFM), information about MVR-free exit dates, and information about a change in fund status or ownership.

Conclusion

The FSCP report has important messages for the industry, the FSA and consumers.

With the majority of the with profits funds in run-off, it is essential that regulation enables policyholders to be given the best opportunity to make informed decisions and that where they choose to continue their policies, every endeavour should be made to ensure that policyholders' original expectations are met.

While improvements in advice, administration and communications will go some way to improving the position of with-profits policyholders, it is the opinion of the authors that weak governance is the chief underlying cause of policyholder detriment and that unless this issue is tackled robustly policyholders in closed and quasi-closed funds run by proprietary companies will continue to be treated unfairly.

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Box 2: Quasi closed funds lurking below the radar

The FSCP report argues that, apart from a handful of actively marketed funds – the big players being Prudential, CGNU, Standard Life, Legal & General, and Royal London – the distinction between closed and open is not clear cut. Indeed, it is evident from analysts' reports (AKG and Cazalet, for example), that the bulk of the with profits market can be considered in run-off.

Many funds that have not closed formally are closed in all but name. They share the characteristics of formally closed funds but operate under different rules in relation to key aspects of policyholder protection and fair treatment.

The report categorises proprietary and mutual with-profits life funds as follows:

Open and actively seeking new business, as is demonstrated in new business figures, as distinct from premiums on existing policies.

Closed formally with a run off plan submitted to FSA, which sets out a process for the distribution of the inherited estate. Policyholders must be informed of formal closure.

Quasi-closed or sleeping, where little or no new business is written but the policyholder protection processes of formal closure are not in place.

Closed and consolidated where a fund has changed ownership to a company that specialises in closed funds. About 10m policyholders are in funds owned by Resolution and Pearl (the chief consolidators), Swiss Re and Reliance Mutual.

While it is not unreasonable for a fund to remain in a quasi closed state for the short term – on the basis that it may decide to actively seek new sales if the market environment changes – for funds to continue in this state raises important issues for TCF. In particular open funds can continue to build up and use surplus assets for new business purposes, the payment of shareholder tax, and mis-selling claims. This use of capital, as an 'investment' on the part of the with profits fund, on close scrutiny, may in certain cases appear imprudent and unprofitable.