With-profit governance

Anisha Shah reflects on the recent return of the FSA's focus.

The FSA carried out a review of the governance surrounding with-profit funds in the early 2000s. As a result, Principles and Practices of Financial Management (PPFMs) were introduced and all firms were expected to have adopted them by 30 April 2004. In addition, the role of the With-Profits Actuary (WPA) was introduced for all with-profit funds. Since then, firms have been operating in a relatively stable governance regime. Recently, however a focus on with-profits governance has returned.

On 19 September 2007, the FSA issued a 'Dear CEO' letter to insurers questioning practices it observed as part of two reviews carried out: one on the governance arrangements of with-profit funds and the other on the management of closed funds. Some of the governance related issues discussed were:

- some providers' arrangements for independent output not involving a wider consideration for Treating Customers Fairly (TCF) issues
- lack of timely information to the With-Profits Committee (WPC)
- conflicts of interest in the way that firms use independent reviewers for the management of their with-profit funds
- insufficient communication of with-profits governance to policyholders.

The letter expected senior management "to review how they have implemented the Principles for Business in their governance arrangements."

In early 2008, the Treasury Select Committee announced that it would undertake an inquiry into inherited estates. This also involved looking into the role of the WPC. The report released on the conclusion of this investigation was accomplished by a press notice which stated: "The report expresses concern that WPCs lack adequate resources, remit and visibility for them to protect policyholders' interests in with-profits funds. It recommends that the FSA consider granting WPCs an explicit role to ensure that a fund is run in accordance with the FSA's principle of treating customers fairly, rather than merely considering the firm's compliance with its own internal rulebook."

The FSA plans to follow up individual firms' behaviour both to ensure that firms' management is such that with-profits policyholders are treated fairly and also through specific follow-up on governance issues raised in the 'Dear CEO' letter.

Against this background, Watson Wyatt carried out a focused survey of WPAs and members of WPCs in the summer of 2008. Responses were received from 19 firms and some of the findings are discussed above. Figure 7 below suggests that the FSA had not engaged with most firms by the time of our survey.

The FSA has stated (in its memorandum to the Treasury Select Committee inquiry) that it expects senior management of firms to ensure that their with-profits governance arrangements are consulted on any significant issues that affect with-profit policyholders' interests.

Figure 7 | The FSA have questioned the adequacy of the arrangements in some respects

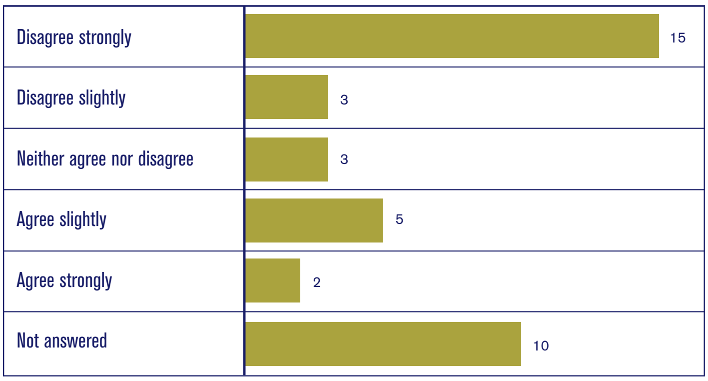

Figure 8 | The WPC regularly reviews the risk appetites set by the company for the with-profits funds it is responsible for relative to the financial strength and past statements to policyholders

Disagree strongly	1
Disagree slightly	3
Neither agree nor disagree	3
Agree slightly	14
Agree strongly	8
Not answered	9

Figure 9 | The terms of reference go beyond assessing compliance with PPFM and include wider 'Treating Customers Fairly' issues

Disagree strongly	0
Disagree slightly	3
Neither agree nor disagree	1
Agree slightly	3
Agree strongly	24
Not answered	7

In relation to this, our survey found that less than one-third of respondents strongly agreed that their committee regularly reviewed risk appetites, and even fewer seemed to receive any risk management information (see Figure 8).

Also there was little evidence that WPCs (or equivalent) were made aware of any supporting management information on TCF in relation to the funds they look after (however, as Figure 9 shows, the vast majority of WPCs were aware that their remit included wider TCF issues).

Under FSA rules, with-profits providers must seek independent input, whether from a WPC or alternative arrangement in a number of situations, and in particular where there may be a conflict of interest between policyholders and shareholders. As noted earlier in this article, the FSA has found evidence of conflicts of interest, where either the independent reviewers are also involved in some other work with the firm or where some or all of the members of the WPC are executives of the firm.

> [The FSA] will take supervisory or enforcement action, where appropriate, in cases where [they] find that customers are not being treated fairly.

More generally, the level of independence applied within with-profits governance arrangements may be a concern. None of the companies we surveyed had a consumer representative on the WPC. Also, there were examples of disconnect between committee member and management views on whether external actuarial advice was needed. This may be because some members of committees are assuming that the presence of actuaries who are independent of the firm can be considered as external actuarial advisors. However, this then poses the question: "what role are these actuaries playing?".

We also found that there were instance where committee members thought that some members contribute much less than others in the discussions. If a subset of the membership becomes dominant, the system is not really performing the role of a committee as intended. In addition, the preference of the majority to receive papers that contain firm recommendations may be challenged for discouraging independent thinking and input to management decision-making.

Plans for the future evolution of with-profits governance arrangements may need to be clarified or strengthened. Our survey revealed that there was limited evidence in firms of mechanisms for measuring the performance of the WPC (or equivalent), and some respondents strongly disagreed with the suggestion that there was a planned and progressive refresh of the WPC membership.

There seems to be mounting pressure for the Actuarial Function Holder (AFH) and WPA roles to be performed by different people so as to increase the independence of the WPA. The Financial Services Consumers Panel has also commented on the viability of a Board member of a company also being a member of the WPC. In conjunction with the earlier comments by the Treasury Select Committee, this may prompt the FSA to revise its current rulebook, which at present contains little in the way of specific rules around governance. There seems to be scope for a number of improvements to the present governance regime. This may include:

- preventing the same individual from holding both the AFH and WPA roles, at least in proprietary companies
- requiring a majority of clearly independent non-directors on the WPC
- externalising the WPA role, or insisting on an external peer review if this role is held internally
- extending the WPC remit to require it to protect policyholders' interests in with-profit funds more explicitly and ensure that the management of the fund adheres to the FSA's TCF principles
- requiring any independent persons (as described in COBS 20.3.2) to be subject to the Approved Persons regime.

The FSA explicitly states the following in their 'Dear CEO' letter: "We will take supervisory or enforcement action, where appropriate, in cases where we find that customers are not being treated fairly." As with other issues, the FSA can wield the regulatory stick if it is not happy with how firms are behaving.

Conclusion

This gives an insight into the issues that firms face in the current governance regime. Greater prescription and strengthening of the requirements around demonstrable independence would be obvious ways for the FSA to respond to the concerns of others. However, this goes against the FSA's decision to have principles-based regulation, so a balance will have to be struck.

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