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Advance copy by e-mail.

Dear Sir,

Re: Response to Consultation Paper CP 11/05 on the Conduct of With-Profits Fund Business.

I write as a policyholder advocate who has been helping to uncover and explain the Equitable Life scandal in the wider context of regulation and management of with-profits funds more generally. There is a vast amount of relevant material covering the transition from the "Freedom with Disclosure", "Policyholders' Reasonable Expectations" (PRE), and "Sound and Prudent Management" (S & PM) to "Treating Customers Fairly" (TCF) approaches. There is also a wealth of material on corporate governance (Myners), Parliamentary Affairs Select Committee/ Treasury Select Committee Reports on the Equitable Life and inherited estates, integration and harmonisation with EU legislation including Solvency II requirements, numerous unsatisfactory and incomplete Equitable Life investigations, disciplinary hearings and court cases, as well as the productions of your own organisation. Suffice it that I am broadly familiar with much of this, and wish you to know that it informs my current response without rehearsing everything in detail. Having said that, your June 2010 with-profits review, May 2011 Consultation Paper and my own critique [1]of the Parliamentary Ombudsman's Second Equitable Life Investigation and Report (PO2) are particularly relevant to what follows.

Preamble.

Your consultation paper seeks comment and guidance in the following areas, all of which I shall address:

- **conflicts of interest;**
- **the fair treatment of with-profits policyholders in mutually-owned funds;**
- **the terms on which new business is written;**
- **material reductions in new business;**
- **market value reductions (MVRs);**
- **strategic investments;**
- **charges made to with-profits funds;**
- **excess surplus;**
- **reattribution of inherited estates; and**
- **corporate governance.**

In setting the overall scene let me make three general observations. Firstly, nobody new to the field who reads your June 2010 Review would realise that there has been chronic panregulatory failure of the entire sector going back some thirty years. As a result many offices have experienced crises, have been demutualised and/or consolidated by predatory organisations, and over 50% of funds are now closed in run-off. Secondly my contemporary analysis of the PO2 process and report demonstrates why it was inherently flawed and unreliable overall, besides being restricted in time and entirely limited to prudential issues. Thirdly, there has been no properly important or suitably official Conduct of Business investigation of the Equitable scandal or other with-profits fiascos including the AXA estate raid or the Scottish Widows and Standard Life GAR problems and demutualisations. That accepted there is still no solidly informed basis for your current Conduct of Business Consultation paper. Perhaps that is why much of it reads as a series of *ad hoc* expedients in the current crisis, and has little inherent logic or coherence. We are also hoping to comfort ourselves by shutting all the stable doors when many of the horses have already bolted.

Prudence, equity, fairness, trusteeship and stewardship.

The fundamental ethical bedrocks of with-profits assurance business over the past 250 years have been prudence and equity. Without the informing ethic of prudence there can be no assurance, let alone equity. From this it follows that if there is to be any rigorously coherent approach to equity and S & PM, PRE or TCF, the underlying prudential issues, nay principles, must be laid down first. Hence too your proposals have an aura of confused detail; had the fundamentals of prudence been tackled first there could have been a systematic approach to the establishment and maintenance of stable, sound and prosperous with-profits offices. And though equity underpins fairness it is more than its synonym; conversely the new creations With-Profits Actuary, Policyholder Representative and With Profits Committee should not be assumed to meet all the traditional legal and fiduciary obligations of trusteeship. Moreover the concept of stewardship is a humbling reminder to directors and officers of mutual societies of their fiduciary relationship and duties to members. In public offices the stewardship concept could help define the relationship of directors to both policyholders and shareholders, such that it deserves wider study. It is therefore surprising that words like equity, trusteeship and stewardship are largely absent from CP11/05. Meanwhile it logically follows that the final consideration of CP11/05 should be deferred until the relevant EU and prudential issues have been properly addressed and defined.

The corrosive effects of conflicts of interest on stewardship and trusteeship.

Following the concept of trusteeship also enables us to see why with-profits business is now in crisis, having previously survived two hundred years of adverse experience including two World Wars. And because the inherited estates of with-profits offices have often been built up over those hundreds of years and come to function as communal benefits held in trust, one should expect much trouble if and when they are misappropriated. Moreover we have recently gone through a period when charitable trusts and institutions of all sorts and their endowments have been widely dispersed, transferred and otherwise abused. Of course trusts are a perennial temptation, but there must have been a sea change in our ethics for such practices to have become widespread. In the United Kingdom the regulators have not been immune from these temptations- witness the fact that the two most recent Chairmen of the FSA itself have been on the Board of the acquisitive insurance consolidator Paternoster, and one of its former Chief Executives now has a similar job at Clive Cowdery's Resolution. The only real protection under these circumstances is to make the estate sacrosanct, and isolate it from ordinary business expenditure, most of which should be financed at the premium inflow stage (a subject with which we shall deal more fully in due course). Policy literature and specifically prepared charging structure explanations must be fully inclusive and unambiguous in these regards; in unhappy contrast the characteristically misleading approach employed in the Equitable's literature and updates involved a succession of selective and consistently misleading partial disclosures.

Whatever, we must first accept that the regulators themselves are not immune to conflicts of interest, in this case of the poacher versus gamekeeper variety during a succession or concurrence of posts. Regulators also naturally align themselves with Government and the financial elite, which is fundamentally opposed to policyholders' interests. Matters can therefore come to an acute head when regulators follow the wishes of the government of the day rather than the relevant UK and EU statutory instruments, or when they might prefer to conceal their own previous mistakes. And though such matters were entirely ignored by the PO2 Investigation and Report, its Chronology contains many pertinent examples [1], of which the Reassurance Treaty has excited the most widespread interest. With-profits business also raises particular conflicts of interest for actuaries, accountants and even trustees. In the first instance they report to boards of management on which they may also be directors, such that their immediate inclination may be towards management policy rather than the welfare of those they exist to protect. When institutional trustees helpfully rubber stamp management decisions they are inherently likely to be in dereliction of duty, as for example occurred when representing those who were disenfranchised in the Equitable GAR Compromise scheme. Such trustee and fiduciary aspects of professional responsibility are mentioned again later.

Estate misappropriation and abuse versus "re-attribution".

The Trust question is doubly important because it is a matter of record that there have indeed been many abuses of with-profits estates. By and large the FSA has not prevented them, such that the resulting situation has caused much anger and concern. The AXA estate re-attribution, which was contemporaneous with the Equitable negative estate/guaranteed annuity rate crisis and which so infuriated Consumers Association Head Sheila McKechnie is deservedly notorious; the FSA declined to intervene despite her representations. Misuse and misappropriation of estates has fatally weakened many offices or jeopardised safe returns to the detriment of millions of policyholders over the past decade or more. At the Equitable the original misappropriation was extended fraudulently into a Ponzi scheme after its estate had been dissipated [2], which the PO2 chronological record helps to demonstrate was concealed by the prudential regulators themselves. We may also note that the Chief Executive and former Appointed Actuary who dispersed the Equitable's estate was also the inaugural Chairman of the Conduct of Business regulator LAUTRO, a crucial impropriety which has not been addressed in any report. This is further corroboration of the regulatory milieu and its culture having been unfit for purpose for at least two decades, which in turn helps to explain its central role in our chronic panregulatory failure.

Market Value Reductions versus basic assurance issues: more rigour needed.

Given this unfortunate background and their own conflicts of interest there is an understandable reluctance among today's actuaries to acknowledge that the estate principle is fundamental to with-profits business, let alone go back over the years to the basic principles of how large it should be. A notable exception is David Forfar, whose writings on the subject to Sir John Chadwick and Lord Myners are required reading [3,4]. More interestingly, if you do not formally acknowledge the assurance and smoothing properties the estate confers, you can more easily confuse income smoothing with capital smoothing, which in turn allows you to be imprecise as to whether asset shares or rate of return should be smoothed, and by how much. And that improperly allows too much latitude in setting Market Value Reductions (MVRs). Had these matters been addressed at source, much of the debate and questioning on MVRs. in CP 11/05 would have been unnecessary. The implications for PRE and TCF are plain, and need no further elaboration here.

Strategic investment: increased volatility and spread complicated by inflation.

It is worth adding that MVRs should not automatically be imposed when the sum of asset shares exceeds the with-profits fund value, although they certainly should be if the estate cannot cover the gap. An important reason for saying this is that two new factors have had a critical effect on the management of with-profits funds, namely increased volatility and a greater diversity of assets which can be held. As a result the importance of matching, mismatching reserves and a changing hypothecation of assets to reflect the way the capital fraction of asset shares increases as maturity approaches are more important than ever. Conversely the dotcom stock market bubble, which was just one factor in one sector of one asset class, has been a widely touted but inherently inadequate excuse for the decline in with-profits fund values or returns and the imposition of MVRs generally. We may also note that obligations arising from guarantees are another factor here. They are also an important underpinning of the assurance element of policies, and the recent tendency for offices to duck this obligation and make most if not all bonus awards unguaranteed is highly regrettable. So much the worse for offices and regulators if it is a necessity imposed by financial weakness. Hence irrespective of whether surrenders are or are not contractual, it is essential that proper actuarial/investment discipline and principles are laid down first before an adequately rigorous and fair approach to MVRs can be made. Incidentally but not irrelevantly, Standard Life's enforced demutualisation might have been avoided had these principles been observed more closely on both sides. Hence here again industry-wide conduct of business principles must flow naturally out of more fundamental prudential reappraisal.

A third new factor in the with-profits equation is inflation. It should have been obvious during the 1970s and 80s that the spectacular rise in monetary value of with-profits investments and their returns were heavily influenced by inflation, such that a close eye should have been kept on the underlying real rate of return and the rise in value of guarantees generally. Not surprisingly, policyholders themselves came to view with-profits products as hedges against inflation, and with proper management that is what they should have remained. Instead the rise in asset values and returns was dissipated or otherwise misappropriated at a time when with-profits business was expanding, often at too fast a rate and hence with inadequate backing. Offices were left depleted and ill prepared for harder times, and policyholders rather than directors or shareholders have sustained huge losses. Of course CP11/05 is in many ways a crisis response to this distressing aftermath. But by the same token it in no way anticipates or addresses the next vast inflationary wave which now threatens us. The irony is that the with-profits concept stands discredited at a time when it could once again be of great benefit. But if so, fund asset mixes must be allowed to be relatively under weight in fixed interest securities, loans and bonds at such times, in which case some increased volatility may have to be accepted. And that in turn suggests that estates will have to be larger than hitherto in order to take up the enforced extra variance. Here again the Standard Life experience is relevant.

Changes in volume of with-profits business: challenges and temptations.

Perhaps unfortunately in this regard, an element of inertia is an important characteristic of stably well funded and managed with-profits business. Unless it is very large, the estate and excess assets it provides cannot accommodate a rapid influx of new business with its encroaching weight of reasonable expectations. In this respect a good with-profits office resembles a club, the privileged security and advantage of which is available only when existing places become vacant. With-profits membership and participation in the benefits provided by the inherited estate must therefore be kept in fundamental balance, such that expansion and contraction of the membership are necessarily gradual. Absent those benefits the with-profits fund and contracts contract progressively lose their assurance and smoothing elements such that they degenerates into ordinary investment funds, and all too often with very high overheads. Latterly the interested parties have been only too keen to get their hands on supposed excess estates, which CP11-05 also reflects. The real challenge, however, is how to refinance and re-expand with-profits business such that the estate ends up strengthened rather than weakened. Predatory consolidations with minimal centralised "revolving estates" supporting an indiscriminate medley of activities are most definitely not in policyholders' interests, and are a most unsuitable platform from which to write new assurance business. Meanwhile there is a dearth of new thinking on what the ideal strength of estates should be, although traditional rule of thumb puts it around 15% of the total asset share/hypothecated fund value. As we have previously seen, increased volatility and the new variety of investments have an important bearing on this, from which the distorting effects of inflation must also be stripped out. It also follows that, if these factors are kept under continuous review, large variations in the desired strength of the estate should not occur. On the one hand surplus is distributed as it arises, and on the other deficit is smoothed. Hence in a well managed office the question of re-attribution of large surpluses should not ordinarily occur, which always makes "re-attribution" proposals a cause for deep concern. As one who voted against the Norwich Union de-mutualisation and had some informed interest in the outcome of the recent Aviva "re-attribution," I should add that the whole affair was shoddy.

By comparison, reducing or ceasing to write new with-profits business increases the relative size of the estate. Left to itself, this would progressively increase the returns and values of the remaining policies. Ordinarily one should expect that it would be an easy matter to replace the desirable business which results from this circle of virtue- but because of widespread abuse both of estates and their participating policyholders the with-profits concept has spiralled downwards into disrepute. In the absence of new business the temptation is to extract more and more money, and this ultimately threatens the with-profits industry with extinction. But let there be no mistake about the causes of all this. Hundreds of years of honestly diligent work have been destroyed in two decades of greed. There is little admirable in the resulting "re-attribution" and consolidation process.

Charges: capital versus income & policyholders/ versus shareholders.

It may well be that the only way to stop estate predation effectively is to ensure that the estate is held in perpetuity on behalf of current and future generation of policyholders and nobody else- which does not prevent shareholders of public offices continuing to obtain their customary tithe on its earnings. Public offices would then have an interest in maintaining their mass of with-profits business in order to enjoy this dividend stream rather than hand the estate from which much of it flows over progressively to a diminishing number of policyholders. And had the principles of equity in respect to mutuality been properly followed many more mutual offices would have survived intact, with the result that their policyholders could have retained the tithe now attributable to owners and shareholders. This too represents a transfer of wealth from policyholder to owner, which disadvantages the policyholder yet further. Conversely we have seen why the "revolving estate" concept of a cash fund which indiscriminately supports minimal smoothing and all other aspects of the business, including mis-selling and misconduct penalties, is to be deplored. It requires further mention here because Sir John Chadwick very recently proposed it as a basis for his "Reconstructed Equitable Life" compensation comparator, and only the most vigorous refutation persuaded his actuarial advisers to dissociate themselves from it. Moreover the "revolving fund" concept inherently creates conflicts of interest between policyholders, directors and shareholders. In mutual offices it creates unnecessary degrees of freedom which can thereby be abused, and it permits an insidiously weakening effect on public and mutual offices alike.

A proper separation of administration charges on policyholders from new business acquisition costs attributable to shareholders or society members is also important. Not only should these be isolated from the estate wherever possible, but they should be clearly separated from each other in the regulatory returns and also duly reported and explained to policyholders and members. And that in turn would make the underlying investment performance and annual rate of return from a truly distinct with-profits fund much more clearly visible. Moreover the relative strengths of the "investment" (appreciation/depreciation/returns) and "assurance" (estate/smoothing/guarantees/capital) elements of with-profits funds themselves could be more clearly demonstrated. All in all, abuses and deficiencies in these areas have cost ordinary citizens many billions of pounds, which have come out of pensions as well as savings. It is an important contributor to the almost universal national outrage at the state of the UK financial services and pensions industry, and at its deeply flawed regulators for permitting the overall state of affairs.

Governance issues for offices and regulators.

The preceding discussion has finally set the scene for corporate and regulatory governance considerations. It is clear that there has been a sea change for the worse in our traditional ethical and cultural background, which no amount of regulatory and governance checks and balances can fully control or dispel. One symptom of this is the poor reputation of the FSA itself, and recent moves to abolish it. We have seen that conflicts of interest and loyalty underlie much of the FSA's problems, just as they do for insurance office actuaries, accountants, trustees and the clubbable circle of directors generally. Mutual interest and benefit issues can also compromise the work of supposedly independent advisers and experts. Strictly speaking the sales and marketing function should sit outside this more professional circle, but its main loyalty is inevitably to management rather than customers, whereas the professional managers have fiduciary duties of information and supervision to it. Hence it may well be that conflicts of interest in relation to sales and marketing deserve special consideration. Whatever, such managerial and governance conflicts of interest are radically different from those between classes and generations of policyholder, or even policyholder and shareholder which are perfectly well addressed by the old principles of equity.

Codes of professional conduct are only a partial answer to the conflict of interest problem, and do not always address this sensitive issue in as much detail as they should. It might be better to construct and implement formal conflict of interest appraisals and audits at the individual, departmental organisation level in order to see where the main risks lie, and into which category they fall. Such appraisals and audits could be of service in disciplinary and forensic investigations or proceedings. They might also help to refine and improve codes of conduct and fiduciary concepts like stewardship, as well as the ordinary cultures of expectation as to professional probity and competence. Anomalies such as a With-Profits actuary reporting his own Chief Actuary would then get weeded out routinely. And never again would an office's Chief Actuary and Executive also be allowed to head up the national conduct of business regulator.

The cumulative effect of these considerations has given my fellow policyholder advocates little enthusiasm for a consultation led by what they see as a comprehensively discredited organisation which is itself in need of urgently radical reform. Indeed one of them has suggested that we are no longer morally equipped for the concept of mutuality, or to be able to run with-profits business, even though our forefathers were well capable of doing so. If that is truly the case then all remaining with-profits funds should be put into run-off immediately, and whatever eventually remains should be by rights be given to charity rather than government, owners or shareholders. But while I fully understand this view I do not yet subscribe to it. There is too much more generally wrong for us to walk away from this particular manifestation, and a great deal more work is needed to clear matters up. Much of what has been discussed here is also pertinent to the requirements of Solvency II, and the general need for closer harmonisation and compliance with EU Life Directives. It is also relevant to understanding why the compensation proposals for Equitable Life victims are both grossly inadequate and unfair to policyholders of all nationalities, and hence why the process has in effect broken down. No way, for example, should a weakened office such as Scottish Widows have been used as a comparator for estimating the relative loss of Equitable with-profits annuitants; in effect it penalises them for the GAR problem twice over. In this connection please also take my letter as a public marker for the future.

Yours sincerely,

Dr Michael Nassim.

E-mail copies: Peter Scawen (Equitable Life Trapped Annuitants); Michael Josephs; Dr Andrew Goudie; Nicholas Oglethorpe; Margaret Felgate (International policyholder advocate); Liz Kwantes (Equitable Members Help Group); Paul Weir (Equitable Members Action Group); Mairead McGuiness MEP; Diane Wallis MEP; Sharon Bowles MEP; Alan Duncan MP.

I am most grateful to the first four copy recipients for their helpful comments and support.

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