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The role of principles and practices of financial management in the governance of with-profits UK life insurers

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1. Overview

The UK insurance industry is the largest in Europe and the third largest in the world with investment holdings valued at £1,480bn in 2006, of which with-profits assets account for some £423bn assets invested. Due to the long-term nature of with-profit contracts and the high level of discretion retained by life insurers in respect of investments and bonuses, the governance of with-profits funds is of considerable importance.

Starting in April 2004 the UK Financial Services Authority (FSA) has required each firm undertaking with-profits business to prepare and publish *Principles and Practices of Financial Management (PPFM)*. PPFMs document how a firm manages its with-profits funds. In January 2006 the FSA required firms to publish consumer friendly versions of PPFMs. Furthermore an annual report for policyholders has to be produced confirming compliance with PPFMs. This report is reviewed by the with-profits actuary who also makes a report to policyholders. An independent input is required and is usually undertaken by an established with-profits committee or an independent reviewer.

This project looked at how PPFMs are being used both internally and externally and the contribution of the PPFM framework to the overall corporate governance arrangements of with-profits funds of firms.

2. Research approach

The research was conducted in three stages. The first stage involved tracing the emergence of PPFMs as a key element of the FSA's governance arrangements for firms' with-profits funds.

A review of the corporate governance arrangements of with-profits funds of different types of UK life insurers was then conducted. In order to reflect the diversity of the UK life insurance sector the following categories were included: large listed insurance firms; major insurance firms forming part of a large listed financial services group; large mutual societies; and friendly societies. A sample of two firms per category was selected so in total eight governance arrangements were considered. The focus of the study was on with-profits funds that remain open to new business.

Finally, semi-structured interviews were performed with individuals from firms and regulatory actors. In total, 25 interviews were carried out with a range of relevant senior individuals, including actuaries, accountants, board and with-profits committee members.

3. Objectives

The aim of the study was to understand how firms as well as stakeholders and regulators were using PPFMs and at the same time assess whether PPFMs have contributed to the overall corporate governance of with-profits funds.

The main research questions were defined as follows:

- What is the role of PPFMs in the corporate governance arrangements of firms' with-profits funds?
- How have PPFMs affected the internal management and oversight of firms' with-profits funds?
- How have PPFMs affected the external oversight of firms' with-profits funds?
- How are PPFMs used, or how might PPFMs be used, for benchmarking?
- What has been the overall effect on the corporate governance of firms' with-profits funds of the FSA's reforms to the supervision of life insurers?

4. Findings and recommendations

a. The role of PPFMs

In introducing PPFMs the FSA's main objectives were:

- to secure an appropriate degree of protection for actual and potential with-profits policyholders by requiring firms to define and make available their principles and practices of financial management
- to strengthen the governance of with-profits business by requiring firms to manage their with-profits business in line with the principles and practices defined in their PPFMs
- to increase transparency of the management of with-profits business, thereby enabling actual and potential with-profits policyholders, and their advisers, to have a better understanding of the way firms manage their with-profits business.

Therefore, PPFMs have an internal governance role whereby firms must ensure that the right corporate governance mechanisms are in place to ensure funds are managed in compliance with PPFMs. They also have an external governance role, as firms need to put in place the appropriate processes to enable boards and the with-profits actuary to report compliance with PPFMs to policyholders.

b. Internal governance

In order to review how PPFMs have affected the internal governance of with-profits firms, PPFMs and annual reports of eight organisations were examined and interviews conducted.

Reviews of documents highlighted that it was easiest to identify the independent element of advice to boards from the documents of large listed firms. This was not necessarily the case for other firms. An important question concerned the independence of members of with-profits committees. As an example, for insurance subsidiaries, should executive directors at group or fellow subsidiary level, who are members of the with-profits committee of the insurance subsidiary, be regarded as independent?

Interviews emphasised how PPFMs had made a major contribution to improving the internal governance of firms for the following reasons:

- information which was tacit in the past had to be written down in an explicit manner
- material that was previously scattered across a variety of records had to be gathered in one publicly available document
- gaps and inconsistencies could be identified and therefore rectified
- management information systems were implemented to monitor and report compliance with PPFMs
- with-profits committees or independent reviews were set up to advise boards
- actuaries were challenged to communicate complex actuarial issues in a meaningful way to non-actuary board and with-profits committee members.

c. External governance

Reviews of documents revealed that board statements to with-profits policyholders about compliance with PPFM had much in common. However, it was highlighted that there is room for improvement when it comes to standardisation of wording, sign off and dating of board statements, and of with-profits actuaries' reports.

With regards to the impact of PPFMs on external users, it is relevant to divide the audience into two groups. The first group consists of consumers, policyholders and independent financial advisers; the second group consists of auditors and the FSA as a regulator.

Interviews were consistent about the fact that PPFMs, including the consumer friendly ones, were of little or no use to the first group of external users. Interviews and research conducted by the FSA confirmed that even financial advisers, who might have been expected to use PPFMs, did not use them but rather used a range of other information. Nevertheless, interviewees agreed that PPFMs provided real benefit to policyholders as a result of the internal governance response by firms to the external governance requirements.

As for the second group of external users, the auditors, PPFMs became an important tool in reviewing the realistic balance sheet approach to the preparation of the statutory accounts. For the FSA, PPFMs became part of the information set used by regulators to supervise firms, but the FSA does not provide a public opinion on individual firms' PPFMs but publishes general feedback via briefings, newsletters and studies.

d. Benchmarking

All firms undertaking with-profits business are required to publish PPFMs which must cover a prescribed range of issues set by the FSA. This could be a good opportunity to undertake benchmarking analyses and identify best practices among targeted organisations.

Interviewees; however, were sceptical about the benefits of comparative analysis. For a number of actuaries the actual benefit for benchmarking was during the initial phase of writing the PPFMs. Once the PPFMs were published and in place, the requirements imposed by the FSA before changes could be made to PPFMs were so onerous that actuaries believed that benchmarking would not lead to substantive changes and therefore was not really worth performing.

Directors similarly acknowledged that comparisons more generally were undertaken but questioned the benefits of benchmarking PPFMs due to the difficulty of the exercise and the diversity of firms and their activities.

Accountants were supportive of benchmarking which was undertaken in a number of areas, but were uncertain about benchmarking PPFMs, perceiving PPFMs as the responsibility of actuaries.

e. Cost allocation

Cost allocation is one area where the introduction of PPFMs has brought together actuaries and management accountants. To be able to demonstrate to the with-profits committee and to the FSA that costs have been allocated fairly, more robust and transparent approaches to cost allocations have been implemented, and which often involve the participation and interaction of both actuaries and management accountants.

f. Overall governance

PPFMs are only one of the changes to the governance structures of life insurers instituted by the FSA. During discussions, interviewees were invited to reflect on the overall effect on the corporate governance of firms' with-profits funds of the FSA's reforms to the supervision of life insurers. A number of important factors contributing to the improved corporate governance of insurers were

identified including:

- making boards collectively responsible for decisions
 - the introduction of realistic reporting
 - conduct of business rules
 - the need for independent review
 - the increased emphasis placed on corporate governance for all firms.
5. **Suggestions for further research**
- **Management information systems:** additional studies on the changes of management information systems in response to the introduction of PPFMs would be of interest, as would research on the changes to financial services firms' management information systems as a result of FSA initiatives. Another area would be the extent to which internal management information systems designed in response to FSA requirements, making firms more accountable, help to improve the quality of management decision making, making firms more efficient.
 - **Independence and policyholders' champion:** an important question worthy of further research is the extent to which the with-profits actuary and the with-profits committee or the independent reviewer see their role as the policyholders' champion or as standing above the fray and balancing competing interests.
 - **Benchmarking:** a benchmarking exercise of firms' PPFMs, focusing on the needs of stakeholders, expressed in clear and plain language that may be easily understood by consumers, policyholders and independent financial advisers, is likely to assist in the identification and dissemination of best practice.
 - **Cost allocation:** a review of cost allocation practices in with-profits funds with a view to identifying acceptable practices that could be used for open funds, and closed funds that are being run off, could be helpful to policy holders and regulators, and potentially published as industry guidance.
 - **Regulation:** a review with the aim of reducing the diversity and increasing the standardisation of PPFMs, consumer friendly PPFMs, boards' statements of compliance with PPFMs and supporting reports, and with-profits actuaries' reports, would help improve communication with and understanding by policyholders.
 - **Wider implications:** research might be undertaken to assess whether the PPFM framework could be adapted as a model of internal and external governance in other sectors subject to a high degree of public interest.

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