GN22: Disclosure – FSA Rules

Classification
Recommended Practice

MEMBERS ARE REMINDED THAT THEY MUST ALWAYS COMPLY WITH THE PROFESSIONAL CONDUCT STANDARDS (PCS) AND THAT GUIDANCE NOTES IMPOSE ADDITIONAL REQUIREMENTS UNDER SPECIFIC CIRCUMSTANCES

Definitions

Defined terms appear in italics when used in the standard.

Reference	**Definition**
FSA	Financial Services Authority

Legislation or Authority
Financial Services Authority Conduct of Business Rules (COBS Rules)[1]

Application
Any actuary called upon to advise a life office or friendly society or other provider of retail investment products (hereinafter referred to as the 'Actuary').

This Guidance Note deals with:

(i) [deleted in v3.0]

(ii) advice given on the allocation of expenses to with-profits business and investment-linked contracts where some or all of the charges may not be explicit.

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Status
Approved under Due Process (technical amendment).

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1.0	28.08.94
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Version	***Effective from***
3.0	01.02.08

Ceased to apply from 01.11.08

Part I: Remuneration Disclosure

[Part I (sections 1 to 5) deleted in v3.0]

[1] Amended in v3.0

Part II: Projections and Charges and Expenses Disclosure

6 Introduction

6.1 The Rules of *FSA* require firms to take into account charges and expenses, including cost of risk benefits, when calculating any projections of future benefits under retail investment products.

6.2 In determining appropriate charges regard shall be had to the principles contained in the *FSA* Guidance.

6.2.1 For a with-profits policy, the appropriate charges must properly reflect the deductions from asset share which a *firm* expects to make in accordance with its *deductions plan*[2]

6.3 The Rules of *FSA* also require disclosure of the accumulation of the charges and expenses expected to be levied against the contract including the cost of any protection benefits ('effect of deductions to date' and 'total actual deductions to date') and a statement of the effect of the appropriate charges (only) on the investment growth (reduction in yield).

6.4 Disclosure has to be made in the following documents:

6.4.1 Documents containing projections of future benefits (COBS Rules sections 4.6.7R and 13.4.1R)[2]

6.4.2 Key Features, which firms are required to prepare according to section 13.1 of COBS Rules.[2]

6.4.3 [deleted on 14.01.08]

6.4.4 [deleted on 14.01.08]

6.5 In both cases, the disclosure relates to the particular policy under consideration or, in certain circumstances, a contemporary example policy (using expenses and mortality at the level expected to be incurred over the period of use of the figures).[2]

6.6 [deleted on 14.01.08]

6.7 [deleted on 14.01,08]

7 Applicability of Guidance

7.1 Part II of this Guidance Note has been prepared to assist the Actuary in providing advice when consulted by the firm in the circumstances set out above.

7.2 This guidance applies to both conventional and accumulating with-profits business.

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[2] Amended in v3.0

7.3 This guidance, suitably interpreted, also applies to investment-linked contracts where some or all of the charges may not be explicit (including contracts the benefits of which are fully or partly linked to the value of an external index).

8 Equity and Commercial Sensitivity

8.1 The outcome of the apportionment will ultimately be reflected in published figures. The Actuary should ensure that the results of the apportionment give rise to figures which, in the context in which they will be presented, fairly reflect the expected effect of the appropriate charges upon the return under the policy and which are not believed to mislead.

8.2 The Actuary should bear in mind the commercial sensitivity of these figures, particularly projections, and should adopt an approach which is neither too conservative nor unduly optimistic (i.e. a ‘best estimate’ approach should be used).

9 Adjustments to Reported Expenses

9.1 The most recent commission and management expenses that were, or will be, reported in the FSA returns will normally provide a suitable starting point for any expense apportionment. This information appears in Form 43 of the returns for most insurers and Form 41 of the FSC1 return for non-directive incorporated friendly societies.[3]

9.2 Adjustments should be made where necessary to make the base more relevant to the purpose of the apportionment. Such adjustments may be required because of timing differences, for example accounting year vis-à-vis base year for expense disclosure, and to ensure that all expenses properly attributable to the long-term business fund are included. For example, due allowance should be made for:

9.2.1 Notional interest forgone on subsidised loans to staff, appointed representatives or company representatives, including investments in appointed representative firms on non-commercial terms, using an appropriate commercial rate as a guideline;

9.2.2 Full commercial rent on premises occupied by the firm and owned by the firm (whether by the life fund or the shareholders’ fund) or any other company within the group;

9.2.3 Either actual or SSAP 24/FRS17 contributions to staff pension schemes and medical expenses schemes. Whichever approach is adopted, that approach should be followed consistently from year to year;

9.2.4 Amortisation of capital expenditure in respect of purchase of equipment or of development costs (see Paragraph 9.3);

9.2.5 Bad debts on commission or any other advances or loans to appointed or company representatives or independent intermediaries;

[3] Amended in v.30

9.2.6 Costs of investment management, but excluding dealing costs of the underlying portfolio and costs associated with the routine management and servicing of existing property investments;

9.2.7 Any cost incurred on behalf of the firm by another company within the same group, to the extent to which that other company is not reimbursed in full by the firm;

9.2.8 Where with-profits policies do not participate in the profits or losses of certain classes of business, expenses allocated to these classes do not need to be taken into account.

9.3 Development costs will normally be written off in the year in which they are incurred. Where, however, the development costs are of an exceptional one-off nature, they may be amortised over a limited period, related to the period over which the benefits of the expenditure are expected to be obtained, and not normally exceeding five years. If amortisation of development costs is adopted, the amortisation, with interest, of prior years' costs should be brought into account.

9.4 There may be circumstances where certain expenses will be met from the estate or shareholders' funds.

Examples might include:

9.4.1 Large, one-off costs (e.g. the compensation payable in respect of the *FSA* Review on Pension Transfers and Opt Outs).

9.4.2 Support for exceptional new business expenses in a particular year.

9.4.3 Support for maintenance expenses whilst cost-reduction measures are being taken.

9.4.4 Shareholders' tax and/or shareholders' additional tax.

9.5 In the circumstances envisaged in Paragraph 9.4, the expenses in question may be excluded from appropriate charges, provided that all the following conditions are met:

9.5.1 Sufficient finance is or will be demonstratively available from the estate or from shareholders' funds as appropriate to meet such expenses as they arise. Where the expenses which will be met from the estate or from shareholders' funds are expected to persist for most or all of the policy duration, it is particularly important that the Actuary can demonstrate how, on realistic assumptions, those expenses will never fall upon policyholders' asset shares.

9.5.2 A firm commitment should exist that the resultant expense assumptions will be used as the basis for determining asset shares for the relevant policies both immediately and in the future. A board minute to this effect would typically be appropriate evidence.

9.5.3 Any reductions in incurred costs anticipated in future years should be evidenced by definite business plans on, in the opinion of the Actuary, realistic assumptions.

9.6 It is permissible to ignore the investment management costs on the estate.

9.7 Except as provided for in Paragraphs 9.4 and 9.6 it would not normally be appropriate to ignore any expenses attributable to the with-profits business.

9.8 Where a product invests in other packaged products it will be necessary to “look through” to ensure that all charges and expenses, both implicit and explicit, which the investor will bear are included.

10 Initial Apportionment

10.1 In making an apportionment, the Actuary would be expected to consider that some expenses will not vary with the volume of business (and may be regarded as fixed costs in the short term) whilst other expenses may increase or decrease as the volume of business rises or falls (and may be regarded as variable costs). The relationship with volume is not necessarily direct or proportionate and changes in variable costs may lead or lag behind changes in volume. The allocation between fixed and variable costs is not an exact science and this is especially so where large development costs are being incurred or if the company is young and small.

10.2 The Actuary may find it helpful first to divide costs into different categories, each of which may be subdivided into fixed and variable elements. Such categories might include:

(i) New business or initial costs (including the costs of cancellations from outset and unsuccessful sales efforts);

(ii) Renewal, maintenance or discontinuance costs;

(iii) Claim costs;

(iv) Investment costs;

(v) Development costs;

(vi) Overheads (e.g. general management).

Judgement must be exercised in any subdivision, although a degree of objectivity is possible in most categories.

10.3 The Actuary would also be expected to consider that many expenses can be identified with particular product lines, both with-profits and non-profit. This can be done either explicitly, or by the use of techniques such as time-spent analysis. The actual expense loadings implicit in with-profits policies may not be relevant to this process particularly if they are out of date. The Actuary should ensure that the allocation of expenses to non-profit business is fair and not in excess of those which are sustainable by that class of business.

10.4 The apportionment of overhead costs, which can be a significant proportion of the total expenses, requires considerable judgement and can be carried out in a number of credible and equitable ways depending upon the type of overhead cost. For example, overhead costs could be added as a layer on top of some or all of the non-overhead costs listed in Paragraph 10.2. Overhead costs could also be allocated uniformly over all product lines or with a bias towards classes of business which benefit most from them (for example, those classes requiring most management attention).

10.5 It is crucial that costs are allocated consistently:

(iii) across all product lines;

(iv) in the treatment of regular and single premiums, and increment policies;

(v) across all companies within the same marketing group;

(vi) over various distribution channels;

(vii) across all territories;

(viii) from one year to the next.

A major change in the basis should normally reflect a significant change in the way in which a firm apportions expenses for the purpose of determining bonuses.

10.6 If the Actuary has reasonable grounds to believe that the costs for the period will be higher than those based on the most recent experience, then those higher costs should be used.

10.7 Costs lower than those based on the most recent experience should only be used if the Actuary has strong grounds for believing that the cost for the period will indeed be lower.

10.8 In making an assessment under Paragraphs 10.6 or 10.7 account would normally be taken of inflation and of any intended changes in commission or other forms of sales remuneration.

11 Translation to Policy Level

11.1 Each different category of expenses so obtained must be translated down to the policy level by dividing it by the measure of volume appropriate to that category of expense.

11.2 The normal basis for this translation would be the most recent experience. However, if the Actuary has reasonable grounds for believing that volumes will be lower than those indicated by the experience, those lower volumes should be used. Only if the Actuary has strong grounds for believing that volumes will be higher than those indicated by the experience should higher figures be used.

11.3 If intending to use volumes higher than those implied by the most recent experience, the Actuary should ensure that any volume assumptions are justifiable taking into account:

(i) Current volumes;

(ii) The firm's plans;

(iii) Expected market conditions (including levels of early terminations); and

(iii) Any other factors which the Actuary considers to be appropriate.

New business assumptions for future periods should be consistent with the assumptions made regarding acquisition expenditure for those periods, taking into account the firm's recent experience of the costs of expansion if necessary.

12 Consistency with Bonus Philosophy

12.1 For with-profits policies the apportionment of expenses for the purpose of projections and disclosure should be consistent with the current methods of apportionment expenses for the purpose of determining bonuses.

12.2 Reasonable adjustment should be made to the apportionment to ensure such consistency. Examples of when an adjustment might be reasonable are:

12.2.1 If the policy fee differs from the apportioned fixed expenses expressed on a per policy basis - in which case the policy fee could reasonably be regarded as the only fixed expense per policy and the excess spread onto the variable expenses. Inflation of renewal expenses should be allowed for in this context (see Section 11).

12.2.2 If no account is taken of known differences in expenses between different policy categories when determining bonuses - in which case the attributed expenses should not be differentiated.

12.2.3 If a policy is offered at more than one price to reflect different acquisition or renewal costs between or within different distribution channels - in which case there would normally be different attributed policy costs for each.

12.2.4 If the attributable expenses for accumulating with-profits business exceed the explicit charges - in which case the Actuary may consider it appropriate to express the excess as an additional fund-related charge particularly if, in profit testing the product, an implicit management charge is assumed.

12.3 The assumed split as between future annual bonuses and terminal bonuses may also affect projections and other features of disclosure. This split must be reasonable and justifiable, taking into account the current split and the assumed future investment return. In particular, if terminal bonus is currently being added, it would not normally be appropriate to assume that there would be no terminal bonus in the future at any of the assumed rates of investment return.

13 Transfers to Shareholders' or Other Funds

13.1 Where transfers are likely to be made to shareholders' funds out of profits arising from with-profits business then allowance should be made for the expected cost of those transfers.

13.1.1 Transfers should be assumed to take place with the same frequency and in the same manner as has been the case in the past, unless any specific change is intended.

13.1.2 Transfers should be assumed to be the same proportion of distributable surplus as has been the case in the past, unless any specific change is intended. Future emergence of surplus should be assumed to be at the level which would be supported by the investment return required to be assumed.

13.1.3 The bonus structure assumed should accord with that currently applying, unless there is a specific intention of a different structure applying in future.

13.1.4 In taking account of shareholders' transfers appropriate allowance should be made for the way in which those transfers are calculated. Where, for example, the shareholders' transfer entitlement is one-ninth of the valuation cost of with-profits bonuses, the transfers should be calculated using appropriate assumptions about the rate of future bonus supportable and the valuation basis. The current valuation basis would normally be assumed to continue unchanged, subject to adjustment as appropriate to ensure consistency with other future assumptions, notably the future investment return.

13.2 Where the firm, whether proprietary or mutual, has the practice or intention of permanently withholding a proportion of surplus from with-profits policyholders, this retention should be treated in a similar manner to a transfer of surplus to shareholders. An example would be when an office has traditionally withheld surplus to expand its estate with no intention to return it to policyholders, even as terminal bonus, and has no intention to change this practice. Contributions to a bonus smoothing account which are not systematic and where contributions to and from the account should average out over the longer term are not 'equivalent retentions'.

13.3 *FSA* COBS Rules allow amounts of transfers or retentions determined as above to be offset by 'any sustainable rate of transfer of surplus from non-profit business'. The starting point for assessing this offset should be a best estimate of the current level of surplus from non-profit business attributable to the with-profits fund. This amount could then be expressed as a proportion of the surplus transferred to shareholders and/or withheld. A similar proportion of future transferred or retained surplus, adjusted as necessary for any changes in the mix or profitability of business reasonably anticipated, could then be offset. The offset should be determined using assumptions consistent with this Guidance Note. The offset cannot, however, be greater than the cost of transfer or retention and therefore must be nil if there is no such transfer or retention.[4]

[4] Amended in v3.0

14 Mortality and Other Costs

14.1 Both projections of future benefits and the disclosure of cumulative deductions are required by *FSA* to include mortality and morbidity on either the current rate or scale (where explicit charges are made) or on a basis appropriate to the class of investor (where no explicit charge is made).

14.2 In the latter case, the mortality (including allowance for AIDS) or morbidity assumed should be a best estimate of the rates expected to apply in the period of use of the figures. No improvements should be anticipated for the future periods for insurances, although this may be appropriate for annuities.

15 Taxation

15.1 For proprietary companies, where it is the current practice for shareholders' tax and/or shareholders' additional tax to be charged to with-profits policyholders' asset shares, allowance for such tax should be incorporated into the appropriate charges. Examples of such tax are shareholders' tax in relation to pensions business profits, and shareholders' additional tax (i.e. tax, net of relief on expenses, in addition to that payable by a mutual company) in relation to non-pensions business taxable income. An approach where such tax is not charged to asset shares is set out in Paragraphs 9.4 and 9.5 above.

15.2 In applying Paragraph 15.1 current practice should be assumed to continue unless any specific change is intended. It would not be appropriate to assume that a change to current practice would be instigated if investment returns were to satisfy (or fail to satisfy) certain conditions.

15.3 Where tax legislation specifies that tax relief on expenses shall be automatically deferred (e.g. the spreading of acquisition expense relief) allowance should be made for this deferment. No allowance should, however, be made for the effect of any other tax losses or unrelieved expenses being carried forward. This will ensure consistency with the net investment return regardless of the firm's tax position.

16 Inflation

16.1 Any expenses which are expected to be incurred other than at the inception of a policy should be adjusted for the effect of future inflation.

16.2 The rates of inflation assumed are required by *FSA* to be as specified in COBS Rules section 13 Annex 2. It should be noted that different assumptions are required for projections at different rates of investment return.[5]

16.3 The rates of inflation assumed for with-profits policies or unit-linked policies with implicit charges should lie at or between that specified for National Average Earnings and that for Retail Prices Index inflation, according to the Actuary's view of the appropriate mix for the policies in question.[5]

16.4 Expenses expressed at policy level as a percentage of funds will, of course, automatically include an implicit allowance for inflation.

[5] Amended in v3.0

17 General

17.1 In the case of a brand new product, the Actuary should be guided by the expenses attributable to the existing product that most closely corresponds to it, but with proper regard to what the Actuary regards as material differences in cost.

17.2 Some of the smaller friendly societies may not have the data for the Actuary to carry out the detailed analysis set out in this Guidance Note. In this circumstance, or in the more general circumstance of lack of up-to-date data, the Actuary may make appropriate approximations. In doing so the Actuary should be conscious of the requirement of Section 8.

17.3 Expense disclosure must be maintained up-to-date. Whenever the Actuary believes that it is appropriate to review the apportionment of expenses such a review should be conducted. This should not be less frequently than annually. If the Actuary believes that the current projection basis and expense disclosure are no longer appropriate then the firm should be advised.

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