Commission on Dormant Assets
4th Floor
1 Horseguards Road
London SW1A 2HQ

10 June 2016

AFM Response to Call for Evidence

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

   - Comment on the questions raised in the call for evidence; and
   - Highlight the nature of the mutual insurance business model that means it is a poor fit for extending the dormant assets scheme into.

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £16.4 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to take account of corporate diversity in discharging their regulatory principles[2], and to analyse whether new rules impose any significantly different consequences for mutual businesses[3].

[1] ICMIF, http://www.icmif.org/global-mutual-market-share-2013
[2] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted
[3] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted

4. AFM is pleased to respond to this consultation on behalf of its members. We have also sought to reflect views of the wider mutual sector and, given the short timescales for response, the significance of the issue for mutual insurance, as well as the limited circulation of the call for evidence amongst mutuals, we were surprised at the indirect nature of engagement. We would ask that the Commission undertakes a wider dialogue before exploring next steps, and we would be happy to support this.

5. AFM and its members are strong supporters of the dormant assets regime in the UK. With over £250 million released to the Big Lottery Fund, charities have benefited significantly from the regime, and the prudent stewardship of the Reclaim Fund. Our members have themselves a strong tradition of supporting local communities and charities, and indeed for some of our members this is written into their constitution. Hence we recognise the value contribution the regime makes to support charities, and to freeing up assets that are not otherwise being used efficiently in the system.

6. By necessity, the Reclaim Fund holds liabilities of nearly twice the amount distributed, emphasising the provisions that need to be held for future claims by the beneficial owners of dormant assets. This is event despite the nature of deposit-based investments, which tend to be relatively transactional.

7. The nature of insurance-backed investments is much different from the range of dormant assets currently within the Commission's remit: where deposit-based accounts are often transactional and viewed as short-term and non-targeted, insurance-backed investments are generally purchased with a view to leaving them untouched over very long periods: particularly where they form part of a pension, or are targeted to repay a mortgage or meet another long-term goal.

8. In a recent thematic review paper, the Financial Conduct Authority provided an estimate from the Unclaimed Assets Register, that there is around £4 billion in life assurance and pensions schemes left unclaimed[4]. However, we consider this to be an overestimate, as it is produced by a commercial enterprise seeking to create a larger market for its services, and because in the past similar estimates of dormant assets (such as in the Irish insurance market) have proved grossly exaggerated. In any event, an unclaimed amount is entirely different to a dormant asset, and depends on the definitions adopted, as we explain below.

[4] http://www.fca.org.uk/static/documents/thematic-reviews/tr16-02.pdf

9. We conclude in our response that it is not practical to extent the Dormant Assets regime to mutually-owned insurance product; in reaching this assessment we have considered the call for evidence according to five different dimensions:

    a. Insurance products with a long-term goal but no fixed maturity date;
    b. Insurance products with a fixed maturity date;
    c. Open-ended products provided by insurers;
    d. Intermediated insurance products; and
    e. Products provided by mutual insurers and friendly societies.

    These dimensions are covered below, and illustrate the inherent difficulties of including insurance assets in the Commission's remit.

<u>Insurance products with a long-term goal but no fixed maturity date</u>

10. Often the product has a maturity date set many years in advance, or at a specified retirement date, but even then the product can remain unvested for a considerable period thereafter. For example:

    a. someone in their 20s may purchase a pension with a planned vesting date to coincide with their sixtieth birthday, but then decide to work longer and not start to draw on their pension until they are aged 75;
    b. an insurance-backed investment might be written on a whole of life basis, meaning that the point at which the funds become available might be at any time up to their death.

    In these and other cases, the funds are not considered 'dormant' at any time, because they are targeted for the long-term.

11. It is not clear therefore how any such products could be included within a scheme for dormant assets.

<u>Insurance products with a fixed maturity date</u>

12. On the other hand, some classes of insurance-backed investments do have a fixed maturity date; for example:

    a. a low-cost endowment policy funded to mature after 25 years in order to pay off a mortgage, or a Tax Exempt Savings Plan invested for ten years;

b. a government-sponsored Child Trust Funds includes a requirement that the funds mature on the child's eighteenth birthday;
c. a Holloway income protection contract, which includes a bonus element that pays out at a specified retirement age.

13. For these products, the funds might be classed as dormant at a given time following maturity, and it would be sensible to adopt a timescale aligned to a dormant deposit-based account: in other words, 15 years after the maturity date, or 15 years after the policy becomes paid-up. However, even this is problematic: in all three examples quoted above an investor may have no immediate need for the money due to him or her on the maturity date, and elect to keep the product invested in order to continue to benefit from the investment returns it is producing. In other words, once the maturity date has passed the product would be treated as a long-term investment with no fixed maturity date indistinguishable from the products discussed in paragraphs 8 and 9 above.

14. The nature of the insurance-backing though is also critical: very often the contract will provide life cover for the individual. In these circumstances it might be possible for the insurer to assign the product to the Commission when dormant, but no money could be transferred until there is proof of death.

15. An additional complication is the nature of bonuses applied to with-profits insurance contracts: these are different from the nature of fixed interest payments to deposit-based savings. Some bonuses are reversionary and cannot later be deducted, others are terminal and depend on the value of underlying assets at the time of maturity. Where a policy is paid up early, the cash-in value of the product will vary according to the investment performance of the product and whether any market value adjuster has been applied. Thus there will often be an incentive for the policyholder to keep the product invested beyond any stated maturity date.

Open-ended products provided by insurers

16. Insurers also provide products with no clear trigger date for maturity: such as an ISA, Junior ISA, with-profits bond or unit-linked contract. In these cases the policyholder will invest a lump sum and/ or regular instalments. The policy may not have a maturity date, but equally there is no required or expected customer-initiated intervention until the funds or partially or wholly withdrawn.

17. The policyholder may have a long-term plan for the funds, which makes the point at which they become dormant difficult or impossible to ascertain. Where the provider has had no contact, and the annual statements are returned marked 'gone away' this might offer some insight that the funds are dormant.

Intermediated insurance products

18. Most banking products are distributed directly to consumers by the provider. Insurance however is often intermediated; this generally means that the customer relationship is not owned by the provider: there may be a financial adviser, employer, or introducer instead who has acted as distributor.

19. The terms of the initial sale may prevent the insurer from initiated contact with the consumer, and the part the product fulfils in a wider portfolio will be known by the intermediary rather than provider. The intermediary will continue to receive ongoing commission on some products, so any attempt by the insurer to treat the product as dormant will be viewed as a breach of contract.

Products provided by mutual insurers and friendly societies

20. The dimensions explored above are likely to be common for all insurers, and will no doubt be covered in a response from the Association of British Insurers, albeit we have related the issue to more specialist mutual products as well as mainstream ones. However this does not cover the specific circumstances of mutual insurers and friendly societies. There are unique features of the mutual model that should be taken into account:

    a. When a consumer buys a product from a mutual insurer, they will typically also become a member of the organisation. This means they assume ownership rights of the business as well as the contractual rights of a consumer. Those ownership rights may realise a monetary value only in certain circumstances; generally when the mutual business wishes to extract surplus capital and share it with members, or in the event of a sale or winding up of the business. Such rights may be lost if the member ceases to be a customer. Furthermore, the constitutions of friendly societies typically provide that membership rights are lost if a policy is assigned to anyone other than the original policyholder. Any transfer to a dormant assets fund will therefore destroy part of the value of the policy being transferred;

b. The business model of mutuals means they tend to retain product lines that attract lower unit value for much longer than their PLC counterparts, because they can tolerate a lower level of profitability. Aged products held in a mutual are ring-fenced for future payout to the policyholder or their beneficiary, but their retention in the business improves the general efficiency and performance of the business as a whole. This has always been a feature of mutual insurers; policyholders will have bought their policies in the reasonable expectation that they will continue to benefit indirectly from the retention of assets allocated to otherwise "dormant" policies. To strip these out of the mutual would be counter to the regulators' objective of ensuring customers are treated fairly;

c. There are some other dimensions of mutual organisations that mean they are characteristically different from other insurers:

    i. The proportion of mutuals that are small organisations is greater than the sector as a whole, meaning that proportionality is a key issue for our sector,
    ii. the value of their holdings are generally much smaller than PLC counterparts: for example, old 'industrial branch' products may only have a realisable value of £20, so that the cost of extracting the asset and undertaking the legal transfer would exceed the value of the product, particularly with the ongoing possibility that the mutual may have to re-appropriate the funds at a future time to pay a claim from the beneficiary,
    iii. in mutual organisations the costs of this work can only be derived from policyholder funds, so that impact is felt directly by all policyholders,
    iv. a with-profits mutual's common fund (or with-profits fund as it is known by regulators) houses the interests of members as policyholders, their interests as members, as well as the accumulated surplus/ capital of the mutual. These monies are not generally separately identifiable due to their long-term accumulation.

d. Mutuals accumulate capital largely through generating an operating surplus: they do not have external shareholders to draw on, so they must act prudently to retain a strong capital base to take account of downside risks. The current generation of policyholders benefit from the intergenerational transfer which for most mutuals has seen capital accumulate across millions of customers over more than 100 years. It would be wrong therefore to attempt to extract funds today that have been accumulated over the long term and which are critical to the capital requirements of the mutual;

e. The financial regulators, PRA and FCA, has provided extra measures to recognise the nature of mutual capital, as well as the different ownership rights and customer rights which often sit in the same common fund within a mutual. Any approach to removing assets from the common funds would most likely need regulatory approval.

21. We conclude from the above that any insurance product that contains any membership rights should be excluded from any extension of the dormant assets legislation. This is a result of the combination of general difficulties in assessing appropriate insurance products, combined with the specific aspects of the mutual business model and the membership rights attached.

22. Our responses to specific questions in the paper are attached below. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Our responses to specific questions

Question 1	**Which types of asset within your sector do you think include a dormant element which could be considered in a potentially expanded dormant assets scheme?**

As we set out above, it is likely only that 'gone aways' are a possible audience for an expanded dormant assets scheme.

This is because for life insurance it is very natural for policyholders to leave their investments untouched for very long periods. Further, many insurance-backed investments are established via an initial single premium invested, or via regular premiums which run for ten years or longer but for which the proceeds are not planned to be used for very much longer.

In such circumstances the policyholder will contentedly have no need to transact on the investment or contact the provider; hence it may not be practical to assess if and when the product becomes 'dormant'.

Question 2	**In your view, are there any assets within your sector that should be excluded from an expanded dormant assets scheme. Please explain why you think this is the case.**

As per our opening remarks, the nature of insurance products means that many investments are held for the long-term, and that simply because the customer has not actively engaged with the provider, they cannot be considered to be dormant. This includes pensions of whole life products, as well as open-ended insurance-backed investments that are not paid up.

As we have also argued above, we consider that all insurance products that convey membership of a mutual cannot be considered as dormant.

The 'inherited estate' created in a mutual by the accumulation of assets over very long periods, is the excess of the value of the assets of the Society over a realistic assessment of the liabilities and provides the working capital for the Society. It is used amongst other things to:

- meet regulatory reserving requirements over and above a realistic assessment of our liabilities;
- provide security for members, protecting their benefits against a range of market and business risks;
- support the writing of new business to benefit new and existing members and thereby ensure the continuation of the Society; and
- provide investment freedom allowing members' funds to be invested in

assets that are more volatile but are expected to provide members with higher returns in the long term.

These funds therefore have an economic value to the organisation and its members: a dormant bank account might attract little or no interest and is therefore serving no useful purpose for society at large, whereas- as the list of bullets above illustrates- there is a broader social value and purpose for the inherited estate of a mutual insurer or friendly society.

Moreover, the concepts of pooling of assets and group ownership are fundamental to the structure and operations of mutuals.

Question 3	**In your view, what are the advantages and disadvantages of defining dormancy by (a) a period of no contact and (b) lack of client traceability?**

The current approach in banking is for assets that have had no customer-initiated intervention for more than 15 years to be regarded as dormant. However, deposit-based savings in particular tend to be short-term and transactional, so 15 years represent a very long time of inactivity. By contrast, most insurance contracts are written with an expectation that the funds are untouched for a considerable period; and partial withdrawals may not be accepted.

In some cases the product has a defined contractual maturity, at which point the insurers communicates the option available to the policyholder. It could be argued therefore that this should trigger the point for a customer to engage and therefore a starting point for assessing dormancy.

Lack of client traceability, or 'gone aways' need not in itself be part of the definition of dormancy due to the long term nature of the investment. Where the customer has made the product paid-up- or consciously decided that their needs for the investment has changed, may present the starting point for a term of dormancy as per banking.

And in a mutual insurer, unclaimed assets are put to good, wider use by the organisation as part of the pooled funds which benefit all members and policyholders (and which, unlike in a listed organisation, are not at risk of being extracted for shareholders).

Question 4	**What are the legal, regulatory, accounting and operational issues which might inhibit the assets you listed in question 1 being contributed to an expanded scheme?**

Investments in an insurer that are still in force are treated as liabilities. These liabilities will include policies that are very old, which cannot be drawn into capital, and might still be withdrawn by a future beneficiary.

From a legal perspective, we consider that an insurance policy would need to be assigned first before becoming part of a dormant assets scheme.

A particular difference between deposit-based investments and insurance-backed ones is the nature of the underlying assets, and the potential for variability of return. The variability of the value of assets in an insurance-backed investment, which have a proportion of equity investment, will be a particular problem for the Reclaim Fund in understanding how to provision for future claims.

Question 5	**What are your views on whether participation in an expanded scheme should be voluntary or mandatory? What are the reasons for your preference?**
Question 6	**What do you see as the advantages and disadvantages of (a) a voluntary scheme and (b) a mandatory scheme?**

The Commission has not set out a case for moving from a voluntary to a mandatory scheme, so we imagine the reasons that encouraged a conservative approach to banking assets apply more broadly. Any insurance assets in scope should be treated in the same way as other assets.

A voluntary arrangement is however more prone to abuse than a mandatory one. As long as a mandatory approach is fair, and excludes assets that are not appropriate and has appropriate de minimus limits, the Commission should explore making the current scheme mandatory.

We consider that a more practical way of expanding the regime would be to explore scope for more of the deposit-takers to adopt the regime, either on a voluntary or mandatory basis.

Question 7	**Are there any regulatory rules that require your sector to disclose or report on levels of dormant assets? If so, please indicate what these rules are.**

No.

Question 8	**Is your sector currently required to treat dormant assets in a certain way, for example via accounting or regulatory systems? Who enforces this requirement?**

Insurers will continue to treat policies that are still in force as liabilities. This will include very old policies or ‘gone aways’.

Question 9	**Are there currently legislative or regulatory restrictions on releasing dormant assets from being held in perpetuity, awaiting their return to the beneficial owners?**

The nature of the insurance contract means the policy can only be assigned but proof of death would be required before release of funds.

Question 10	**If legislation regarding transparency was introduced, what information does your sector carry which could be reported?**

As we stated previously, the inherited estate of a mutual is comprised of assets that are legally and beneficially owned by the Society, for the benefit of current and future generations of policyholders: the estate is thereby not owned by the policyholders themselves.

The nature and scale of mutual organisations varies significantly, and government and regulators recognise their business model is different from listed companies, and that this means that legislation and regulatory rules might have different consequences. This is at least in part due to the separate legislation that is maintained for mutuals: for example, the Friendly Societies Act is the primary legislation for much of our sector, not the Companies Act.

Our members collect and report data in their report and accounts and regulatory returns, so any calls for transparency would need to account for the common data available, such as:

- Value of assets invested.
- Number and value of paid up policies by product.
- Number and value of 'gone aways' by product.

We consider though, as previously stated, that mutual insurers and friendly societies should be exempted from attempts to widen the dormant asset regime, and that any new transparency requirements should not be relevant.

Question 11	**The Commission would also like your views on how your sector would benefit from being part of an expanded dormant assets scheme.**

Insurers are long-term investors in the UK economy, and their role in supporting infrastructure projects and in supporting local communities is well-established. It is not clear therefore what additional value would be attached to becoming part of the scheme.