

## **Permitted Links for Long Term Insurance Business A Consultation Paper from the Financial Services Authority**

A response by

### **The National Association of Pension Funds**

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This response is from the National Association of Pension Funds (NAPF). The NAPF is the leading voice of workplace pension provision in the UK. Some 10 million working people are currently in NAPF Member schemes, while around 5 million pensioners are receiving valuable retirement income from such schemes. NAPF members hold assets of some £750bn, and account for one sixth of investment in the UK stock market.

The NAPF welcomes the opportunity to comment on the FSA consultation paper.

### **Pre-amble**

The NAPF strongly supports the modernisation intentions behind the FSA's review and proposed reform of the permitted links regime. The use of a principles rather than rules based approach is very much welcomed. A principles based approach will permit the exercise of firms', and their advisors', professional judgement and skills for the benefit of policyholders. Rules unnecessarily inhibit the proper functioning of investment decision making in a competitive environment. However, the NAPF has a concern that the rules supporting the overarching principles do not always seem to reflect the spirit of the principles and might lead to uncertainty and conflict in deciding which to follow. The NAPF believes that the drafting of the rules needs revisiting to ensure that they are fit for achieving the principles purpose.

(Rules do not sit comfortably with principles – "Regulations" or "Guidelines" would be better)

### **Questions**

- 1. Do you agree with our proposal to allow realisability to be based on the firm's obligations under its policies?***
- 2. What increase in risk to policyholders may arise from moving away from the current 'readily realisable' definition?***

The NAPF agrees with the FSA that there is a case to be made for allowing an appropriate proportion of a long-term fund's assets greater tolerance. The principles encourage realistic valuations to be used; this should permit fair pricing and use of professional judgement. It is not considered that this will lead to an increase in policy holder risk since a more realistic and flexible realisation period should help policy holders.

**3. Do you agree with this principle? What effect would you expect it to have on unit-linked business in practice?**

The NAPF suggests the insertion of **reasonably** before foreseeable in Principle 3 and similarly in draft rule 6.14.6.

**4. Do you agree that, with a risk-based approach to regulation, the economic effect of an asset should be the main consideration? What consequences do you foresee as a result of this requirement?**

The NAPF agrees that the economic effect is the key consideration and that the proposals seem workable. Although the risk-based approach might allow some things to be permitted that otherwise might not be, the NAPF does not believe this increases the risk of abuse.

**5. Do you agree that all the principles achieve their purposes to afford greater flexibility to firms without added risk to consumers?**

The NAPF recognises the need to update and modernise the previous rules and welcomes the extensive use of principles. However, the NAPF has some concern here that the rules as drafted and set out at 6.14 in Annex C do not always accurately reflect the principles. 6.14 appears overly restrictive and not principles-led. Use of principles would allow, for example, immaterial divergence from the letter of the rule, which currently would not seem to be recognised by the drafting of 6.14. A specific suggestion relates to draft rule 6.14.11 where it is suggested the word **material** be inserted before failure.

**6. What are the likely consequences of removing the 10% limit on unlisted securities?**

The NAPF welcomes the proposed removal of the 10% limit on unlisted securities and notes that a de-facto limit will be imposed by the need to meet emerging obligations. Investors need to recognise the characteristics of the investment together with understanding that such assets are seldom readily realisable. The NAPF is unsure how the reference in 4.6 *...any unlisted security must be able to be realised in the **short term*** sits with the principles in 6.14.3 and 6.14.4. It is suggested that the use of short term reduces flexibility and seems inconsistent with the proposed principles.

**7. Do you agree with our proposals for the treatment of investment in land and CIS investing in land?**

This is helpful and is welcomed by the NAPF.

**8. Do you have any comments on the suitability of the factors we have identified as indicating a properly functioning market?**

The NAPF believes that the factors represent the principles behind a properly functioning market. However the wording used in the draft rules appears less clear here and not entirely consistent with the thrust of the principles' intention.

**9. Do you believe there are any further risks or unintended consequences arising from our rules for a properly functioning market that have not been identified?**

The NAPF has not identified anything.

**10. Do you agree with our proposals for those CIS to be made available to retail policyholders?**

The NAPF does not have a view on this.

**11. Do you agree with our proposals to extend the use of CIS to institutional investors and the restriction of their use to trustees of defined benefit occupational pension schemes only?**

The NAPF welcomes the proposal to extend the use of CIS to institutional investors. Whilst NAPF also recognises the intention to confine risk in such investments to those who can bear it – e.g. pension schemes that can be expected to have access to high quality professional advice, NAPF believes the definition is too narrowly drawn. It is suggested that any trustee-based scheme (which would include occupational DC schemes) should be allowed to invest in this manner if they choose to do so, as the trustees of such schemes will also take professional advice. It is however recognised that for contact-based DC and similar arrangements such investment may not be appropriate in terms of risk.

**12. What are your views about extending links for institutional investors to include funds equivalent to QIS in other EEA jurisdictions?**

The NAPF welcomes the proposed extension.

**13. Do you agree that our proposals on derivatives and quasi-derivatives will give firms enough investment freedom on EPM and reduction in investment risk? If not, please give evidence of how the proposed rules will be unduly restrictive?**

There is demand from institutional pension schemes for products which would not meet the criteria set out by FSA if the rules are applied within the product itself but would do so when taken as a whole with the institutional investor's other assets or liabilities. Liability-driven investment products are a case in point. The NAPF believes that insurers should be able to issue a product which does not comply with the "within product" principle, provided the institutional investor is prepared to state in their

proposal that it meets these rules when taken as a whole with their assets and liabilities. Before making any such investment a pension fund would of course have been under a duty under trust law to have obtained written investment advice.

**14. Do you agree with our approach on reinsurance?**

In the new defined contribution world with open architecture, insurers will offer products where guest funds are offered. To obtain better administration or lower price, the lead insurer will be selected and investments channelled out to other managers some of whom may be insurers. In such circumstances, the onwards placement may well be by a contract for re-insurance. The rule as proposed by FSA requires the lead insurer to use its capital to cover to FSA requirements the risk of the insolvency of the re-insurer. This may put the members of the DC arrangement in a better position than if they had invested directly with the second insurer. We do not normally argue against increased protection for members of pension funds but we understand that the need for capital provision is placing a capacity constraint on how much business the lead insurers are prepared to underwrite and this is we think against the interests of a sensible market place. The NAPF therefore suggests amending the wording as follows:

"16.14.14R A *firm* that has ceded linked business under a linked *reinsurance contract* must discharge its responsibilities under its *linked long-term insurance contracts* as if no *reinsurance contract* had been effected, unless the conditions of COB 16.14.15R apply.

16.14.15R The conditions referred to in COB 16.14.14R are as follows:

- (a) The direct firm offers the linked product of the reinsurance company as part of a fund platform, where customers may choose to invest in linked fund(s) of explicitly named external providers; and
- (b) An explicit statement is made in the insurance contract that the direct policyholder is exposed to the risk of default of the external provider."

**15. Do you agree with our approach to stock lending?**

No. Stock lending can usefully add value to pension funds and is an important part of maintaining an active and liquid market. The FSA's proposed rules appear to interfere with market functioning and may risk substantially reducing stock lending's attractiveness. As drafted the rules state that all income from this source less **expenses** must be passed to the investor. Where the insurer uses an agent for stock lending, the agency fees will be allowable as an expense. Where the insurer acts as principal in the stock lending programme acting as his own agent, he should be able to retain a proportion of the lending income that is having regard to the work done and the general level of agency fees. In both examples, transparency of charging is paramount and, with this in place, the market should be allowed to function.

**16. Do you have any further comments on the proposed new rules for permitted links?**

In regard to Principle 7, the NAPF wonders whether it is necessary since it appears to duplicate other principles. NAPF suggests that the Principle 7 is unnecessary since rule 6.14.9 already covers the point.

**17. Do you believe there is a need for further guidance or case studies to support our proposed new rules?**

No.