

PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT (“PPFM”):

LEGAL IMPLICATIONS FOR PENSION FUNDS



INTRODUCTION: PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT

- An issue of insurance law
- Relates to “discretionary participation” business (also called “with-profits” or “smoothed bonus” business) carried on by long-term insurers (as opposed to market-linked investments)
- An area where the insurer enjoys substantial **contractual discretion** (e.g. in relation to investment strategy and bonus declarations)
- The basis for the exercise of this discretion has typically not been disclosed to clients
- This issue is relevant to pension funds which are often holders of long-term discretionary participation insurance policies

HISTORY OF PPFM

- Introduced in the United Kingdom in 2004 – Financial Services Authority
- Demutualisation principles of financial management (Old Mutual and Sanlam)
- Directive 147.A.i of Registrar of Long-Term Insurance (under auspices of the Financial Services Board) - 2006
- Applies to all long-term insurers with any discretionary participation business on their books
- Each insurer had to produce and publish PPFMs by end of 2007

SELECTED INTERNET SOURCES OF PPFM DOCUMENTS

- OLD MUTUAL: <http://www.oldmutual.co.za/personal/principles-and-practices.aspx>
- SANLAM: <http://www.sanlam.co.za/eng/aboutus/principlespractices/default.htm>
- LIBERTY: <http://www.liberty.co.za/Liberty/content/main/fundperformance/pdf/withprofitpolicieswork>
- METROPOLITAN: <http://www.meteb.co.za/eb/default.asp>
- HOLLARD: <http://www.hollard.co.za/downloads/HollardPPFM2007.pdf>

STATED PURPOSE OF PPFM

- “[T]here are often no specific or transparent guidelines that insurers are required to use to set out how they use their discretion. There are usually also no transparent or specific ways to show how, in doing so, they have managed any conflicts of interest and ensured policyholders are treated fairly.” (Para 1.4 of the FSB Directive)
- “Documenting ... how [insurers] will operate their business – and keeping the document up-to-date – may help to improve the way in which some insurers manage and control their discretionary participation business. It might also assist insurers to take decisions on the use, or distribution of life funds, which are consistent with previous undertakings to policyholders.” (Para 3.6)
- “There could also be benefits in terms of consumer understanding. Documenting the approach taken when using discretion – and making the PPFM available to policyholders, advisers and market commentators – should mean that consumers are better able to understand how their policies operate and what to expect from them.” (Para 3.7)

BRIEF OVERVIEW OF CONTENTS OF PPFM DOCUMENTS

- **Principles** (“enduring statements of overarching standards”) – longer-term, less likely to change
- **Practices** (“the insurer’s specific approach to managing discretionary participation business”) – shorter-term, subject to more frequent change
- **Typical subject-matter**
 - Surplus and amounts available for bonuses (and how shareholders share in surplus)
 - Determining the amount of bonuses (interim, final, vested, non-vested, smoothing)
 - Investment policies
 - New business and closure of funds
 - Costs
- **Publication of PPFM**
- **Amendment of PPFM**

LEGAL IMPLICATIONS

- Public level: FSB / Registrar of Long-Term Insurance
 - Establish the requirement to produce PPFM
 - Insurers must verify their own compliance in annual statutory return
- Self-imposed regulation: independent board committees and reporting obligations
- Private law level: contractual discretion
- PPFM not intended to alter contract terms, but to describe how the insurer operates or intends to operate within its area of discretion.
- Legal control of discretion: *Arbitrium boni viri* (“act reasonably and exercise a reasonable judgment”)
- PPFM at least provides an objective yardstick to measure the reasonableness of the exercise of discretion
- No direct regulation of contractual discretion (but see the UK example: increasing regulation)

HOW CAN A PENSION FUND USE THE PPFM?

- Investment information for new business
- Information on compliance with PPFM to review continued investment
- Possible claims based on breach of contract (or unreasonable exercise of discretion):
 - Specific performance?
 - Damages?
- No precedent as yet
- While the Court will be loath to leave the client without a remedy for an unreasonable exercise of discretion, there are considerable difficulties in giving practical redress and quantifying loss

CONCLUSIONS

- PPFM is located within the realm of contractual discretion
- This is by its very nature a very difficult area to police
- Discretion is central to discretionary participation business: it gives the life company the flexibility to meet investors' needs over time and to balance shareholders' and policyholders' interests
- But it can be open to abuse and lack of transparency
- The delicate balance is to allow discretion without over-regulating it: the PPFM currently seeks to do so mainly through publication/disclosure and self-regulation
- The PPFM is valuable in providing greater transparency, but may not present investors with significantly enhanced direct legal remedies
- Direct regulation / fettering of discretion (as per the UK) could be the next step