Product Rationalisation, Part VII Transfers, and Part 26 Schemes

(with a little Australian economic history and an introduction by Charles de Gaulle)

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Introduction

How would you govern a country which has two hundred and forty-six varieties of cheese?

Charles de Gaulle (c. 1962)

How would you manage a life company that has two hundred and forty-six varieties of single premium unit-linked insurance bond, two hundred and forty-six types of YRT policy, and so on…

Michael Aa (2015)

Introduction (cont.)

This is the essence of the product rationalisation problem – too many products, many of which are obsolete and:

- give customers poor value for money; and
- create excessive cost and risk for the providers.

Introduction (cont.)

What's caused the problem?

creating new products (lots of them) because of:

- legislative (incl. tax) changes;
- new technology capabilities; and
- changes in the market;

while (usually) leaving existing business (some of which may have long future lifetimes) unchanged.

Introduction (cont.)

Parallel with the automotive industry:

Imagine if Mercedes Benz (which has been in business for over a century) was obliged to maintain a full range of spare parts and comprehensive service and repair manuals for every type of vehicle they'd ever made, while at least one of that type was still on the road!

Introduction (cont.)

How big is the problem?

- Australian estimates are that 25% of the funds under management in the life insurance and funds management industry are in are in obsolete products.
- For example: Australia (pop. 24 million) has about 10,000 individual managed fund options, while the USA (pop. 320 million) has about 25,000 mutual funds.

Introduction (cont.)

How big is the problem (cont.)?

- The problem in the UK is likely to be similar, especially with all the merger and acquisitions activity, and the resultant Part VII transfers – the remaining life companies become more and more complicated.
- The problem is significant in both open and closed companies, and will only worsen.

Brief digression – how did I become interested in this?

Recommendation 43 of the final report of the Murray Inquiry (November 2014) said:

"Introduce a mechanism to facilitate the rationalisation of legacy products in the life insurance and managed investments sectors."

Digression (cont.) – Inquiries into the Australian Financial Services System

1981 – Campbell Committee

- *Float the A$; allow introduction of foreign banks*

1996 – Wallis Inquiry

- *Dual regulatory structure (APRA and ASIC)*

2014 – Murray Inquiry

- *Changes to conduct regulation; encourage innovation, **including facilitating product rationalisation***

Timeline of Product Rationalisation Discussions in Australia

- Jan 2006 – Regulation Taskforce recommended that a mechanism for rationalising legacy financial products be developed.
- Jun 2007 – Treasury published issues paper (responses indicated disagreements between respondents on several key issues).
- Feb 2008 – Government formed panel of experts to consider topic (APRA, ASIC, Tax Office (as observers).

Timeline (cont.)

- May 2008 – paper submitted to IAAust Financial Services Forum by Guy Thorburn.
- Dec 2009 – Treasury proposals paper
- Oct 2010 – Productivity Commission’s annual review of regulatory burdens said that greater efforts should be made to implement a rationalisation process.
- Nov 2014 – Murray Inquiry said the same.

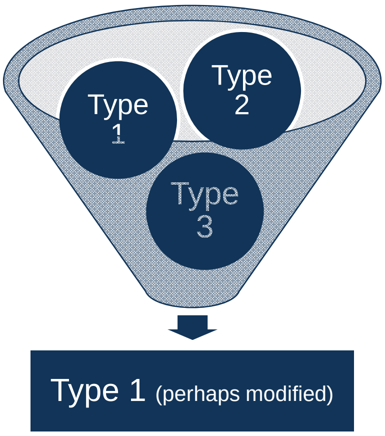
Definition of Product Rationalisation

“The process of converting or consolidating products of a similar nature into a single product with equivalent features and benefits.”

How might product rationalisation work in the UK?

I'd like to turn now to how one might try to rationalise life insurance products in the UK, and to look at some of the difficulties, paying particular attention to some of the legal aspects.

Diagrammatically…



UL insurance bond example:

Perhaps expand range of funds in Type 1;

give Type 1 the lowest of all the existing AMC rates;

give Type 1 the lowest annual policy fee with the lowest future escalation.

Possible Complications

- Newer products may have Smoker/Non-Smoker differential premium rates; older ones may not.
- Gender Neutral Pricing may not have been applied to older products but does apply to newer ones.
- Liberalising disability definitions may be awkward if reinsurers aren't supportive. Tightening them up is unacceptable.
- Essentially, it comes down to comparing the **cost of** what the insurer has to **give away** to ensure that no customer can be materially worse off, plus **implementation costs**, with the **cost savings** of eliminating legacy products and all their associated procedures and systems.

Are You Allowed to do a Rationalisation?

- You'll be changing the terms of the contract between you and the policyholder(s).
- Do your policy documents explicitly give you the right to do this, perhaps with some policyholder protections built in?
- I doubt it.
- So you need to find some legislation or regulations that will explicitly give you the right to do it, or at least give you some solid protection if you do it.
- What legislation or other avenues offer this protection?

Possible Legislative and other Solutions

- Part VII (*FSMA 2000*) Scheme
- Part 26 (*Companies Act 2006*) Scheme
- Just do it
- New legislation

Part VII (*FSMA 2000*) Scheme

- Part VII of *FSMA 2000* facilitates transfer of business from one entity to another
- Generally only nibbled at the edges of product rationalisation. It's unclear how far the Court would let you go with comprehensive rationalisation proposals in a Scheme.
- There are two potential stumbling blocks:

Part VII (*FSMA 2000*) Scheme (cont.)

- You have to do a transfer of business from one entity to another (with valid reasons) for Part VII to apply.
- A Part VII transfer is difficult enough without the added complication and risk of large-scale policy changes:
  - There's greater chance of policyholder objections;
  - You may not know enough detail of the business you're acquiring to know exactly what's worth rationalising and in which direction you'd rationalise.

Part 26 (Companies Act 2006) Scheme

- The key section is S.899, which requires a meeting of affected "creditors", and the **vote** in favour of your proposals must be carried by a majority in number representing 75% in value of the creditors present and voting at the relevant court meeting, either in person or by proxy.
- Unless your proposal is compelling, the meeting may be dominated by the people who don't like it.

Part 26 (Companies Act 2006) Scheme (cont.)

- It could be tricky to define "value" if your proposal covered a wide range of business (say a mixture of various unit-linked insurance bonds and a mixture of YRT policies).
- It would be excessively complicated and expensive to have multiple schemes and meetings, each for a different type of product to be rationalised.

Just Do It!

- If your proposals are compelling you could just make the changes and, in effect, dare people to complain or sue you for damages. If they can't prove they've suffered loss of economic benefits, they have no valid claim.
- This is not satisfactory and could be reputation-damaging.

New Legislation

- Suitable legislation would permit sensible rationalisation schemes that protect policyholder interests (no diminution in rights and benefits) and protect the insurer from claims for breach of contract.
- What should be the key characteristics of such legislation?

New Legislation (cont.)

- Should it be rules-based or principles-based?
- Who would approve rationalisation schemes:
  - The affected customers?
  - The Board of the insurer?
  - An independent expert or arbitrator?
  - The financial services regulator (PRA, FCA, both?)
  - The High Court?

New Legislation – Rules (example)

Australian Treasury proposal (Dec 2009) was rules-based, suggesting a definition of “legacy product” that would be eligible to be converted to something else. Suggested eligibility criteria were:

- Product has been closed to new customers for at least 2 years and satisfies at least one of the following:
  - Product has become uneconomic for the provider;
  - Product is out of date because of regulatory changes; or
  - Product operating costs have become excessive.

New Legislation – Principles (example)

- Products to be converted to another product are already closed, or will be closed, to new entrants before the rationalisation.
- There is unlikely to be any material disadvantage to customers.

New Legislation – Who Approves?

- The affected customers – this has all the problems and complications of a Part 26 Scheme.
- The Board of the insurer – why not? The Board already has a statutory obligation to treat customers fairly and to maintain the financial soundness of the insurer.
- An independent arbitrator – wouldn't this create yet another layer of bureaucracy?
- The financial services regulator – which one?
- The High Court – under a process similar to that of a Part VII Scheme?

New Legislation – Independent Expert?

- Irrespective of who approves a rationalisation scheme, perhaps the legislation should require that the proposing company commissions a report from a suitably qualified independent expert that covers the implications for policyholders.
- The report would be made available to policyholders and to whoever approves the scheme.

New Legislation – Taxation

- You would not want to rationalise products if that caused an increase in, or acceleration of, a tax liability for customers or the provider.
- Part of a rationalisation scheme will require the tax authorities to grant exemptions that would avoid such tax problems, and the legislation should allow for that.

Potential Risks

- How you present policyholder communications is important – unless your offer is very compelling.
- To make worthwhile cost savings a rationalisation must be comprehensive. This increases the likely costs.
- FOS risk – policyholder communications may prompt policyholders to review their policies and why they bought them at all. Possible opening up of mis-selling complaints.

Principal References

- Australian Federal Treasury (Dec 2009) – *Product Rationalisation of Managed Investment Schemes and Life Insurance Products (Proposals Paper)*
- Guy Thorburn (May 2008) – *The Principles and Practice of Product Rationalisation* (presented to the Institute of Actuaries of Australia's Fourth Financial Services Forum (Melbourne – May 2008)
- Jurgen Van Weegen, Peter Van den Brande, Pascal Verheijden (2011) – *The Insurance Challenge: Managing Complexity* (published by A. T. Kearney)
- David Murray et al (Nov 2014) – *Final Report of the Financial System Inquiry* (published by the Australian Federal Government)

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Questions

Comments

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