

The governance of unit-linked funds: a thematic review

Life Conference - November 2013

Governance of unit-linked funds - agenda

- 16.30 Thematic reviews in the new FCA approach to supervision
Summary results of the thematic review

Caroline Gardner

Financial Conduct Authority

- 16.50 Selected results from the thematic review
Next steps

Mike Hawes

MacNaughtan Consulting Limited

- 17.10 Questions

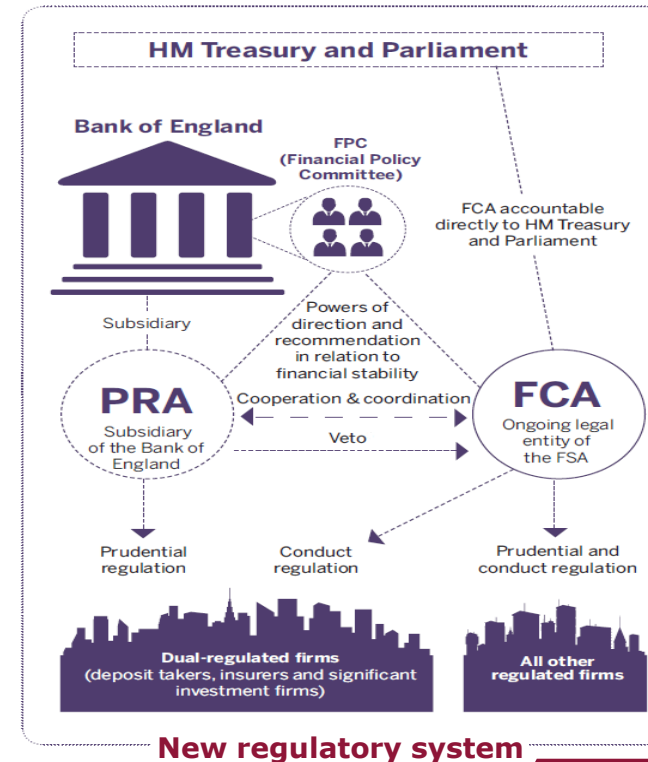
The Financial Conduct Authority (FCA)

Strategic objective

- ensuring the relevant markets function well

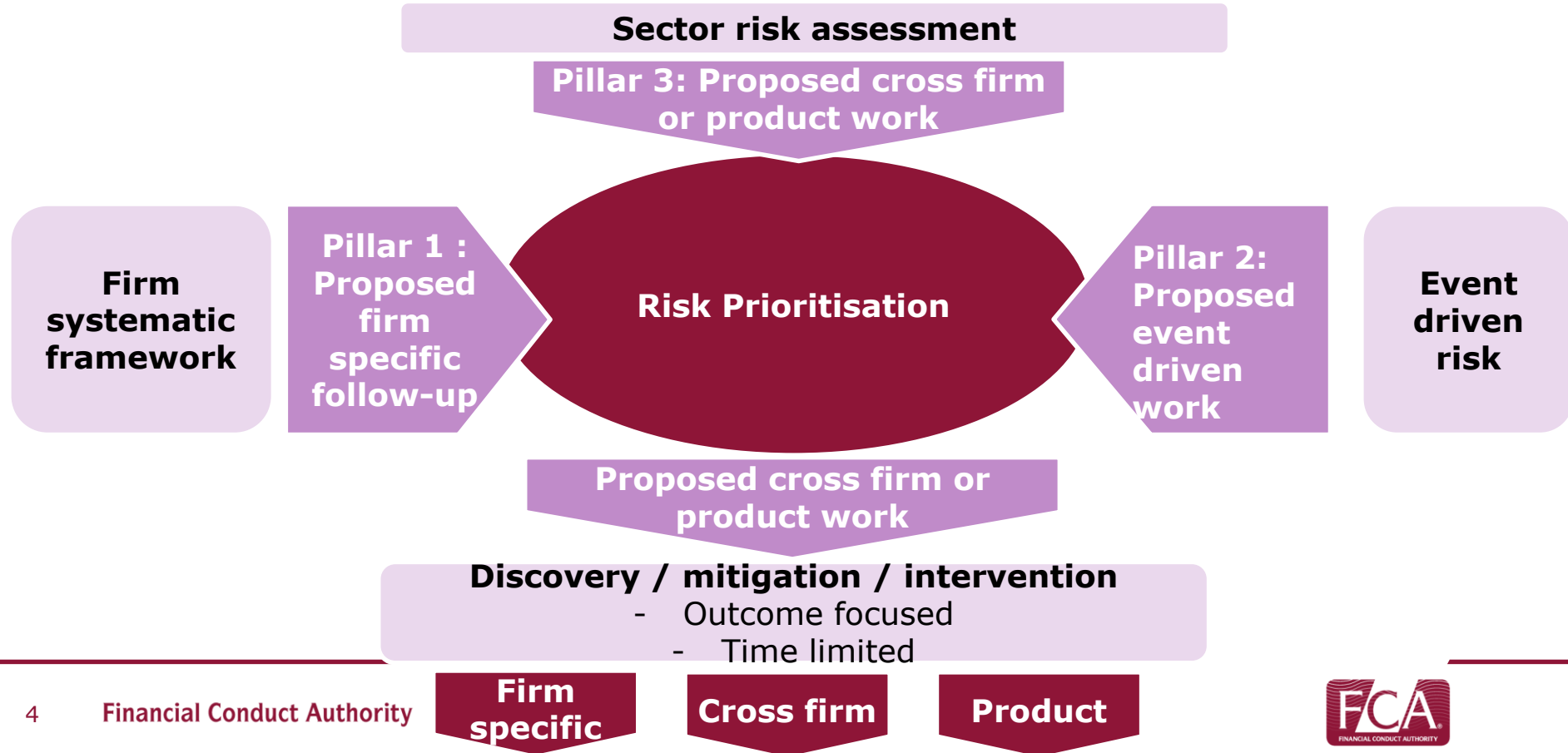
Operational objectives

- promoting effective competition in the interests of consumers
- securing an appropriate degree of protection for consumers
- protecting and enhancing the integrity of the UK financial system



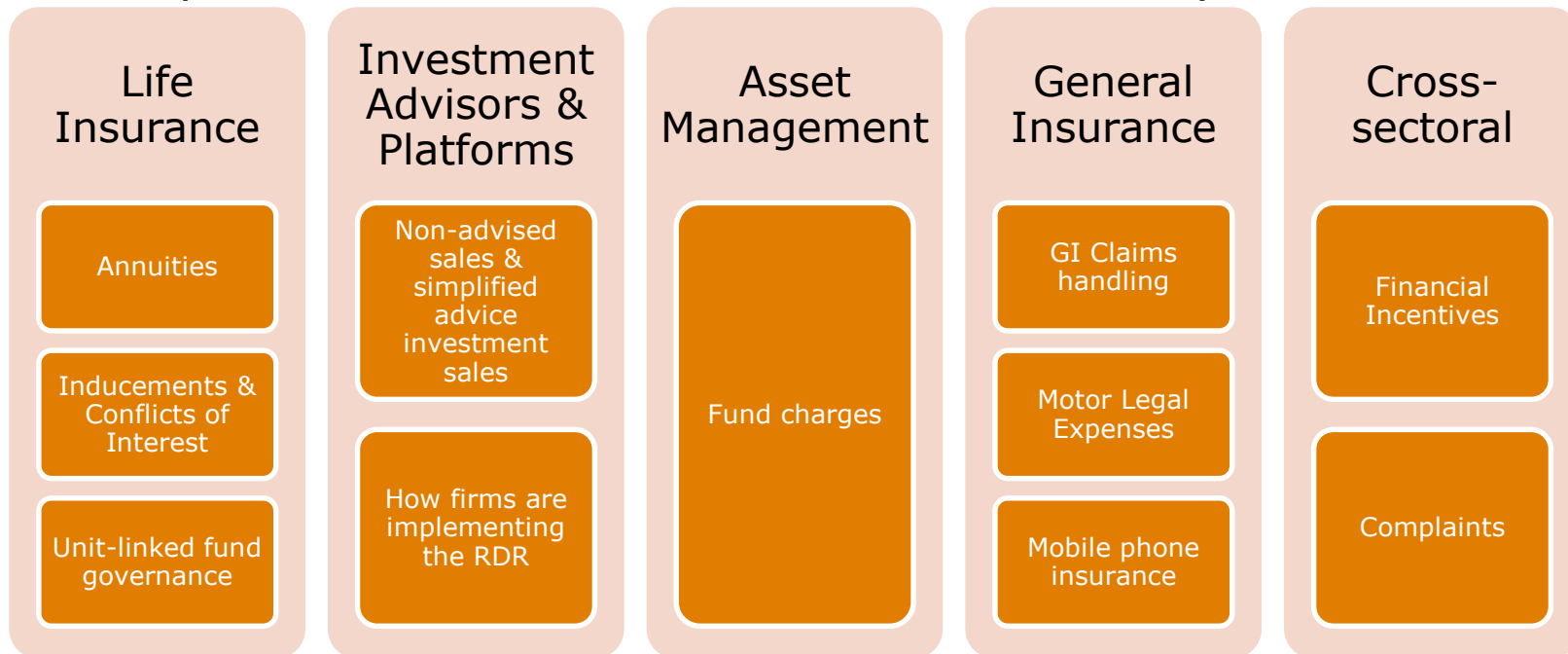
How will we achieve our objectives?

Supervision of firms – Three Pillars



Issues & Products work affecting insurers

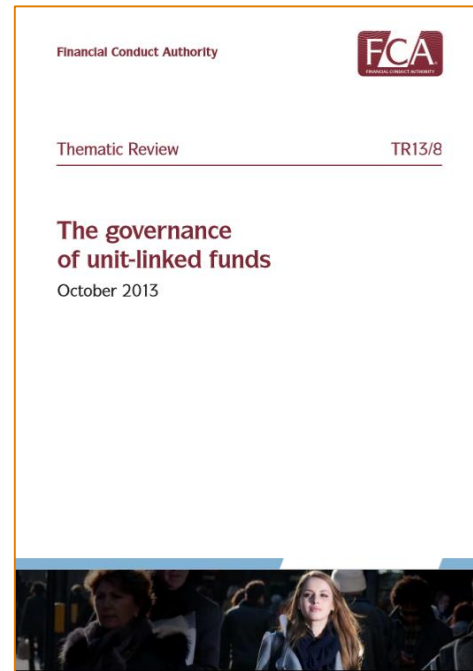
Examples of current or recent thematic work – by sector:



Governance of unit-linked funds

Governance of unit-linked funds:

Summary results of the thematic review



Method of assessment

- Information request to sample firms
- Analysis of data
- On-site visits: interviews & walkthroughs
- Assessment of results
- Moderation

What did we find?

Overall, results were mixed

- With room for improvement in most areas

Few common failings

- No evidence of significant systemic failings in the sector

Some material failings in specific firms

- Depending on their particular business model or operational arrangements

No evidence of customer detriment

- But skilled persons are investigating in a few cases

Common failings identified

Poor oversight of outsource service providers

Delays in the rectification of errors

Conflicts of interest

Fair apportionment of tax

Historic pricing

Material firm specific failings

Governance structure not able to provide adequate challenge

Deficient controls to assess whether assets were permitted links

Reliance on estimated unit prices without sufficient controls

Insufficient operational capacity and knowledge of pricing team

Inadequate oversight of outsource service provider

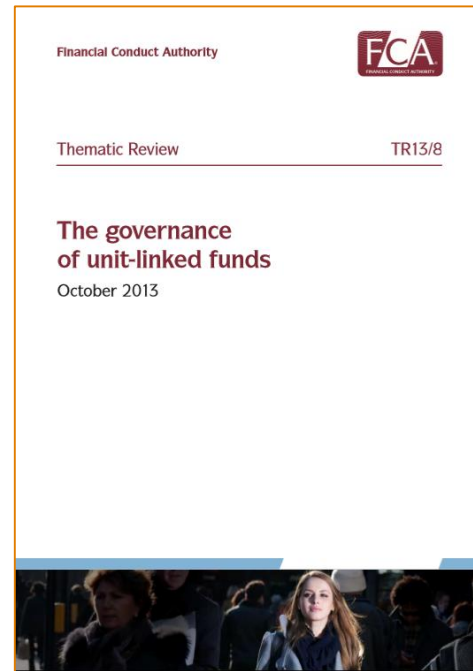
Governance of unit-linked funds

Governance of unit-linked funds:

Selected results from the thematic review

Mike Hawes

MacNaughtan Consulting Limited

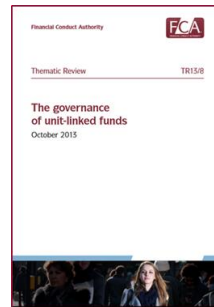


Three key areas of assessment

Firms had adequate systems and controls to administer and manage funds fairly
(‘governance’)

Assets backing unit-linked policies were appropriate for customers
(‘investment management’)

Customer benefits were calculated fairly and accurately
(‘customer benefits’)



Specific Elements

Governance

- Strategy
- Board Oversight
- ★ Committee structure
- ★ Risk Management and Compliance Oversight
- ★ Conflicts of Interest
- ★ Outsourcing
- ★ Breach Reporting and notifications

Investment Management

- ★ Mandate Compliance and Consistency with Customer Literature
- ★ Permitted Links and Economic Effect Test
- Investment Restrictions
- ★ Third Party Fund Link
- ★ Reassurance Credit Risk
- Fund Launches, Closures and Mergers
- ★ Stock Lending

Customer Benefits

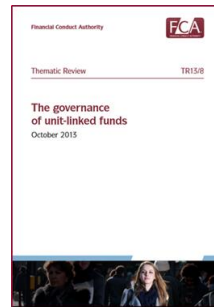
- ★ Valuation of Assets
- ★ Unit Pricing Process
- ★ Unit Pricing Basis - Rounding, Bid Offer
- ★ Taxation
- Treatment of Charges and Expenses
- Cash investment and disinvestment
- ★ Box Management and Unit Allocation

Governance

Firms had adequate systems and controls to administer and manage funds fairly
(‘governance’)

Assets backing unit-linked policies were appropriate for customers
(‘investment management’)

Customer benefits were calculated fairly and accurately
(‘customer benefits’)

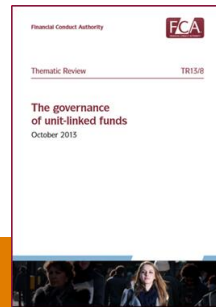


Example findings – Outsourcing



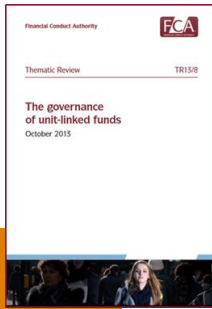
- Varying levels of oversight seen by:
 - Operational management
 - Assurance functions (Risk, Compliance and Internal Audit)
- Intra-group outsourcing
 - Informal reliance on group assurance functions
- Deficiencies in chains of outsourcers
 - Levels of sub contracting not uncommon

Example findings – Conflicts of Interest



- Awareness of potential unit-linked conflicts
 - Reliance on generic firm, or group, conflicts of interest policies
- Various conflicts of interest can arise between, for example:
 - Customers and shareholders
 - Unit-linked and with-profits customers
 - Different generations of unit-linked customers

Example findings – Errors and Breaches



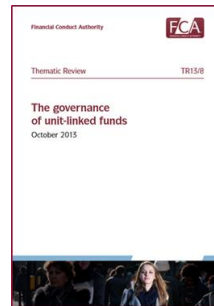
- Firms sought to identify abnormal variances
 - However tolerances and frequencies varied
 - Potential to miss small systemic problems
- Notification requirement in COBS 21
 - Inconsistent arrangements for notifying breaches to FCA
 - Report individually non-significant breaches in a proportionate, agreed manner
- Delays in rectifying errors in half of the firms

Investment Management

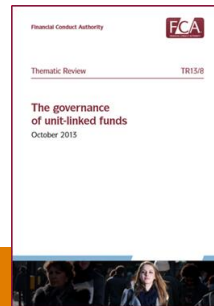
Firms had adequate systems and controls to administer and manage funds fairly
(‘governance’)

Assets backing unit-linked policies were appropriate for customers
(‘investment management’)

Customer benefits were calculated fairly and accurately
(‘customer benefits’)

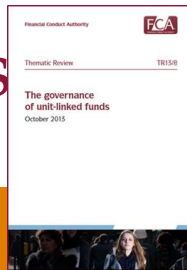


Example findings – Permitted Links



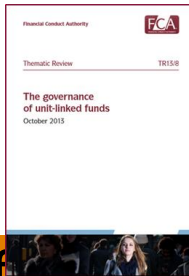
- More an issue for Institutional market:
 - Firms more likely to invest in alternative, more exotic assets
 - Institutional customers may have underlying retail customers
 - Needed to improve their assessment and decision-making processes
- Firms with retail customers invested in less contentious, mainstream assets

Example findings –Third Party Fund Links



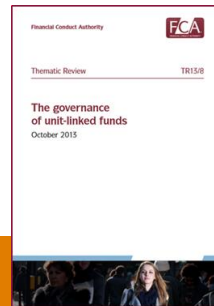
- Increasing numbers investing in third party funds:
 - collective investments
 - insurer funds (via reinsurance)
- To meet obligations firms should:
 - Satisfy themselves fund behaving as expected
 - Monitor way fund managers manage their funds
 - Ensure eg pricing errors dealt with appropriately
 - Consider what MI they need to manage the risks arising
- Some more comprehensive than others

Our findings – Reinsurer Credit Risk



- Customers potentially exposed to the credit risk of the reinsurer
 - Most did not pass credit risk to customer
 - Customers need to understand any risk and loss of FSCS
 - Policy documentation and marketing material both clear ?
- Firms looking to pass risk to customers:
 - Valid contractual variation clause
 - Unfair Contract Terms requirements
 - Principles for businesses (TCF and information needs)

Example findings – Stock Lending



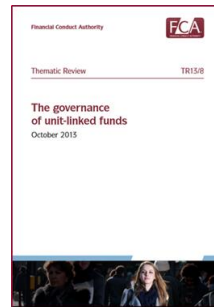
- Requirements in INSPRU
 - High standards – collateral, monitoring, disclosures
- Fund should receive either:
 - 'all recompense'
 - 'fair and reasonable recompense'
 - Depends whether it bears the risk, or not
- FCA found:
 - Most firms complied with these requirements
 - However some revenue allocation not justified

Customer Benefits (aka Fund Administration)

Firms had adequate systems and controls to administer and manage funds fairly
(‘governance’)

Assets backing unit-linked policies were appropriate for customers
(‘investment management’)

Customer benefits were calculated fairly and accurately
(‘customer benefits’)

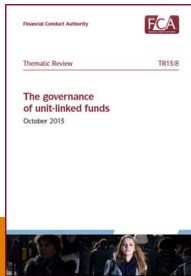


Example findings – Unit Pricing



- Use of estimated prices
 - Systematic (over) reliance on indexation
- Resources
 - Experience of pricing team
- Outsourcing
 - Knowledge and ownership of underlying activity and challenge
- Interaction with unit allocation
 - Historic pricing controls
 - Monitoring of swinging prices

Example findings – Apportioning Tax



- No perfect solution in this area
- Firms to demonstrate policy was reasonable and delivered a fair outcome
- Improvements required in just under half of firms
 - Documentation
 - Tax inconsistent with unit-linked 'PPFM'
 - Tax inconsistent with customer communications
 - Discounting of tax rates not fully considered
 - Value of capital losses inadequately considered

Governance of unit-linked funds

Governance of unit-linked funds:

Next Steps

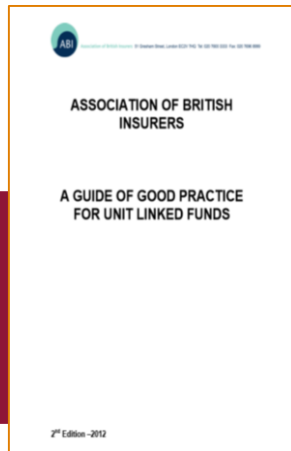


What action are the FCA taking?

The sample firms

- Few common failings, some specific material ones
- Firm reviews and improvements of processes – most complete
- Skilled person reviews for material failings

What action are the FCA taking?



Wider market mitigation

- Publication of thematic report outlining findings
- Firms have begun reviewing practices
- Working with ABI to enhance *ABI guide to good practice*
- Key FCA message: Your Fund, Your Customer, Your Responsibility

Governance of unit-linked funds

Governance of unit-linked funds:

Questions ?



The governance of unit-linked funds: a thematic review

Life Conference - November 2013