The Actuarial Profession
making financial sense of the future

Death of a mis-salesman

Preventing future mis-selling

2 November 2005

Death of a mis-salesman

"Ah Ah, I know what you're thinking. Did he fire six shots or only five? Well, to tell you the truth, in all this excitement, I've kinda lost track myself. But being as this is a .44 Magnum, the most powerful handgun in the world, and would blow your head clean off, you've got to ask yourself one question: 'Do I feel lucky?'. "

Well do ya punk?

- There is no formula to work out whether to stay out or opt back into S2P. It is a personal decision based on your own circumstances and attitudes
- The more risk you take the more you stand to gain or lose. The key to success is striking the right balance. The answer lies in your own personal approach to risk. There is no 'best' option because everyone is different

Controlling mis-selling risks

- Mis-selling risk is comprised of three main risks, namely:
  - That a product generates a financial loss for customers
  - That the suitability of the product cannot be demonstrated
  - That a significant proportion of customers have to be compensated
- The second **– demonstrating suitability –** is the key to controlling mis-selling risk since it is normally the only risk under the control of the company
- Companies must be able to demonstrate suitability **–** it is not sufficient for products to be suitable

Demonstrating Suitability

- In order to demonstrate suitability in an advised sale, a company has to be able to show that:
  - It knew sufficient personal and financial information about the customer
  - The product sold met the customer's financial needs
  - Reasonable steps were taken to ensure the customer understood the risks associated with the product and the reasons for the recommendation
- The FSA's rules require companies to produce a **Suitability letter** and **Key Features Document** in order to comply with the last two bullet points and most companies have designed a **Fact Find Document** to meet the requirements of the first bullet point

Problems in demonstrating suitability

- Lack of a credible audit trail justifying the advice given.
  - Over-reliance on a customer's attitude to risk, which is often recorded in a Fact Find Document using a simplistic tick box approach
  - The risks associated with products are usually described in Key Features Documents but not quantified in any way
  - Suitability letters don't expand on how the risk characteristics of the product(s) sold matched the customer's needs
- Makes it difficult to defend accusations that risks were misrepresented in advice process

Best practice standards (Faculty and Institute press release 13 July 2005)

Best practice standards within firms that might have helped to prevent past mis-selling problems include:

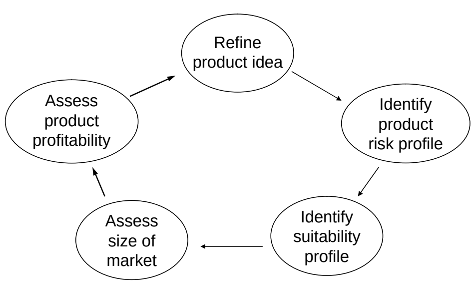
- setting out clearly the consumer need for which the product is designed
- including in product specifications a detailed assessment of the risk profile of the product
- including in product specifications a suitability profile
- ensuring that those responsible for selling and marketing the product are made aware of the risk and suitability profiles; and
- ensuring that marketing literature is targeted at customers for whom the product will be suitable.

Risk and suitability profiling – in step with FSA statements on TCF

Two key points from FSA cluster work

- The product development process (PDP) needs specific consideration and tests for TCF. There is generally an insufficient emphasis placed on assessing the risks to customers as part of the development and approval process [RISK PROFILE]
- Still too much focus is placed on 'who would want to buy?', how best to market the product, and what are the competitors doing rather than, 'who is the product suitable for'. Further, reliance on customer feedback is not the correct basis on which to start product design [SUITABILITY PROFILE]

Product development process



Risk profiling

- A product risk profile should identify the financial need (or needs) that the product is intended to meet and address the questions:
  - How likely is it that the product will fully meet the need?
  - What are the circumstances in which the need will not be met?
  - How likely are these circumstances to arise?
- A key aim is to identify and quantify the “nasty surprise” risks identified in answering these questions
- This recognises that the root cause of virtually all mis-selling claims is that a product has failed to deliver what was expected.

Identification of product risks

- Perform scenario tests to assess how the product performs under various situations
- Compare with other products
- Most common approach for investment risk would be to use a stochastic model of investment performance
- However, there may be other types of risk to consider

Points on modelling

- Remember it’s only a model
- Stochastic techniques can be applied to other risks in addition to investment risk
- Need to understand the type of risk and be able to construct a model around it
- But you shouldn’t duck assessing risks that can’t be modelled

Suitability profile

- Assess who the product is most and least likely to be suitable for and why
- Analyse in generic terms and avoid hard rules
- A product's risk profile will typically be a key element in developing a suitability profile
- Avoid over reliance on attitude to risk

Uses of Risk & Suitability profiles

- Help assess the viability of products before they are brought to the market
- Avoid deficiencies in marketing literature
- Identify gaps in fact find documents
- Help construct suitability letters
- Monitor sales
- Help decide appropriate post sales communications

Case study 1 - a past mis-selling problem

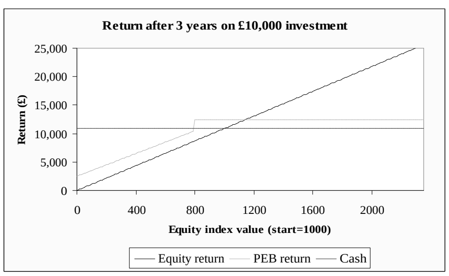
- A precipice bond with a 3 year term
- At the end of 3 years the customer receives:
  - Income of 25% of the investment; plus
  - Full return of capital unless the FTSE falls by more than 20%; otherwise
  - Capital is only partly returned – the payment proportional to the reduction in the FTSE below it's starting point
- If the policy is surrendered before the end of the 3 years the value paid is not guaranteed and could be less than the initial investment

Case study 1 - a past mis-selling problem (contd)

Assessing the risk profile of the precipice bond

- The product is intended to address the need to achieve a higher return than is available from deposit accounts
- The need will not be met if:
  - the FTSE100 index falls by 20% or more
- The ‘nasty surprise’ risk is the risk of not getting a full return of capital

Case study 1 - a past mis-selling problem (contd)



Case study 1 - a past mis-selling problem (contd)

Results from a stochastic analysis:

- A payment after 3 years of £12,500 compares to:
  - average deposit return of £11,240
  - average tracker fund return of £12,367
- There is a 51% chance that the investment will return more than a tracker fund
- There is an 85% chance of the product returning the maximum of £12,500
- A 10% chance of getting back less than the investment of £10,000
- A 2% chance of getting back less than 80% of the initial investment
- A 5% chance of getting back between 100% and 125% of the initial investment

Possible risk definitions – but great care needed

Description		Probability
Very likely	-	90-99%
Likely	-	66-90%
Possible	-	33-66%
Unlikely	-	10-33%
Very unlikely	-	1-10%

Case study 1 - summary risk profile

- More risky than cash
- Less risky than an equity tracker fund
- Not certain but likely to receive the maximum return
- Possible but unlikely that you would lose money
- Possible but very unlikely that you would lose a significant amount of money

Case study 1 - summary suitability profile

- Must be prepared to accept some equity risk
- Younger age groups, up to and including those who have recently retired
- Sufficient income to meet most outgoings; not reliant on savings to cover expenditure on essential items
- More savings than are required for rainy day purposes
- Tactical decision to increase/decrease risk exposure

Case study 1 - what went wrong?

- 'Very unlikely' risk happened
- Marketing literature attracted people who didn't fit the suitability profile
- risk of capital loss clearly signposted in literature but not quantified
- Suitability of a product that could lose 75% of capital was not demonstrated in advice process
- Recorded attitude to risk not supported by investment history

Case study 1 - Quality control checks that could have identified potential problems

Warning signs:

- sold to older ages
- no equity investments
- income < outgoings
- savings low
- high proportion invested in bond

Potential future mis-selling issues

- Reviewable protection products
  (risk of higher than expected premium increases)
- CI policies
  (risk of misunderstanding extent of cover)
- Equity release schemes
  (risk of roll-up mortgage being a higher than expected proportion of house value)
- S2P rebate policies
  (risk of benefits being lower than S2P)
- With-profit bonds
  (risk of high MVAs and low 'income')

Potential future mis-selling issues

- Income drawdown
  (impact of equity and longevity risk)
- Derivative based replacement with-profits products
  (risk of poor returns due to cost of providing underlying guarantee)
- Corporate bonds
  (risk of capital loss due to default and/or change in market yields)
- Guaranteed equity products
  (risk of poor returns relative to both equities and cash)

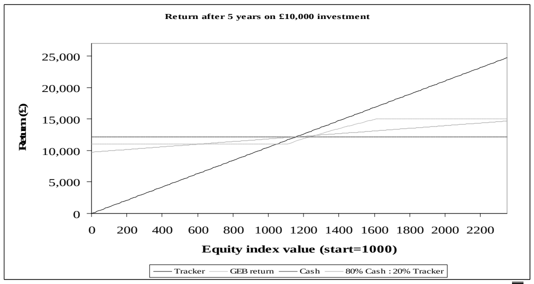
Case study 2 – a future mis-selling problem?

- Guaranteed Equity Bond
- Five year fixed term with a guaranteed minimum return of 110% at the end of the term. Guarantee backed by product provider
- Return is linked to performance of FTSE 100 index. The underlying investment is a derivative
- The return is the sum of the annual increases in the FTSE 100 index over the five year period (subject to a maximum annual return of 10% and a maximum annual fall of 5%) with a guaranteed return as specified above i.e. the maximum return after 5 years is 150%
- Surrender value is not guaranteed, it is dependent on the value of the derivative less charges
- Up front charge of 7%, plus management charge of 1.0% per annum; the maturity values quoted are net of charges.

Case study 2 - aims of Guaranteed Equity Bond

- To provide a better return than cash on deposit but there is no target maturity value or other explicit performance expectation (apart from the guarantee)
- To offer equity exposure with a high level of downside protection
- Not to give any nasty surprises. Does it succeed?

Case study 2 – initial analysis



Case study 2 – sample stochastic results

Chances of returns from GEB being:

- At maximum level = 1%
- At minimum level = 30%
- Better than cash = 56%
- Better than Tracker = 28%
- 125% or more of investment = 30%
- Worse than Cash and Tracker = 23%
- Better than 80% Cash : 20% Tracker = 34%
- Less than 150% if tracker fund returns >175% = 97%

Case study 2 – sample risk profile

- The GEB is guaranteed to give a return after 5 years of 10% but it is still more risky than a term deposit
- The GEB is very unlikely (1% chance) to return the maximum of 150%
- It is possible (30% chance) that the GEB will return only the minimum amount at the end of 5 years
- It is possible but unlikely (23% chance) that the GEB will return less than cash and equities after 5 years
- It is unlikely that the GEB will return significantly more than cash on deposit (only 30% chance of more than 25% return over 5 years)
- Less risky but not dissimilar in risk profile to an 80/20 cash/equity investment
- Very unlikely to receive the maximum return, even if overall equity return is very good
- Surrender risk – no guarantees on surrender, [risk not analysed in slide]

Case study 2 - sample suitability profile

- Investment outlook – possible tactical investment for someone who would not normally consider equity investment but perceives deposit returns to be very poor. Suitable if prospect of higher than cash returns is assessed as outweighing the risk of lower returns
- May also be suitable for an equity investor nervous about short/medium term outlook for equities.
- Lifestage/age – most ages including those who have retired; unlikely to be suitable for the very elderly
- Income – sufficient income to meet outgoings not completely reliant on savings to cover expenditure on essential items
- Absolute wealth – more savings than are required for rainy day purposes
- Attitude to risk – could cover a wide spectrum, must be prepared to accept risk of poorer return than deposits; subject to this, product is suitable for a cautious investor
- Investment experience – may be suitable for someone with no experience of investing in equities
- Amount invested – not suitable for short term rainy day savings but guarantee may make it suitable to invest a significant proportion of longer term savings in the bond
- Positioning re other products – offers a different mixture of downside protection upside gain than could be achieved through other funds
- Tax status – ignored for purposes of exercise but would also be factored in as relevant.

Case study 2 - changing the product design

Impact on profitability, risk profile and suitability profile if:

- Annual returns altered to:
  - Maximum of 7% rise
  - Maximum of 7% fall
- Product marketed as 'superior to cash'
- No other changes

Case study 2 – impact of changing the product design

Chances of returns in GEB being:

- Better than cash = 39%
- Better than Tracker = 27%
- 125% or more of investment = 9%
- Worse than Cash and Tracker = 40%
- Better than 80% Cash : 20% Tracker = 16%

Case study 2 - impact of alternative product design compared with original

- Profitability - higher
- Nasty surprises – similar but more likely to happen
- Risk profile – median return worse than cash
- Suitability profile – becomes increasingly difficult to justify relative to other products

Killing off the mis-salesman

- Should reduce complaints
- But will not stop them
- The onus is on firms to defend the advice they gave
- Having a process in place to ensure firms have this defence should go a long way to ensuring they are treating customers fairly