

Session F6  
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# Assets within personalised funds Does default matter?

22 November 2011

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# Agenda

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1. Introduction
2. Investment risk in personalised funds
3. Where are the assets?
4. Custody risk
5. Regulatory agenda
6. Fund examples
7. Solvency II
8. Conclusions

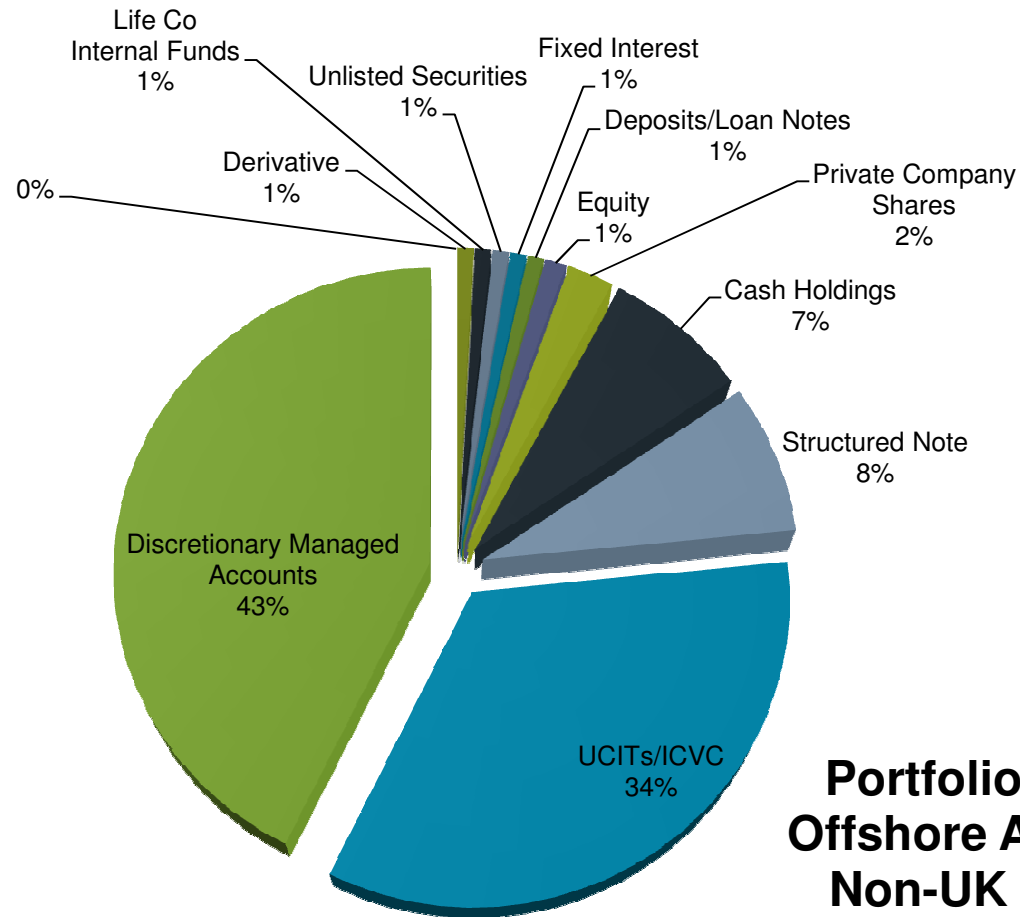
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# What are Personalised Funds?

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- “Individualised” life products
  - SIPPS / SSAPS
  - Offshore Portfolio Bonds
- Competing products include
  - Execution only stockbroker accounts
  - Online stockbroker accounts
  - Banking custody accounts
- A life company “wrapper” often brings tax advantages (e.g. gross rollup of investment gains)

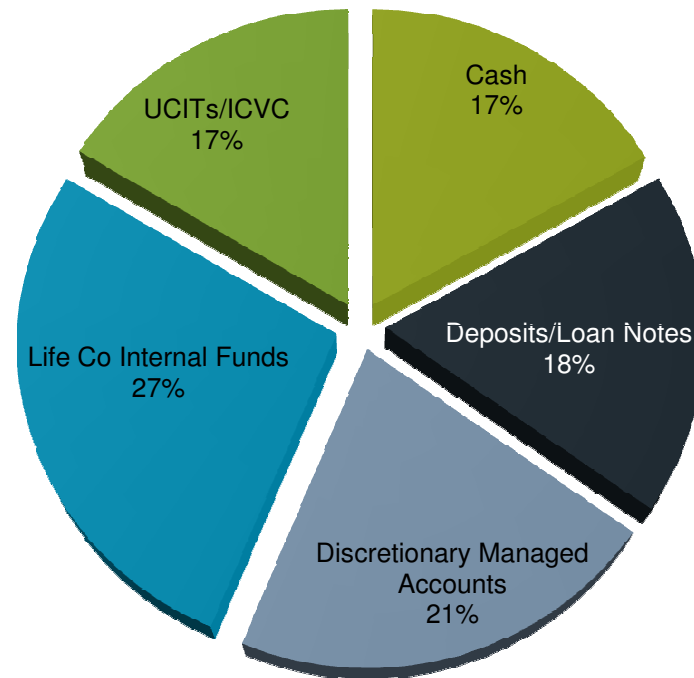
# Asset Distribution – Non-UK Offshore



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# Asset Distribution – UK Offshore

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**Portfolio Bonds  
Offshore Asset Mix  
UK Clients**

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# Fund universe – how big is the market?

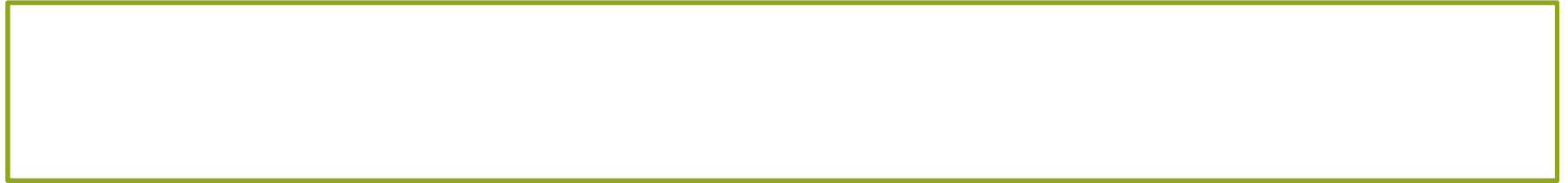
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## **FE Trustnet UK listings**

- Offshore Funds – 3,545 funds listed
- Unit Trusts and OEICS – 2,297
- Investment Trusts – 382
- Exchange Traded Funds – 2,422

## **FE Trustnet “Offshore” listings**

- Offshore Mutual Funds – 23,719 funds listed



# Defining investment risk

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# Personalised Funds: property linked not index linked?

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- Solvency I
  - the insurer always bears an investment risk in the case of index linked contracts (even if only a counterparty risk)
- FSA Guidelines
  - If the insurer bears the whole risk of **counterparty default** (so that policy holder benefits are wholly, determined by the performance of the index) then the assets are index linked.

If, however, the contract is such that the benefits would be reduced (from those which would be calculated by reference to the index) to reflect part or all of the reduction in the value of the linked assets resulting from **any counterparty default**, then the assets are property linked.



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# Investment risk as per key features documents

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- Life Industry
  - “the value of your bond depends on investment performance”
  - “the value of the investments in your SIPP and any income from them may go down as well as up”
  - “It's possible that an underlying asset could reduce significantly in value”
  - “Investments available can vary in their level of risk and their value can do down as well as up”
- Stockbroker Accounts
  - “In the event that a custodian or credit institution becomes insolvent, you may not receive back all or any of the assets or funds that that custodian or credit institution holds on your behalf.”



# Where are the assets?

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# Legal structure of the non-cash assets

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## Range of ownership structures by Life Company

- Self-Custody
- Local Custodian
- Global Custodian
- Discretionary Managed Assets
  - Nominee Accounts
  - Policyholders Chosen Custodian
- SIPPS Assets may be held within a trustee company

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# Legal structure of the cash assets

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- Type of cash held
  - Nominated bank assets
  - Generic Cash account
- Failure of Banking Institution (covered later)

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# Nominee and Trustee type risks

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- Nominee Accounts and W&R Morrogh case
  - Regional based stockbroker, ceased trading 2001
  - Irish High Court ruling and consequences
  - Similar case in English Law 1988 - Berkeley Applegate
  - Where are discretionary managers holding assets?
- Trustees (SIPP etc.)
  - Fiduciary Duties

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# Custodian Services

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- Common for Life Companies to use custodian banks
  - Remove requirement for dealing with multiple CSDs
  - Administrative efficiencies e.g. corporate actions
  - Legal issues with overseas securities
- Global custodians offer services geared for Funds Industry
- Service governed by a Custody Agreement
- Unusual for Life Company policy documentation to mention custodianship arrangements
- Wealth management providers frequently explain custody

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# Custodian Risks

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- Fraud
  - Luxalpha, Herald SICAV
- Legal Risks
  - Unauthorised use of the assets by the custodian
  - Protection in case of Custodian Bankruptcy
- Operational Failure & Unavailability of Transfer of Assets
- Trade Failures
- Dispute with Custodian over other assets

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## Sub custody and their risks

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- Widespread use of sub-custodians
- Common for holding foreign securities
- Custodian management of liability
  - UBS use of BLMIS for sub custody
- Cash held with custodian bank



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# Consequence of failure of custody arrangements

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- Temporary loss of assets
- Permanent loss of assets
- Consequential losses for portfolio clients
  
- New rules in AIFM Directive aimed at reducing custody risks
- Proposals for UCITS V
- Directive will introduce new higher standards of custody  
“Strict Liability”

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# Minimising Custody Risk - checklist

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- Who oversees custody arrangements including analysis of custodian strength
- Is there a custody agreement in place. Is it reviewed?
- Are multiple custodians allowed? Can policyholders choose custodians?
- Who are the custodians behind nominees if these are used
- What does the custody agreements say about use of sub-custodians and liability for their failure
- Are sub-custodians reviewed?
- What are the procedures for ceasing custody agreements esp in distress?  
How to retrieve assets, balances and outstanding settlements
- How often are assets reconciled (company to custodian to fund)?
- Who monitors errors if and when they occur
- What transfer risks are exposed (e.g. currency controls)?



# Regulatory agenda

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# Context – Irish Financial Services Ombudsman

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- Annual Report 2010

*“The public is under greater financial distress and is making more demands of the providers. The providers must respond accordingly and move to a higher level of service if trust with the public is to be restored.”*

- Reputation does matter

*“In reviewing the complaints record of the industry, I am struck by the very different record of some of our regulated financial institutions.”*

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# UK Financial Services Ombudsman

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- **Investments and pensions represented 7.5% of complaints (15,483 cases in total)**
  - complaints about sales and advice: 63%
  - complaints about administration: 30%
  - other complaints: 7%

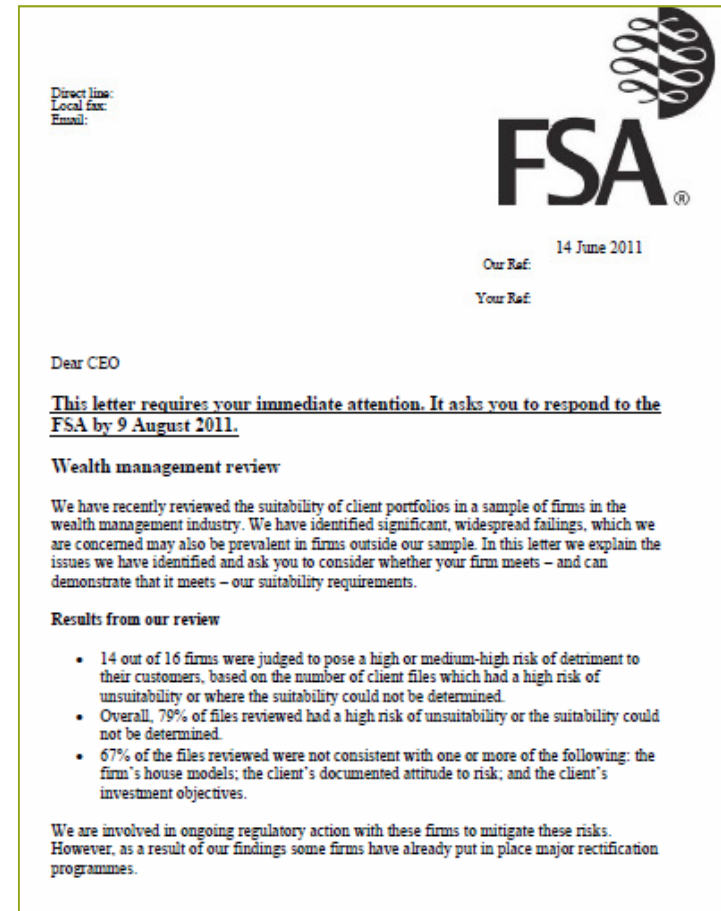
# UK Financial Services Ombudsman

Type of complaint	%
whole-of-life policies and savings endowments	21.5
mortgage endowments	20
personal pension plans	9
portfolio management	7.5
stockbroking	7
unit-linked bonds	5.5
investment ISAs	5.5
“with-profits” bonds	4.5
“structured” products	3.5
small self-administered schemes (SSASs) and self-invested personal pensions (SIPPs)	3
guaranteed-income bonds	2.5
annuities	2.5
derivatives (including spread-betting)	2
unit trusts	1
SERPs	1
other products	4

# 2011 wealth management review by FSA

## Mainly about advice:

“The key focus of the review was to assess suitability of client portfolios against **documented client information**, which includes, but is not limited to, the client’s knowledge and experience, financial situation and investment objectives.”





# Revisit the life company



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# Life company risk management

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Policy conditions – unit linked text  
“prices may fall as well as rise ...”



Alternative Risks waiver – “I, the  
client understand the risks ...”



The Financial Adviser – life company  
not responsible for financial advice



Appointment of an external  
“discretionary asset manager”

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# Irish Regulations – liquidity

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- All assets must be “*realisable in the short term*”, although there is no official definition of what is meant by “*short term*”
- The guidance notes acknowledge that there should be some flexibility as to what would be accepted as short term, but state that “*as a general guide, a period of six months might be regarded as reasonable*”
- The guidance notes set out other criteria that should be met when applying the liquidity test including, for example, that there should be no restriction on the transferability of assets e.g. pre-emption rights



Caveat – these are examples from the public domain to highlight possible risks to liquidity. This is not a comment on the actual funds.

# Funds – some examples

# AIG Enhanced Variable Rate Fund

Retail Fund

Financial Services Authority



## FINAL NOTICE

To: Coutts & Company  
FSA Reference Number: 122287  
Address: 440 Strand, London WC2R 0QS  
Date: 7 November 2011

### 1. ACTION

- 1.1 For the reasons given in this Notice, the FSA hereby imposes on Coutts a financial penalty of £6.3 million.
- 1.2 Coutts agreed to settle at an early stage of the FSA's investigation. It therefore qualified for a 30% (Stage 1) discount under the FSA's executive settlement procedures. Were it not for this discount, the FSA would have imposed a financial penalty of £9 million on Coutts.

### 2. SUMMARY OF REASONS

- 2.1. The penalty is in respect of Coutts' failure to comply with Principle 9 in connection with its sale of the AIG Life Premier Access Bond and Premier Bond, Enhanced Variable Rate Fund (the Fund) between 3 December 2003 and 15 September 2008 and its compliance review of those sales between October 2008 and July 2009.

Offered to retail policyholders in life company



Wealth managers –  
Portfolio Bond wraps

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# AIG Enhanced Variable Rate Fund - liquidity

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- Fund invested in illiquid paper, asset backed securities, etc
- Lehmans failed, fund owner (AIG) share price fell, run on fund
- Fund suspended 15 September 2008
- Customers were subsequently permitted to withdraw 50% of their investment
- 14 December 2008 customers were given the opportunity to withdraw the remaining 50% of investment with 13.5% haircut
- Alternatively, customers were given the option of transferring that 50% into a Protected Recovery Fund (PRF) which guaranteed that customers would get back this proportion of their investment in full if they kept their money in the PRF until 1 July 2012
- The vast majority of customers chose the PRF

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# Kaupthing Singer & Friedlander (Isle of Man)

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- Bank went into administration in October 2008 (as part of the Landsbanki failure)
- Thus far, the Kaupthing Singer Friedlander (IoM) depositors have recovered 73.6% of their savings, with a further minimum 9.5% expected before the end of 2011
- Landsbanki Guernsey depositors have received 85%, with a possibility of 90% ultimately
- It is now three years since the bank went into administration

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# Italian case study - Trackers

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- In the beginning ...
  - Linked funds holding MTN's issued by a bank
  - MTN provided guarantee and upside performance
  - Default risk on MTN passed to policyholder (and concentration risk also)
- Then ...
  - Post Lehman, Regulator forced life companies to “guarantee” performance (including default)
  - Linked funds holding government bonds for guarantees, plus OTC options for upside performance
- Now ...
  - Are Italian government bonds risk free?
  - Who posts collateral on OTC's when markets crash?

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# List of suspended hedge funds

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No centralised list of funds with suspended redemptions



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# Bank accounts

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- Policyholder directed term deposits
- Policyholder directed structured deposits
  - Bank location – country seems to matter!
- Internal cash fund of life company
- “Transaction” account
  - Underlying banks
  - What does the policyholder understand?

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# Fund innovation continues - litigation funds

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- Third party funding of litigation
- “Recent edition of Litigation Funding magazine lists 15 litigation funders”
- Typically a limited partnership with capital commitment (maximum investment), but fund only draws capital as needed to invest in new litigation cases
- Tranche nature to “investments” – target ultimate term and payouts as individual claims settled
- This needs liquidity at subscription!



## A brief word on assets under Solvency II

# Solvency II

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# Solvency II

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## Article 132 Prudent Person Principle

- Where the benefits provided by a contract are directly linked to the value of units in an UCITS as defined in Directive 85/611/EEC, or to the value of assets contained in an internal fund held by the insurance undertakings, usually divided into units, the technical provisions in respect of those benefits must be **represented as closely as possible by those units** or, in the case where units are not established, by those assets.

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## Permitted Links under Solvency II – Article 132

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- ✓ insurers shall only invest in assets and instruments whose risks they can properly identify, measure, monitor, manage, control and report
- ✓ all assets are to be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole
- ✓ assets held to cover technical provisions shall be invested in a manner appropriate to the nature and duration of the insurance and reinsurance liabilities
- ✓ assets shall be invested in the best interest of policyholders and beneficiaries taking into account any disclosed policy objectives

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# Solvency II

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## Article 13 Definitions

- ‘liquidity risk’ means the risk that insurance and reinsurance undertakings are unable to realise investments and other assets **in order to settle their financial obligations** when they fall due

Would paying surrender claims by way of in-specie transfers “settle” life company financial obligations?

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# Solvency II

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## Article 13 Definitions

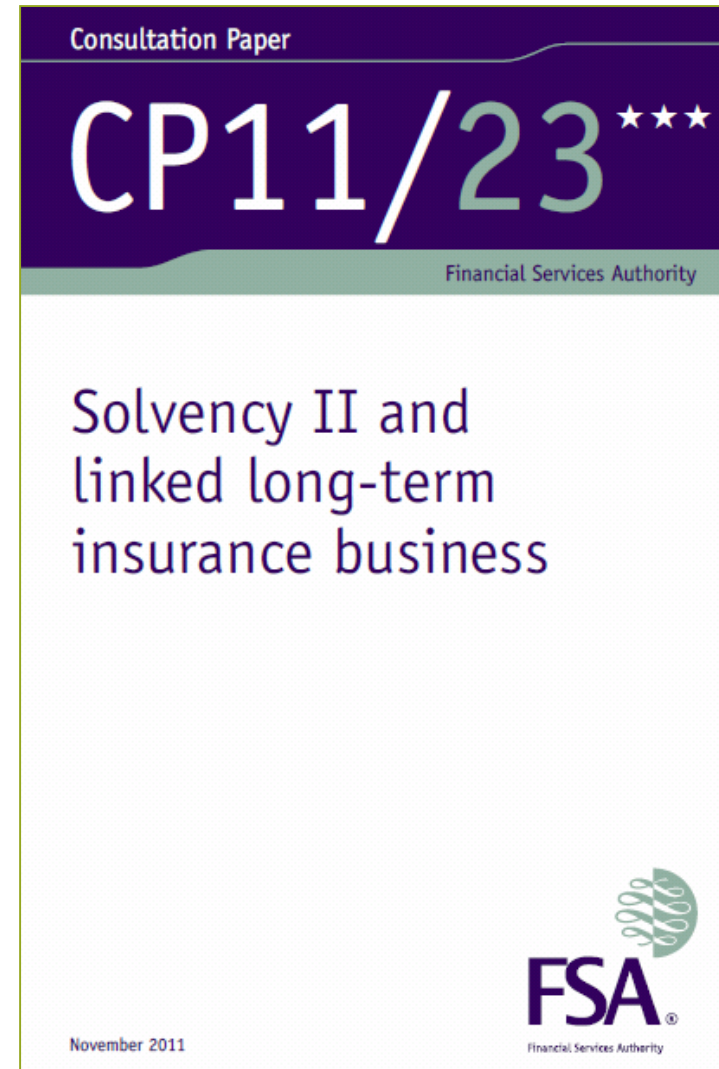
- ‘credit risk’ means the risk of loss or of adverse change in the financial situation, resulting from fluctuations in the credit standing of issuers of securities, **counterparties** and any debtors to which insurance and reinsurance undertakings are exposed, in the form of counterparty default risk, or spread risk, or market risk concentrations

Consequence for custodian arrangements in life companies?

# FSA Permitted Links consultation

## COB rules:

First impression – more about the type of investment over the nature of investment (e.g. reference to legal and authorised vehicles)





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# Investor Compensation Schemes

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## **Too much to cover today!**

- Protection for ICVC and banking retail customers
- How aware are policyholders that they are not covered by these schemes?
- Most life companies do not mention ICS
- EU White paper on Insurance Guarantee Schemes



# Conclusion

# A gradient of fund “governance”

## Fund level

- Disclosure
- Retail versus “institutional” funds
- Authorisation
- Due diligence undertaken
- Compensation schemes?

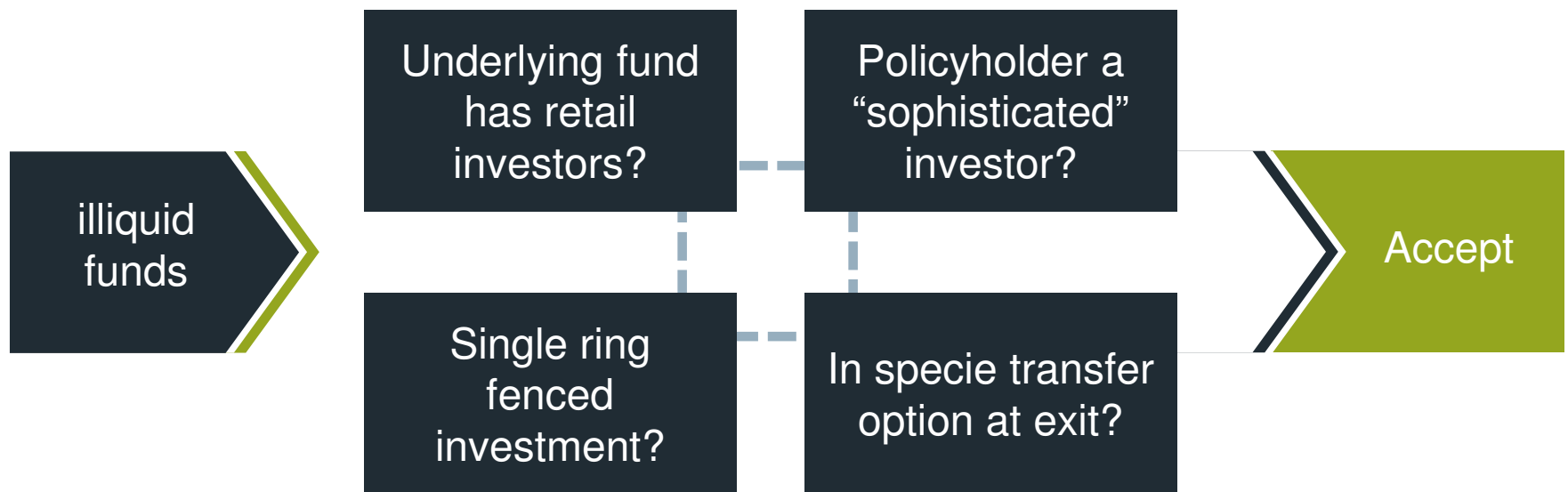
## Counterparty

- The fund
- Your custodian
- Fund custodian
- Subcustodians
- Bank accounts

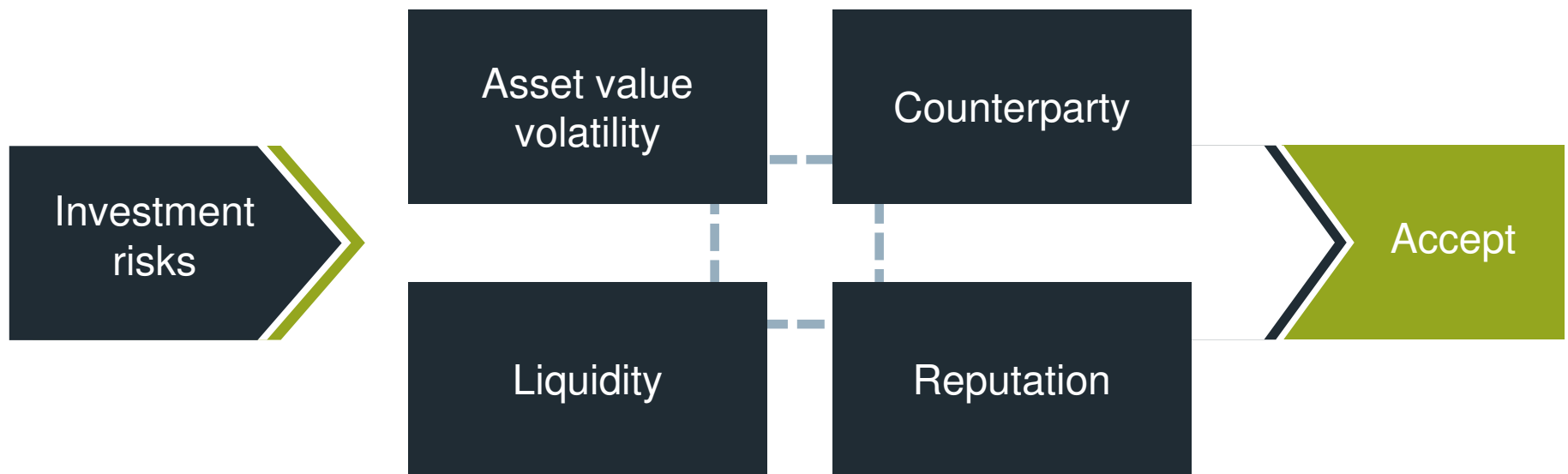
## Advice

- Point of sale
- Ongoing discretionary investment advice
- Outsourcing of execution to DAM

# Possible decision tree – current approach



# Possible decision tree – risk based



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# Questions or comments?

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Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenters.

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