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£1Trn and Counting – the Rise and Rise of Unit-Linked Funds

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04 November 2015

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Unit-Linked Fund Structures Working Party
Craig Smith, Standard Life (Working Party Chair)
Robert Whitehouse, Royal London (Working Party Member)

Life Conference – 20 November 2015

04 November 2015

What we'll cover today

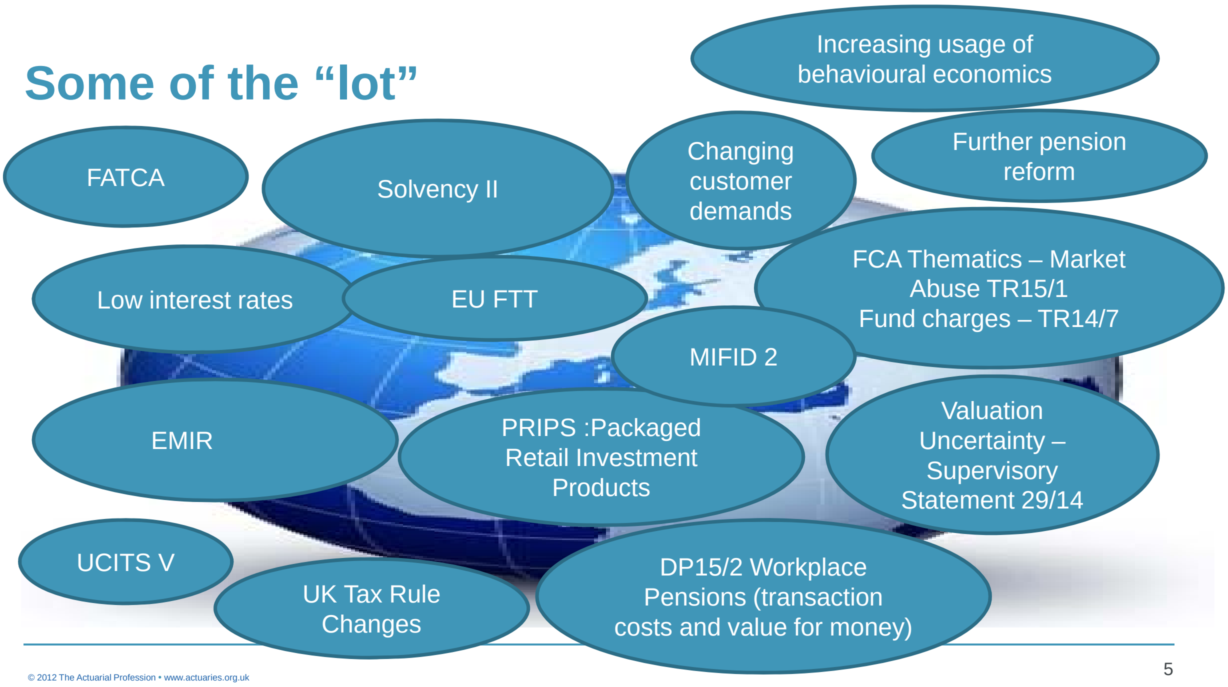
- There's a lot going on which impacts on unit-linked funds
- Background to working party and current state
- Key Risks on unit-linked funds and structures
- Key changes looking forward which are impacting unit-linked funds
- Questions (10 mins)

There's a lot going

"He who rejects change is the architect of decay. The only human institution which rejects progress is the cemetery."
~Harold Wilson

"Time is a dressmaker specializing in alterations."
~Faith Baldwin

Some of the "lot"



Current state and how we got there:

"A brief of history of time"

From with profits to whole of market offerings

"There is nothing so stable as change"

Bob Dylan

Current state and how we got there:

Many firms commenced unit-linked business in the 1980s

- *Firms typically only offered their own funds*
- *For many evolution from traditional with profits into unitised manged fund structures – driven by capital efficiency*
- *Typically a mixed range of specific asset classes and 'managed funds'*
- *Fund management performed in-house (or within the group)*
- *Simple fund structures used*
- *Direct asset holdings*
- *Relatively small number of funds offered*

Own funds directly investing into the market

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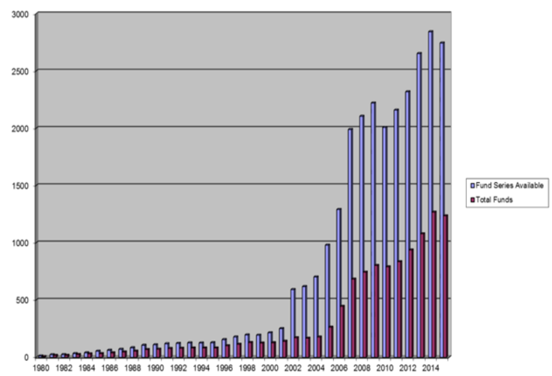
Current state and how we got there:

21st Century – Ever widening fund offerings

- *Many investment departments split off to form new investment companies,*
- *Can't compete with global investment managers*
- *Use of open architecture and 'mirror funds'*
- *Fund of funds increase in usage – directed by different stakeholders*
- *Reinsured funds*
- *Increasing complexity of some fund offerings*



Heavier usage of investing into other funds which in turn may invest into the market

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And the regulatory environment

Some useful regulatory context in which the UL universe operates:

Limited regulation which governs unit-linked funds:

- *COBS rules on promotion/marketing*
- *Focussed Unit-Linked principles/rules in COBS 21*
- *Prudential regulation – close matching of assets and liabilities*

Guidance provided by the ABI forms the main requirements

- *ABI Guide of Good Practice for Unit-Linked Funds (covering governance and operational expectations for UL business) - originally published in 2006, updated in 2012 and 2014*

But, more recent regulatory interest:

- *FCA Thematic review "The Governance of Unit-Linked Funds" - TR13/8, October 2013*

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…hence a UL Working Party

- Instigated by Life Board / Life Research Committee
  - Limited research/focus on unit-linked work to date in profession
  - Significantly growing area of insurance business
  - Significant change which impacts on UL offering
- Aim was to focus on something which will:

  "serve the ***public interest*** *by ensuring that where there is uncertainty of future financial outcomes, actuaries are trusted and sought after for their valued analysis and authority."*

- 'Fund Structures' was the adopted theme for the working party, but possibly too wide a scope in hindsight.

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Key risks on unit-linked funds and structures

A key risk is what does a prudent person do

"*Member States shall ensure that insurance and reinsurance undertakings invest all their assets in accordance with the prudent person principle*"

Article 132, Solvency II Directive

Some context from a customer and company angle

Prudent customer focus concerns

Customer (lack of) Risk Understanding in UL Funds

- *When am I going to retire?*
- *What's enough money to save?*
- *Do I understand what I am buying? What is my protection?*
- *Why cant I get a guarantee like my parent's did ?*
- *What's appropriate for me today? Will it be tomorrow?*
- *Why wont anyone tell me what to do?*
- *And don't the rules keep changing so why bother?*

Prudent Company concerns

Insurance company requirements under Solvency II

- *Article 132 requirements – Prudent Person Principle*
- *Know your assets – doesn't distinguish between linked/non-linked assets*
- *Litigation risk for Insurers*

On top of general themes such as:

- *Know your customers*
- *Lack of understanding by customers*
- *What's appropriate for each customer?*
- *Is it acceptable to still think around the generic sample customer – even though it's a pooled product?*
- *Charge caps – transaction costs*
- *Further regulations*

A selection of structure 'themes' impacting UL considerations

- Mutual funds or unit linked funds
- Solvency 2 :
  - Close Matching
  - "Look Through" or "Know your assets"
  - Reinsurance
- Pensions Reform
  - Impact
  - Auto enrolment

An example of uncertainty – Direct or indirect

Mutual funds or unit linked funds?

- **Advantages of UL Funds vs Mutual Funds**
  - *Easier/cheaper to create – no regulatory approval required*
  - *Can have multiple layers of funds of funds*
    - *Different fund/risk profile for each pension scheme*
    - *Mutual funds only allowed 1 layer*
  - *Lower reporting/audit costs*
  - *Direct property investment more easily accessible*
  - *Tax benefits from double taxation treaties, particularly for overseas equities*

- **Disadvantages of UL Funds vs Mutual Funds**
  - *Not ring-fenced – customers have no right to the assets*
  - *Less transparency (at present) – no audited accounts of each fund etc*
  - *More restrictive on certain assets such as derivatives (COBS21 vs COLL) although this looks like it is changing with S2 revisions (especially around derivatives)*

Do Customers and Companies understand this?

Two examples from Solvency 2

Close matching of unit-liabilities

Close matching 'rules' don't change under solvency 2 - but the application does:

- *Choice of risk for firms – market risk on VIF, or persistency risk if not fully matched.*

If firms choose to 'go short' the structures might impact on:

- *Their ability and the ease with which they can do so.*
- *The capital support needed for other products*

(this is a working party in itself!)

Look-through requirements

Issue

Firms are required to 'look-through' their unit-linked funds to understand what assets they actually have exposure to.

A simple UL operation should find this easy but the challenge grows if you link to lots of external managers and have lots of fund layers.

Help to resolve the issue…

France, Germany & the UK designed the "tripartite" form to help.

Firms are unlikely to get 100% coverage – information received will be sensitive so what controls will be in place to de-risk the information.

And another – Reinsurance Credit Risk

Life Company funds are usually more tax efficient than OEICs but Life Companies can not invest into each other.

Hence they sometimes link to funds via reinsurance, generating:

- *Counterparty risk and the capital requirements under SII*
- *Very difficult for firms to pass the credit risk onto customers – FCA requirement is that customers need to "know and understand" the consequences of the credit risk before they can take it.*
- *Capital requirements likely to be misaligned to impact if an event did occur*
- *How real is the risk and what would have to happen for the risk to materialise?*
- *What options are there to derisk but still deliver to customers?*

UK - auto-enrolment charge caps and what more to come?

Auto enrolment has been gaining momentum in recent years with a huge number of firms due to stage over the next 2 years.

Main issues for consideration include:

- *Members will likely be **passive in their behaviour** and different to more traditional active/advised unit-linked customers*
- *Given more passive behaviour, firms might need freedom to change underlying funds to continue to meet customer requirements – but who is on risk for changes being made in the future (customers will likely only complain if they lose with the benefit of hindsight)*
- *Charges will become increasingly important – original stagers would likely have been below charge cap levels – but what can be offered for 75bps for very small schemes?*
- *More recent consideration on the charge cap is the inclusion of property costs within the 0.75% charge cap – could this make property unviable under auto-enrolment, or could it create a 2 tier fund range – large employers vs small employers?*

Focus on UK - charge transparency

Charge disclosure and transparency:

Along with workplace pensions comes greater focus on charge/cost transparency and 'value for money' discussions with Independent Governance Committees and Trustees.

Main issues for consideration include:

- *Multi-asset fund-of-fund structures can be difficult to look through – but need to balance between efficient/diversified investment and being open/clear on costs and where they arise*
- *Transaction costs disclosure came into force in 2015, but still consultation on what to disclose (expect next round from DWP/FCA in early 2016) – unclear how this information will be used and potential for it to drive inappropriate behaviour.)*
- *With the passive audience, how do you explain complex fund structures and charging structures and ensure they understand what they have.*

…but, what impact might this have on innovation for funds as more complex structures don't lend themselves multiple layers of transparency

Pension freedoms…yet more to think about

And some recent headlines…

- **Pension reforms: 'Shortfall risk' from cashing in funds**
- **Pension changes 2015: Annuity or pension drawdown?**
- **£4.7bn paid out in first six months of pension freedoms**
- **MPs fear lack of pension support could lead to scams**
- **Think-tank calls for pension freedoms 'early warning system'**

‘Future’

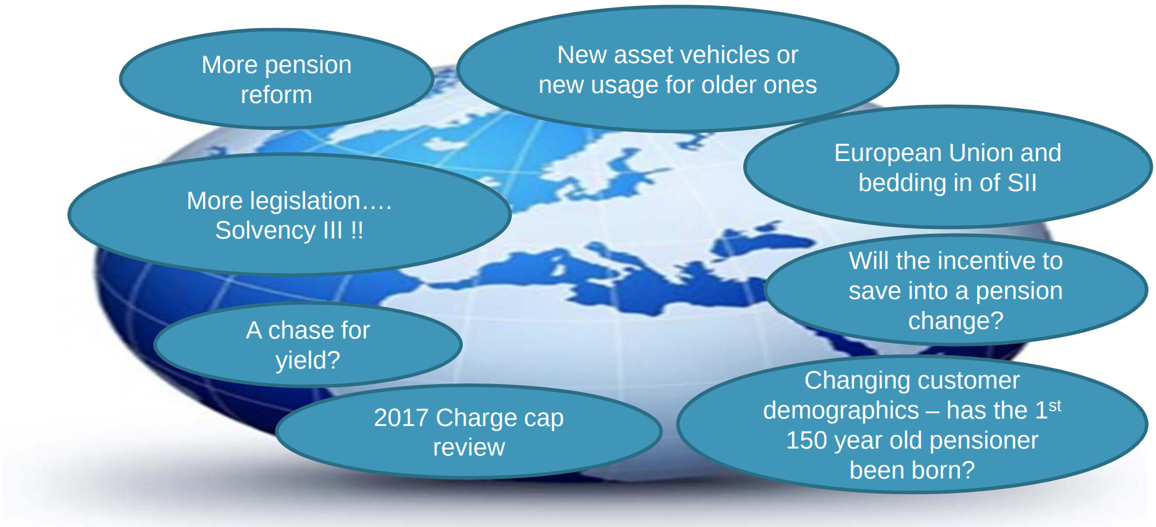
What should the Working Party focus on

“Time is a dressmaker specializing

in alterations.”

~ Faith Baldwin

What might be coming?



So what next for the working party?

We are thinking of narrowing focus to a reduced number of Customer Outcomes.

Possible focus areas are:

- *Cost disclosure – charge cap, transaction costs*
- *Consumer Protection for unit-linked funds*
  - *are protections to consumers appropriate given how industry has changed over last 10-15 years*
  - *how do you get consumers to engage in their investments?*
- *Pension Freedoms*

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

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