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Unit Linked Fund Structures
Past, Present and Future

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05 May 2015

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Unit-Linked Fund Structures Working Party
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Risk and Investment Conference – 4 June 2015

05 May 2015

What we'll cover today

- Background to the Working Party (5 mins)
- 'Past' – looking at how we've got to current state (15 mins)
- 'Present' – current structures used focussing on risks of current structures (10 mins)
- 'Future' – what changes are happening in the 'UL Universe' (10 mins)
- Questions (10 mins)

And a little quiz as we go along with a (small) prize!

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Background to 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."*

- Decided that structures were important going forward and also to ensure we understand what risks customers may face as a result of different structures being used

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Background to Working Party

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 – what you can and can't invest in*
- *Prudential regulation – effectively hold face value of assets to match customer liability*

Guidance provided by the ABI forms the main requirements

- *ABI Guide of Good Practice for Unit-Linked Funds (covering governance and operational expectations for firms engaged in UL business)*

But, more recent regulatory interest:

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

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Potted History of Unit-Linked Funds:

- Most firms commenced unit-linked business in the 1980s
  - *Firms offered their own funds*
  - *Typically a mixed range of specific asset classes and 'managed funds'*
  - *Fund management performed in-house (or within the group)*
  - *Simple fund structures used*
  - *Relatively small number of funds offered*

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Potted History of Unit-Linked Funds:

- Early 2000s - Open Architecture
  - *Life company internal investment departments sub-scale*
  - *Can't compete with global investment managers*
  - *Use of open architecture 'mirror funds' becomes more commonplace*
  - *Fund of funds managers*
  - *Reinsured funds*

Potted History of Unit-Linked Funds:

- Regulation
  - *Insurance funds - governed by Solvency I rules (COBS 21 rules introduced in 2007)*
  - *Mutual funds governed by UCITS regulations*
  - *Different restrictions on investments compared to mutual funds*
  - *Greater use of fund of funds in insurance world*

Potted History of Unit-Linked Funds:

- 2012 – Auto-enrolment commences
  - *More focus on 'default' funds*
  - *Move away from traditional managed funds to fund of funds either through mutual funds or insured funds of funds*

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'Present'

The focus of the 'Present' section of the working party has been in a few key areas:

- *Benefits of insurance funds over mutual funds*
- *Customer understanding of the risks they face from different structures*
- *Reinsured Funds – what is the risk, and how real is the risk*
- *Customers being active vs passive in their choice of investment (driven by Auto-Enrolment)*

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‘Present’

Section still to be completed….

‘Future’ – UK change

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There is a huge amount of change impacting on unit-linked businesses at present. UK driven changes include:

- *Auto-enrolment commenced in 2012 and significant increase in firms on-boarding in 2015-2017*
- *DWP Charge cap applies from 6th April 2015 - how does that apply to insured funds and how will insurers comply*
- *Pension freedom and choice – what people were previously targeting (annuity) will likely need to change going forward*
- *Transaction costs disclosure – disclosure of transaction costs being incurred by funds – what happens when multiple layers and multiple pricing basis etc. Also consideration of this being included in charge cap in 2017.*

‘Future’ – UK - auto-enrolment

Auto-enrolment & charge caps:

As mentioned earlier, auto enrolment has been gaining momentum in recent years with a huge number of firms due to stage over the next 3 years.

Main issues for consideration include:

- *Members will likely be passive and different to more traditional active/advised unit-linked customers*
- *Given more passive nature, 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 only complain if it isn’t to their benefit)*
- *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*

‘Future’ – UK - charge transparency

Charge disclosure and transparency:

The DWP charge cap is an important change, but still has potential changes to contend with for years to come. Also a greater focus on charge/cost transparency and ‘rip-off pensions’.

Main issues for consideration include:

- *Multi-asset fund-of-fund structures don’t lend themselves to transparency with multiple layers to look-through – but need 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 – 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.*

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‘Future’ – Europe/Solvency II

Gabriel Bernardino, Eiopa Chair

Jerzy Buzek, President of European Parliament - signed 2009/138/EC

Jose Manuel Barroso
Former President Of
European Commission

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'Future' – Europe/Solvency II

The UK change has a significant impact, but there is also the small matter of Solvency II coming into force in 6 months on 1/1/2016.

Solvency II has a couple of significant changes coming into force which impact on unit-linked funds and structures used:

- *Close matching of unit-liabilities*
- *Look-through requirements*

'Future' – Europe/Solvency 2

Close matching of unit-liabilities

Close matching rules don't change under solvency 2 – firms have to closely match 'technical provisions' under S1 and SII, but the 'technical provisions' will change:

- *S1 technical provisions are the unit-liability*
- *SII technical provisions are loosely unit-liability – value of future profits*

The capital of the firm will be invested in unit-linked funds and be at risk of market movements – a choice will need to be made by firms as to which risk they would prefer – market risk or persistency risk. If firms choose to 'go short' the structures might impact on their ability and the ease with which they can do so.

Look-through requirements

Firms are required to 'look-through' their unit-linked funds to understand which assets they actually have exposure to. A simple UL operation should find this easy – if you link to lots of external managers, this could be challenging, and if you offer fund of funds this becomes even more challenging.

Firms are unlikely to get 100% coverage – and will have to contend with potential for many different data inputs – direct from managers, Morningstar, Silverfinch. Current indications are that many firms will require all 3 approaches to get sufficient coverage and will also require the agreement of multiple NDAs with the fund managers they link to.

What next for unit-linked funds?

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- *Unit–linked funds will continue to be a very important part of the insurance industry going forward – it has taken 30+ years to reach £1Trn of assets, but how long until it reaches £2Trn?*
- *Auto-enrolment will drive significant flows into unit-linked funds, with those flows being split into insurance funds and mutual funds in the background*
- *Charge and cost disclosure will have a continued focus from Government going forward and the industry needs to prove it is being open and transparent in this area – this does conflict slightly with the aim of trying to provide innovative investment solutions to customers*

- *Solvency II will likely have a significant impact, but it make take time for the changes from that to bed-in*
- *There is the potential for innovation with the change in close matching, but will costs and risk of doing so outweigh the benefits?*

- *Unit-linked governance and operational needs actuaries to support this work – those experienced in this area will understand that what appears simple on the outside is complex under the bonnet. Actuaries have the required skills to work through the issues and get the ensure the right outcomes for customer are a key focus.*

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Questions

Comments

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.

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