The Actuarial Profession
making financial sense of the future

Treating Life Customers Fairly

2006 Life Convention, Glasgow

Life TCF Working Party

Treating Customers Fairly - Agenda

Background

- **FSA and industry statements**
- **Working party approach**
- **Implications of TCF for firms**

Sample Applications

- Reviewable premiums
- Unit linked discretionary charges
- Non profit surrenders
- Product suitability

Generic Conclusions

- The role of the Actuary
- Small blocks of business
- Governance

The Actuarial Life TCF Working Party

Steve Dixon
John Elwood
Dave Grimshaw
Alan Morris
Ashley Rebello
Phil Roberts
Jerry Staffurth

A date for your diaries:

13th March 2007

Staple Inn Actuarial Society

FSA Principle 6

"A firm must pay due regard to the interests of its customers and treat them fairly"

The FSA has encouraged the Principle to be implemented in a number of ways

- COB 6.10 to 6.12 (with profits business)
- Arrow visits
- Themed investigations (mystery shopping)
- Publications addressing specific issues (Statement on variation clauses)
- Several key speeches
- DP 06/04 (covering the roles of provider and adviser)
- ABI Industry Guidance (Unit pricing, reviewability, critical illness)

TCF influences all stages of the product life cycle

Communication to policyholders

Product Design → **Sales Process** → **New business** → **Renewals** → **Claims**

Actuarial Profession's Working Party on Life TCF:

Steve Dixon
John Elwood
Dave Grimshaw
Alan Morris
Ashley Rebello
Phil Roberts
Jerry Staffurth

TCF therefore affects many areas of strategy and financial management….

Embedded values

ICA – risk assessments

Product development strategies

TCF

Statutory Valuations and FSA Returns

Assessing new strategic options

M&A – risks and valuation

Firms have been addressing TCF requirements in various ways……

- TCF projects and committees
- Gap analyses
- TCF leaders / experts
- Embedding TCF into processes (e.g. product design and literature)
- Raising awareness amongst all staff

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Example - Reviewable premiums

- Generally applies to Critical Illness and Income Protection business and less commonly Term Assurance
- Reviewable premiums offer advantages to consumers in the form of lower premiums and the ability to offer covers that would otherwise be uninsurable
- Considerations differ as, typically, mortality has improved but morbidity may have deteriorated. The range of variability may also differ substantially
- For new business, the position is improved if the reviewability is set out prominently including an explanation of how, when and why reviews will occur
- Regulations and guidelines already exist in this area:

The Unfair Terms in Consumer Contracts Regulations 1999

The FSA Statement of Good Practice on variation clauses in consumer contracts

The ABI's "Advice on practical aspects of unfair contract terms for non-investment protection policies with reviewable premiums

The challenges can be greater for in force business….

- Reviews may not have taken place in the past and there may not be clear processes for how the reviews should be carried out
- Does a firm need to review rates downwards if its original intentions were that rates would only be reviewed upwards?
- Reinsurers may not be subject to the same TCF constraints and could enforce changes which insurers may not be able to pass on to customers
- Practical considerations include:
  - Reviews should not lead to greater profit margins than in the original pricing basis (which has often not been documented anyway!!)
  - Unless explicitly stated, reviews should not be recovering past losses but reflecting future expectations
  - Future expectations will be based on the insurers recent experience, but what if poor experience is due to weak underwriting processes etc.?
  - How should insurers deal with experience by different rating factors and other sub-groups?

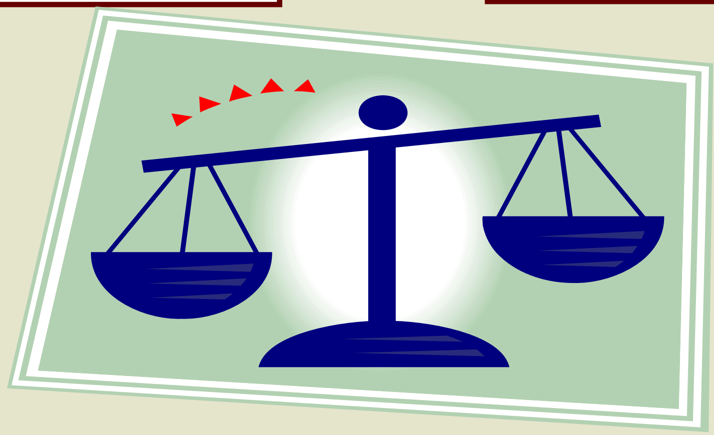
Reviewable premiums - is the balance right?

“Consumer protection gone mad”

- Policies have always stated that premiums are reviewable
- Consumers may not expect insurers to reduce premium rates
- Consumers accept similar reviews in other areas, such as changes to the mortgage rate

“Insurers have got away with too much for too long”

- Policies stated that companies would review experience – but they haven’t done so and no systems were put in place or principles set out
- Insurers treated reviews as a one-way option against their customers
- Little external validation (e.g. interest rates)



Example – Unit linked discretionary charges

- Interaction with Unfair Contract Terms Directive
- Is it a one way or two way option?
  - Can increase charge or set charge at any time to different level
    - Unfair Contract if only one way?
- Examples:
  - Annual management charge in unit price;
  - Policy fee deduction from premium;
  - Policy fee deduction from units;
  - Mortality / Risk deductions from units;
  - Charges in unit fund for expenses, taxation and interest on overdraft.

Two way option

- Need to establish formal review process
- Need a starting point
  - Note the Ombudsman decision on reviewable premiums
  - Can only increase premiums if returning future profit to level previously foreseen
  - Not allowed to recover past losses
  - Profitability reports when plan established
- What do you do if documentation lost?
  - Redo?
- Can you increase charges to cover losses on other items of the basis?
  - Annual management charge for losses on mortality?
  - What is charge for and how has it been described to customers.
- Need to reduce charges now
  - Mortality fallen;
  - Productivity improvements

Impact on technical provisions, solvency, ICA

- Real area of concern for many actuaries
- Technical provisions:
  - Probably limited other than margins on charges;
- Solvency margin:
  - Annual management charges are limited if cannot increase charges
  - Less of an impact now of switching to 1% of funds under management from 25% of expenses
- ICA
  - Freedom of management actions reduced
- Embedded value
  - Ensure allow for reduction of charges to remove profits due to mortality changes or improvements in productivity.

Example - Non profit surrender values

- Different considerations for unit linked and conventional business
- Often applies to small classes of business and historic surrender bases that haven’t changed for many years
- Need to reflect policy documentation and other policyholder communications
- Should the surrender value be a prospective or retrospective value?
- Should current values be included with annual benefit statements (as would be expected for unit trusts etc.)?
- What about if there is a history of penalising non profit surrenders and crediting the surplus to with profits business – can we be fair to both groups?

Product suitability – Critical Illness

- The product has a number of issues but the most fundamental is that it often fails to meet customer needs – paying out large amounts for “relatively minor” events and nothing when it can be really needed;
- Often sold with a mortgage – where the real need is for mortgage payments to be maintained;
- CI doesn’t cover many events that can lead to long term disability (stress and musculo-skeletal are main examples)
- Do customers understand what they are buying?
- 25% of claims are declined – possibly indicating that customers don’t understand the product
- Income protection arguably meets needs better in most circumstances

- So, should companies be offering CI?
- Or can they argue that it is better than nothing?

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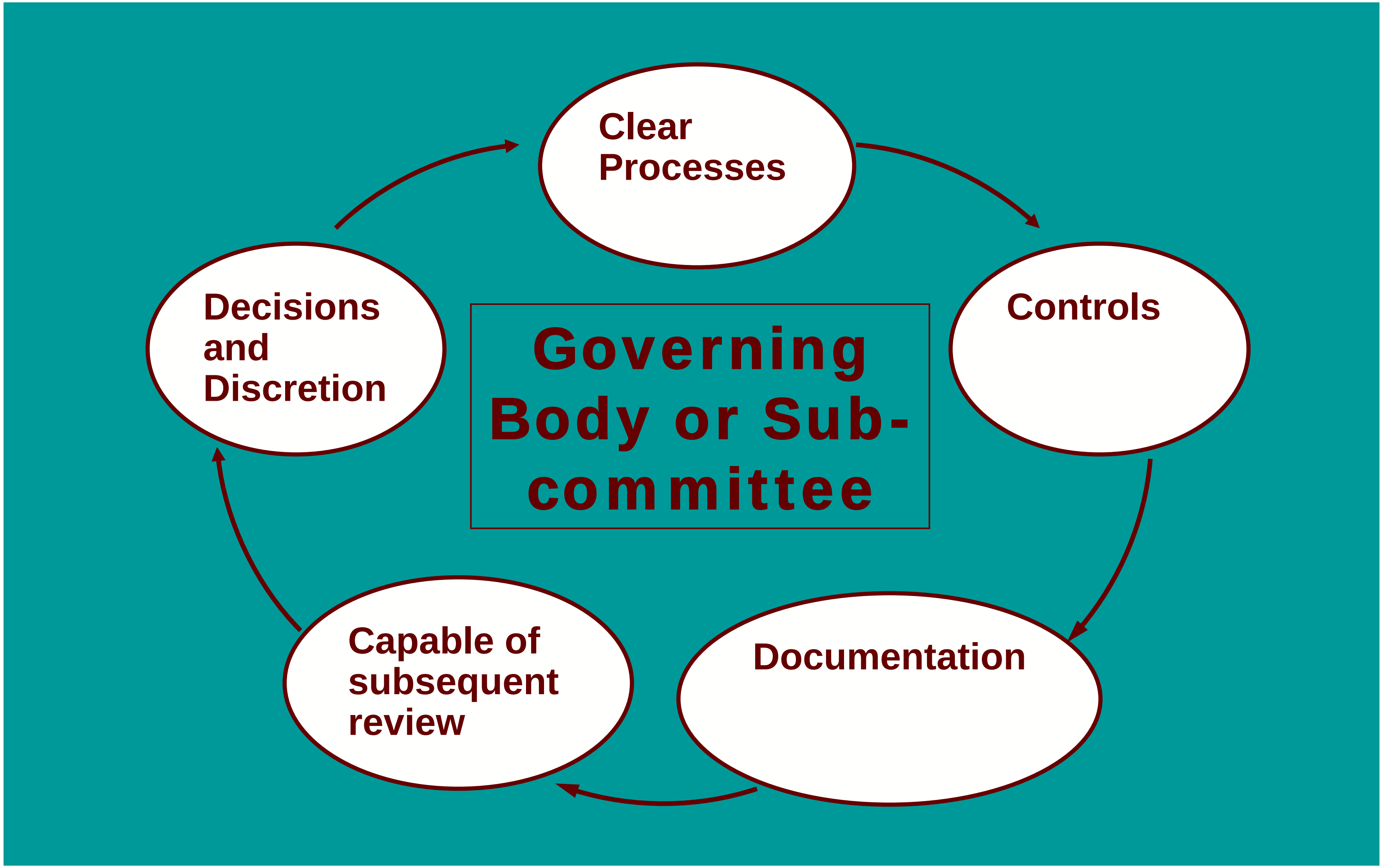
Strong Corporate Governance is vital to avoid future problems



The Role of the Actuary

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- Should the Actuary still take this responsibility or should it now be the Board?

There are specific considerations for Small Blocks of Business

- Governing Bodies need to consider how TCF is applied to small blocks of business
- The expenses involved often make it impractical to apply the same approaches and levels of consideration
- Are some customers being “treated less fairly than others”?
- A recent SIAS paper considered this in respect of closed funds (Pallister et al), concluding that outsourcing and / or the merging of blocks of business are a partial solution
- Other steps can be taken, such as merging internal linked funds, but this would require careful consideration of TCF issues itself

Governing Bodies could consider introducing PPFMs for Non Profit and Unit Linked Business

PPFMs would cover the main areas of discretion such as……..

Non Profit PPFM

- Approach to Surrender values, PUPs and other alterations
- Premium review clauses
- Application of discretion in options and guarantees
- Claims management
- Communications with policyholders

Unit Linked PPFM

- Unit pricing practices
- Investment strategy (where not specified in product literature)
- Discretionary charges
- Application of discretion in guarantees and options
- Communications with policyholders

The Governing Body would need to agree how formal the PPFMs should become

Areas to be considered include…………

Should they be made public or retained as internal documents?

- Increased consumer confidence and awareness
- Reduced flexibility and additional costs

What restrictions should exist when changes are required?

- Increased consideration of changes
- Reduced flexibility and additional costs

Should the application be subject to external or independent review?

- Greater consumer confidence and improved governance
- Additional cost and burdensome processes

Questions and Discussion