Institute and Faculty of Actuaries

TR16/2: Fair Treatment of Long-Standing Customers in the Life Insurance Sector

IFoA response to the Financial Conduct Authority

3 June 2016

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

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The Pensions and Retirement Income Themes Team
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Financial Conduct Authority
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3 June 2016

Dear Sirs

IFoA response to FCA Thematic Review TR16/2: Fair Treatment of Long-Standing Customers in the Life Insurance Sector

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the FCA's proposals arising from its thematic review of long-standing customers in the life insurance industry. This response has been written by members of the IFoA's Life Standards and Consultations sub-Committee and Life Board.

2. The actuarial profession has extensive and long-standing experience in the design, pricing and ongoing management of life insurance products, including operation of both unit-linked and With Profits funds. As the FCA will be aware, many of our members have the statutory role of With Profits Actuary (WPA). WPAs advise on the fair management of With Profits funds, including taking into account the interests of different With Profits policyholders. Accordingly, we believe the profession has an important role to play in this thematic review, and we would welcome the opportunity to discuss our response with the FCA.

3. The questions ask whether we have any comments on the draft guidance produced for each of the 14 sub-outcomes identified. Where we have not responded to a question, this means that we do not have any substantive comments on the draft guidance.

4. The IFoA agrees that closed book customers, who have life insurance products which are now closed to new business, should be treated fairly, and that this should be properly reflected in the firm's strategy and its outsourcing arrangements. However, in many cases the costs of more complex analysis of data/ presentation of results to policyholders would be borne by these policyholders themselves. The IFoA would be keen to engage with the FCA on this matter, as we feel there must be a balance to be struck between a uniform style for all firms, of presentation and analysis, and what is a sensible cost/benefit for a given firm or With Profits fund. We note this tension in a number of our responses below where we are concerned that the suggested guidance could prove more costly to, rather than informative for, policyholders of many firms or funds. We also note a number of practical challenges with some of the FCA's proposals below, particularly in relation to With Profits funds.

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Question 1: The firm's overarching strategy, including any outsourcing arrangements, takes proper account of the fair treatment of customers?

5. We agree that it may sometimes be necessary for a firm to go beyond a strict adherence to terms and conditions in order to treat its customers fairly. However, we would also note that conditions today are not the same as applied in the past and there are clear dangers to applying 'hindsight regulation' to past generations of products. If a product were fairly priced, and fairly sold, in the context of the regulations that applied at the time, then it seems reasonable to presume that the outcome will be fair, provided the product has been operated as intended, and there has been clear communication at the appropriate points. There is a danger that providers of capital to the life insurance industry could be deterred if they believe there is a risk that the goalposts are shifted and apply today's standards to past business.

Question 5: Regular communications to customers provide them with sufficient information to make informed decisions?

6. The draft guidance points towards an annual statement which builds up the closing policy value from the opening value, the premiums paid, the costs incurred and the investment returns earned. Whilst this approach should work for a unit-linked policy, it could prove problematic for With Profits policies, particularly conventional With Profits policies. The suggested presentation in your guidance may give policyholders the impression that they have a segregated pot of assets, to which investment returns are added at an individual policy level. With Profits policies operate on a pooled basis, and contain other features such as smoothing, guarantees and estate distribution, all of which makes the position far more complex than this.

7. We therefore suggest that the guidance recognises alternative approaches that may be adopted for With Profits policies, possibly by disclosing generic information regarding the costs and returns associated with the With Profits fund. Generating information at an individual policy level could require considerable systems development, the costs of which might be borne by the With Profits policyholders. It is not clear that such costs would be justified, particularly if the resulting output presented an overly simplified impression of how a With Profits policy works.

Question 6: Communications to customers at the time of key policy events are clear, accurate and enable them to make informed decisions?

8. As above, we feel it may be difficult to present charges in pounds sterling amounts for With Profits policies, and it would be helpful if the guidance could recognise that other approaches may be appropriate.

Question 8: The firm takes effective action to locate and make contact with 'gone away' customers?

9. The IFoA agrees that insurers should have effective processes in place to maintain contact with customers, and we agree with the core thrust of the proposed guidance. However, we feel that some of the additional tracing activities suggested, such as using heir hunters or professional genealogists, would only be suitable in exceptional circumstances. In the case of closed With Profits funds the likelihood is that the other policyholders will be meeting the costs of any activity, which therefore needs to be reasonable and proportionate.

Question 10: Overall expenses are allocated fairly to closed-book products?

10. We believe that benchmarking expense allocations to those of other insurers could be difficult in practice. Benchmarking against other firms with different product mix and expense base / allocation policies may not give a consistent comparison, and any conclusions reached from such analysis could be of limited value or potentially spurious; the potential variety of expense arrangements could make it very difficult to compare like with like. For example, many With Profits funds will be charged on a per policy basis, but the per policy charge may or may not include many 'extras' such as being non-reviewable, or covering the costs of change activity as well as core services. It would be helpful if the guidance could recognise these points, as otherwise With Profits funds (and hence policyholders) may have to bear costs for carrying out benchmarking investigations that may ultimately result in more questions than answers.

Question 11: The firm regularly reviews the overall fairness of cost allocations and actual customer outcomes and applies a consistent basis for these reviews?

11. The draft guidance suggests that firms should have a regular cycle for reviewing actual customer payouts on all policy types, and should assess payouts relative to what a well-informed customer might reasonably expect from their investment over its full lifetime. It also suggests that firms might consider whether payouts are providing positive real returns to customers, and also how payouts compare to what might have been achieved in alternative investment portfolios (such as managed or other unit-linked funds), with comparable mixes of assets.

12. Whilst it seems reasonable that firms should broadly understand how their products have performed, and the reasons for that performance, it is not clear from the guidance what they are expected to do about it. Forward looking action to correct identified issues (such as sustained below benchmark investment performance) would seem reasonable. However, we would propose that the guidance should make it clear that there is no suggestion that firms' customers had been treated unfairly, or should somehow be compensated because they could have obtained a better return from a different fund or a different product, if their existing fund and product had been properly operated. Any such suggestion would otherwise amount to 'regulation by hindsight', and could seriously undermine the industry and its ability to provide long-term savings solutions.

13. Benchmarking payouts on With Profits policies is particularly difficult, as the funds and products contain features, such as guarantees and estate distribution, which are not necessarily comparable. Many With Profits funds had to reduce their holdings of equities in the 2000 to 2003 period in order to ensure that they could meet the guarantees they had provided. This may mean that some policies will not produce a real return after inflation because the funds do not have sufficient resources to provide both nominal guarantees and real returns. Provided that appropriate customer communications have been made along the way, we do not believe that such circumstances should be construed as having produced unfair outcomes. It would be helpful if the guidance could recognise that different With Profits funds have very different histories which should be allowed for when assessing outcomes.

Question 12: The firm proactively monitors the actual experience of its closed-books of business and consistently passes on benefits and costs to customers, to the extent permitted

by policy conditions?

14. In principle, we support the suggestion that mortality and other risk charges should be subject to review, with modification as appropriate in the light of evolving experience. This should allow for the differing experience of differing cohorts of customer, where data allows. As noted by the FCA, any charges applied should reflect the specific characteristics and experience of customers in closed book products.

15. However, although terms and conditions on collective investment vehicles and bank accounts are regularly changed by firms, insurance products have, traditionally, not changed terms and conditions even if the change has been necessary to protect the firm against very poor experience. Changing terms and conditions on insurance products if experience has been favourable, does therefore seem one-sided.

Question 13: Exit and paid-up costs are not excessive and are not driving poor customer outcomes?

16. The IFoA agrees with the principle that customers should not face unreasonable barriers to exit or making their policy paid-up, particularly if their current product is no longer suitable for their circumstances.

17. We also support the principle that insurers should assess whether exit or paid-up charges are not excessive or disproportionate; and that insurers should then take appropriate action where necessary.

18. We recognise that where exit fees are applicable, they will predominate in products designed in the 1980-90s or earlier; many such products would charge a fee on early exit to recover initial set-up costs. The product environment has undergone considerable change since then, but that does not mean that it has become unfair for insurers to recover costs they have incurred. We therefore welcome that the guidance refers explicitly to excessive or disproportionate exit charges. In a closed With Profits fund, the cost of unrecouped expenses would have to be borne by other With Profits policyholders

19. Exit charges linked to providers' current administrative costs of exit would also not appear excessive or unfair, if disclosed.

Question 14: Target ranges for With Profits pay-outs appear reasonable and firms meet these target ranges without the variation of pay-outs being too wide?

20. The IFoA supports the principle that insurers should monitor payouts on their With Profits policies, and ensure that payouts are fair to all classes of With Profits policyholder, including those in closed-book policies.

21. The draft guidance indicates that the FCA expects payout ratios to narrow over time. We note that the operation of many With Profits funds is constrained – for example, such as adhering to the relevant Scheme of Demutualisation. Even where there is flexibility to reduce the width of payout ratios, narrowing the ratio may have unintended consequences, and could reduce the degree of smoothing of payouts over time. Narrow target payout ratios could also reduce the degree of investment freedom, which may then reduce payouts overall. It would be helpful if the guidance could make it clear that FCA is not attempting to force firms to narrow payout ranges if this would require changes to investment strategy or smoothing policy.

22. We do not agree with the FCA view that improved systems and targeting processes should allow payout ranges to be narrowed over time. By their very nature, With Profits funds operate by pooling experience across customers. In closed funds the inherent level of diversity is now ‘locked-in’ and cannot be changed, unless firms were to change fundamentally the way the funds operate. Furthermore, it is possible that the amount of diversity will increase as funds become smaller and the data for the remaining policies becomes more sparse and widely distributed. In such cases, the fair outcome may be to provide smooth and predictable outcomes for policyholders, rather than forcing larger changes in payouts to hit a narrow target range. It would be helpful if the guidance could recognise these points.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely,

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President-elect, Institute and Faculty of Actuaries