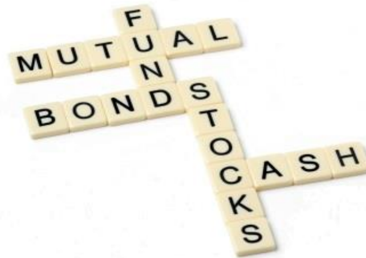
Knowledge based solutions



Research Update: November 2013

Thematic Review of Unit Linked Funds: FCA Findings (TR 13/8)

Unit-Linked Funds

George McCutcheon MSc FIA discusses the findings of the FCA thematic review.

Background

The FCA published in October the findings of its thematic review of unit linked funds. In this research update, George McCutcheon discusses some of the key issues in more detail, following on from the short summary published by FRS on October 10th.

Key Outcomes for Life Companies

- There will be no change to the Financial Services Handbook regulations arising from the thematic review.
- The FCA will work with the Association of British Insurers (ABI) which has committed to enhance its 'Guide to good practice for unit-linked funds' in light of the thematic review findings. This will make it clearer what good practice looks like and help introduce improvements across the whole of the unit-linked industry.
- Firms are required to report all unit pricing errors and permitted links breaches, not just material ones, to the FCA.
- For the purposes of compliance with permitted links rules, it is not necessary to look-through authorised collective investment schemes to ensure that the underlying assets are themselves permitted links.

Background

The FCA's Thematic Review of the management and governance of unit-linked funds commenced in Q4 2012.

The thematic review was to assess whether:

a. Firms have adequate systems and controls in place to ensure that funds are administered and managed fairly and in accordance with customer expectations;
b. Assets backing unit-linked policies are appropriate for policyholders; and
c. Policyholder benefits are calculated fairly and accurately."

The reason for the thematic review was that the FCA wanted to check that firms were meeting its standards and treating customers fairly given the size and importance of the unit linked funds market. The catalyst for the thematic review was the FSA's 2012 Retail Conduct Risk Outlook where the FSA had identified one of the key emerging risks for life insurers as the concern that some insurance firms have poor governance and control practices around their unit linked funds.

Speaking at an ABI conference in July 2013, the FCA chief executive Martin Wheatley highlighted some key issues:

a) Are firms allocating a fair proportion of revenue received from stock-lending to the fund or are they recycling too much to the shareholder?
b) Are providers of unit-linked funds managing them in line with the stated investment objectives?
c) Are they transferring counterparty credit risk from reinsured funds to policyholders without asking them and without obtaining their express consent?

The FCA reviewed 12 firms, which between them manage a significant proportion of the total amount invested in unit-linked funds. It selected a broad range of firms of varying size, type and business model to ensure it was a representative picture of the sector as a whole.

Copyright © 2013 Financial Risk Solutions Ltd. All rights reserved.

Overview of FCA Findings

> 'We found no material issues throughout our sample of firms that posed a serious threat to customers' investments'
>
> 'We found specific material problems in individual firms'

The findings represent a relatively clean bill of health for the UK life industry particularly when viewed in the context of the reports of other FCA thematic reviews. However media headlines were unflattering.

> 'FCA uncovers specific failings in unit-linked fund probe'
> 'FCA demands insurers review unit linked fund failings'
> 'FCA probe uncovers insurer unit-linked fund failures'
> 'FCA finds material problems in £900bn funds review'

The FCA findings on its thematic review of unit linked funds are consistent with Financial Risk Solutions (FRS) original expectations. In our Research Update of April 2013 we stated that "FRS anticipates that the thematic review findings will confirm that the governance of unit-linked funds in in general robust but that some issues might be identified where there is scope for improvement". Potential issues for improvement identified in the FRS Research Update included governance structure, counterparty credit risk, outsourcing and historic pricing and these broadly correspond to the substantive issues identified in the FCA findings.

Executive Summary of FCA Findings

- The FCA found no material issues evident throughout the sample of firms that could have posed a serious threat to customers' investments. So it does not believe there are any significant widespread, systemic failings in the sector.
- The FCA did find some specific problems in individual firms, which if left unchecked could have led to customers being disadvantaged:
  - Poor oversight of an outsource service provider;
  - Insufficient controls over permitted assets; and
  - Overly-stretched operational capacity in a pricing team.

  In these cases, the FCA required Skilled Persons Reports to investigate whether customers have lost out and whether compensation is required. The FCA required the firms to make improvements in response to the detailed findings and much of this work has now been completed
- The FCA also found other areas where firms in general need to make improvements to ensure that customers are treated fairly:
  - Fair allocation of tax and stock lending revenues between customers and shareholders;
  - The identification and rectification of errors; and
  - The management of potential conflicts of interest.

FRS Comment

In the FRS April 2013 Research Update on the FCA thematic review, we suggested inter alia that the FCA might place special focus on issues such as:

- Outsourcing -Undue reliance on the outsourcer i.e. inadequate oversight of outsourcing within the insurer

Copyright © 2013 Financial Risk Solutions Ltd. All rights reserved.

- Counterparty risk – Reinsured funds
- Historic Pricing - Potential customer detriment
- Mirror Funds

Most of those items have emerged as significant.

In this research piece Financial Risk Solutions discusses some of the key issues arising:
  - Outsourcing
  - Conflicts of Interest
  - Reinsured Funds
  - Historic Pricing
  - Securities Lending

Outsourcing
The FCA rules on outsourcing for insurers are in the FCA Handbook SYSC 3, with additional guidance in SYSC 13.9. Outsourcing may affect a firm's exposure to operational risk through significant changes to, and reduced control over, people, processes and systems used in outsourced activities.
Key FCA rulebook provisions include:
  - Firms that outsource operations to third parties retain responsibility for all obligations to their customers and compliance with regulatory requirements;
  - A firm is required to obtain sufficient information from its outsourcers to enable it to assess the impact of outsourcing on its systems and controls;
  - A firm cannot contract out its regulatory obligations and should take reasonable care to supervise the discharge of outsourced functions;
  - A firm should not assume that because a service provider is either a regulated firm or an intra-group entity an outsourcing arrangement with that provider will, in itself, necessarily imply a reduction in operational risk.
  - A firm should consider whether the agreements establishing the arrangement will allow it to monitor and control its operational risk exposure relating to the outsourcing;
  - A firm should have regard to reporting or notification requirements it may wish to impose on the service provider;
  - A firm should have regard to whether sufficient access will be available to its internal auditors, external auditors or actuaries and to the appropriate regulator.

FCA Findings on Outsourcing
The FCA identified some failings in the oversight of outsource service providers in approximately half of the firms in the sample as follows.
  - The extent of oversight activity conducted by operational management varied considerably.
  - The level of assurance work undertaken by functions such as Risk, Compliance and Internal Audit varied. In half of the firms the level of assurance provided by control functions was insufficient given the nature, scale and complexity of their operations.
  - There was 'Informal' reliance on group control functions to provide assurance on the effectiveness of controls in the outsource service provider (for intra-group outsourcing).
  - 'Chains' of outsource service providers led to gaps in accountability which posed risks to customers.

FRS Comment on Outsourcing
Outsourcing issues are addressed by the EIOPA guidelines on the System of Governance. The EIOPA guidelines include provisions on outsourcing including the requirement for firms to designate a person within the undertaking with overall responsibility for the outsourced key function who is fit and proper and possesses sufficient knowledge and experience regarding the outsourced key function. Whilst the level of knowledge required would not need to be

Copyright © 2013 Financial Risk Solutions Ltd. All rights reserved.

as in depth as that of the relevant person(s) at the service provider, at a minimum the person has to possess enough knowledge and experience regarding the outsourced key function to be able to challenge the performance and results of the service provider. For fund administration, this would require that the person have specialist knowledge of key business processes such as unit pricing, unit appropriation, fund accounting, fund taxation, etc.

The key action points for life companies will be:

- Potential need to deploy more internal resources in monitoring outsourcing;
- Increased focus on the crucial importance of an appropriate designated person within the undertaking – expertise and experience is crucial;
- Control functions need to assess adequacy of controls in the outsource service provider (rights to do this to be covered in outsourcing contract) and also internal operational management controls; and
- Less reliance on group control functions as guidelines on the System of Governance apply to the undertaking;
- Reduce number of chains of outsourcers.

Conflicts of Interest (CoI)

Conflicts of interest are not directly addressed in the ABI Guide. Section 3.1.5 states, in the context of the use of discretion in managing the fund, that

"Robust and effective reporting structures should be in place to allow the Board to monitor the exercise of this discretion on an on-going basis, to ensure that policyholder interests are safeguarded".

The issue of conflicts of interest is addressed in the High Level Standards of the FCA Handbook under Principles for Business PRIN 2.1. Principle 8 states:

"A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client."

Consumer Protection Legislation would typically [1] include provisions relating to conflicts of interest relating not just to managing such conflicts but also to the identification of circumstances that might give rise to a conflict of interest.

FCA Findings on CoI

The review found that firms typically relied on generic firm, or group, conflicts of interest policies to manage their conflicts which were inadequate for purpose. This resulted in a lack of awareness amongst the senior executives of the nature of conflicts of interest that could arise in respect of unit-linked business.

The FCA found that half of the firms in our sample did not fully consider specific unit-linked conflicts of interest even though potential conflicts did exist, for example:

- The 'seeding' (i.e. the provision of initial working capital) of new funds with shareholder capital or other customer funds.
- An insurer making use of the with-profits fund or inherited estate to support its unit-linked business

Although the FCA considered that some firms were not doing enough to demonstrate they were managing their conflicts of interest, it did not find evidence of any issues which were posing a serious threat to customers' investments.

[1] The Consumer Protection Code 2012 (Central Bank of Ireland) states:

"3.28 A regulated entity must have in place and operate in accordance with a written conflicts of interest policy appropriate to the nature, scale and complexity of the regulated activities carried out by the regulated entity. The conflicts of interest policy must:

a) identify, with reference to the regulated activities carried out by or on behalf of the regulated entity, the circumstances which constitute or may give rise to a conflict of interest entailing a risk of damage to the interests of its customers who are consumers; and

b) specify procedures to be followed, and measures to be adopted, in order to manage such conflicts."

Copyright © 2013 Financial Risk Solutions Ltd. All rights reserved.

FRS Comment on CoI

The FCA would have expected to see documented CoI policies and documented CoI procedures specifically relating to issues for unit-linked funds with particular reference to transactions between shareholder funds, with-profit funds or non-linked funds with the unit-linked funds and transactions between unit-linked funds and other group entities.

The expectation is that the ABI Guide will be extended to directly address CoI policies specifically relevant to unit-linked funds.

It was a bit surprising that EIOPA didn't as part of the consultation process on the guidelines on the System of Governance accept the Insurance and Reinsurance Stakeholders' Group (IRSG) proposed amendment to Guideline 9 according to which procedures are to be established and communicated by the undertaking for the identification and management of potential conflicts of interest in relation to governance. Instead EIOPA say that conflicts of interest are expected to be covered by the draft Implementing Measures.

Reinsured Funds

The issue is whether firms are transferring counterparty credit risk from reinsured funds to policyholders without asking them and without obtaining their express consent.

Whilst firms can invest in external collective investment schemes, they cannot directly invest in other insurers' unit-linked funds and hence they need to enter into reinsurance contracts with other insurers in order to provide access to funds offered by other insurers.

In order to comply with FCA rules firms should:

- Disclose to customers the implications of any credit risk exposure they may face in relation to the solvency of the reinsurer, and
- Suitably monitor the way the reinsurer manages the business in order to discharge its continuing obligations to customers

Reinsurance can expose customers to additional risks, particularly the financial failure of the reinsurer, where the firm has sought to 'pass on' to customers the risk of the reinsurer's failure through their policy wording and disclosures. If the reinsurer suffered financial failure, the customers of the primary insurer would not be covered by the Financial Services Compensation Scheme (FSCS) because their contract is with the primary insurer and the FSCS would only cover them for failure of that firm and not the failure of the reinsurer.

If the primary insurer's policy wordings are silent on reinsurance credit risk exposure, the FCA view is that the risk continues to fall on the firm. This would particularly be the case where documentation states 'this policy is covered by the FSCS' without any further qualification. The FCA does not accept that it is inherent in the general nature of unit-linked business that customers should bear this risk.

FCA Findings on Reinsured Funds

Of the firms who entered into reinsurance arrangements, the FCA found that most agreed to pay out to the customer regardless of whether the reinsurer fails i.e. they did not pass the counterparty credit risk to the customer. Where the customer was exposed to the risk, the FCA identified one firm where, although it was clear in the policy documentation that the customer held the risk, the firm needed to improve its accompanying marketing material to ensure that customers fully understood the extent and nature of the FSCS protection.

The FCA are aware that there is an increasing trend to pass on the reinsurance counterparty credit risk to customers, at least in part prompted by the anticipated Solvency II capital requirements for holding counterparty credit risk.

FRS Comment on Reinsured Funds

Firms seeking to vary customers' policies to achieve this transfer of risk would need

- Clear contractual powers (consistent with the requirements of the Unfair Terms in Consumer Contracts Regulations, 1999) to make such a change; or
- Informed, express consent from customers

Under the former, firms would also need to demonstrate to the FCA that any action which they propose to take complies with the Principles for Businesses, in particular Principle 6 (treating customers fairly) and Principle 7

Copyright © 2013 Financial Risk Solutions Ltd. All rights reserved.

(information needs of customers) because in the FCA's view the transfer of this risk would be a significant change in the nature of what customers had committed to.

Historic Pricing
Historic pricing is where unit-prices are based on asset values calculated at a historic valuation point. This is in contrast to forward pricing where prices are based on the next valuation point. The use of historic pricing can be exploited by customers with market knowledge who can strategically deal to their own advantage – and potentially to the detriment of the fund and other customers.

FCA Findings on Historic Pricing
The FC identified serious issues of funds operating on a historic pricing basis with no, or very few, controls to protect customers. In a third of the sample firms, the FCA identified concerns (of varying degrees) about historic pricing. The FCA found that the firms in the sample that operated historic pricing were lacking, or had limited, controls. Some firms were complacent about this risk and simply relied on the nature of their customer base (whether that be 'unsophisticated' or, contrastingly, 'professional') as a rationale for not having robust controls.

FRS Comment on Historic Pricing
The ABI Guide includes:
"4.3.8 Where a firm identifies a significant movement in asset values based on interim price information or proxy data since the last pricing point, the firm should consider whether, in the interests of its customers, it should continue to execute orders at the historic price, or move to update the price/unit valuation in advance of the next scheduled pricing point. Amongst the factors to take into account in choosing to do so will be the terms at which the company, fund and transacting customers deal with each other" and
"4.3.9 Where a firm transacts on the basis of historic prices and/or asset valuations, then certain additional safeguards should be considered, both to protect against strategic dealing activity and to ensure fairness to policyholders." Moving to a forward pricing model is one of such safeguards.

It will be interesting to see how a revised ABI Guide might deal with the issue of historic pricing but in the light of the FCA findings the industry might consider it to be an opportune time to move to an exclusively forward pricing basis (or else proceed on the basis of historic pricing being applied only to liability unit transactions between the company and customers with forward pricing being applied to asset unit transactions between the company and the fund with resultant profits/losses for the company (or with-profit policyholders in the case of a mutual) on the unit matching process). This is another potential conflict of interest between unit-linked policyholders and shareholders (or with-profit policyholders in a mutual) which we would expect to see addressed by the unit-linked governance committee.

Securities Lending
The FCA states:
"Although legally the assets lent belong to the insurer, they have been purchased with money provided by customers and, therefore, those customers are entitled to a fair share of the stock lending revenues and to be reasonably protected from the risks involved".
In broad terms, the FCA rules require that:
• If the customers' fund bears any risk, the extent of this must be disclosed to them
• If the fund bears the risk, then the fund should receive all recompense (less fees and expenses) or
• If the risk is borne outside the fund (e.g. by the firm), then the fund should receive 'fair and reasonable' recompense

FCA Findings on Securities Lending
The FCA found that most firms allocated a fair share of revenues from stock lending to the fund. However, two firms were unable to clearly justify that the share of revenues allocated to their unit-linked funds was fair as their stock lending revenues were based on a common pool of assets (e.g. shared between with-profits and unit-linked funds) and not appropriately segregated.
In one firm, the FCA found that customers were not receiving a 'fair and reasonable' level of recompense. The firm

Copyright © 2013 Financial Risk Solutions Ltd. All rights reserved.

itself indemnified the fund against the risk and employed a sister company, from the same group, to oversee its stock lending operations. The FCA considered that the firm received a disproportionately high share of revenues (relative to the risk it was accepting) and its sister company also received a disproportionately high share (compared to the commercial cost of the services it provided). This left the customers in the fund with a share that, in the FCA's view, was not 'fair and reasonable'. Following discussions, the firm reviewed, and increased, the share of revenues allocated to the fund.

FRS Comment on Securities Lending

It is somewhat surprising that the FCA qualifies the securities lending issue by referencing the legal status of the assets because unit-linked assets are generally understood to be policyholder assets. Securities lending has proved to be a controversial area particularly where the fund bears the risk but receives only part of the securities lending revenues. It is particularly problematic where the amount of fees and expenses is not clear and is subject to the discretion of the insurer as illustrated by the specific FCA example referenced. This issue is compounded by the absence of FCA rules on what constitutes a fair allocation of revenues. The concept of the insurer itself deciding what an appropriate level of fees and expenses should be with no disclosure required represents a potential conflict of interest.

In the FRS Research Update of August 2013 on Securities Lending we stated:

"In a similar way to Section 4.1.1 of the ABI Guide, which states that the unit pricing mechanism should not be used as a deliberate means of extracting value from the fund or from policyholders, the expectation is that firms should not have operational processes (such as securities lending) within their unit linked funds which could be interpreted as a means of extracting value from the fund or from policyholders".

We would expect extensive discussions between the FCA and the ABI on specific guidance on fair allocation of securities lending revenues to ensure that customers are treated fairly.

Biography; George McCutcheon MSc FIA:

Mr. McCutcheon is a graduate of University College Dublin in Mathematical Science and is a Fellow of the Institute of Actuaries. He is a director and co-founder of Financial Risk Solutions (FRS), a software company specialising in the licensing of fund administration software to life assurance companies.

He has presented a number of papers at the Life Convention of the Institute of Actuaries and has co-authored a number of papers for the Society of Actuaries in Ireland, including a 2011 paper on placing value on tax losses in unit linked funds.

About Financial Risk Solutions (FRS)

Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund accounting software to the Life Assurance and Pensions industries. It was founded in 1999 by actuaries and IT specialists and is one of the leading software providers in its sector. Its Invest|Pro™ product family is a recognised leading benchmark in the investment fund accounting area and customers are some of the biggest brands in Life Assurance and Third Party Administration including MetLife, SEB, IFDS Percana, and Accenture Insurance Services.

FRS's mainline product Invest|Pro™ manages unit pricing and portfolio valuations, asset/liability unit matching, box management, trade order management, investment accounting, financial reporting and compliance with investment mandates in a single application. Product types covered include unit linked funds, portfolio bonds, self-invested/directed pensions, shareholder funds and with-profit funds. Invest Pro™ was specifically designed to securely automate complex fund administration processes.

For more information contact george.mccutcheon@frsltd.com or visit www.frsltd.com

Copyright © 2013 Financial Risk Solutions Ltd. All rights reserved.

FRS
Invest|Pro™
Knowledge based solutions