

Financial Conduct Authority Thematic Review TR16/2

The FCA issued Thematic Review [TR16/2](#), “Fair Treatment of long-standing customers in the life insurance sector” on 3 March 2016. The work by the FCA in this area has already led to six insurers facing enforcement action and, in our opinion, has the scope to have considerable impact on the industry as a whole.

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There are also very important comments about the management of with-profits business, which apply to all with-profit funds.

Why this is important

The Review focussed on the treatment of “long-standing” investment-based life and pension policies issued pre 2000, to determine whether such policyholders are being treated fairly. It is important to note that the Review also uses the term “closed-book” to refer to long-standing contracts and defines these as contract types that are closed to new business. This terminology may lead to some insurers considering that they are not affected by the Review if they do not consider that they have “closed funds”. This would be a mistake.

The Review itself appears to move between concerns over management of closed funds and the more general management of long-standing customers. There are also very important comments about the management of with-profits business, which apply to all with-profit funds. Moreover, in our opinion, many of the Review findings apply equally to all savings and investment contracts currently being sold and need to be considered at the outset of designing any new product offerings.

This means all life insurance companies should consider whether they need to take action as a result of the Thematic Review. The only possible exception to this is companies with only protection and pure annuity business, although see “Wider considerations” later in this briefing note.

This Thematic Review needs to be considered as part of the overall work by the regulators on investment business, covering pensions, asset management and with-profits. Insurers therefore need to have a strategic and holistic approach to these issues, rather than adopt a piece-meal approach to specific individual topics.

At a glance

The FCA considered four high-level areas, broadly covering governance, communication, investment performance and exit charges. It identified what it considers to be failings across the eleven insurers included in the review with six now subject to enforcement action (further investigations potentially leading to censure/fines).

The FCA discusses its findings in TR16/2 and sets out its expectations in draft “non-handbook guidance” which is subject to a three month consultation process.

The FCA expects firms to consider their own positions relative to the findings and make any changes necessary to meet the FCA’s expectations. The FCA expects to engage with firms through the normal supervisory process.

At a high-level, the expectations can be summarised as:

- All customers should be kept well informed with clear information on performance and charges
- Firms should be proactive in identifying drivers of overall product performance and act to ensure fair treatment in respect of investment performance, expense allocations and charges
- Customers should not face unreasonable barriers to exit or unfair charges if they stop paying premiums

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This is a wider exercise than that initiated by the Treasury that is focused on exit charges for pension business only.

Although the Review report makes an opaque reference to opening a debate with industry on exit charges, the FCA has stated in the [Dear CEO letter](#) that accompanied the publication of the Review that it will be looking for “industry-wide discussion with a view to industry reaching a voluntary solution to capping or removing exit and paid-up charges” on closed-book products. This is a wider exercise than that initiated by the [Treasury](#) that is focused on exit charges for pension business only.

Further detail

Structure of TR16/2

The FCA Review report is split into the following sections:

- Section 1.** Overview (giving summary information on background, aims, approach, overall findings, intended outcome and next steps)
- Section 2.** Assessment framework, scope and methodology (elaboration of the process followed and the regulatory landscape)
- Section 3.** Key findings (relatively detailed discussion of the findings and draft non-handbook guidance of the FCA expectations)
- Annex 1.** List of consultation questions
- Annex 2.** Examples of good and poor practice
- Annex 3.** Examples of good and poor practice with regards to regular statements
- Annex 4.** Cost benefit analysis
- Annex 5.** Glossary

Assessment framework, scope and methodology

The well-publicised Thematic Review was intended to determine whether firms were treating closed-book customers fairly.

In particular the FCA considered four high-level outcomes, each with sub-outcomes:

OUTCOME 1

The firm’s strategy and governance framework results in the fair treatment of closed-book customers.

- 1.1** The firm’s overarching strategy, including any outsourcing arrangements, takes proper account of the fair treatment of customers.
- 1.2** The firm checks, through periodic product reviews, that closed-book products remain fit for purpose and continue to provide the benefits they were originally designed to.
- 1.3** The firm has adequate governance arrangements for its closed-book business.
- 1.4** The firm’s remuneration, reward and performance management arrangements are consistent with the fair treatment of customers.

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In some cases the increased detail and prescription may cause unforeseen and possibly undesired consequences.

OUTCOME 2

The firm's closed-book customers receive clear and timely communications about policy features at regular intervals and at key points in the product lifecycle that enable them to make informed decisions.

- 2.1 Regular communications to customers provide them with sufficient information to make informed decisions.
- 2.2 Communications to customers at the time of key policy events are clear, accurate and enable them to make informed decisions.
- 2.3 Communications with customers make them aware of guarantees or options (whether time critical or not).
- 2.4 The firm takes effective action to locate and make contact with 'gone away' customers.

OUTCOME 3

The firm gives adequate consideration to and takes proper account of fund performance and policy values in a way that ensures it treats its closed-book customers fairly and proportionately.

- 3.1 The firm takes steps to deal with poor performance with closed and actively marketed products given equal attention.
- 3.2 Overall expenses are allocated fairly to closed-book products.
- 3.3 The firm regularly reviews the overall fairness of cost allocations and actual customer outcomes and applies a consistent basis for these reviews.
- 3.4 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.

OUTCOME 4

The firm's closed-book customers are able to move from products which are no longer meeting their needs in a fair and reasonable manner.

- 4.1 Exit and paid-up costs are not excessive and are not driving poor customer outcomes.
- 4.2 Target ranges for with-profits pay-outs appear reasonable and firms meet these target ranges without the variation of pay-outs being too wide.

In our view, these Outcomes and the draft non-handbook guidance included in the Review will presumably supplement the existing six outcomes set out in the current TCF framework. Although this additional wording from the FCA will help insurers assess the TCF outcomes and meet the FCA expectations, in some cases the increased detail and prescription may cause unforeseen and possibly undesired consequences. For example, the FCA suggests that with-profit pay-out target ranges should be narrower than some firms are currently using. Reducing ranges may lead to greater investment restrictions, potentially leading to lower pay-outs overall.

The Review was primarily carried out in the second half of 2014. The FCA assessed eleven firms through a combination of a desk-based review of requested materials and on-site visits/interviews with key staff.

The Review makes reference to a multitude of historical documents including parts of the FCA Handbook, other communications from the FSA and FCA, and UK legislation.

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The FCA also makes quite far-reaching comments on the management of with-profits business, with a particular desire to see narrower bands on pay-outs (expressed as a percentage of asset share) and for bands on surrenders to mirror those on maturities.

In our view the number of documents referenced helps to underline the piecemeal approach that the regulator has taken and, while not an excuse, may have contributed to firms failing to meet the FCA's expectations. Greater compliance might have resulted had the FCA (and FSA) historically taken a more consolidated approach to setting out its thoughts and expectations. Related to this, we were struck with how there is no mention in the Review of the management of the estate in the run-off of a closed with-profit fund. The equitable distribution of the estate is, in most cases, the key issue for the fair treatment of policies in such funds. Although all such companies have run-off plans, we consider it would be optimistic to assume that since the FCA has not mentioned this issue it is fully satisfied with those run-off plans.

Key findings

Section 3 and Annexes 2 and 3 of the Review discuss the FCA findings and examples of what it considers good and poor practice in some detail. These are also summarised in paragraph 1.22 of the Overview. Perhaps not surprising, but somewhat disappointing from the industry's viewpoint, is that in a number of cases the FCA stance appears to be that firms should make concessions to policyholders to the detriment of shareholder (or with-profit member) profit. For example it is not sufficient to rely on adherence to a policy's terms and conditions as being evidence of treating customers fairly.

Without replicating the paragraph 1.22 summary in full, some key findings are:

- Culture plays a key role in the approach and outcomes
- Some firms rely on contractual terms and conditions and are not taking action when detriment is identified
- Product reviews are limited or ineffective
- Ongoing disclosures/statements are inadequate (sometimes non-existent and often do not include appropriate information)
- Firms are not doing enough to trace “gone away” policies (i.e. policyholders they have lost contact with)
- Poor (net of charges) investment performance is often a result of high charges that are not necessarily disclosed to policyholders on an ongoing basis
- Poor monitoring of whether unit linked policy fees and risk charges are appropriate
- Firms are not making sufficient use of benchmarking expenses (both unit linked and with profit)
- While most exit and paid-up charges appear reasonable, a small number are suffering significant charges

The FCA also makes quite far-reaching comments on the management of with-profits business, with a particular desire to see narrower bands on pay-outs (expressed as a percentage of asset share) and for bands on surrenders to mirror those on maturities. It is however silent on the implications this would have, for example, on smoothing of pay-outs over time.

In our view, based on the material included in TR16/2, the FCA could be criticised for perhaps placing excessive focus on individual elements rather than looking at the whole. For example, on a unit linked contract, the overall charging structure (annual management charge, policy fee, risk charges, allocation rate etc.) will have been determined to achieve an overall appropriate balance between expected profitability and outcomes for customers. Taking elements in isolation such as whether the policy fee is “higher than it should be” takes no account of whether, for example, the monetary value of the annual management charge is lower than was expected.

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It appears that the FCA believes it is inadequate to simply ignore poor investment performance even if the fund was actively selected by the customer from a wide range of external funds.

We are also concerned about the apparent over-emphasis on bench-marking of costs. In our view such exercises are rarely able to be carried out on a fully consistent basis, and can therefore be at best of limited value and at worst dangerous.

In our view the comments on the monitoring of unit fund performance are also potentially far-reaching, and it is interesting to compare what is being done in the workplace pensions space on the appropriateness of default and other investment strategies. Certainly it appears that the FCA believes it is inadequate to simply ignore poor investment performance even if the fund was actively selected by the customer from a wide range of external funds.

In a number of instances the FCA refers to firms being unable to evidence decisions or justify the approach being taken. A common theme from both the PRA and FCA is that there needs to be documentation as to what firms do and why they are doing it.

Cost benefit analysis

In Annex 4 of the Review, the FCA makes it clear that it considers its expectations should have been predicted from the existing FCA rules and Principles. It therefore suggests a cost benefit analysis is not required on the basis that any costs incurred by firms would be to meet existing compliance requirements rather than incremental ones. However, it does then provide a brief and helpful analysis.

The FCA identifies three main areas and two additional areas where it expects firms may incur additional costs:

Main areas

- Product reviews (both the cost of carrying out reviews and potential cost of consequential actions)
- Improved (and regular if not already) customer communications
- Additional effort to trace “gone aways”

Additional areas

- Expense benchmarking
- More frequent review of with-profit surrender and paid-up bases

The FCA also recognises that firms may incur some additional costs in respect of strategy, governance, remuneration, reward and employee performance management and fund performance management, although it considers these will be minimal for most firms.

The FCA recognises that some of these additional costs may well fall on the with-profit policyholders or unit linked policyholders that it is trying to protect.

The expected benefits, in the opinion of the FCA, are:

- Products are more likely to remain fit for purpose and to deliver the benefits originally intended
- Customers able to make better informed decisions
- Customers less likely to “go away” and therefore more likely to maintain/obtain the policy benefits
- Customers less likely to suffer exit and paid-up charges
- More effective competition, which should benefit consumers

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In summary, we consider the Review may well force companies to reconsider their strategic approach to their UK operations.

Wider Considerations and Next Steps

The FCA has asked specific questions, and have set out what they describe as “draft non-handbook guidance”. It is therefore important that the industry responds to the Thematic Review in a thorough, balanced manner, addressing the questions and the implications of the draft guidance. We would hope that all life insurers will submit a response to the FCA by the deadline of 3 June.

It is important to recognise that, despite the title of the Review and the terminology used, this is not an issue solely for closed-funds or long-standing customers. The approach the FCA is taking covers all savings or investment contracts and will need to be factored in to the product design stage of any new products that an insurer is considering launching, whether accumulation or de-cumulation. Indeed, the management of recent drawdown and other at retirement products will need to be reviewed to ensure all aspects are consistent with the FCA's objectives and target outcomes.

The comments from the FCA around fund performance also have potential wider strategic implications for many insurers. It may be no longer feasible to simply offer a platform approach with numerous external funds for customers or their advisors to choose from. If such an approach is still desired then significantly increased investment governance processes may need to be put in place.

Finally, at present protection business has not come under the spotlight. However, in our opinion, insurers should also consider this part of their business to identify if there are any “read-across” lessons that can be learned.

In summary, we consider the Review may well force companies to reconsider their strategic approach to their UK operations.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact David Gulland or John Hoskin via the following:

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