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Newsflash

FCA Thematic Review TR19/3: Review of fair treatment of with-profits customers

Life insurance products are often complicated, may give rise to conflicts of interest between different customer and other stakeholder groups, and their long-term nature means that outcomes emerge over very long periods of time. Combined with often-low levels of customer engagement and understanding, there is a real risk that customers are not aware of poor emerging outcomes and then have little time to take corrective action.

These factors were at the heart of the Financial Conduct Authority's (FCA's) decision, as part of its ongoing Life Insurance supervision strategy, to embark upon a programme of work to identify and remedy the key risks of potential harm that life insurance firms may pose to their customers. The FCA's programme of work is broad, and not for discussion here, but one specific area of investigation was a thematic review into the fair treatment of with-profits customers. The FCA's findings were published in April 2019 in Thematic Review TR19/3.

In this brief summary we highlight the FCA's key findings in TR19/3, together with some key areas that with-profits firms will need to consider to improve the management and governance of their with-profits funds.

The approach

The review was carried out on a representative sample of eight firms, covering approximately 80% of total with-profits assets under management. It focused on outcomes in the following four areas:

- investment strategy and management,
- capital management in key areas such as estate distribution,
- fair allocation of risk and reward between stakeholders in capital management decisions, and
- governance of with-profits business in connection with the three areas listed above.

Most firms assessed were judged to be taking reasonable care to manage the risks of customer harm in their with-profits business, but a number of weaknesses were identified. The review highlighted both good and poor practices seen by the FCA as part of its investigations, and we give a flavour of some these areas under the various headings below.

Some overarching comments

Before considering the specific outcomes focused on by the FCA, it is worth beginning with two overarching comments.

Firstly, the FCA reminds firms in no uncertain terms that, unless and until a waiver or rule modification is granted, all of its rules apply to all firms. Specifically, if a firm believes that an FCA rule is unduly onerous or doesn't achieve its objectives, perhaps because of some specific circumstances relating to its with-profits funds, then it must apply for a waiver. You have been warned!

Secondly, and we would certainly encourage you to do so, if you read the text of TR19/3, it very quickly becomes apparent that every single comment made by the FCA has at its heart the need to treat customers fairly, particularly where the interests of various stakeholders may conflict – and to be able to demonstrate this. This comes up again and again, and is worth bearing in mind when taking proposals through with-profits governance.

With these points made, we now turn to the specifics of the review.

Outcome 1: Investment Strategy

While the FCA did not assess the investment performance of each fund, its findings in relation to investment management were generally very positive. In particular, the FCA liked the approach typically taken by firms of hypothecating assets to different liability cohorts, enabling various factors – such as policy duration, the fund's capital position, and the prevalence of guarantees – to be taken into account in setting asset strategies.

Where firms have an in-house fund manager, it is common practice for these managers to also manage the with-profits assets. The FCA found that firms' governance and oversight of in-house fund managers was typically good, and ultimately effective in managing the potential conflicts of interest that might arise in such circumstances. Good practice examples were provided in relation to holding in-house managers to account for poor performance and in relation to ensuring appropriate fee structures were in place.

Outcome 2: Capital Management

The FCA's investigations here covered such diverse areas as the use of run-off plans, the approach to fund-level capital management, estate distribution, assessment of excess surplus, and sunset clauses. The findings were somewhat more mixed, too.

The use of run-off plans

The review explored firms' use of closed fund run-off plans (ROPs), and highlighted that most firms were not using them fully as intended, i.e. as a tool to manage in a fair manner the run-off and distribution of a closed with-profits fund and any inherited estate. Specific findings included:

firms are typically not using ROPs as living documents in the day-to-day management of their with-profits funds, making it difficult to show that the approach to the distribution of the fund is fair to different groups of customers,

some firms did not consider scenario analysis in their ROPs, or where they did the focus tended to be on solvency as opposed to ensuring a fair distribution of the fund in the scenarios considered, and

the decision-making horizon of firms without up-to-date ROPs tends be shorter-term than would be expected for firms with comprehensive and up-to-date plans which arm the Board and management with a holistic, long-term view of the risks associated with the run-off of the fund.

Fund-level capital management, estate distribution, excess surplus

A range of approaches exists in relation to setting capital risk appetite at individual fund level. However, not all firms had defined fund-level risk appetite statements, and nor could all firms articulate clearly either how they had been arrived at or why they were fair to customers.

While the FCA's rules do not require fund-level risk appetites, the FCA did comment that their absence makes it more difficult for firms to show that their approaches to estate distribution, and the assessment of whether the fund was in an excess surplus position, were fair to customers.

The FCA also commented that the lack of a framework such as this also made it difficult for firms to show appropriate planning and governance around actions that could be taken in stressed situations.

In the context of assessing excess surplus, the FCA underlined the requirement to assess at least annually the level of surplus within with-profits funds. One reason for this is to avoid over- or under-distributing surplus, to help ensure inter-generational fairness for with-profits customers. The review highlighted that several firms were not carrying out such assessments and therefore risking causing customer harm.

In the context of estate distribution, the FCA commented that merely following historical court-approved schemes to determine the distribution of the estate is not enough to ensure fair customer outcomes. Rather, the FCA set out its very clear expectation that firms should regularly assess whether these approaches remain fair, taking account of developments since they were set, sometimes decades previously.

Sunset clauses

Many sunset clauses, which define the trigger point at which firms can – or sometimes must – restructure a with-profits fund, were defined as part of a court-approved scheme, again sometimes decades previously. There is a risk of customer harm if a fund is restructured either too early (potential loss of equity upside) or too late (potential diseconomies of scale). In keeping with its stance on following court-approved schemes for estate distribution, the FCA commented that some firms had not recently assessed whether historical sunset clauses remained appropriate.

Outcome 3: Risk and Reward

The FCA's investigations here focused on assessing whether firms adequately considered the potentially-conflicting interests of different stakeholders in the use of a with-profits fund's capital and in the allocation of any resulting gains and losses. Specific areas considered included controls over expenditure, management information, the continuation of past practices, and management actions. The FCA's findings were once again mixed.

Control over expenditure

The FCA underlined the need not only to ensure a fair allocation of costs between shareholders and with-profits policyholders, but to ensure good disciplines and controls are in place to monitor budgets, to limit spending, and to ensure efficiency. In short, the FCA is keen to ensure that expenditure made from with-profits funds is appropriate and for the benefit of the fund's policyholders.

Continuation of past practice

Building upon the discussion in relation to fair estate distribution and the appropriate implementation of sunset clauses, the FCA reiterated firms' over-reliance on continuing to apply the provisions of court-approved schemes without an up-to-date assessment of whether this results in fair outcomes for policyholders. Potential remedies in such situations include making use of any discretion allowed by historical schemes, exercising variation provisions where they exist, or potentially going back to court to seek to amend the historical schemes. Firms will of course need to be mindful that there needs to be a clear cost-benefit rationale (for the policyholder) for any option chosen here.

Management actions

While there is no specific requirement for firms to include management actions in their Principles and Practices of Financial Management, the FCA did comment that their absence creates the risk that management actions in stressed situations may be taken either without adequate governance or sufficient time to consider fairness to groups of customers, thereby increasing the risk of customer detriment.

Outcome 4: Governance

All firms in the review were considered to have strong governance structures, and certainly in line with the requirements set out in Chapter 20 of the FCA's Conduct of Business Sourcebook (COBS). However, the FCA did remark that governance issues did exist in relation to the practical implementation of intended governance structures.

The FCA commented that this sometimes reflected a lack of resources, and correspondingly reminded firms of their requirements under COBS 20 to ensure that their with-profits governance arrangements were sufficiently resourced to allow the firms to comply with FCA rules and ensure that their with-profits customers were treated fairly.

In that vein, one firm was noted to have commissioned an independent review of its with-profits governance which was able to identify some improvements which ultimately led to a greater focus on customer fairness issues and reduced the need for such a great emphasis being placed by the With-Profits Actuary on operational considerations.

Finally, the FCA commented on the timing of With-Profits Committee (WPC) meetings in advance of Board meetings, and the need for there to be enough time for challenge by WPCs ahead of Board meetings to be addressed satisfactorily.

Next steps

While the FCA does not propose to consult on new rules and guidance, all firms managing with-profits business are expected to consider the findings of the review, and can expect these to be a focus of business-as-usual supervisory interactions in the near term. The FCA has said that further action will be considered for firms who do not address the areas of poor practice highlighted by the review. So, once again, you've been warned!

Firms operating With-Profits Advisory Arrangement (WPAA) governance structures will be interested to read that the FCA is planning to carry out some work in this area before the end of the 2019/20 business year. One area which will be assessed is any impact of WPAAs now being senior managers under the Senior Managers and Certification Regime.

If you would like to discuss the implications of this thematic review and what it means for how you manage your with-profits fund, please get in touch with one of our with-profits experts – we'd be delighted to help.

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