

Response on TR16/2: Fair treatment of long-standing customers in the life insurance sector

We welcome the effort that the Financial Conduct Authority (FCA) has put into carrying out this review, and in preparing the draft Non-Handbook Guidance (NHG). Focusing on good customer outcomes has always been important for well-run life insurers, and we agree with the FCA that it is important that all customers should be considered throughout the duration of their policy. Hence at a very high level we have no material disagreement with the intentions of the FCA.

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At a very high level we have no material disagreement with the intentions of the FCA.

We do however have many concerns around the detail contained in the Thematic Review.

These are as follows:

1. We are concerned that the general thrust of the proposals could make the savings and investment industry less attractive to investors. There is a perception that there is a 'ratchet' effect, with the FCA expecting increased policy benefits regardless of the need for the insurer (often a mutual or a with-profits fund) to remain financially viable
2. A particular example of the above point is that in some instances it appears the FCA is requiring insurers to go beyond what was originally intended when the product was launched, for example in taking responsibility for the performance of an external fund selected by the customer (or their advisor)
3. We are concerned that some of the FCA's conclusions appear to be based on considering individual elements of the management of business in isolation, rather than taking a holistic approach. For example, it is not appropriate to criticise one element of a product's charging structure (such as an apparently high policy fee) without also considering other features (such as a very low annual management charge)
4. The proposals would significantly reduce a key attraction of with-profits to customers, namely the level of smoothing of payouts from year to year
5. A more restrictive target range for payouts, expressed as a percentage of asset share, could also potentially reduce actual payouts if investment strategies were amended
6. The creation of further material for insurers to consider, in the form of NHG, can only be welcomed if it is used as a complete source of guidance, replacing any continued need to refer to historic documents from the FCA or previous regulators
7. We also doubt whether some of the additional activity, such as benchmarking, will either add insight to insurers, or lead to improved outcomes for customers
8. There appears to be ambiguity as to whether the FCA is considering closed funds or long-standing customers. The two are not synonymous and the issues for good customer outcomes differ between them, particularly for a closed with-profits fund
9. Finally, we consider that if small organisations (that are often with-profit mutual) were to seek to adopt most of the best practices set out, it is likely that the additional costs would be such that a merger with another provider would be the most appropriate course of action

We expand on these key points in the remainder of our response, and also comment, as requested on the specific draft outcomes, sub-outcomes and NHG.

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There are particular regulatory and technical issues around closed funds, particular closed with-profit funds and it is important that any NHG is consistent with the requirements on those funds.

Scope and structure of draft: Non-Handbook Guidance

It would be helpful if the FCA did not use the phrase ‘closed-book’ as this does not appear to reflect the general emphasis of the FCA, which appears to be on ensuring customers with long-standing policies are treated appropriately – regardless of whether the product they have is currently marketed. Conversely, the rapid evolution of the market and constant product design means that many ‘closed-book’ customers are likely to have only had their policy for a short period. Hence we suggest that the FCA determines precisely what group of customers it is considering (if not all) and uses a precise and consistent terminology in future work.

Further, there are particular regulatory and technical issues around closed funds, particular closed with-profit funds and it is important that any NHG is consistent with the requirements on those funds (for example the need to maintain a run-off plan).

The NHG could become a useful single reference point for companies seeking to understand what the FCA is expecting. The usefulness of this NHG would be materially enhanced if it was also made clear by the FCA that the NHG covered all the relevant points from the earlier publications by the FCA and its predecessors. It is not helpful for insurers to have to refer to a multitude of different, old, sources. In addition, it would be helpful if the FCA was explicit about how it expects the NHG to interact with the existing Treating Customers Fairly (TCF) framework.

Specific comments on each outcome, sub-outcome and draft Non-Handbook Guidance

Outcome 1:

Wording of outcome: We do not understand why the phrase ‘closed-book’ is included in the wording for this outcome. This seems artificial and implies that policies in a closed-book are in some way different. We would expect insurers to seek to apply this outcome, and the sub-outcomes, to all policies regardless of whether they happened to be in a closed or open fund.

Draft NHG: The emphasis on closed-book should be amended, as described earlier in this response.

Note: This comment about the phrase ‘closed-book’ is relevant to many outcomes, sub-outcomes and draft NHG. For brevity we have not repeated or comment each time the phrase occurs.

Sub-outcome 1.1:

Wording of outcome: No comments.

Draft NHG: Insurers will always seek to exit an unsatisfactory outsourcing arrangement. However the FCA should recognise that terminating agreements (whether at the end of a contract or earlier) is likely to result in additional costs. These additional costs could result in worse customer outcomes than retaining a sub-optimal outsourcing arrangement. Hence we suggest that the wording in the last paragraph of the NHG is amended so that it is not expected that all outsourcing arrangements should be automatically terminated if not in the best interests of customers.

Sub-outcome 1.2:

Wording of outcome: We find the phrase “continue to provide the benefits they were originally designed to” potentially confusing and very far-reaching if interpreted in certain ways. For example commentators could interpret this as introducing new guarantees on products which were never intended to have such guarantees. In effect it could encourage vexatious claims of misselling on any investment product sold with policy illustrations that are now unlikely to be met due to changes in economic conditions. We are confident that this is not what the FCA intends, but its draft wording could be taken as such, and hence a better phrase should be drafted to avoid the risk of such claims.

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We suggest that there should be recognition of materiality in carrying out periodic reviews of products.

Draft NHG: We are very concerned with the wording in the penultimate paragraph. This wording, taken with the wording of the sub-outcome, could result in new, inappropriate, investment guarantees or quasi-guarantees becoming effective. If this is not the intention of the FCA then the wording should be amended to clarify what the guidance is seeking to achieve.

Although we agree that the T&Cs should not always be regarded as the sole yardstick by which to measure a policy's management, we are concerned that there is a real danger of applying current standards and expectations to products sold many years ago, which can be totally inappropriate.

Finally, we suggest that there should be recognition of materiality in carrying out periodic reviews of products.

Sub-outcome 1.3:

Wording of outcome: No comments.

Draft NHG: The second paragraph illustrates the difficulty that insurance companies can face, since they are required to consider “the Principles and other rules and customer outcomes, in relevant decisions taken by their Board..”. This does not mention the NHG. We reiterate the value of having a single reference source setting out what Boards need to consider, rather than a generic obligation to consider anything that the FCA or its predecessors have produced in the past.

The methods described in the third paragraph could in some instances be useful mechanism for considering customer issues in a focused manner. But it is also a potential source of increased regulatory confusion and increased governance costs for no material improvement in customer outcomes. In particular there is a danger of unclear lines of responsibility, hence we suggest this paragraph is substantially re-drafted.

Sub-outcome 1.4:

Wording of outcome: No comments.

Draft NHG: Our main concern with the draft is the apparent presumption that there is always a conflict between what is good for a customer and what is good for the insurer – with the FCA appearing to consider that high policy retention is poor for customers and good for the insurer. We do not consider the reality to be as simple as this, given the great variety of products and cost structures in the industry. Hence we do not think the example provided is particularly helpful and should be removed.

Sub-outcome 2.1:

Wording of outcome: No comments.

Draft NHG: Although the wording of the outcome is, in itself, non-controversial and the FCA appears to have found examples of insurers not complying with their existing obligations, we have many concerns with the proposed NHG.

Our overall concern is the potential prescriptive nature of the text, setting out what insurers need to provide. There are two aspects to this concern. First, we are not convinced that some of the items that are proposed to be set out each year are technically correct or reflect how some with-profits funds (for example) are run. The FCA implicitly recognises this by saying that “the current value may be challenging to calculate”. Secondly, we expect that the costs of amending systems could lead to customer detriment. This is particularly the case for smaller insurers, many of whom are mutuals, for whom making significant changes to their IT and administration systems could be unduly burdensome.

A further concern is that the proposed items to communicate may actually confuse the customer, particularly if the information does not reflect how the products work in practice. One example would be the addition of reversionary bonus to a conventional with-profits contract, which does not appear to be envisaged by the draft NHG.

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We agree with the importance of seeking to track gone-aways, but suggest that some of the examples are not particularly helpful.

Finally, although we support the objectives in the Smarter Consumer Communications initiative, it must be recognised that all such developments come at a cost. It may well be the case that smaller organisations are unable to justify the expenditure to comply with these changes and hence need to merge with larger organisations. This could lead to improved customer outcomes, but the impact on competition should be recognised.

Sub-outcomes 2.2 & 2.3:

Wording of outcome: No comments.

Draft NHG: Our earlier point about the potential costs for smaller organisations is applicable here too.

Sub-outcome 2.4:

Wording of outcome: We consider the use of “effective action” to be unduly burdensome and should be replaced with “appropriate and proportionate action”. This is because in some cases insurers have exhausted what further they can do on ‘gone aways’, and requiring them to take further ‘effective’ action is quite likely impossible, or at least a poor use of funds. This is not to seek to excuse some of the apparent poor practices set out by the FCA in paragraphs 3.127 to 3.138, but rather to stress that not all companies will have such practices.

Draft NHG: We agree with the importance of seeking to track gone-aways, but suggest that some of the examples are not particularly helpful. For example if attempting re-contact after 18 months has failed, repeating this every three years in the same way is unlikely to yield better results. A more targeted approach might be better, for example prior to a significant birthday on a whole of life policy, or prior to maturity on an endowment.

A further low-cost solution could be for the FCA to maintain a central database of all historic life company names and where their business now resides. This will enable dependents of a deceased policyholder who held a policy with a company that has been subject to various Part VII transfers or other corporate restructuring to more easily identify what company to contact. There appear to be several commercial websites offering this service, but aimed at the US market (www.insure.com/life-insurance/lost-policies.html and www.findyourpolicy.com). There is a UK equivalent but it appears to be significantly out of date (<http://policydetective.co.uk/searchResults.jsp#myAnchor>)

Sub-outcome 3.1:

Wording of outcome: We agree that it is important to monitor fund performance across all the range. However we are slightly concerned with that the wording of this sub-outcome could cause insurers to be over-active in their management of unit-funds. As the FCA is well aware, a key determinant of poor investment performance is excess trading, and the sub-outcome as drafted could encourage inappropriate switching of customers’ investments out of funds at the wrong time. The phrase ‘takes steps’ appears to be a call for action that could in fact be unwarranted.

Draft NHG: In general we agree with the principles behind the draft NHG. We suggest that formal quarterly reviews of all funds is however unrealistic if there are a large number of external funds, some of which can be very small if made available through a platform approach and self-selected by the customer (or their advisor). Hence the wording should allow for some proportionality in the approach to governance and oversight.

Incidentally there is good practice in being open about fund reviews, most notably the public posting of Royal London’s Investment Advisory Committee meetings here: www.royallondon.com/customers/pensions-investments/int/fund-information/investment-governance/investment-advisory-committee. We see no reason why other insurers, of similar size, should not be able to provide such information to their customers.

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We suggest that the FCA may wish to require insurers to be satisfied at a macro level that their corporate model and expense structure is viable for the long-term.

Sub-outcomes 3.2:

Wording of outcome: No comments.

Draft NHG: We suggest that the wording is amended to recognise the reality that different groups of policyholders do generate different costs, and this is an appropriate feature to recognise in the allocation of expenses. It is also important to recognise that judgement will always be needed in the allocation of expenses, and the allocation of some items can depend on earlier decisions so as to achieve fairness over time (for example a company could have decided not to allocate a share of the additional overhead from regulatory change to a closed fund, but eventually such a practice could become unfair or unsustainable).

Note: We find it startling that the FCA found a with-profits fund where the expenses were in excess of 6% of asset share (paragraph 3.167). In such instances we would have expected the fund to have been merged with another, or other action taken, to correct this situation many years previously. It might be more useful, in terms of preventing customer detriment, for the FCA to focus on situations such as these rather than on some of the other areas in the TR16/2.

Sub-outcomes 3.3:

Wording of outcome: No comments.

Draft NHG: We agree with those firms that suggested to the FCA that benchmarking does not always provide useful, actionable information – particularly on the allocation of expenses across funds. Companies may well wish to understand their total cost structure as an input into their corporate strategy (including whether they are able to remain a viable independent entity) but we doubt whether benchmarking as described in the TR and in the draft NHG is really valuable for allocation. This is because of the wide variety of entities and product designs.

We suggest that the FCA may wish to require insurers to be satisfied at a macro level that their corporate model and expense structure is viable for the long-term, rather than to concentrate on the micro level of allocation of expenses.

Sub-outcomes 3.4:

Wording of outcome: We note the wording includes the phrase “to the extent permitted by policy conditions” yet elsewhere in the TR it appears as if the FCA expects firms to go above and beyond what is in the T&Cs of a policy. This is slightly confusing.

Draft NHG: It is important to recognise the fundamental difference between policies written with guaranteed and reviewable rates. The draft NHG is appropriate for the latter but should not be extended to the former.

Sub-outcomes 4.1:

Wording of outcome: We consider the use of the word ‘excessive’ to be emotive and subjective. It would be better to have wording such as “costs are justified and proportional”. In the draft NHG the wording is ‘fair’.

Draft NHG: We welcome the FCA’s recognition of the importance of being able to recoup additional set-up costs, since in the past these were material and were a reason for the design of, for example, capital and accumulation units. We also agree that it is useful to set out the options open to the customer. The insurers will however have to delay acting on an instruction from the customer until such information has been given. When insurers had to go through the risk warnings around pensions freedom customers often did not appreciate the delays that this caused. Hence this process should be recognised in the NHG

Note: We welcome the intention to have an industry debate about the treatment of personal pension policies transferring from one provider to another.

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We agree with the FCA's views on the importance of regular reviews of paid-up and surrender value bases.

Sub-outcomes 4.2:

Wording of outcome: The wording does not reflect the importance of smoothing in with-profits payouts in absolute terms from year to year. This can be a more important feature for customers selecting a with-profits investment than the movement in payout as a percentage of asset share from year to year.

Draft NHG: In our opinion seeking to move payouts into a narrower band of asset shares is not an appropriate policy aim.

This is because:

1. It ignores a fundamental aspect of with-profits business, which is to smooth payouts over time. Such smoothing moves a significant amount of market risk from the customers (who are less able to bear the risk, and have chosen a with-profit fund rather than a unit-linked fund at least in part because of this) to the fund. It can mean, for example, that the payout on equivalent 25 year endowments expressed as a percentage of asset share may move significantly from year to year. This is set out in firms' PPFMs.
2. It could result in firms seeking to reduce the volatility of the assets held in the fund, which in turn could lead to lower future payouts for customers.

It is also worth noting that most large companies used stochastic modelling when first setting ranges for payouts for their initial PPFMs, and had such capabilities because of the need to produce realistic balance sheets. This level of modelling is needed because of the costs of guarantees and smoothing which are impacted by the ranges adopted. If narrower bands were to be required some smaller with-profit funds, often mutual, may need to carry out such modelling, for the first time, and could find the costs of such work to be disproportionate to any beneficial impact on customers.

We agree with the FCA's views on the importance of regular reviews of paid-up and surrender value bases.

Comments on the example Good and Poor practice

We have the following comments on the tables set out in Annex 2.

Sub-outcome 1.1:

We disagree that the separation of a firm's business into new and existing business should necessarily be regarded as 'good practice'. Indeed, since the general thrust of the FCA's work appears to be to ensure all customers are treated fairly, such a separation could actually accentuate the feeling that older business is less important or different from new business.

Sub-outcome 1.3 good practice:

We noted the creation of an 'independent customer governance function' and note that although such a function could provide good insights, there is a risk of such a function implicitly carrying on a Controlled Function, or being 'shadow directors' and so care should be used in using this as a good example for others to follow. The designation of one Non-Executive Director as a TCF champion, as described in a separate example of good practice, avoids such risks.

Sub-outcome 2.2, 2.3 good practice:

We agree that the third bullet point describing a 'Pause for Thought' document is positive. However we would not wish to see the Financial Ombudsman Service (FOS) or the FCA then criticising companies for any delays in processing a customer's request for a surrender or transfer. The experience around the risk warnings for pensions freedom is of interest here.

Sub-outcome 3.3 good practice:

As outlined previously, we are not convinced that external bench-marking of costs is always useful. As the TR notes, this is often a requirement after a Part VII transfer where there is considerable uncertainty over what the expenses for a fund will be in 10 or 20 years time and hence benchmarking can be a useful mechanism.

Sub-outcome 4.2 good practice:

The example given of changing the AMC on capital units is clearly beneficial to customers but will have come at a cost that would have been borne by either shareholders or other policyholders. Not all insurers will be in a position to absorb such costs and so there is a risk in setting out this example as one of good practice, since not everyone will be able to implement it.

Comments on the Cost Benefit Analysis

We consider the Cost Benefit Analysis (CBA) materially understates the potential costs (and time) involved in updating policy administration systems. The cost of changes to systems will depend on the current flexibility of system and so we have not provided estimates. However in discussion with many insurers they expressed considerable concern over their ability to make the required systems changes in the suggested timeframe.

The CBA has not allowed for the costs of carrying out the modelling to investigate the financial impact of altered target ranges.

Benchmarking costs are also not likely to be “relatively small” if carried out in a thorough manner (we have commented on the usefulness of such exercises earlier in this response).

We consider the costs of the proposed guidance are likely to be a material issue for smaller with-profit funds.

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

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