TR19/3 FCA Thematic Review

Fair treatment of with-profits customers

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On 25 April 2019, the Financial Conduct Authority (**FCA**) published the findings from its thematic review, 'TR19/3: Review of the fair treatment of with-profits customers' (**the thematic review**). In this review, the FCA focused on the areas of with-profits fund management it assessed as presenting the highest risk of customer harm at present. These were:

- Investment Strategy & Management (Outcome 1).
- Capital Management: Estate Distribution & Fund Resolution (Outcome 2).
- Capital Management: Allocation of Risk & Reward between Stakeholders (Outcome 3).
- Governance (Outcome 4).

A sample of 8 firms were selected for the thematic review, representing approximately 80% of total with-profits assets held[1] across the UK insurance industry and comprising a mixture of funds that are closed and open to new business, mutual and proprietary firms, and funds and firms of varying sizes.

The findings from the thematic review are intended to help firms continue to evaluate their own with-profits fund management practices to ensure they are complying with FCA rules and treating their with-profits customers fairly. In this paper, we summarise and discuss these findings.

Main findings from the thematic review

The FCA identified the following as the main findings from the thematic review:

- Most firms assessed were taking reasonable care to manage the risk of harm to with-profits customers. This was particularly highlighted by the findings in relation to investment strategy and management (Outcome 1) and governance (Outcome 4).
- Many firms with closed with-profits funds were not keeping run-off plans up-to-date and were not utilising them in the day-to-day management of the fund. The FCA identified a widespread need for firms to use their run-off plans fully as intended and described in FCA rules and guidance.
- Specific areas of poor practice identified that may lead to customer harm were weaknesses in assessments for, and distribution of, excess surplus, and insufficiently robust fund-level capital management approaches.
- In most cases, there was no evidence of actual customer harm having arisen but there is potential for customer harm in the future if these practices continue.
- In limited instances where practices were found to present a higher risk of customer harm, a key cause was identified as a failure of governance, in particular ineffective oversight and challenge by senior individuals and the Board.

Summary of findings under each Outcome

OUTCOME 1 – THE FIRM HAS IMPLEMENTED AN APPROPRIATE INVESTMENT STRATEGY FOR THE FUND AND REGULARLY MONITORS ITS ONGOING APPROPRIATENESS AND THE TERMS ON WHICH IT IS IMPLEMENTED

The FCA's work on this outcome focused on firms' approaches to investment strategy and management, and the associated governance. In summary, the FCA's findings were:

- Examples of good practice were identified in relation to firms' approaches to formulating and monitoring an appropriate ongoing investment strategy for their with-profits funds. This included the use of hypothecation to tailor investment approaches to take account of factors specific to different funds or different cohorts of customers.
- Where firms employ their in-house fund managers to manage the investments of their with-profits funds, firms were carrying out reasonable governance and oversight (covering areas such as fees and performance) to satisfy themselves that customers were not disadvantaged.
- More generally, firms were regularly monitoring the performance of with-profits investments and taking actions where they identified poor performance.

*The FCA notes that it did not assess the actual investment performance of each with-profits fund, and the findings do not include discussion of an appropriate investment strategy or appropriate investment benchmarks. Firms should ensure they regularly monitor the suitability of the investment strategy for their with-profits funds, taking account of factors such as the capital position of the fund relative to risk appetite, the expected run-off of the fund and past communications to with-profits customers, e.g. through the Principles and Practices of Financial Management (**PPFM**).*

[1] For some firms, only the operation of selected with-profits funds was reviewed.

The two good practice examples given in the findings under Outcome 1 focus on the firms' processes for monitoring investment performance and fees. These examples particularly highlight an expectation that firms should take action where they identify persistent poor performance or fees that cannot be justified by the level of work being carried out by the fund manager.

OUTCOME 2 – THE FIRM HAS AN OVERALL CAPITAL MANAGEMENT APPROACH FOR THE WITH-PROFITS FUND THAT FAIRLY BALANCES THE INTERESTS OF DIFFERENT GENERATIONS OF WITH-PROFITS CUSTOMERS

The FCA's work on this outcome covered run-off plans, fund-level capital management approaches, estate distribution, excess surplus assessments and plans for fund cessation. In summary, the FCA's findings were:

- Most firms with closed with-profits funds were not using their run-off plans as intended and described in FCA rules and guidance. In accordance with COBS 20.2.56R, a run-off plan is required to include an up-to-date plan demonstrating how the firm will ensure a fair distribution of the closed with-profits fund and any inherited estate.
- Examples of good practice include a run-off plan being reviewed annually by the With-Profits Actuary with oversight from the With-Profits Committee (**WPC**), consideration in the run-off plan of the pattern of pay-outs over the lifetime of the fund, and inclusion of scenarios for key risks faced by the fund and the impact these would have on the distribution of the estate. Examples of poor practice include a focus on the current position of the fund without consideration of the impact of current decisions on longer-term projections.

It is common for firms to use SUP Appendix 2.15 as a guide to the appropriate content of their run-off plans. However, this presents the risk that the run-off plan is produced as a 'tick-box' exercise to align with FCA guidance rather than being drafted to give management and the Board a holistic and long-term view, allowing them to manage the run-off of the fund in the interests of the fund's with-profits customers.

Furthermore, run-off plans drafted solely against SUP Appendix 2.15 may not demonstrate adequately how the firm will ensure a fair distribution of the fund and its estate. In order to demonstrate this, the run-off plan should include projections that cover both fund solvency and the level of estate distribution (e.g. uplifts per policy) over the run-off of the fund. The run-off plan can further be used as a tool to test the appropriateness of other areas of with-profits fund management, such as risk appetite, plans for fund cessation, and alignment of the investment strategy with the run-off of the fund and the approach to estate distribution.

Having a comprehensive plan in place for the run-off of the fund that is regularly reviewed, and ensuring compliance with this plan, reduces the risk of an inequitable distribution of the fund and its estate. It should also provide a robust basis for demonstrating a firm is managing the run-off of the fund in the interests of its with-profits customers.

- Some firms demonstrated they had implemented appropriate policies to ensure they struck a balance between ensuring fair pay-outs for exiting customers and the security of benefits for continuing customers. However, some firms lacked a clear definition of the desired level of capital to protect against risks in their funds. FCA rules do not require fund-level capital risk appetites but in the absence of this (or equivalent controls) it was difficult for firms to demonstrate their approach to estate distribution and excess surplus assessments are fair to customers.
- A poor practice example is given of a firm that managed solvency risk at firm rather than fund level. This presented a risk that 'overs' and 'unders' at individual fund level went unchallenged. Additionally, the firm was unable to justify why the chosen level was appropriate.

*Without a defined capital risk appetite at fund level, it is difficult to demonstrate that management, the WPC or With-Profits Advisory Arrangement (**WPAA**)[2], and the Board have a considered or consistent view of what a 'good' or 'bad' capital position for the fund is. Where a capital risk appetite has been defined at fund level, for some firms these are chosen based on 'gut feel' without being tested for fairness to different groups of customers, e.g. through the run-off plan. Without such testing, it is not clear why the chosen risk appetite appropriately balances fair pay-outs to exiting customers and security of benefits for continuing customers. In both cases above, there is a risk that inappropriate actions (which may include no action) are taken in the fund in relation to its capital position.*

The findings from the thematic review include a good practice example of a fund-level capital risk appetite that includes different 'zones' rated as Red, Amber and Green, with a Solvency Intervention Ladder indicating actions to be considered in each zone. For firms using a similar approach, these zones may be defined as "the capital required to be able to cover capital requirements following a 1-in-X year stress event", with the appropriate level of capital being calibrated annually to the risk profile of the with-profits fund. This approach allows the desired level of capital as a percentage of capital requirements to vary, taking account of the emerging experience and the changing operating environment.

[2] COBS 20.5.1R permits a WPAA, rather than a WPC, to be appointed for a with-profits fund, but only if this is appropriate in the opinion of the firm's governing body, having regard to the size, nature and complexity of the fund.

- Firms adopted a range of approaches to estate distribution but for the majority, the FCA saw no evidence of monitoring the fairness of the chosen approach.
- A poor practice example was given of a firm extending estate distribution to non-profit customers in response to developing a tontine, without consultation or notification to the FCA, consideration of reattribution rules or changing the PPFM.
- Several firms were not carrying out (at least) annual assessments of whether their with-profits funds have an excess surplus as required by COBS 20.2.21R[3]. Reasons given by some firms were that the distribution approach aimed to distribute the entire estate or that it was self-evident the fund did not have an excess surplus. Failure to identify an excess surplus where one exists may result in surplus that should be distributed being retained and may indicate a breach of Principle 6[4].

An excess surplus, as defined in COBS 20, is present in a with-profits fund if (broadly speaking) the fund's surplus is greater than the maximum of the notional Solvency Capital Requirement for the fund and the capital requirements of the fund at the firm's own risk appetite (plus any amount necessary to support new business plans). A number of firms have an upper limit in the fund-level capital risk appetite, such as a cap on the Green zone, where this limit is used to determine whether the fund has an excess surplus. Therefore, if a capital risk appetite is defined for the fund, annual assessments of excess surplus should not be onerous for firms. However, it is more difficult for firms to demonstrate the absence of an excess surplus, or to justify why the speed of distribution is appropriate and fair to different generations of with-profits customers, without such a measure in place.

- Most closed funds reviewed had a sunset clause that defined the trigger point after which the Board either can or must restructure the with-profits fund. However, some sunset clauses were set more than 20 years ago and in some cases had not been reviewed recently to assess whether they remained fair to customers.

OUTCOME 3 – THE FIRM APPROPRIATELY CONSIDERS THE RISK BORNE BY DIFFERENT STAKEHOLDERS IN ALLOCATING REWARDS FROM USE OF WITH-PROFITS FUND CAPITAL

The FCA's work on this outcome focused on assessing whether firms adequately considered the interests of different stakeholders in decisions about the use of with-profits capital and the allocation of consequent gains and losses. In summary, the FCA's findings were:

- Most firms had taken reasonable care to ensure that risk and reward were distributed fairly between shareholders, with-profits customers and other stakeholders such as non-profit customers. However, there were some examples of firms' controls over expenditure by with-profits funds not being sufficiently robust.
- Examples of good practice in relation to capital resources management information included providing the capital position of the fund relative to its risk appetite and a summary of the key drivers of changes in surplus between periods. Examples of poor management information are given as those that did not provide sufficient, timely information to allow the WPC and Board to have a good understanding of the fund's capital resources when making fund management decisions.
- Some firms relied too much on continuing application of provisions in court-approved schemes, without carrying out on-going reviews of whether practices resulted in fair outcomes. Two poor practice examples are included in the findings from the thematic review relating to the terms on which charges were paid from one fund to another not being reviewed or updated to ensure the charges remained appropriate.

Another example of over-reliance on the continuing application of provisions in schemes is insufficient review of sunset clauses noted in the findings under Outcome 2. Overall, the findings in this area imply that compliance with past schemes, in isolation, is not an adequate measure of fairness to with-profits customers; firms should regularly consider whether continuing with practices as set out in court-approved schemes is fair to customers. This may include consideration of the original intention of the provision in the scheme at the time it was sanctioned. If firms identify that the current application results in unfair outcomes, firms should explore whether issues can be addressed in a cost-effective manner. While the findings from the thematic review note that, if necessary, firms could go back to court to apply to have the scheme amended, it may be that the cost outweighs the benefit to with-profits customers. Nevertheless, a lack of less costly solutions, e.g. discretion allowed by the scheme or variation provisions, should not be used as justification for disregarding wider fairness considerations when operating in line with the scheme.

- For some funds, management actions were not clearly set out in the PPFM, presenting the risk that management actions may be taken by firms in stressed situations without adequate governance and/or sufficient time to consider fairness to different groups of customers.

OUTCOME 4 – THE FIRM'S GOVERNANCE FRAMEWORK RESULTS IN THE FAIR TREATMENT OF WITH-PROFITS CUSTOMERS

The FCA's review of firms' with-profits governance covered both documented structures and how effective these were in practice. In summary, the FCA's findings were:

[3] The requirement is at least once every three years for non-directive friendly societies.

[4] PRIN 2.1.1R – Principle 6 (Customers' interests): A firm must pay due regard to the interests of its customers and treat them fairly.

- All firms in the sample had governance structures that were in line with the requirements of FCA rules on paper, though in some instances concerns were identified in relation to the application of the governance arrangements in practice.

Typically the terms of reference for the WPC or WPAA are drafted in line with the requirements of COBS 20.5.3R, and will therefore include all areas of with-profits fund management listed in this rule. However, adequate consideration of each of these areas may not occur in practice. For example, the findings from the thematic review suggest the WPCs / WPAAs for some firms were not giving appropriate consideration to the identification of excess surplus and to the review of and compliance with run-off plans. As required by COBS 20.5.1R, firms should ensure their WPCs or WPAAs operate in accordance with their terms of reference.

- Good practice examples are included of firms' governance processes resulting in changes to firm practices and proposals to make them fairer to with-profits customers, and of a firm initiating an independent review of its governance structure and subsequently making improvements.
- There were indications of resource stretch in with-profits fund management at some firms, including suggestions from discussions with firms that some issues identified under Outcomes 1 to 3 may have resulted from a lack of resources.
- There were mixed standards of documentation for Board and WPC meetings, for example in meeting minutes, resulting in limited documentation of factors considered and the challenge presented during with-profits fund related decision making.
- In some instances, WPC meetings were held very close to Board meetings, creating a risk that the WPC may not have time to give sufficient challenge or for WPC queries to be resolved before the Board makes a decision. The FCA has not suggested a specific minimum time period but has highlighted it is important that firms satisfy themselves that the timing of meetings does not present a barrier to effective challenge.

Holding WPC meetings very close to Board meetings could also result in decisions being delayed if there is challenge from the WPC, increasing the potential for customer detriment. This risk may be reduced by allowing sufficient time between meetings for issues to be addressed. It can also be reduced by ensuring the WPC receives early notification of proposals and the information it will receive, is asked what additional information it is likely to require and is brought into discussions in good time ahead of the point at which it is required to provide its view or recommendation to the Board.

Next steps following the thematic review

The FCA expects all firms managing with-profits business to consider the findings from the thematic review, as well as the good and poor practice examples included, and assess whether they need to make any changes to the management of their with-profits business. The FCA will consider the need for further action if firms do not address the areas of poor practice highlighted.

Under the Senior Managers and Certification Regime from December 2018, the role of WPAA is treated as a senior manager role for the first time. The FCA is considering carrying out some focused work on the use of WPAAs before the end of its 2019/20 business year to evaluate the impact of WPAAs now being senior managers, and to give further insight into the conduct of smaller firms that manage with-profits funds.

How Milliman can help

Milliman consultants have extensive knowledge of the fairness considerations that arise in respect of with-profits business.

We have fulfilled With-Profits Actuary roles and With-Profits Committee advisory roles for a wide variety of insurers and acted as the Independent Expert/Actuary for many of the large transactions and transfers of with-profits business. We are able to support our clients with in-depth experience and tailored insight in relation to with-profits business, including both the application of discretion and the general management of with-profits business.

In addition, through these roles and through our recent work with the FCA, we have a strong understanding of the regulators' requirements in relation to with-profits business, and are well placed to guide you through any dealings with the UK regulators, and to identify and advise on areas that they may query.

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