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Research Update: March 2014

Revisions to ABI Guidelines following TR13/8

Background

The ABI published on 5 March 2014 a revised consultation version of its "Guide to Good Practice for Unit-Linked Funds". In this research update, George McCutcheon discusses this important issue in more detail.

Background

The amendments to the Guide were made by an ABI Working Group, in close liaison with the FCA, and reflect the changes that have been made in response to the FCA's TR13/08 "The governance of unit-linked funds".
Although not currently part of FCA's regulatory framework, it is expected that non-ABI members will adopt the Guide and implement it to the same degree and timescales as ABI members.

Key Findings of the FCA Thematic Review

The FCA's thematic review of the governance of unit-linked funds published in October 2013 identified some areas where life companies needed to make improvements to ensure that customers are treated fairly.

- Fair allocation of stock lending revenues[1] and tax between customers and shareholders
- The identification and rectification of errors; and
- The management of potential conflicts of interest[2]

Timeframe

The ABI expects that by 31 December 2014 member firms should have reviewed their operations against the updated guidelines and begun making progress towards following them.

Key Conclusions –Implications for Life Companies

- Section 5.60 (preserving fairness between different generations of policyholders and between policyholders and shareholders) might have wide-ranging consequences for the methods of tax provisioning and the methods for placing value on tax losses
- The changes made reflect a consistency of approach between the ABI guidelines and the EIOPA System of Governance Guidelines (e.g. provisions that the primary responsibility lies with the Board for governance and the establishment of committees and ensuring that all appropriate information for decision-making is available to the Board)
- Post adoption of the Guidelines (end April) life companies will need to immediately start to review their operations against the updated guidelines
- As both the ABI Guidelines and the EIPOA System of Governance Guidelines provide a more prescriptive approach for outsourcing, life companies will need to review their outsourcing arrangements
- Life companies will need to identify and manage potential conflicts of interest in their fund operations.
- Life companies should review their contractual arrangements with third party investment managers to ensure that there is contractual reinforcement for the cost of rectification of pricing errors.
- The changes provide greater clarity and more detail in interpreting TCF and the FCA's Principles for Business

Stock Lending

In respect of securities lending, the 2012 Guide merely said that the investment mandate should specify whether securities lending was permitted and what collateral is required. The 2014 Guide has much more detailed provisions (Sections 4.16 to 4.19) e.g. the fees and expenses charged to the fund must be reasonable and proportionate to the

[1] Guide addresses stock lending issues in sections 4.16 to 4.19
[2] Guide addresses conflict of interest stock lending issues in sections 2.21 to 2.24

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cost of undertaking the activities.

FRS Comment on Stock Lending Changes

A more concise provision would be to require that the unit-linked fund should receive the whole of the recompense less fees and expenses and less cost of indemnity provided and that fees and expenses and cost of indemnity provided should be reasonable and proportionate to the cost of these activities. That would cover all situations and would make it clearer that the unit linked fund should be entitled to the entire stock lending recompense less deductions (on a reasonable and proportionate basis) to be taken only in relation to the costs (both explicit and implicit) incurred in carrying out the stock lending activities.

However the new provisions are to be welcomed as they address financial media concerns that firms were charging fees and expenses in respect of stock lending activities in a non-transparent manner where there was no requirement that such fees and expenses had to be reasonable and proportionate.

Tax

The FCA thematic review found that improvements were required in just under half of the firms in the sample. These typically related to the consistency of approach across different types of funds and the fair treatment of losses.

Tax - Funds of Funds

The FCA found that, whilst customers were being told that funds were taxed on a standalone basis, funds established as 'funds of funds' had their tax based on the combined total of the tax for the individual sub-funds. The FCA said that there was no perfect solution in this area but firms should ensure their approach to the apportionment of tax is reasonable and delivers a broadly fair result for customers.

The 2014 Guide seeks to address this through changes in disclosure requirements [3] and also with new provisions in Section 5.63 viz "In addition, firms should:

- Ensure that the offsetting of losses against gains before calculating tax liabilities is done fairly and consistently.
- Document their processes and procedures for offsetting gains and losses and have in place systems and controls to ensure those processes and procedures are correctly applied.
- Aim for consistency of approach in offsetting gains and losses and the rationale for any inconsistency should be documented with a view to ensuring that all policyholders are being treated fairly."

Tax - Fairness

There is an FCA requirement that customer benefits are calculated fairly and accurately and that there is fair allocation of tax between customers and shareholders.

The 2014 Guide has a new provision "5.60 …..However, the pricing methodology adopted should seek to preserve fairness between different generations of policyholders and between policyholders and shareholders" and an amended provision "5.62 The following factors should be considered …

- Appropriate relief for external expenses charged to the fund.
- The discounting of tax rates where there is likely to be a prolonged period from the pricing date until the expected date of payment of the tax, for example on deemed and unrealised gains or losses. The approach to discounting should also be consistent with the settlement of tax provisions, or the holding of cash within a fund against the provision, required to avoid accidental or inappropriate gearing of the fund".

FRS Comment on Tax Changes

The section on tax in the 2012 Guide comprised about half a page. That has been extended to about two pages.

The key change is section 5.60 prescribing that the pricing methodology should seek to preserve fairness between different generations of policyholders and between policyholders and shareholders (whereas the 2012 Guide qualified that by "if appropriate".

There are two potential key consequences:

- Fairness between different generations of policyholders may require renewed focus on an appropriate methodology for placing value on tax losses in unit pricing

[3] 5.59 ... For funds where tax charging basis varies from the firm's standard approach, e.g. where the standalone basis is not applied, such variations should be disclosed, if material to the policyholder outcome."

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- Fairness between policyholders and shareholders may require a review of the method of quantifying the amount of tax losses and in particular that seven year spreading of deemed disposals should be applied in unit pricing for that purpose

An important issue is the seven year spreading of deemed disposal gains.
The risk is that if a life company is not applying seven year spreading of deemed disposals and is also placing little or no value on tax losses that likely scenarios could arise where the standard unit pricing approach resulted in unfair unit prices for customers and that the life company might not detect that in good time to prevent unit pricing errors arising.

Consider the example below of a fund that holds only external collective funds which are subject to the CGT deemed disposals rule.

Gross Assets at Start of Year 4		10,000				
Investment Return					-30%	
		Year 1	Year 2	Year 3	Year 4	Total
Investment Return		1,500	1,500	1,500	-3,000	1,500

The key question is what proportion of the 30% fall in asset values would be covered by the spreading forward of deemed disposal gains. This depends on the percentage of investment return that arises as realised gain.

Results

100% of Assets subject to Deemed Disposals						
Realised Proportion		0%	10%	20%	40%	60%
% Effect on Unit Price (compared to No Spreading)						
7 Year Spreading with no carry back		**9.8%**	**9.5%**	**8.4%**	**6.3%**	**4.2%**
7 Year Spreading with carry back		**9.8%**	**9.8%**	**9.8%**	**7.6%**	**5.1%**
Tax Losses c/f as % of Gross Assets						
No Spreading		42.9%	42.9%	42.9%	42.9%	42.9%
7 Year Spreading with no carry back		0.0%	1.5%	6.1%	15.3%	24.5%
7 Year Spreading with carry back		0.0%	0.0%	0.0%	9.8%	20.8%

Explanatory Notes:

- The figure of 6.3% (for the 40% realised proportion data point for seven year spreading with no carry back) means that the unit price would be 6.3% higher than the unit price (with no seven year spreading) where no value is placed on the different level of tax losses c/f for the two approaches.
- The percentage difference in unit prices reflect the differences in the tax losses c/f e.g. for the 40% realised proportion data point, 20% of the difference between 42.9% and 15.3% is 5.5% of gross assets which is 6.3% of net assets.

It is clear that this is a potentially very significant issue in certain scenarios.
FRS will shortly publish a detailed research update on this issue.

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Other Significant Changes

Section 2 Fund Governance

- Board

2012 Guide: Board

Ultimate responsibility for oversight and management of the fund

2014 Guide: Board (2.3to 2.4)

Ultimate responsibility for governance of UL funds including oversight.... along with ensuring fair treatment of customers

Must Ensure

- Adequate systems and controls to administer and manage funds fairly
- Assets backing unit linked funds are appropriate for customers
- Customer benefits are calculated fairly and accurately

FRS Comment

The revisions clearly establish that the primary responsibility for fund governance lies with the Board which is consistent with EIOPA's Guidelines on the System of Governance ("5.1. The focal point of the governance system is the administrative, management or supervisory body.")

The additional provisions closely mirror the terms of reference of the FCA Thematic Review TR13/8.

- Committees

2012 Guide: Committees

The Board may appoint committees:

- General Management Committee
- Pricing and Actuarial Committee

2014 Guide: Committees (2.5to 2.9)

Governance Arrangements for Committees

- Clearly defined responsibilities
- Appropriate structures for decisions to be challenged
- Appropriate scope
- Policies and procedures that outline their rationale and are documented

Roles and Responsibilities

- Documented terms of reference
- Board to ensure sufficient information
- Structure and composition of groups

FRS Comment

The new provision 2.8 is consistent with EIOPA SOG "4.69. In accordance with Article 46 of Solvency II Directive, national competent authorities should ensure that the undertaking establishes that the monitoring and reporting mechanisms within the internal control system provide the administrative, management or supervisory body with the relevant information for the decision making processes."

- New Requirement: "Firms should maintain adequate governance arrangements to ensure that unit-linked funds are managed appropriately and in accordance with policy disclosures."
- The scope of governance is specified to include "Valuation and Pricing"; "Fund development & monitoring"; "Investments and mandate compliance" and "Outsourcing".
- Outsourcing

2012 Guide: Outsourcing

2.1.8 Board must ensure that they have appropriate systems and controls to fulfil responsibilities to policyholders. Further specific requirements in this area are set out in the FSA Handbook.

2014 Guide: Outsourcing (2.12to 2.20)

- Board should exercise skill, care and diligence in selection and have appropriate systems and controls to manage the risks
- Take reasonable care that third party is supervised and discharges its outsourced functions appropriately
- System and controls to oversee fund operations
- Relevant factors to consider for entering into and overseeing outsourcers
- Appropriate understanding of outsourced activities
- Management information
- Review MI and validate operational processes
- Intra group outsourcing
- Chain of outsourcers

FRS Comment

The provisions referencing outsourcing have been considerably beefed up (sections 2.12 to 2.20). Previously there was just a single section 2.1.8 referencing outsourcing).

- Conflict of interests

2012 Guide: COI

2014 Guide: COI (2.21 to 2.24)

- Consider conflicts of interest
- Identify and manage conflicts of interest
- Clear conflicts of interest policy
  - Scope and purpose
  - How conflicts are identified, recorded and managed
  - Responsibility for maintaining the policy and ensuring adherence
  - Dealing with exceptions
- Examples of conflict of interests

FRS Comment

There are now provisions relating to conflict of interest (sections 2.21 to 2.4). Previously the Guide was silent on conflict of interest issues.

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Examples of potential conflicts of interests between different generations of policyholders

- For an expanding fund, the basis on which value is placed on tax losses in unit pricing impacts on the respective interests of existing unit-holders and incoming unit-holders
- For a contracting fund, the basis on which value is placed on tax losses in unit pricing impacts on the respective interests of continuing unit-holders and exiting unit-holders
- Where the unit pricing basis doesn't change when the net flow of investment changes (between incoming/exiting unit-holders compared to existing unit-holders)
- The non-application of a forward pricing approach for unit movements impacts on the respective interests of existing unit-holders and incoming/exiting unit-holders
- Market timing issues (i.e. the need for robust arrangements to protect against strategic dealing activity which might create unfairness for continuing unit-holders)

Examples of potential conflicts of interests between shareholders and policyholders

- Who provides the funding for the seeding of new funds (finance provided by shareholder, other funds)?
- The use of historic pricing
- In a contracting fund, what happens to the tax losses of exiting unit-holders (do those go the shareholder or to the remaining unit-holders in the fund?)
- Box management arrangements
- Transactions between the funds and group entities

Section 3 Fund launches, mergers and closures

- This was previously Section 5 but is otherwise largely unchanged

Section 4 Fund Operations

- Provisions on "Operating Standards" largely unchanged
- Sections on "Use of Discretion" incorporated from old Section 3
- New sections 4.13 to 4.16 on "Mandate Compliance"
- New sections 4.16 to 4.19 on "Stock Lending"
- New sections 4.20 to 4.22 on "Permitted Links"

FRS Comment

There is a new requirement Section 4.2 requiring that firms have appropriate capabilities and skill-base in respect of their unit-linked operation irrespective of whether or not outsourcing is used.

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Section 5 Valuations and unit pricing

- Provisions on "Pricing Issues-overview" and "Pricing Models"; incorporated from old Section 4 and largely unchanged
- "Pricing frequency and unit transaction timing"
    - New provisions 5.15 [4] and 5.17 [5] prescribing that customers causing unit pricing basis changes or the incurring of transaction costs should bear those costs
    - New provision re historic pricing "5.19 Firms should ensure that where a mismatch can occur that appropriate controls are in place to ensure there is no material customer detriment arising where customers seek to take advantage of any mismatch or potential arbitrage".
    - New provisions 5.26[6] and 5.27 [7]re market timing
- Provisions on "Box management" and "Cash transaction timing" incorporated from old Section 4 and largely unchanged
- "Valuations"
    - New provision 5.32 requiring a written valuation policy
    - New provision 5.35 requiring a check that the valuation time of the assets is consistent with the relevant pricing point of the fund.
    - New provision 5.38 to avoid the use of stale prices
    - New provision 5.43[8] requiring reasonable controls to prevent errors.
    - New provision 5.44 requiring that pricing functions have adequately skilled/suitably experienced and resourced staff
- Provisions on "Unit price rounding"; "Charges" ; "Dealing costs" and "Other Charges" incorporated from old Section 4 and unchanged

Section 6 Breaches, errors and material incidents

- New provision 6.2 to have appropriate systems and controls for the identification, prompt rectification and reporting of errors
- New provisions 6.3 to 6.5 on identification of errors and that arrangements for the rectification of pricing errors affecting underlying (third party collective investment schemes) should be reinforced contractually
- New provision 6.6 that error and breach events be rectified in a prompt and timely manner
- New provision 6.20 re error notification on agreeing a reporting format and frequency with supervisory contacts

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[4] 5.15 Firms should apply a principle that the customer(s) causing the pricing basis change to take place should have the price change applied at the right time to impact on their transactions, otherwise detriment could occur for customers who are unconnected to the changing direction of flows.

[5] 5.17 …. Where customers are causing funds to incur transaction costs, those customers should have allowance made for the actual or expected costs in their transaction to reduce the impact on other customers in the fund."

[6] 5.26 Firms should ensure they have access to appropriate information and have sufficient controls in place to be able to identify any customers who may be actively trading their funds as this could be an indication that these customers are potentially seeking to take advantage of market timing opportunities.

[7] 5.27 Firms should be mindful of how market timing may impact on other customers and take appropriate action to mitigate the impact on them. Where possible, the firm should take action to stop the customer from being able to take advantage of these opportunities (this may be from applying customer restrictions, changing pricing timing, changing dealing cut-off times). In taking any action, firms should be mindful of any policy conditions that apply.

[8] 5.43 A firm should have in place reasonable controls to prevent errors. This may include checking individual asset valuations compared to daily tolerance levels. Areas of higher risk, such as manual entry of information, should be subject to appropriate levels of checks and controls.

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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.

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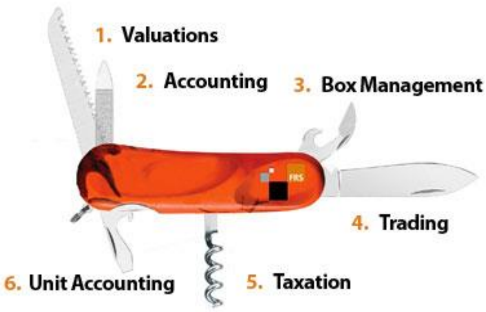

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