



Knowledge based solutions



Research Update

UK Unit Linked Funds Thematic Review

Background

The FCA's Thematic Review of the management and governance of unit-linked funds became public knowledge on 17th January 2013 through the FCA's Insurance conduct supervision newsletter and was subsequently highlighted in MoneyMarketing's 31st January 2013 article on the review into the £800bn unit-linked sector.

The thematic reviewing is assessing whether:

- firms have adequate systems and controls in place to ensure that funds are administered and managed fairly and in accordance with customer expectations;
- assets backing unit-linked policies are appropriate for policyholders; and
- policyholder benefits are calculated fairly and accurately."

The FCA expects to publish its findings in the Autumn.

FRS View

FRS anticipates that the thematic review findings will confirm that the governance of unit-linked funds is in general robust but that some issues may be identified where there is scope for improvement.

Based on the results of previous similar thematic reviews, issues that the FCA might place special focus on may include:

- **Whether or not there are weaknesses in the governance structures e.g.**
 - Any instances of failures to bring substantive issues to the attention of appropriate governance committees in a timely manner?
 - Any concerns about the knowledge and expertise of the membership of governance committees particularly in respect of complex pricing issues such as taxation and placing value on tax losses?
 - Is there a need for specialist training for the membership of governance committees?
 - Are there any deficiencies in senior management oversight?
- **Are there instances of inadequate disclosure to customers of counterparty credit risk where unit linked funds are linked to external funds or other assets?**
- **Where the administration of unit linked funds is outsourced**
 - Is there the potential that emerging issues might not be identified in a timely manner?
 - Is there an undue level of reliance being placed on the outsourcing company particularly where within the life company there is a lack of specialist knowledge of fund administration and fund taxation issues?
 - Is there a lack of knowledge in the life company of the detail of the outsourcer's fund administration systems and resultant 'out of sight out of mind' difficulties?
- **Are there weaknesses in the liability unit allocation, asset unit creation and investment processes used by some life companies and in particular in the context of the operation of mirror funds?**
- **Is there potential customer detriment in relation to the use of historic pricing?**
- **Is there inadequate management of operational risk in some companies with inadequate systems and heavy reliance on spreadsheets and manual 'workarounds'?**
- **Is there inadequate risk identification processes and risk mitigation planning underpinned by poor quality management information often resulting from poor systems?**

Implications for Life Companies

The potential implications for life companies are:

- In future there may be a greater level of FCA regulatory focus on the management and governance of unit-linked funds.
- Greater operational challenges for life companies in ensuring that their systems and procedures for unit linked funds meet the high standards now expected by the FCA. This should be viewed in the context of the FCA enforcement process where the FCA has said that it seeks to change behaviour by making it clear that there are real and meaningful consequences for those firms or individuals who don't play by the rules. The FCA intends to bring more enforcement cases and to press for tough penalties for infringements of rules and to hold members of senior management accountable for their actions
- The need for a greater focus on meeting the FCA objective that firms put consumers at the heart of their business. For unit-linked business the appropriate governance of unit-linked funds underpins treating customers fairly.
- If there is a finding that the governance of unit-linked funds has the potential to cause significant consumer detriment, then following the model of previous FCA thematic reviews, it is likely that there would be a series of Consultation Papers and a Policy Statement to implement changes and more supervisory work across the sector focusing on key risks
- Life companies who are unable to demonstrate during any future supervisory contact with the FCA that they have analysed their systems and controls as a result of the thematic review and made any necessary improvements, may be the subject of further regulatory action.

Action Plans

The action plans required for life companies may include:

- A need for internal/external review of systems and controls based on the actual assessment process (as outlined below) used by the FCA in the thematic review;
- The structure and membership of unit linked fund governance committees may need to be reviewed and appropriate training may need to be provided;
- A review of the adequacy of documentation of policies and procedures;
- A review of the control and oversight of outsourcing arrangements;
- A review of allocation and investment processes particularly for mirror fund/external link funds;
- An action plan for identified weaknesses.

FCA Regulatory Approach

The FCA uses a dual approach to regulation. The first approach is monitoring firms to check if they are complying with the regulatory requirements and taking action as necessary. The second is thematic work which involves analysing a particular product, market or practice to see if there are widescale issues that it needs to act on.

The FCA can use either, or both, of these approaches to best manage the risks it identifies.

The main risk the FCA focus on is that of **consumer detriment** caused by unfair, unclear or misleading promotions.

FSA Dual Approach

Monitoring & Thematic

“Thematic work helps us identify the scale and nature of risks that emerge from our surveillance of markets and, where appropriate, to take action to address these risks. It enables us to consider the activity taken by different firm across a particular sector in a consistent way and helps us identify good and bad practice.”



Background to Thematic Review

This thematic review followed from the FSA's 2012 Retail Conduct Risk Outlook ("RCRO") published in March 2012 which identified seven key emerging retail conduct risks for life insurers, one of the risks being the governance of unit-linked funds.

In late Autumn 2012, the FSA wrote to a sample of life insurers announcing the review and indicated that the thematic review was further influenced by the introduction of pensions auto-enrolment.

Assessment Process

The assessment process was to comprise three stages:

Stage 1: For sample insurers, an FSA desk-based analysis of governance and control

Stage 2: For sample insurers, onsite visits by the FSA including interviews and walkthroughs of processes and testing of issues on specific funds

Stage 3: FSA moderation of results when sample insurers have been assessed

Stage 1: Desk-Based Analysis

In order to complete their desk-based analysis the FSA sought detailed documentation from the sample insurers. This documentation was categorised under three headings:

- Overarching Governance;
- Investment Management; and
- Fund Administration and Policyholder Benefits.

The information sought in each category is outlined below.

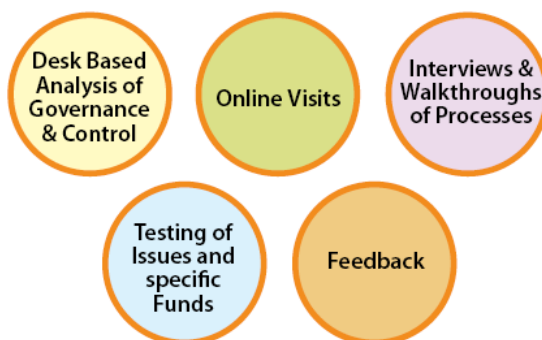
FSA 2012 Retail Conduct Risk Outlook

3.1 Communication and management of the risk profile of Life Assurance funds (emerging risk)

"We have concerns that some insurance firms have poor governance and control practices around their unit-linked funds."



Assessment Process



Overarching Governance

The type of information sought on overarching governance issues included:

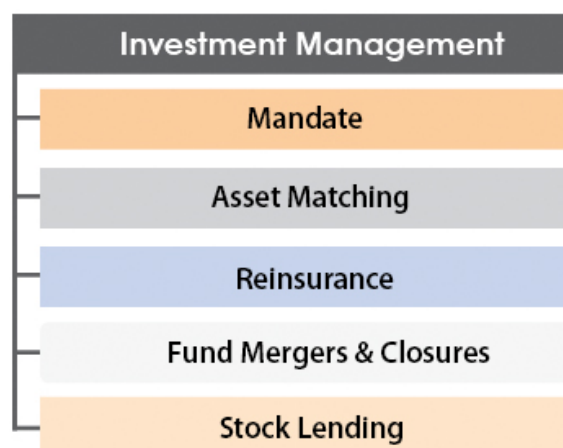
- Governance Structures – details of working committees, terms of reference, agendas and minutes;
- Strategy & Approach – copy of documentation e.g. unit-linked equivalent of the Principles and Practices of Financial Management of with-profit funds;
- Risk Management - internal audit, risk and compliance reports and recent reviews of fund administration;
- Breaches – policies and procedures, recent breaches;
- Conflicts of Interest – shareholder or non-linked funds investing into unit funds, transactions between unit-linked funds and other group entities;
- Outsourcing – procedures, minutes of relationship management meetings, internal audit, risk and compliance reports and recent reviews of fund administration.



Investment Management

The type of information sought on investment management issues included:

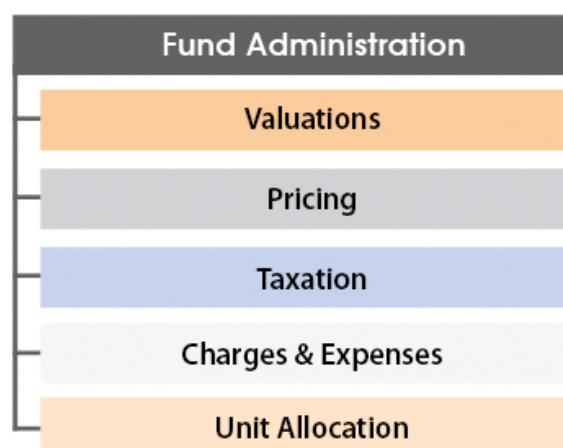
- Mandate & Permitted Links – policies and procedures, derivative usage policy, monitoring of external fund links;
- Asset Matching – unit liability matching, deferral conditions for property funds;
- Reinsurance – counterparty risk and disclosure;
- Fund mergers and closures – anticipated plans;
- Stock Lending – assessing counterparties and collateral.



Fund Administration and Policyholder Benefits

The type of information sought on fund administration and policyholder benefits issues included:

- **Valuations** – frequency of pricing, price feeds, prices for unlisted securities, valuing property, validation process;
- **Pricing** – unit pricing bases and assumptions (bid/offer basis, buying costs, tax rates and review procedures), error tolerance thresholds;
- **Taxation** – policies and procedures, responsibility for tax, responsibility for challenging approach;
- **Charges & Expenses** – list of charges;
- **Unit Allocation & Investment Processes** – a timetable for the various processes such as receipt of customer instructions, receipt of customer monies, allocation of liability units on the policy administration systems, asset units created in fund, cash position advised to fund manager, cash passed to fund, cash invested in underlying assets.



Stage 2: Onsite Visits

The onsite visits were used to expand on and clarify any issues that arose in the desk-based reviews in Stage 1 of the process. The interview subjects were:

For the on-site visits, the FSA discussed the interview subjects with relevant personnel, e.g. fund operations management, compliance manager, actuaries, finance managers, customer services managers, etc and where operations were outsourced with the personnel who have the oversight and responsibility for the relevant function.

The process walkthroughs were conducted with operational financial staff and where operations were outsourced with the outsourced service provider.

Stage 3: Outcome of Thematic Review

It is anticipated that the FCA will publish the Thematic Review Findings and Guidance in the Autumn. The results are awaited with interest.

Following on from the MoneyMarketing article, Standard Life has publicly called on the FSA to scrutinise the use of external fund links in automatic enrolment default funds due to concerns about the lack of protection offered to savers (e.g. if the external fund manager should run into problems) – see <http://www.moneymarketing.co.uk/pensions/standard-life-calls-on-fsa-to-scrutinise-external-fund-links/1065396.article>.

We can speculate about some of the issues that might arise. The FSA thematic review includes an analysis of the timelines for the various actions in managing unit-linked funds in general (but this we believe is particularly important for mirror funds/external fund links) including:

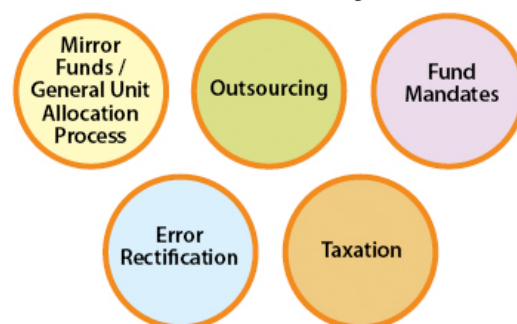
- Customer instructions received
- Customer monies received
- Customer units allocated on policy administration system
- Units created on fund administration system
- Cash position advised to fund manager
- Cash passed to fund
- Cash invested in underlying assets

Whilst the above analysis is in respect of all types of unit funds, it has specific resonance for mirror funds. A review of these timelines will indicate that some life companies do not operate on a forward pricing basis. It will be interesting to see how the FCA views this issue and how it seeks to ensure that there are no detrimental effects to policyholders resulting from this practice. FRS will discuss forward pricing in a future research note.

Another area where practices can differ between life companies is in the provisions for taxation in unit-linked funds. Life company taxation is quite complex and there is no agreed methodology for calculating provisions for tax or placing value on tax losses in unit-linked funds. It will be interesting to see what observations, if any, the FCA has on the different approaches used by different companies, particularly in relation to placing value on tax losses. FRS will discuss taxation issues in a future research note.



Potential Industry Issues



Action Plans for Life Companies

No company wants the adverse publicity and financial costs associated with being sanctioned for breaches of the regulatory requirements. The administrative costs arising from customer compensation programmes, i.e. significant management time, projects to recalculate historic unit transactions based on corrected unit prices and using external firms to verify the calculations, tend to be many multiples of the actual regulatory fine.

There are steps that life companies can take to prevent this scenario applying to them.

Companies not selected as sample insurers, who haven't gone through the review process, should consider the merits of an internal review process to assess the extent to which they would have prepared for such an FCA review. Would their governance structures, their documentation of policies and procedures, their controls on fund mandates etc meet the regulator's expectations and standards?

Systems Review

Companies should consider a detailed assessment of their fund administration systems:

- Are they fit for purpose, robust, documented and supported?
- Is there significant operational risk arising from a non-systematic approach, e.g. widespread use of spreadsheets?
- Is there a significant keyman dependency risk?
- Can the system administer forward pricing?
- Is provision for taxation an integrated part of the fund valuation? Given the complexity of taxation calculations, if these are performed outside of the system this introduces significant operational risk.
- Is the taxation provision calculated with the same frequency as the unit price? If not the validity of the unit price may be undermined.

Future Environment for Fund Administration for Life Companies

It is likely that there will be a greater level of regulatory focus on the management and governance of unit-linked funds particularly in the context of the introduction of pensions auto-enrolment in the UK.

There is likely to be a greater incidence of sanctions with publicity for those companies who breach regulatory requirements. This will serve to emphasise the importance of appropriate systems and controls and the importance of comprehensive documentation thereof.

Reprimand and fine

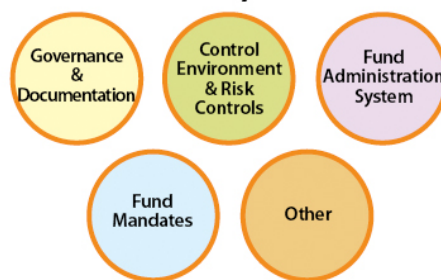
It could be you!

"...Company X: Reprimand and fine
The Regulator reprimanded the firm and required it to pay monetary penalty of Y"

The breaches identified are..."



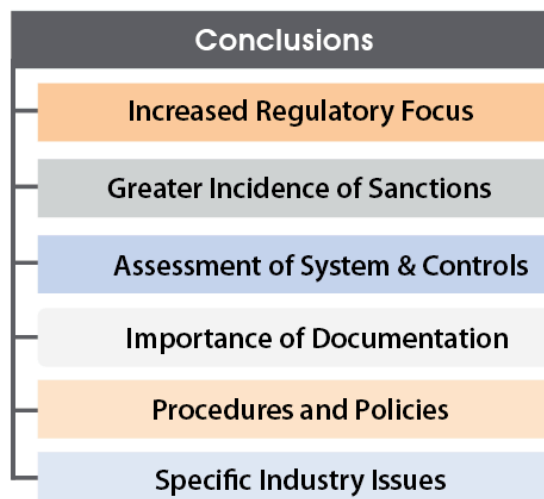
Assessment of Systems & Controls



Internal Review



Conclusions



About Financial Risk Solutions (FRS)

Financial Risk Solutions Ltd (FRS) is a 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.

Invest Pro™ was specifically designed to securely automate the complexities in companies that perform critical fund administration functions.

FRS's product Invest|Pro™ manages unit pricing and portfolio valuations, asset /liability unit matching, box management, trade order management, investment accounting, financial reporting and compliance with investment mandates in a single application. Product types covered include unit linked funds, portfolio bonds, self-invested/directed pensions, shareholder funds & with-profit funds.

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