Financial Conduct Authority

FCA
FINANCIAL CONDUCT AUTHORITY

Thematic Review TR13/8

The governance of unit-linked funds

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1. Overview and scope

1.1 Overview

1.1.1 Why have we reviewed the unit-linked fund sector?

Unit-linked funds are a type of pooled investment offered by insurance companies through their life or pension policies.[1] Millions of consumers invest in these funds either individually or through their employers' pension schemes. Over £900bn is invested in unit-linked funds, approximately 85% of which is pension savings.

As increasing numbers of employees are 'auto-enrolled' into employer-arranged pension schemes the number of customers investing through unit-linked funds is expected to increase significantly.

Considering the size and importance of this market and the need to ensure that customers' pensions and investments are protected, we wanted to check that firms were meeting our standards and treating customers fairly. So we reviewed 12 firms, which between them manage a significant proportion of the total amount invested in unit-linked funds.

Our rules set requirements as to how these funds are managed. In addition, the Association of British Insurers (ABI) has a 'Guide of good practice for unit-linked funds' which sets out good practice for firms.[2] This guide was originally developed in conjunction with our predecessor organisation, the Financial Services Authority.

This thematic review was pre-emptive and focused on ensuring that firms have arrangements in place to ensure that customers' interests are protected effectively.

1.1.2 Who will be interested in this report?

This report summarises the thematic work we conducted on the unit-linked fund sector – it is not general guidance on the operation of our rules.

This review is primarily aimed at insurers that operate in the unit-linked market, however our findings will also be of interest to other firms, including asset managers and other outsource service providers that are involved in the operation of unit-linked funds. It may also be of interest to consumers, pension trustees, trade associations and consultancy firms.

1 Unit-linked funds offer customers exposure to a range of different asset types and investment strategies. Our review did not cover with-profits funds.

2 www.abi.org.uk/~/media/Files/Documents/Publications/Public/2013/A%20Guide%20of%20Good%20Practice%20for%20Unit%20Linked%20Funds.ashx

1.1.3 What did we find?

We found no material issues evident throughout our sample of firms that posed a serious threat to customers' investments. So we do not consider there are any significant widespread, systemic failings in the sector.

We did, however, find specific material problems in individual firms which – if left unchecked – could have led to customers being disadvantaged. For example:

- poor oversight of an outsource service provider – which could increase the risk of errors not being identified
- insufficient controls over permitted assets – which could lead to investment in riskier assets than allowed, and
- overly-stretched operational capacity in a pricing team – which led to errors occurring and delays in rectifying them

In these cases, we required firms to appoint independent external experts[3] to investigate whether customers have lost out and whether compensation is required.

We also found other areas where firms need to make improvements to ensure that customers are treated fairly, for example:

- fair allocation of tax and stock lending revenues between customers and shareholders
- the identification and rectification of errors, and
- the management of potential conflicts of interest

1.1.4 What action has been taken?

We have asked the firms in our review to make improvements in response to our detailed findings. Much of this work has now been completed.

We are pleased to see that many firms, that were not part of our review, have also proactively begun to review their practices.

1.1.5 Next steps

The ABI has committed to enhance its guidance, by adding more detail, in light of our findings. This will make it clearer what good practice looks like and help introduce improvements across the whole of the unit-linked industry.

1.2 The scope of our review

1.2.1 Firms in the review

We reviewed 12 firms which between them manage a significant proportion of the total amount invested in unit-linked funds. We selected a broad range of firms of varying size, type and business model to ensure we got a representative picture of the sector as a whole. The results outlined in this report are based on this sample.

3 Skilled Persons appointed under s166 of FSMA.

1.2.2 Method of assessment

We assessed whether firms were complying with our rules and principles[4]. To do this we tested whether:

- firms had adequate systems and controls to administer and manage funds fairly
- assets backing unit-linked policies were appropriate for customers, and
- customer benefits were calculated fairly and accurately

The structure of this report mirrors these three key areas.

Our review involved analysing information we requested from firms and conducting on-site visits – which included interviews with staff from both insurers and outsource service providers (where applicable) and firms demonstrating to us systems and processes operating in practice.

4 In particular we took into account COBS 21, SYSC 3, 13 and 14, INSPRU 3 and Principles 2,3,6,7 and 8.

2.
Key findings

2.1 Do firms have adequate systems and controls to administer and manage funds fairly?

We assessed whether firms had governance arrangements in place to ensure the fair treatment of customers.

We found that most firms had adequate systems and controls in place to manage the risks arising from the operation and management of their unit-linked funds – although there was scope for some improvement in nearly all firms in our sample.

The key areas where we identified that improvements were required were:

- *the oversight of outsource service providers*
- *the timely resolution of rule breaches (such as material pricing errors), and*
- *the management of conflicts of interest*

Deficiencies in these areas could lead to errors not being identified and corrected promptly and the unfair treatment of customers.

It is in firms' interests, as well as their customers', to ensure that a robust control environment exists. Quantifying and rectifying errors is costly, labour-intensive and time-consuming.

2.1.1 Outsourcing

Firms are increasingly outsourcing operational functions associated with unit-linked business to specialist providers. For example, fund management and pricing/valuation activities are typically outsourced.

Our rules on outsourcing for insurers are in the FCA Handbook SYSC 3, with additional guidance in SYSC 13.9. Firms that outsource operations to third parties retain responsibility for all obligations to their customers and compliance with regulatory requirements.[5]

We identified some failings in the oversight of outsource service providers in approximately half of the firms in our sample. The size and nature of these firms varied considerably.

5 See SYSC 3.2.4G

We found problems in four key areas:

- The extent of oversight activity conducted by operational management (the 'first line of defence'[6]) varied considerably. Where processes were more accounting-related (e.g. unit-pricing), operational management were generally more involved in actively validating and reconciling information from the outsource service provider. However, for other, less 'precise' processes (e.g. mandate compliance[7]), operational management were less engaged with the third party's specific activities and could not demonstrate how they could be certain that processes were operating effectively. The control exercised by operational management is key in ensuring the adequate oversight of outsource service providers.

- The level of assurance work undertaken by functions such as Risk, Compliance ('the second line of defence') and Internal Audit ('the third line of defence') varied. In some firms, these functions had not only assessed the adequacy of controls that operational management had put in place but also those in operation in the outsource service provider (using their audit rights to undertake such reviews). However, in half of the firms we found the level of assurance provided by control functions was insufficient given the nature, scale and complexity of their operations.

- Where operational functions were outsourced to other companies in the same group, there was an 'informal' reliance on group control functions (such as Group Internal Audit) to provide assurance on the effectiveness of controls in the outsource service provider. This approach generally relied on personal relationships as opposed to specific, clear engagement with the audit universe, audit plan and reporting arrangements. A firm should not assume that because an outsource service provider is an intra-group entity (or, more generally, a regulated firm) an outsourcing arrangement with that provider will, in itself, necessarily imply a reduction in operational risk.[8]

- There were also deficiencies in circumstances where oversight was not direct – for example, where one outsource service provider was overseeing another (whether by virtue of a formal contractual arrangement or otherwise). These 'chains' of outsource service providers led to gaps in accountability which posed risks to customers.

6 In a typical 'three lines of defence' risk management model.

7 By 'mandate compliance' we mean ensuring that funds are managed in line with their investment mandate, objectives and the disclosures that are provided to customers (see section 2.1.5).

8 SYSC 13.9.3G

Example – insurer demonstrating insufficient oversight over outsource service providers

One insurer had outsourced the valuation of assets and unit-pricing to one firm and relied on another firm (in its group) to oversee that arrangement. We found the engagement or oversight that the insurer had was too limited in the circumstances. Also, the insurer had not done enough assessment of the effectiveness of processes operating within the group firm on which it was relying for oversight.

So, the insurer was not in a position to satisfy itself of the quality of work being undertaken, or the accuracy of data provided, by its outsource service providers.

Example – insurer with comprehensive oversight of its outsource service provider

One insurer had a wide range of different controls in place to oversee its outsource service provider. These included:

- Regular engagement at various levels – including executive, middle management and subject matter expert.
- Separate forums for issue and change management.
- A contractual requirement for the outsource service provider to adopt 'industry best practice' and comply with the firm's own policies.
- Comprehensive management information.
- Six-monthly reviews of standing data used by the outsource service provider.

2.1.2 Identifying, rectifying and notifying errors and rule breaches

Unit-linked fund operations involve very high volumes of transactions, typically on a daily basis. Inevitably, errors can occur and it is important for firms to have appropriate arrangements in place to identify and rectify these in a timely manner. Where necessary, firms must also notify us of errors that amount to rule breaches.[9]

Identifying errors

All of the firms in our sample had some arrangements in place to identify issues (for example, abnormal variances in asset valuations or unit-prices) although tolerance levels and the frequency of checks varied.

9 COBS 21.2.8R

Small errors (which may fall under daily tolerance levels) can build over time into material issues. Two firms had significant pricing errors caused by an initial small error compounding over a period of years. Our review identified a small number of firms that, in addition to daily checks, conducted reviews over longer periods (e.g. quarterly, annually). This increased the chance of identifying such errors.

Rectifying errors

Errors, such as those relating to unit-pricing, can be difficult and time-consuming to rectify. Although, ultimately, errors get corrected and redress (where appropriate) is paid, delays can disadvantage customers, particularly those who have exited the fund, moved away or purchased an annuity. We considered half of the firms in our sample could have worked more quickly to correct errors and compensate customers. We noted that delays were sometimes caused by the ineffectiveness of out of date 'legacy' administration systems.

Example – delay in rectifying a pricing error

One insurer took over a year to quantify the extent of a material pricing error. A lack of experience led to delays in identifying the error initially. The responsible pricing and valuation team was also very resource constrained and resolving the error was consistently made a lower priority than other business needs.

Notifying us of errors and rule breaches

Recurring errors can indicate wider, more systemic issues. So, it is important that our firm supervisors have appropriate oversight of pricing and other relevant errors. However, we found that arrangements for notifying them of relevant rule breaches were inconsistent.

Although firms were aware of the rule requirements for notifying issues that have a serious regulatory impact[10], they were less aware they needed to notify their supervisory contact of potentially non-significant breaches of our rules in an appropriate, mutually agreed manner.[11]

2.1.3 Managing conflicts of interest

Various conflicts of interest can arise in the course of unit-linked business. These can be between shareholders and customers, with-profits customers and unit-linked customers or different generations of unit-linked customers.

Our review found that firms typically relied on generic firm, or group, conflicts of interest policies to manage their conflicts. Often these were more 'gifts & entertainment' or 'directors' interests' type policies than those designed to manage wider conflicts of interests. This resulted in a lack of awareness amongst the senior executives that we interviewed of the nature of conflicts of interest that could arise in respect of unit-linked business.

We found that half of the firms in our sample did not fully consider specific unit-linked conflicts of interest even though potential conflicts did exist, for example:

10 SUP 15.3.1R

11 COBS 21.2.8R

- The 'seeding' (i.e. the provision of initial working capital) of new funds with shareholder capital or other customer funds. This can lead to conflicts of interest when the shareholder wishes to withdraw their investment, as this could affect the fund value. The need, or desire, to use existing funds to seed new funds could encourage firms to invest in a manner incompatible with investment mandates, fund objectives or customers' best interests.

- An insurer making use of the with-profits fund or inherited estate to support its unit-linked business – for example, to provide liquidity or subsidise costs. If this conflict of interest is not managed it could disadvantage with-profits customers.

Although we considered that some firms were not doing enough to demonstrate they were managing their conflicts of interest, we did not find evidence of any issues which were posing a serious threat to customers' investments.

2.1.4 Unit-linked fund governance structures

In most cases, firms had appropriate governance arrangements which considered unit-linked funds issues in sufficient depth and granularity and which provided robust independent challenge.

However, in one instance, the particular group structure meant the insurer's management had limited influence over the operation of its unit-linked funds.

Example – a comprehensive governance structure to support unit-linked fund operations

One insurer had introduced a comprehensive, well-considered governance structure for its unit-linked business. This structure comprised overarching senior committees supported by specialist individual sub-committees or working groups overseeing key operations such as stock-lending, mandate compliance and unit-pricing.

2.1.5 Investment mandate compliance

By 'mandate compliance' we mean ensuring that funds are managed in line with their investment mandate, objectives and the disclosures that are provided to customers. The impact of a fund's asset mix moving away from that disclosed to customers can be significant and result in material levels of detriment.

Generally, we found that the descriptions of assets and investment strategies provided to customers were very broad and provided firms with considerable latitude in managing the fund in accordance with customer disclosures. The investment mandates provided to the actual fund managers were more detailed but the actual specificity of them varied from firm to firm.

We assessed the overarching controls and processes that firms had to ensure mandate compliance. We found that most firms in our sample had robust arrangements in place with only two requiring some relatively minor improvements.

2.2 Are the assets backing unit-linked policies appropriate for customers?

The second element of our review assessed whether firms invested in assets appropriate for their customers – whether these were retail or institutional customers. Our rules define the types of assets allowable for different types of customers. These are known as 'permitted links'.

We also considered how firms monitored and exercised oversight of their assets to ensure that they continued to be appropriate and that risks to customers were managed effectively.

We found that firms operating in the retail market generally invested in mainstream assets and we identified no concerns regarding their selection of assets.

Where firms operated in the institutional market, they were more likely to invest in alternative, more exotic assets and legal structures, which can be more risky. Institutional customers such as pension trustees could be investing on behalf of underlying retail customers so it remains important that protections are in place.

Our review found that these firms needed to improve their assessment and decision-making processes for determining that such assets complied with our rules.

We also identified some concerns about how firms dealt with business that was reinsured with other insurers.

2.2.1 Permitted links

Our review found that firms operating in the retail market generally invested in mainstream asset types. They did not invest in assets where their appropriateness – and accordingly, their permissibility – was more subjective and required more detailed analysis. We identified no concerns in this area for the firms operating in the retail market.

The firms in our sample that undertook institutional business sought to make more use of the flexibility in our rules (for example, by using non-UK based asset types) and the principle that firms must consider the 'economic effect' of an asset ahead of its legal form.

We found that these firms did not always conduct sufficient, in-depth analysis to enable them to make informed decisions that assets were appropriate as permitted links.

Example – insufficient assessment of whether an asset was compliant

Our rules allow the use of underlying assets or legal structures which meet certain specified criteria. We challenged the way in which one insurer had made the assessment against these criteria.

Although the insurer had commissioned an external assessment we found that in the circumstances the assessment was too 'high-level' and did not adequately highlight areas of doubt. Relying solely on this assessment did not give the insurer's management sufficient information about areas of uncertainty to make an informed decision about the eligibility of the asset.

Example – insufficient consideration of whether an asset met the 'economic effect' test

One insurer had made use of the 'economic effect' assessment described above to determine that a particular asset was appropriate as a permitted link.

We found the firm had not sufficiently considered how any lower quality securities (that formed part of the overall asset) could have affected the value of the overall asset, or provided any justification of how such risks were mitigated by the particular structure.

2.2.2 Investment via regulated collective investment schemes & reinsured funds

Regulated collective investment schemes

It has become common for unit-linked insurers to offer exposure to third party firms' collective investment schemes (CIS) through their own unit-linked life and pension funds.

Authorised CIS are permitted investment types, but the fact that a fund invests in authorised investment vehicles does not alter the firm's obligations to its customers or the need to comply with the unit-linked rules.

So firms need to have appropriate arrangements in place to reasonably satisfy themselves that the underlying CIS is performing as expected and that pricing errors, or other issues arising, are dealt with appropriately.

We found that the firms in our sample had adequate arrangements in place although some had more comprehensive measures than others. The firms in our sample typically used some form of regular questionnaire to assess the operational performance of fund managers on an ongoing basis and these covered areas such as pricing errors, other breaches and information on stock lending. Firms also monitored the fund performance of the insured fund relative to the underlying CIS and other benchmarks.

Example – selection approach for new funds

One insurer, which offered a large range of funds linked to external CIS, operated a strict due diligence assessment. To support the automated processes needed for administering a large number of funds, the insurer would only invest in CIS with pricing points that corresponded with its own.

Example – compliance review of fund managers

In addition to assessments by its operational areas, one insurer's compliance department conducted two yearly reviews of all fund managers (including those through which the insurer invested via CIS).

This more independent assessment provided the insurer's management with an additional source of comfort that funds were administered and managed in customers' interests.

Reinsured funds

Unlike CIS, firms cannot directly invest in other insurers' unit-linked funds. To provide access to funds offered by other insurers, firms enter into reinsurance contracts with particular insurers. In this respect, reinsured funds operate as another form of 'external fund link'.

Our rules require firms that enter into reinsurance arrangements for unit-linked funds to discharge their responsibilities as if no reinsurance contract was in place.[12]

In order to comply with this rule firms should:

- disclose to customers the implications of any credit risk exposure they may face in relation to the solvency of the reinsurer, and
- suitably monitor the way the reinsurer manages the business in order to discharge its continuing obligations to customers[13]

Reinsurer credit risk

Reinsurance can expose customers to additional risks, particularly the financial failure of the reinsurer. This is because some firms have sought to 'pass on' to customers the risk of the reinsurer's failure through their policy wording and disclosures.

Customers need to know and understand that the value of their policy is linked to a third party and any consequences of this. For example, a customer's view on the financial soundness of an insurer may have influenced their choice of provider. They may be unaware that their investment in a reinsured fund could expose them to the risk of financial failure of a different firm.

12 COBS 21.3.3R
13 COBS 21.3.4G

If the reinsurer suffered financial failure this could significantly affect the value of its funds. If the customer was bearing this risk, the value of their policy could be materially affected. They would not be covered by the Financial Services Compensation Scheme (FSCS) because their contract is with the primary insurer and the FSCS would only cover them for failure of that firm – not the reinsurer.

As we have previously stated, it is for firms to make a commercial decision over who takes on the credit risk of the reinsurer. If the firm intends the customer to bear this risk, it should set this out explicitly in the policy wording and customer-facing material such as the Key Features Document. Any reference to the extent to which FSCS cover applies to the policy must also set out clearly instances where it does not. Without this requirement being met, it is not clear that the firm is treating the customer fairly or considering the information needs of its customers.

If the policy is silent on reinsurance credit risk exposure, our view is that the risk continues to fall on the firm. This would particularly be the case where documentation states 'this policy is covered by the FSCS' without any further qualification. We do not accept that it is inherent in the general nature of unit-linked business that customers should bear this risk.

Of the firms who entered into reinsurance arrangements, we found that most agreed to pay out to the customer regardless of whether the reinsurer fails i.e. they did not pass the counterparty credit risk to the customer. Where the customer was exposed to the risk, we identified one firm where, although it was clear in the policy documentation that the customer held the risk, the firm needed to improve its accompanying marketing material to ensure that customers fully understood the extent and nature of the FSCS protection.

One firm in our sample advised us that it was looking to pass the reinsurance counterparty credit risk to its customers. We are aware that this is an increasing trend at least in part prompted by the anticipated Solvency II capital requirements for holding counterparty credit risk.

Firms seeking to vary customers' policies to achieve this transfer of risk need the contractual powers to make such a change. This includes them needing to ensure that any term on which they wish to rely is relevant and also complies with the requirements of the Unfair Terms in Consumer Contracts Regulations, 1999.

In addition, firms need to demonstrate to us that any action which they propose to take complies with the Principles for Businesses, in particular Principle 6 (treating customers fairly) and Principle 7 (information needs of customers).

Based on our experience, we have generally not been convinced that firms would be acting fairly if they do not obtain informed, express consent from customers for such a change in the absence of a clear contractual power. Given that the transfer of this risk appears to us to be a significant change in the nature of what customers had committed to, in any event, firms will need to show that they are treating customers fairly.

Oversight of reinsurers

We found that all the relevant firms in our sample had conducted initial due diligence and were also monitoring the reinsurer's activities on an ongoing basis. The nature of this varied but typically took the same form as the oversight of CIS fund managers described above. One firm used a quantitative model as part of its due diligence (see example below).

Example – risk-based approach for reinsured business

One insurer adopted a risk-based scoring system for determining the extent of business that it would be prepared to place with a particular reinsurer. The insurer scored counterparties on aspects such as regulatory jurisdiction, capital position and the auditor's opinion of accounts.

This methodology helped the insurer manage both its own risks and the risks to its customers.

2.2.3 Ensuring sufficient liquidity

Firms must ensure that their assets are sufficiently liquid to enable them to meet their liabilities (e.g. paying policy maturities or transfers out).

Most funds invest, to varying degrees, in listed securities which are relatively liquid and can be sold rapidly to provide cash. A notable exception is property funds that invest in direct holdings of property.

Our review assessed how firms managed their liquidity, particularly in respect of property funds.

We identified no significant concerns in this area. We found that firms made use of a wide range of tools to provide liquidity including active monitoring, longer term forecasting, property shares, overdrafts and shareholder funds (through box management). The deferral of exits from the fund (which is generally allowed for in policy conditions) was considered by most firms to be a 'last resort'.

In some cases firms were holding property indirectly, sometimes through investments in unregulated Collective Investment Schemes (uCIS). Holdings in uCIS, particularly property uCIS, can be illiquid as they may hold a small number of large property developments with limited numbers of unit holders. In the cases we saw, firms were properly managing the liquidity issues, along with the restrictions in our rules on the extent of holdings in a fund, where they applied.

Example – managing liquidity in a property fund

One insurer had established a clear range of metrics regarding liquidity in its property fund. These included not only set percentages of cash (relative to the fund size) but an estimate of required liquidity based on historic experience.

In the event that liquidity fell below the established tolerance, a specialist working group (which would ordinarily be dormant) would come into force with the express purpose of managing liquidity in the fund.

2.3 Are customer benefits calculated fairly and accurately?

The third element of our review assessed whether firms had arrangements in place to calculate the value of customers' investments (such as their pension fund) fairly and accurately.

The determination of individual policy values is a combination of mathematical processes and, in some instances, subjective judgement exercised by the firm.

To establish a unit-price (on which the value of a customer's policy is based), a number of steps are required; for example: underlying assets (e.g. shares, property) are valued, fees, charges and an allowance for tax are deducted and income to the fund (e.g. dividends, rental income) is added.

These complex processes, which typically occur daily, need to be managed carefully and fairly to ensure that customers receive the policy values that are due to them.

We found scope for improvement in most of the firms in our sample. In the three firms where we found the most serious issues, we required them to appoint skilled persons to investigate further to make sure that customers have not been disadvantaged.

Some of the deficiencies related to areas where firms apply judgement and subjectivity (such as in unit-pricing, the apportionment of tax and the allocation of stock lending revenues) – we considered that half of the firms could do more to ensure the fair treatment of customers.

We considered that, generally, firms could do more to improve the way they calculate customer benefits. But, apart from the three firms mentioned above, we did not find evidence that customer benefits were calculated incorrectly resulting in customer detriment.

2.3.1 Valuing assets

Most mainstream asset types (e.g. shares, corporate bonds) have regular prices readily available. We identified no concerns about how firms handled the valuation of these assets.

For other asset types (e.g. property, certain derivatives, unlisted shares), values can be more subjective – sometimes demonstrating variations depending on the source.

To ensure accurate valuations, most firms in our sample used a variety of price sources to value their assets. Some firms had established sophisticated methodologies in respect of their valuation sources (see example below).

Example – structured approach to selecting valuation sources

One insurer had assessed the various valuation sources for each asset type and established a clear hierarchy based on their experience of accuracy, reliability etc.

The top position in the pricing hierarchy would be the preferred value and would be used if available. If for some reason this source was unavailable, the value for the next position down would be used.

The firm also compared all the values in the hierarchy and if they were significantly different, then this would be investigated further.

This process helped to ensure that the firm always had access to the most accurate price available.

We identified that nearly half of the firms in our sample could make some form of improvement to their valuation processes. These typically related to enhancing the range and/or independence of the valuation sources. In one instance, we found that the firm could have done more to challenge its 'stale' prices (an asset value where it has not been possible to obtain an up to date price for a certain period of time). In another firm we identified that manual processes could lead to errors in valuations (see example below).

Example – errors in valuations arising from manual processes

One insurer invested in a range of collective investment schemes (CIS) provided by a particular fund manager. The daily prices for the underlying CIS were notified to the insurer by email and manually keyed into the insurer's valuation & pricing system.

Manual processes of this type (occurring at both ends of the transaction) increase the risk of error. Despite 'four-eyes' checks being in place, at the time of our visit, a pricing error had occurred when a member of staff inputting the price transposed two of the digits. Fortunately, this error was identified as a result of other checks and was able to be corrected.

2.3.2 Unit-pricing

We identified a range of areas where firms could improve their practices around unit-pricing and the allocation and de-allocation of units.

In three cases, we identified more serious issues, these related to:

- an over-reliance on estimated unit prices
- the competence and capability of a pricing team, and
- funds operating on a historic pricing basis with no, or very few, controls to protect customers

The first two of these issues were very specific to the firms in question. However, in a third of our sample firms, we identified concerns (of varying degrees) about historic pricing.

Historic pricing is where unit-prices are based on asset values calculated at the last valuation point. This is in contrast to forward pricing where prices are based on the next valuation point. Although historic pricing allows customers to trade on known prices, this can be exploited by customers with market knowledge who can strategically deal to their own advantage – and potentially the detriment of the fund and other customers.

We found that the firms in our sample that operated historic pricing were lacking, or had limited, controls. Some firms were complacent about this risk and simply relied on the nature of their customer base (whether that be 'unsophisticated' or, contrastingly, 'professional') as a rationale for not having robust controls.

We also identified concerns about the application of 'swinging' prices in dual-priced funds.[14] Firms move (or 'swing') their unit-prices from offer to bid (or buying to selling) in various circumstances. If a fund is generally contracting (the money coming out of the fund exceeds money going in), firms will use the bid price. If the fund is expanding they will use the offer price. Firms adopt varying practices, some move their price based on long-term trends, others more mechanically on a daily basis depending on whether outflows for that day exceed inflows (or vice versa).

One firm, that adopted a long-term approach, did not have the ability to swing the price in the event of a material transaction that went against the 'trend'. This could lead to customers receiving an inappropriate price.

Two other firms, which also adopted a long-term approach, did swing their price in the event of a material transaction which went against the trend – but a delay in their processing timeline meant that the 'swung' price was applied to customers transacting the following day – and not those customers whose transactions actually caused the price movement.

2.3.3 Stock lending

Stock lending (or 'securities lending') is the practice of lending securities (e.g. shares) from one party to another. The insurer receives a fee for lending its assets and the borrower can use the borrowed asset to support its investment strategy.

This practice can involve risk should the borrowing party fail, or otherwise be unable to return the borrowed security. The insurer will receive some form of collateral to minimise their loss should this occur.

To protect customers, we set rules for insurers who practice stock lending.[15] Although legally the assets lent belong to the insurer, they have been purchased with money provided by customers and, therefore, those customers are entitled to a fair share of the stock lending revenues and to be reasonably protected from the risks involved. In broad terms, our rules require that:

- if the customers' fund bears any risk, the extent of this must be disclosed to them
- if the fund bears the risk, then the fund should receive all recompense (less fees and expenses) or

14 Funds can be single-priced (where you buy and sell at the same price) or dual-priced (where you buy and sell at different prices).

15 INSPRU 3.2.36R-3.2.42G

- if the risk is borne outside the fund (e.g. by the firm), then the fund should receive 'fair and reasonable' recompense

For those firms that engaged in stock lending, our review found that they operated high standards of control – this included the collateral standards set and the ongoing monitoring of stock lending operations. This was generally in firms' interests as they typically indemnified unit-linked customers against the risks arising from stock lending – where they did not, we found that disclosures to customers were appropriate.

We also found that most firms allocated a fair share of revenues from stock lending to the fund. However, two firms were unable to clearly justify that the share of revenues allocated to their unit-linked funds was fair as their stock lending revenues were based on a common pool of assets (e.g. shared between with-profits and unit-linked funds) and not appropriately segregated.

In one firm, we found that customers were not receiving a 'fair and reasonable' level of recompense.

Example – customers not receiving a fair share of stock lending revenues

One insurer was operating a limited stock lending programme. The firm itself indemnified the fund against the risk and employed a sister company, from the same group, to oversee its stock lending operations.

We considered that the firm received a disproportionately high share of revenues (relative to the risk it was accepting) and its sister company also received a disproportionately high share (compared to the commercial cost of the services it provided). This left the customers in the fund with a share that, in our view, was not 'fair and reasonable'.

Following our discussions, the firm reviewed, and increased, the share of revenues allocated to the fund.

2.3.4 Apportioning tax

For life (but not pension) funds, firms pay tax on income and capital gains accruing in the fund. Firms make allowance for the future tax liability in the unit price that the customer receives.

The apportionment of tax (allocating the tax liability between the firm, funds and customers) is a subjective, complex matter. It is not possible to precisely calculate the tax liability attributable to a particular policy – as when individual customers leave the fund this does not necessarily correspond with a sale of assets (which could generate a tax liability). Firms can also offset losses against gains and these could have been carried forward for many years.

So, firms have to make a wide range of assumptions when apportioning tax with a view to achieving a fair balance between shareholders and different generations of customers.

We found that improvements were required in just under half of the firms in our sample. These typically related to the consistency of approach across different types of funds and the fair treatment of losses, some examples of which are detailed below.

Generally, firms aimed to tax their funds on a 'standalone basis'[16] as they considered this offered the fairest solution for customers. However, we found that in a number of cases, although customers were told that all funds were taxed on a standalone basis, those funds that were established as 'funds of funds' were not – their tax was based on the combined total of the tax for the individual sub-funds. So, customers were not experiencing the tax treatment indicated by the firms' disclosures.

In one case, we found that a firm had no clear tax policy (the firm had not paid tax since the financial crisis due to losses carried forward). The firm was not able to justify to us that its apportionment of tax was, or would be, fair to customers.

Example – operating an inconsistent approach to taxation

One insurer offered a 'fund of funds'. The approach to the taxation of this fund was inconsistent – as the unrealised gains[17] were taxed at the overarching 'fund of fund' level ('top down') whilst the realised gains[18] were taxed at the underlying component fund level ('bottom up'). This meant that losses in one fund may not be offset against gains in another and may lead to customers paying an overall higher rate of tax.

There is 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.

16 The fund is taxed as if it was a separate entity (for example with losses offset against gains arising in that fund alone).

17 Gains arising from an increase in the value of assets prior to their sale.

18 Gains arising on the sale of an asset.

3. Follow-up actions

We have asked the firms in our sample to make improvements in response to our detailed findings. Much of this work has now been completed.

Where failings were more serious, we have required the firms to appoint Skilled Persons[19] to support this work. In the limited number of cases where we felt there was potential for consumer detriment, we have asked the Skilled Person to investigate this.

We are pleased to see that many firms, that were not part of our review, have proactively begun to review their practices – even before we published this report.

The ABI has committed to add more detail to its ‘Guide to good practice for unit-linked funds’ in light of our findings. The enhanced guide will provide further clarity on what good practice looks like and help introduce improvements across the whole of the unit-linked industry.

19 Appointed under s.166 FSMA

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25 The North Colonnade Canary Wharf
London E14 5HS
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk
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