

Thematic Review

TR16/2

Fair treatment of long-standing customers in the life insurance sector

August 2025 update:
This review is historical. See [What we publish](#) for more information and current views.



March 2016

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Abbreviations used in this document

ABI	Association of British Insurers
AMC	Annual Management Charge
BPS	Basis Points
CEO	Chief Executive Officer
GAR	Guaranteed Annuity Rate
HMT	Her Majesty's Treasury
MVR	Market Value Reduction
OSP	Outsourced Service Provider
PPFM	Principles and Practices of Financial Management
RPPD	The Responsibilities of Providers and Distributors for the Fair Treatment of Customers
T&Cs	Terms and Conditions
TCF	Treating Customers Fairly
TER	Total Expense Ratio
UTCCRs	Unfair Terms in Consumer Contracts Regulations

1. Overview

Introduction

- 1.1 We want firms to ensure that 'closed-book' customers, who have life insurance products that are closed to new business, are treated fairly and do not receive less attention than customers who have recently taken out a new product. So we looked at how some firms have treated these customers.
- 1.2 We found that most firms in our sample are demonstrating good practice in one or more areas and poor practice in others. A small number of the firms we looked at were delivering poor customer outcomes against most of the areas we assessed.
- 1.3 In this paper, we set out how we conducted the review, our findings and our expectations for firms.

Background

- 1.4 We conducted this thematic project because, as we said in our *Business Plan 2014/15*¹, we wanted to assess how firms were operating their investment-based life insurance product closed-books and to determine if they were treating their closed-book customers fairly. We had identified some risks which could lead to closed-book customers being treated unfairly, such as firms benefitting from customer inertia by keeping them in high-charging, poorly performing products or by cutting costs in a way that was detrimental to customers. We also saw some of these risks start to crystallise as part of our supervisory activities.
- 1.5 In this review, we use 'closed-books' to mean life insurance products that are closed to new business. The only new monies invested in them are additional investments from existing customers. These policies were set up and priced at least 15 years ago and in an economic environment which was very different to that of today. Our review focused on investment-based life insurance products sold before 2000.

How we carried out the review

- 1.6 We visited and analysed information from a sample of 11 firms for the review. These firms varied in size and type of business model with the aim of capturing a representative picture of the sector as a whole. We included firms which were consolidators or closed to new business and firms that were still writing new business but also had closed-books. The firms within

¹ www.fca.org.uk/static/documents/corporate/business-plan-2014-2015-interactive.pdf

our sample have approximately £153bn held in closed-book products across approximately 9.4m customers. The average value for policies in our sample is approximately £18,000 for an endowment policy and £23,000 for a personal pension policy. The findings outlined in this paper are based exclusively on this sample.

- 1.7** The products in scope² of our thematic review were individual personal pensions (including SIPP^s and Retirement Annuity Contracts); whole-of-life (individual); endowments and investment bonds. These products can be provided either as with-profits investments or unit-linked investments.
- 1.8** We excluded industrial assurance policies³, general insurance products, pure protection products (e.g. term assurance), group personal pensions and stakeholder pensions from the review.

Aim of the project

- 1.9** The aim of this thematic project was to assess how firms were servicing their closed-book customers, for example by:
- reviewing the quality and frequency of information being sent to closed-book customers to help them understand how their policies were performing, including the impact of ongoing charges
 - assessing what firms were doing to ensure that closed-book products remained fit for purpose to deliver against what they were originally designed for and to ensure they were on track to meet customer's expectations and⁴
 - determining what barriers, if any, customers faced if they wished to withdraw from their closed-book policies
- 1.10** This project did not extend to reviewing how individual policies were sold in the past.
- 1.11** Consumers pay into investment-based policies in the expectation that at maturity there will be a return on the monies invested in line with the expectations set when the policies were taken out. To have a realistic chance of delivering against these expectations, firms and consumers should be aware:
- whether the product is continuing to meet the general needs of the target audience it was designed for or
 - whether the product's performance will be significantly different from what the provider originally designed it to deliver and communicated to the distributor or customer at the time of sale
- 1.12** This is particularly important given the long-term nature of these products.

² NB: Where we refer to 'in-scope' products in this paper we refer to the products listed here.

³ FCA Glossary definition – Industrial assurance policy: <https://fshandbook.info/FS/html/FCA/Glossary/>

⁴ When referring to customer expectations in this report we mean the provisions set out in Paragraph 1.21 (2) of The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD) and TCF outcome 5 which states 'consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect'.

- 1.13** If a closed-book customer discovers towards the end of a 30-year personal pension contract that it is not going to provide a lump sum that will provide the level of expected income in retirement it is too late for that customer to do anything about it. Had the customer been informed during the course of the policy that it was unlikely to deliver against its original expectations, they would have had time to take appropriate action, which may have included seeking advice.
- 1.14** This is the first time we have undertaken a thematic project looking at how closed-books operate and how closed-book customers are being treated. We found examples of good and poor practice, which are set out in Annex 2 of this report.
- 1.15** Although we have previously shared our views on⁵ some of the areas we cover in this review, we are giving more detail on our expectations under each outcome assessed. So we are consulting on these expectations with a view to issuing non-Handbook guidance.
- 1.16** We would welcome views from not just life insurers but also consumer groups and firms from outside this sector, as some of our expectations will be relevant to other sectors which sell retail investment products.

Overall findings

- 1.17** Most firms in our sample were demonstrating good practice in one or more areas and poor practice in other areas. A small number of firms in the sample were delivering poor customer outcomes across a majority of the areas we assessed.
- 1.18** We consider that a key driver of how a firm treats its closed-book customers is how central the customer is to the business. Firms who had customers at the heart of their businesses were more likely to assess the outcome the customer was receiving and to take steps to address the driver behind any poor outcome identified, including when the driver was within the product's contractual terms and conditions (T&Cs).
- 1.19** Conversely, firms that did not have the customer at the heart of their businesses generally relied on strict compliance with contractual T&Cs which they felt would automatically result in fair outcomes for their customers, without taking any other action to ensure fair outcomes. These firms had, in some cases, not identified the poor outcomes that we found as part of this review. In some other cases firms had been aware of poor outcomes but had taken no action because in their view, the customer had signed up to the T&Cs many years ago and the firm was entitled to apply the term or condition regardless of the resulting outcome.
- 1.20** Firms' obligations under our Principles for Businesses and rules are wide and require them, amongst other things, to consider customer outcomes. In line with our findings, delivering against contractual T&Cs is an important part of treating customers fairly. However, strict compliance with delivering what is required by T&Cs only, without considering wider outcomes, might not necessarily ensure a fair outcome for customers. We are concerned that most firms sampled did not carry out effective reviews of products to assess whether customers were getting fair outcomes. We were also concerned by the standard of communications sent to customers both on an ongoing basis and at key policy events, for example at maturity, surrender or point of transfer.

⁵ See chapter 2, regulatory landscape section, page 14.

- 1.21** We also found that although many customers did not incur a fee on exiting their policy or converting their policy to paid-up, those that did were often not told about the charge they would incur at the point that it was charged or its subsequent effect on the policy. We saw a small number of examples of policies where the level of these charges resulted in a poor outcome for the customer; for example, the impact of the paid-up charge consistently outweighed any fund growth.

Key thematic findings by outcome

- 1.22** We assessed firms against four high-level outcomes (see Chapter 2 for more details of our assessment). Here are our key findings by outcome.

Outcome 1: The firm's strategy and governance framework results in the fair treatment of closed-book customers.

- The culture of a firm plays a key role in shaping the outcomes experienced by closed-book customers. Some firms are taking action for the benefit of these customers, while others are only delivering what they are contractually obliged to do, regardless of the outcome for the customer.
- Firms that have strategies or customer plans that recognise the needs of closed-book customers are more likely to be able to identify and address poor customer outcomes and demonstrate what they have done to improve the outcome.
- Some firms are overly reliant on compliance with contractual T&Cs and are not taking action even where actual customer detriment is identified.
- Generally, boards and senior management do not have a grasp of closed-book customers and outcomes. They may rely on management information that is not giving them a rounded and comprehensive picture. For example, in some cases boards and senior management use complaints data to measure whether they are delivering fair consumer outcomes, but most closed-book customers are disengaged so they rarely complain and can be unaware of issues with their products.
- We had concerns in relation to product reviews, as many firms were not able to demonstrate they had fully effective processes for ensuring closed-book products remain capable of delivering against the reasonable expectations of customers. Generally firms do not review their closed-book products. Where they do, they do not carry out the review effectively to ensure these products remain fit for purpose to meet reasonable customer expectations, or only review the products against contractual T&Cs.
- A minority of firms are unaware of and therefore do not effectively manage the risk relating to outsource providers' performance management structures, which set call centre staff daily targets to retain customers.

Outcome 2: The firm's closed-book customers receive clear and timely communications about policy features at regular intervals and at key points in the product lifecycle that enable them to make informed decisions.

- Some firms are not communicating with some customers at all throughout the lifetime of some products. This means a large number of closed-book customers are not receiving regular information to put them in an informed position.

- Where firms do send annual communications to closed-book customers they can be of poor quality. They do not help the customer understand how their policy is performing or the level and impact of ongoing charges they are paying.
- Most firms in our sample are not giving closed-book customers important information at key events. So, for example, some firms are neither disclosing charges for converting the policy to paid-up or for surrendering, nor are they disclosing the loss of important benefits such as guarantees or the effect of these on future policy values. Some firms are relying on point-of-sale disclosure and/or policy T&Cs, which were often provided to the customer years earlier.
- Firms are not doing enough to ensure they keep in contact with their closed-book customers during the lifetime of a policy. Over time, this is resulting in some customers losing track of a policy they hold or being unable to monitor how that policy is performing. Once contact had been lost, the steps firms take are generally insufficient to re-establish contact. For example, some firms are not using phone numbers held on file when attempting to trace the customer.

Outcome 3: The firm gives adequate consideration to and takes proper account of fund performance and policy values in a way that ensures it treats its closed-book customers fairly and proportionately.

- Firms are generally identifying and taking action where poorly performing unit-linked funds result in poor returns for closed-book customers. A minority of firms have insufficient processes in place meaning they are unable to identify poorly performing unit-linked funds, or have good processes in place but are not applying them to all funds.
- A significant proportion of the worst performing unit-linked funds are poorly performing due to charges, with a key driver being capital unit charging structures that affect a portion of a customer's policy. Some closed-book customers are unaware of the impact of the capital unit charge due to inadequate ongoing disclosure.
- On with-profits business where firms have some discretion in the allocation of expenses, they are not loading expenses so closed-book customers are paying a disproportionate share of the businesses' costs. However, many of these firms are not active in benchmarking the resulting charges incurred by the customer and are not adequately monitoring the impact of the charges on customer outcomes.
- Firms are generally poor at monitoring the extent to which unit-linked business is generating expense profits or losses and how this compares to their original assumptions. They also often do not actively link actual experience to the charges being incurred by the customer to ensure they remain fair. Some firms presume that applying contractual T&Cs will ensure fairness to their closed-book customers, and there is no benchmarking of charges on unit-linked business.
- Many firms in our sample were not systemically considering both the aggregate impact of all charges on their various closed-book customers as well as the resulting pay-outs being achieved, both at maturity and surrender.

Outcome 4: The firm's closed-book customers are able to move from products that are no longer meeting their needs in a fair and reasonable manner.

- Most products we looked at did not incur an exit or paid-up charge in our sample period or, if they did, it was under 5% of the policy value in the clear majority of cases, although this could still result in a significant charge for the customer.
- Where we did find exit and paid-up charges, we found a minority of closed-book customers are incurring relatively high charges for making their policies paid-up or a relatively high exit charge on surrendering or transferring their policies possibly resulting in unfair outcomes. This mostly affects personal pension customers.

1.23 Our findings are set out in more detail in Chapter 3 of this report.

What do we want this paper to achieve?

1.24 We want firms to recognise that closed-book customers may have different characteristics and needs than customers who have recently taken out a new product. We want firms to take steps to ensure that all their customers receive fair outcomes, not just those who are most engaged or have had recent dealings with them.

1.25 This means firms should identify the outcomes their customers are receiving and where poor outcomes are identified, take steps to treat their customers fairly. We expect:

- all customers to be kept well informed about the product they are invested in, being clear about the policy's performance and the charges applied
- firms to be proactive in identifying the drivers of overall product performance and act to ensure that customers are being treated fairly regarding investment performance, expense allocations and charges
- customers should not face unreasonable barriers to exit or unfair charges if they stop paying premiums into the policy

Who does this paper affect?

1.26 The primary audience for this review is life insurers who have closed-books. However, some of our expectations will be relevant to any firm that deals with customers who are of a long-standing nature, whether as a product provider or intermediary.

1.27 It will also be of interest to trade bodies, consumer groups, and consumers themselves, as it sets out our expectations on how consumers should be treated by companies they hold closed-books products with.

Next steps

- 1.28** Taking into account individual circumstances, we will be liaising with all the firms in our sample to address the findings relevant to them. We also expect life insurance firms outside our sample to consider the findings and the good and poor practice outlined in this review and make any changes necessary to meet our expectations. So firms outside the sample can expect us to engage with them on these findings at appropriate points in their supervisory cycle (after the closure of the consultation period) using a range of supervisory tools.
- 1.29** We will also carry out a Guidance consultation. Based on the findings from our thematic review, we have set out as draft non-Handbook guidance the actions we believe firms should be taking to treat their customers fairly, in the sections headed 'our expectations'. These are not new expectations; they reflect our Principles for Businesses (the Principles) and certain other rules and have also previously been set out in:
- formal Guidance in the shape of the Responsibilities for Product Providers and Distributors (RPPD)
 - other communications such as a previous With-Profits Regime Review Report and various Treating Customer Fairly (TCF) communications
 - senior management speeches
- 1.30** However, in this paper, we are using the findings from this work to add an extra level of detail about our expectations to improve customer outcomes, while still being reasonably predictable from the Principles and other rules. These expectations are based on the Principles and other rules identified in Chapter 2 and, in particular, Principles 2, 3, 6, 7 and 8.
- 1.31** Guidance is not binding on firms, it is intended to illustrate ways (but not the only ways) in which a firm can comply with the relevant rules. But it is potentially relevant to an enforcement case and a decision maker may take it into account in considering the matter. Further information on the status of guidance is in Chapter 2 of the FCA's Enforcement Guide.⁶
- 1.32** We want your views on the draft guidance under the headings 'our expectations' and would encourage any organisation, or individual, with an interest in these issues to respond to the questions set out in this report. The consultation period will be for three months. We will then analyse the responses and set out our finalised guidance.

⁶ www.handbook.fca.org.uk/handbook/document/EG_Full_20141212.pdf

We have set out questions in Annex 1. Please send us your responses by 3 June 2016. You can send your response by email to: tr16-02@fca.org.uk, or by post to:

The Pensions and Retirement Income Themes Team
Supervision Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London, E14 5HS.

Please state whether you are responding as an individual or on behalf of an organisation. Please include your contact details with your response, in case we need any more detail on any issues you raise.

It is our policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

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2. Assessment framework, scope and methodology

Assessment framework

- 2.1** We assessed firms against four high-level outcomes, broken down into a series of sub-outcomes. We used these to gather data, which we then considered against our Principles and other rules.
- 2.2** Here are the outcomes, with the sub-outcomes under each.

Outcome 1: The firm's strategy and governance framework results in the fair treatment of closed-book customers.

- 1.1** The firm's overarching strategy, including any outsourcing arrangements, takes proper account of the fair treatment of customers.
- 1.2** The firm checks, through periodic product reviews, that closed-book products remain fit for purpose and continue to provide the benefits they were originally designed to.
- 1.3** The firm has adequate governance arrangements for its closed-book business.
- 1.4** The firm's remuneration, reward and performance management arrangements are consistent with the fair treatment of customers.

Outcome 2: The firm's closed-book customers receive clear and timely communications about policy features at regular intervals and at key points in the product lifecycle that enable them to make informed decisions.

- 2.1** Regular communications to customers provide them with sufficient information to make informed decisions.
- 2.2** Communications to customers at the time of key policy events are clear, accurate and enable them to make informed decisions.
- 2.3** Communications with customers make them aware of guarantees or options (whether time critical or not).
- 2.4** The firm takes effective action to locate and make contact with 'gone away' customers.

Outcome 3: The firm gives adequate consideration to and takes proper account of fund performance and policy values in a way that ensures it treats its closed-book customers fairly and proportionately.

- 3.1** The firm takes steps to deal with poor performance with closed and actively marketed products given equal attention.
- 3.2** Overall expenses are allocated fairly to closed-book products.

3.3 The firm regularly reviews the overall fairness of cost allocations and actual customer outcomes and applies a consistent basis for these reviews.

3.4 The firm proactively monitors the actual experience of its closed-books of business and consistently passes on benefits and costs to customers, to the extent permitted by policy conditions.

Outcome 4: The firm's closed-book customers are able to move from products which are no longer meeting their needs in a fair and reasonable manner.

4.1 Exit and paid-up costs are not excessive and are not driving poor customer outcomes.

4.2 Target ranges for with-profits pay-outs appear reasonable and firms meet these target ranges without the variation of pay-outs being too wide.

How we carried out the review

2.3 We conducted the main part of our thematic review during the third and fourth quarters of 2014, following an initial pilot project of one section of our review. Our methodology had three distinct elements:

- a desk-based assessment of information submitted in response to our information request
- a desk-based review of a sample of firm communications with closed-book customers
- on-site visits to firms to follow through any enquiries arising from the information request and the desk-based review and to interview key members of staff

2.4 We asked firms to give us a range of qualitative and quantitative information.

2.5 For outcome 1 we assessed firms' strategy documents and any customer plans in place. We reviewed product review processes and examples of products which had gone through a firm's process. We considered firms' governance structures, reviewed minutes from relevant committee meetings and also assessed some other elements of firms' interactions with their closed-book customers including reviewing any targets and incentives in place, call scripts and staff training.

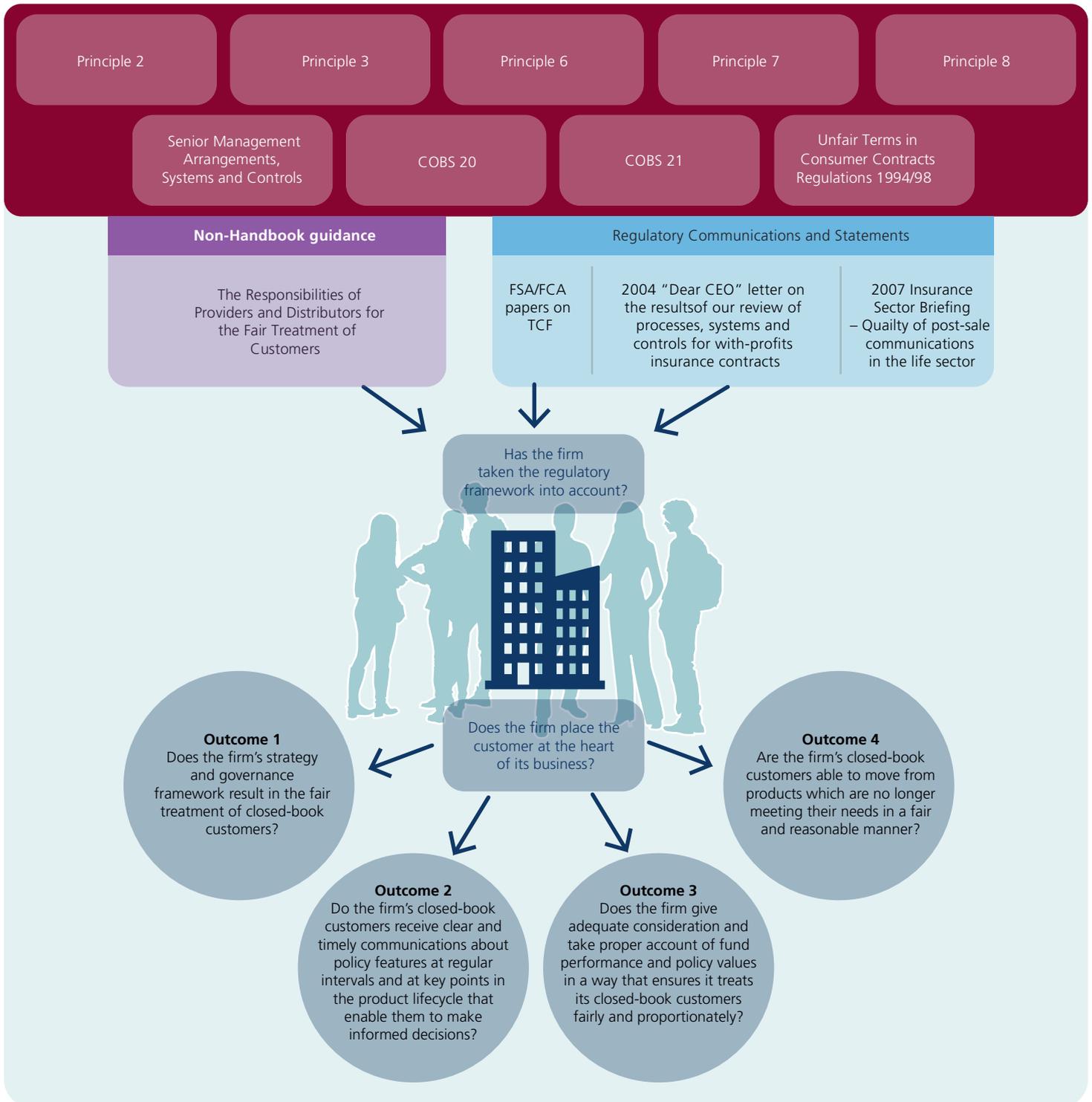
2.6 For outcome 2, we reviewed data in relation to customer communications at key points in the product lifecycle. We did this by reviewing all documentation selected customers received from a firm within a 12 month period before any of the events below:

- the closed-book product maturing
- the customer wishing to surrender their product
- the customer wishing to transfer their product
- premiums being altered by the customer
- charges being varied by the firm

- 2.7** We also considered firms' 'gone away' processes by reviewing the activities they undertook to try and re-establish contact with customers they had lost touch with.
- 2.8** For outcome 3, we assessed firms' responses to our detailed information request as well as a range of documentation such as firms' Principles and Practices of Financial Management (PPFM), annual PPFM compliance reports and, where available, documentation setting out the firm's approach to managing its unit-linked business. We also reviewed data on the firm's top and three bottom performing unit-linked funds, as well as expense allocations and charges for the five-year period up to end 2013.
- 2.9** For outcome 4, we reviewed sample data in relation to actual exit charges on surrenders and transfers and charges on premium cessations (paid-ups). For most firms, this sample period was the first six months of 2014, while slightly different dates were agreed with two firms for practical reasons.
- 2.10** As our review looked at policies that actually exited, the picture may not reflect the underlying book. It may not be representative due to data being collected over a relatively short sample period or, for instance, because some customers may be put off exiting a policy because of the presence of an exit charge and hence our sample would underestimate the overall impact of charges. Where possible, we looked to confirm with firms whether they believed the sample period was representative of the underlying book. Firms all generally believed this to be the case.
- 2.11** Our desk-based reviews allowed us to assess each firm's approach to treating its closed-book customers. For example, did closed-book customers feature in the firm's strategy as a distinct group of customers and how did this flow through to the actual customer experience? We visited firms to test specific examples they gave us which indicated the potential for unfair treatment of closed-book customers and to get answers to any questions which arose from our desk-based review work.

Regulatory landscape

Figure 1 – A summarised view of our regulatory framework and the outcomes assessed



- 2.12** In developing our assessment framework, our starting point was to consider the requirements in our Principles, in particular those dealing with management and control, customers' interests and communications and relevant rules. We also took into account non-Handbook guidance as well as relevant previous regulatory statements or speeches.
- 2.13** Although firms are able to rely on contractual T&Cs that were compliant at point of sale, firms are providing an ongoing service today and need to comply with today's regulatory standards for this service. For example, a communication sent to a customer needs to comply with the regulatory landscape in place at the time of that communication, not what was in place when the policy was sold. The outcome being provided to the customer is being provided today and we would expect it to be a fair outcome in line with the firm treating its customers fairly.
- 2.14** The rules and guidance referred to here are not intended to be an exhaustive list of firms' regulatory obligations and other regulatory provisions may also be relevant depending on the circumstances.

The Principles for Business⁷

- 2.15** We consider the following Principles are most relevant for firms when considering their strategic approach and overseeing the fair treatment of closed-book customers:
- Principle 2 (Skill, Care & Diligence) – A firm must conduct its business with due skill, care and diligence.
 - Principle 3 (Management & Control) – A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
 - Principle 6 (Customers' Interests) – A firm must pay due regard to the interests of its customers and treat them fairly.
 - Principle 7 (Communications with Clients) – A firm must pay due regard to the information needs of its clients and communicate information to them in a way that is clear, fair and not misleading.
 - Principle 8 (Conflicts of Interest) – A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

Other relevant FCA rules

- 2.16** SYSC (Senior Management Arrangements, Systems and Controls) outlines our management requirements for firms, with the application to insurers being set out in SYSC 1.1A. SYSC focuses on the responsibilities of directors and senior management to ensure the firm has appropriate control, supervision and accountability systems in place, including appropriate operational risk systems and controls. For example, SYSC 3.1.1R requires that firms need to take reasonable care to establish and maintain such systems and controls as are appropriate to their businesses. The nature and extent of the systems and controls which a firm will need to maintain will depend on a variety of factors and further guidance is provided on some of the main issues which a firm is expected to consider in establishing and maintaining the systems and controls appropriate to its business (SYSC 3.1, SYSC 3.2 and SYSC 13 including for outsourcing SYSC 13.9). A firm must also take reasonable steps to establish and maintain adequate internal controls (SYSC 14.1.27 R and the guidance in SYSC 14).

⁷ www.fca.org.uk/about/operate/principles

- 2.17** The Conduct of Business Sourcebook (COBS) outlines our requirements for the conduct of long-term insurance and certain other business. COBS 20 covers the specific conduct of business requirements for a firm carrying on with-profits business, covering various issues relevant to the fair treatment of with-profits customers (COBS 20.2), the requirement for a set of principles and practices (PPFM) for the management of a firm's with-profits business (COBS 20.3), communications with with-profits customers (COBS 20.4) and with-profits governance arrangements (COBS 20.5). COBS 21 covers various conduct of business principles (COBS 21.2) and rules (COBS 21.3) for a firm carrying on linked long-term insurance business, including where a firm has entered into a reinsurance contract in respect of its linked long-term insurance business (COBS 21.3.3R).

FCA Guidance

- 2.18** The regulatory guide – 'Responsibilities of Providers and Distributors for the Fair Treatment of Customers' (RPPD)⁸ – provides guidance to help firms understand what the Principles and rules require respectively of providers and distributors to treat customers fairly. Key areas specific to this paper are in RPPD customer communications paragraph 1.19:

'When providing information to customers, Principles 3, 6 and 7 are particularly relevant. In particular, a firm:

1. should pay regard to its target market, including its likely level of financial capability;
2. should take account of what information the customer needs to understand the product or service, its purpose and the risks, and communicate information in a way that is clear, fair and not misleading;
3. should have in place systems and controls to manage effectively the risks posed by providing information to customers

Product life-cycles and post-sale responsibilities are set out under paragraph 1.21.

Firms should periodically review products whose performance may vary materially to check whether the product is continuing to meet the general needs of the target audience that it was designed for, or whether the product's performance will be significantly different from what the provider originally expected and communicated to the distributor or customer at the time of the sale. If this occurs, the provider should consider what action to take, such as whether and how to inform the customer of this (to the extent the customer could not reasonably have been aware) and of their option to seek advice, and whether to cease selling the product.'

Regulatory communications and statements

- 2.19** In addition to the Principles, Rules and Guidance, we – or our predecessor, the Financial Services Authority (FSA) – have published a range of communications and statements which are relevant to the post-sale activities assessed as part of this project.
- 2.20** **Treating customers fairly after point of sale published in June 2001⁹:** This paper explains the outcomes for consumers the regulator was looking to achieve through the treating customers fairly (TCF) initiative. This sets out the need for firms to take proper account of providing clear information to their customers after the point of sale as it plays an important role in helping to ensure that consumers are kept aware of product performance.

⁸ www.handbook.fca.org.uk/handbook/RPPD/link/PDF.html

⁹ www.fsa.gov.uk/Pages/Library/Policy/DP/2001/discussion_07.shtml

- 2.21 Treating customers fairly – progress and next steps published in July 2004¹⁰:** This paper expanded further on previous publications and updated the industry with findings from a limited pilot study. It also set out results from research relating to the extent to which consumers understand financial services, the role of senior management in implementing TCF and provided insight into issues that firms may need to consider to achieve fairness throughout the product lifecycle, for example making charges transparent and balancing commercial objectives with TCF.
- 2.22 Treating customers fairly – towards fair outcomes for consumers, published in July 2006¹¹:** This paper outlined our broader vision for TCF. It also explains what we intended TCF to achieve for consumers, putting this in the context of work on consumer responsibility and the associated financial capability challenges in the retail financial services market. This paper sets out six TCF consumer outcomes and expands on each to provide firms with additional information where each outcome may apply, for example by ensuring that TCF is taken into account within firms' strategies and that post-sale communication is sufficient to make customers aware of their options at various stages of the product life-cycle.
- 2.23 Treating customers fairly – culture, published in July 2007¹²:** This paper sets out the results of our TCF reviews and outlines findings of our review of firms' culture frameworks, including areas such as firms' strategies and leadership. For each area assessed, the paper provides examples of good and poor practice. For example, the paper outlines a concern that firms' strategies have not gone far enough in understanding the risks to customers or in monitoring outcomes.
- 2.24 Insurance Sector Briefing - Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholders, published in May 2007¹³:** This briefing sets out the results of thematic work into post-sale communications of a sample of life insurers, setting out the link to our work on TCF. As part of this review we asked senior management to implement any changes required by the paper by December 2008. Some key areas set out in this briefing and which are relevant to this report are:
- Whether or not the customer has an adviser they should receive information throughout the lifetime of the product that enables them to make informed decisions about their investment.
 - How poor post-sale information reduces consumers' understanding of product performance and/or product features, which, as a result, means consumers are less able either to plan their finances (including recognising when it is sensible to switch), or to take advantage of product features for which they have paid.
 - A lack of clear understandable information from insurers is an obstacle for consumers being able to take informed decisions.
 - The absence of clear communications may mean consumers make poor decisions (or no decisions at all) about their investments.
 - Non-disclosure of valuable features of a product due to the costs of making changes to communications is unlikely to be meeting Principle 8.

¹⁰ www.fsa.gov.uk/pubs/other/tcf_27072004.pdf

¹¹ www.fca.org.uk/your-fca/documents/tcf--towards-fair-outcomes-for-consumers

¹² www.fca.org.uk/static/fca/documents/fsa-tcf-culture.pdf

¹³ www.fsa.gov.uk/pubs/other/isb_quality.pdf

- Principle 7 requires post-sale information to be clear enough for customers (or their advisers) to understand how their investment is performing, so they can judge if the policy still meets their requirements. It should also remind them of the key benefits of that policy, particularly if they are about to take actions which would result in them losing these benefits.
- Firms not undertaking any consumer testing on the effectiveness of their post-sale communications suggest a lack of care in preparing these communications.
- A number of good and less good features for communications. So setting out that certain penalties might apply but not explaining why or indicating the amount of penalty is a less good feature, while giving clear descriptions of the current and previous cash in values and the total investment paid into the plan within an annual statement is a good feature.

2.25 Results of our review of processes, systems and controls for with-profits insurance contracts – ‘Dear CEO’ letter¹⁴: In 2004 we wrote to all CEOs of life insurance firms and friendly societies. We highlighted that the findings applied to firms whether they had with-profits funds or not. It aimed to inform firms of our principal findings and to set out that firms should review their policies and practices in light of them.

2.26 One of the concerns highlighted was that most of the firms in the sample had no formal procedures for *‘periodically reviewing whether all current and legacy products are being managed consistently with contractual obligations and other undertakings given in contracts, marketing literature and other communications.’* At this time we said that *‘firms who failed to carry out such verifications may not be meeting their obligations to customers and treating them fairly.’* The letter also sets out that a periodic product management review should occur every three to five years depending on the product. The contents of this letter are relevant to in-scope firms when considering product governance arrangements.

2.27 With-profits regime review report – published in June 2010¹⁵: This report sets out the findings of our review of the with-profits regime introduced in 2005. It considered how senior management in firms had implemented our rules, including the Principles, and in particular whether they manage their commitments to with-profits customers appropriately and treat them fairly. The review covered areas such as governance, consumer communications and with-profits fund operations, including the allocation of expenses and the fairness of maturity and surrender pay-outs. In each area assessed, it sets out the findings and consequent actions for firms. For example, the report made clear that we expect average pay-outs on with-profits business to be within a much narrower range over the longer term.

Industry produced guidance

2.28 We also noted with interest some good practice guides produced by a number of firms in the industry carried out in conjunction with the ABI¹⁶ in 2007, but now withdrawn. These considered a number of areas, some consistent with our review, and the guidance produced was in line with the guidance by the FSA. For example, under ‘Responsibilities of product providers’ it states that firms should:

‘Provide regular, accurate, timely, and understandable information as appropriate for the product, keeping customers and/ or advisers informed of product performance...’

The Guide for ‘Yearly Statements’ further notes:

¹⁴ Results of our review of processes, systems and controls: www.fsa.gov.uk/static/pubs/ceo/ceo_letter_24aug04.pdf

¹⁵ www.fca.org.uk/static/documents/fsa-with-profits-report.pdf

¹⁶ <http://web.archive.org/web/20070615122250/http://www.customerimpact.org/main/guides/listofguides.aspx>

'Yearly statements should help customers to understand how their plan is performing...

For investments the key information to include is:

the original investment

current fund value in £s (net of any MVR and exit charges – if such reductions apply then make this clear)

previous year's value in £s (to show growth)

total additional sums invested since the start

any sums invested since the last statement (if relevant)

total taken out of the plan since the start and in the last year (if relevant)...

3. Key findings

- 3.1 This chapter sets out our key findings in more detail. For each outcome it firstly covers general findings and is then split by sub-outcome.
- 3.2 We include tables with individual examples of good and poor practice in Annex 2.

Outcome 1: The firm's strategy and governance framework results in the fair treatment of closed-book customers.

General findings

- 3.3 In addition to assessing firms' strategies, governance and oversight arrangements, this outcome focused on some key internal processes that we believe are fundamental to ensure the fair treatment of closed-book customers. These are a firm's product review process and its remuneration, reward and performance management processes.
- 3.4 Firms had a variety of different business models and a range of different strategies. A minority had a strategy or customer plan for closed-book customers which recognised their specific needs. Where this was the case, firms were better able to articulate clear and explicit consideration of what fairness meant to closed-book customers, with senior members of management, often backed by well-resourced teams, having specific responsibility for delivering the strategy or customer plan.
- 3.5 At other firms we found little mention or consideration of fairness to closed-book customers in firms' strategies as these tended to focus on areas such as increasing sales and cutting costs. These firms had apparently not considered whether different groups of customers had different needs. There was a strong correlation between firms with strategies not taking proper account of closed-book customers with a high incidence of poor customer outcomes – for example, not meeting the information needs of customers, or not being able to identify or address poor customer outcomes.
- 3.6 We had major concerns about product reviews as we saw little evidence that firms were always able to demonstrate a fully effective process for ensuring closed-book products can deliver against the reasonable expectations of customers.
- 3.7 Apart from a small number of firms making some effort to identify shortcomings and put them right, overall the governance and oversight arrangements of closed-books appeared to be inadequate as they were driven by a focus on compliance with contractual T&Cs rather than an assessment of the wider outcomes being delivered to closed-book customers. Very few firms were able to tell us what customer outcomes they were trying to deliver for closed-book customers and how they were going about measuring such outcomes.
- 3.8 With respect to remuneration, reward and performance management, a minority of firms were setting retention targets in a way that we considered increased the risk of poor customer outcomes arising.

Sub-outcome 1.1: – The firm’s overarching strategy, including any outsourcing arrangements, takes proper account of the fair treatment of customers.

Background

- 3.9** A firm’s culture has a significant influence on the behaviours of management and staff, and therefore on customer outcomes, which is why we attach a high degree of importance to it. We wanted to gain a better understanding of how a firm’s culture, drove its strategy for closed-book customers. A firm’s strategy is an opportunity for its senior management to make clear their intent for their customers and they can do this by setting out the customer outcomes they seek as part of their approach.
- 3.10** We also wanted to understand how the outsourcing of customer service and administrative functions affected closed-book customers. Our review included firms using outsource service providers (OSPs) and firms keeping applicable functions in-house. In each case we asked firms why they chose their approach, focusing on whether those decisions resulted in fair outcomes for closed-book customers.
- 3.11** An important element of our work was to compare and contrast the treatment of closed-book customers across firms with different business models. This was split between firms that are consolidators or are closed to new business (closed-book firms) and firms that are still writing new business but also have closed books (hybrid firms). We refer to these terms below in our findings.

Findings from our review of firm practices

- 3.12** For closed-book firms it was clear that their strategies were focused on their closed-book customers. However, for hybrid firms it was often difficult for them to articulate in any detail what plans they had for their closed-book customers.
- 3.13** For both hybrid and closed-book firms there was no evidence to suggest any strategic intention, either implicitly or explicitly, to take advantage of closed-book customers, although we did find examples of firms looking to extract value from their closed-book customers. In one example this was achieved by specifically targeting new products at closed-book customers and in another by increasing value through new transactions with corporate entities such as longevity¹⁷ or reinsurance arrangements.
- 3.14** Where we found poor practice, there appeared to be a lack of engagement with the specific characteristics and needs of closed-book customers; and/or a focus that was reliant solely upon compliance with contractual T&Cs rather than on customer outcomes.

The impact of firms’ business models on their strategic approaches

- 3.15** Our review of hybrid firms found mixed practice when setting out the strategic direction for closed-book customers. Some hybrid firms segment their business lines between open and closed-book business to provide a more focused strategic direction for each. These firms were able to articulate their plans and intentions for their closed-book customers more clearly than those hybrid firms which did not segment. It was also clear that these firms had considered the specific characteristics that might apply to their closed-book customers and the resulting conduct risks. We felt this approach lent itself to a clearer articulation of the firms’ intentions towards their closed-book customers and appeared to facilitate good practice.
- 3.16** In contrast, hybrid firms which did not segment their business lines were less able to articulate their plans for their closed-book customers, with firms saying that specific strategies for closed-book customers were not needed as they treated all their customers the same.

¹⁷ Using a derivative to transfer the risk that arises from Pension Scheme members living longer than expected.

3.17 Treating customers fairly does not necessarily equate to treating all customers the same; different groups of customers have different needs and characteristics. We expect firms to consider the specific characteristics of groups of customers and have in place effective systems and controls to ensure it acts in a way that is likely to be fair for customers' circumstances. An example of this might be a firm considering the information needs of its customers who were sold a product a long time ago. These customers are more likely to be unengaged with their product and its benefits, and in some cases may have even forgotten they hold a product at all.

Strategy and customer outcomes

3.18 Some firms had strategies that appeared to give little weight to fair outcomes for customers and focused largely on commercial objectives. Other firms had specific customer-focused plans central to their strategic direction and gave a good indication how they sought to treat closed-book customers fairly.

3.19 To illustrate this further, one closed-book firm had a clearly documented strategy that placed strong emphasis on the fair treatment of customers alongside its commercial considerations. It achieved this with a customer plan setting out clear strategic aims that aligned to good customer outcomes, for example by ensuring that it identified orphaned customers¹⁸ at the earliest opportunity and considered their specific information needs. Another firm identified priorities for the year ahead, including a project to review outcomes when reminding closed-book customers of their policy benefits.

3.20 In cases where firms' strategies did not explicitly take account of how they intended to achieve fair outcomes for closed-book customers it was more likely that the focus was on commercial considerations, such as maintaining financial strength and managing expenses. In one such example, a firm explained that its strategic approach for closed-book customers was not overtly highlighted in its strategic documents because it was implicitly considered when setting commercial objectives and day-to-day operational processes. But the firm was unable to articulate the steps it had taken to ensure fair customer outcomes and could not demonstrate how the customer was at the heart of its business.

3.21 We also saw firms that had established a strategy, which often resulted in a culture throughout the firm, based entirely on compliance with contractual obligations. In these cases our analysis identified that customers are receiving poor outcomes that the firm's review process had not identified or acted on.

3.22 When setting its strategy, a firm should consider:

- who its customers are
- what their specific circumstances and needs are and
- the associated conduct risks that could impact on the specific outcomes that customers receive

3.23 Where firms have not included this explicitly as part of their strategy firms were less likely to put customers at the heart of their businesses, which also resulted in poor practice in other areas we assessed.

¹⁸ For the purposes of this paper we refer to orphaned customers as those that have not had a professional contact with their financial adviser for at least three years.

Relationships with outsource service providers (OSPs)

- 3.24** We found that firms had reasonable rationales for either outsourcing or keeping customer service functions in-house. Firms were able to articulate both the commercial and customer benefits from their decision, but were not always able to provide evidence that they had tested whether the potential customer benefits identified had been achieved.
- 3.25** However, we identified a few firms where there was little evidence they had adequately considered the customer impact of outsourcing arrangements and how they were consistent with the fair treatment of closed-book customers. In one example a firm's contract with an OSP has been in place for the last 17 years on a 'rolling' basis¹⁹ with no clear break-clause. The firm was unable to articulate when periodic reviews of the contract took place or the basis on which the contract continued to be 'rolled over'.

Draft guidance: our expectations

When establishing a strategic approach for closed-book customers, firms should recognise there are different characteristics across different types of customers, for example new and historic customers, and that different customer groups may have different needs. Treating customers fairly does not necessarily amount to treating all customers the same and where firms take a one-size-fits-all approach to fairness they increase the risk of poor outcomes for some customers.

A firm's strategy for closed-book customers should be clearly articulated and include how the firm intends to achieve fair outcomes for those customers and examples of where this has happened in practice. We expect a firm to take proper account of fair customer outcomes and not rely solely on compliance with T&Cs or processes to achieve this. Furthermore firms should not just rely on generic statements, such as 'we treat all our customers fairly' to demonstrate a culture of fairness.

When considering outsourcing customer service functions (e.g. call centre operations or administration of policies) firms should be clear on the impact of this decision on closed-book customers. This should apply equally if a firm considers that retaining customer functions in-house is the right solution. Firms should have processes to conduct ongoing reviews to consider if the solution remains appropriate in the light of its obligations to customers.

Where a firm identifies that an outsourcing arrangement is no longer in the best interests of customers it should take steps to address the situation. Firms should be able to exit outsourcing contracts where remaining in them would result in detriment to customers.

Sub-outcome 1.2: The firm checks, through periodic product reviews that closed-book products remain fit for purpose and continue to provide the benefits they were originally designed to.

Background

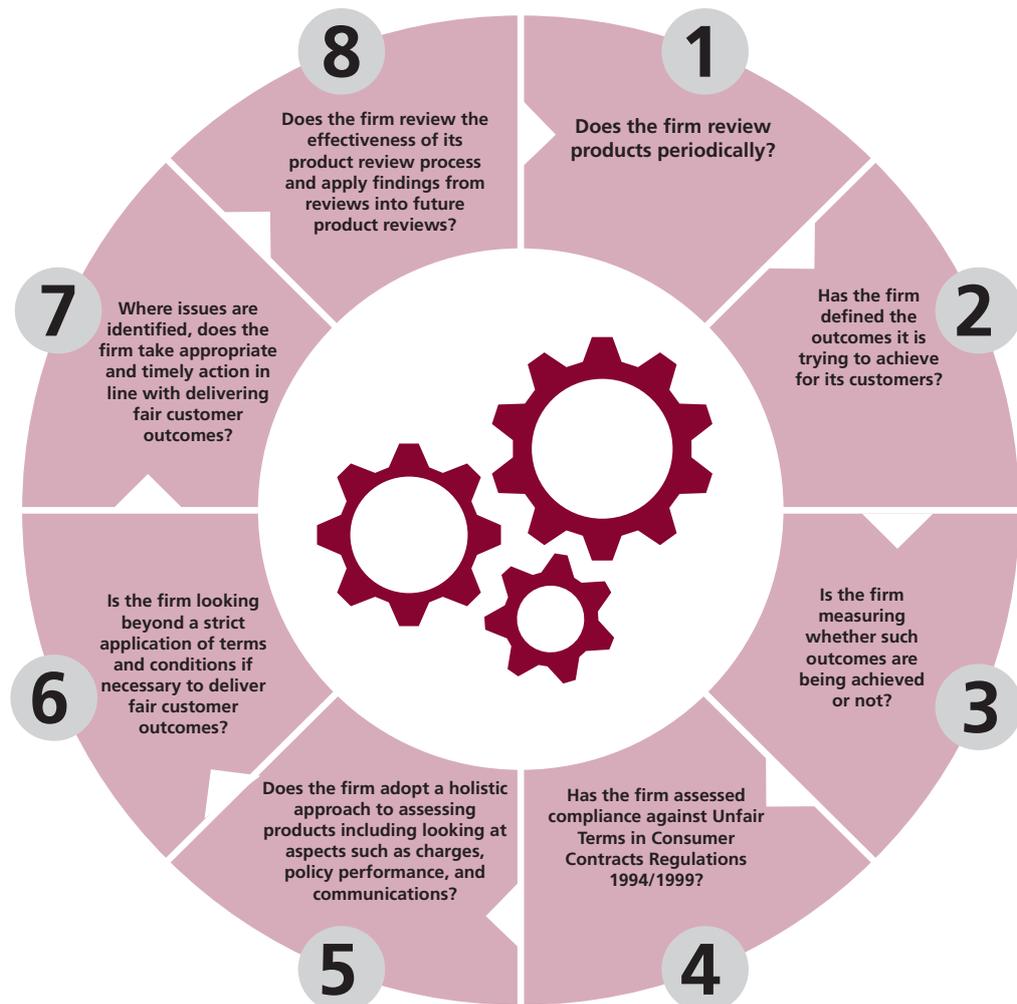
- 3.26** The complexity of closed-book products and the length of time for which they are generally held can increase the risk of firms delivering poor customer outcomes. The nature of closed-

¹⁹ Rolling Basis: We use this term to describe a contractual arrangement that has no clear end point and potentially allows the contract to be renewed without entering into further negotiations about the terms of service.

book products often means these products were manufactured and sold a long time ago, when economic and other conditions may have been fundamentally different.

- 3.27 Closed-book products may include different types of important benefits and features, such as cash-in values, MVRs, Guaranteed Annuity Rates (GARs) and flexible options. These products can also have charging structures that may vary over time and, when combined with an evolving taxation landscape, can have elements that make these products even more complex and difficult to understand for customers. This could also be further compounded where customers are uninformed or not engaged with their policies, as we discuss in Outcome 2 – Communications.
- 3.28 We wanted to understand more about how firms approached this aspect of their business to ensure their customers were receiving a fair outcome in relation to closed-book products. In addition to reviewing the processes firms had adopted for product reviews we also wanted to understand the issues firms identified during the relevant period and to discover how those had been resolved and how the customer was impacted.

Figure 2 – Key questions we sought to answer during our review of product review processes



Findings from our review of firm practices***How firms structured and scheduled reviews***

- 3.29** Many firms in our sample were unable to demonstrate a comprehensive and effective product review process. We found a wide spectrum of behaviour including:
- firms which did not conduct any periodic reviews of their closed-book products
 - reviews that were focused on compliance with contractual T&Cs only rather than effectively assessing the outcomes being received by customers and
 - reviews that relied on information that did not provide a comprehensive picture
- 3.30** Some firms relied upon various management information to indicate issues with closed-book customers. Examples include outputs from scheduled internal audit reviews or feedback from customer surveys. However, this data was often collected and analysed in silos within the firm and varied in quality and focus on actual customer outcomes. While specific problems may be rectified there is a risk that firms may not be drawing wider lessons.
- 3.31** A small minority of firms relied almost entirely on their complaints data, feeling that the output from this gave them enough information to be able to identify poor customer outcomes.
- 3.32** We consider that there are limits to the types of issues that firms can identify through analysing complaints about these types of products. The technical and complex nature of closed-book products means that customers are not always in a position to assess and understand when they are being treated unfairly – especially given the poor practice identified in some firms' communications. Where a firm relies heavily on its complaints data to identify poor customer outcomes there is a risk that some poor customer outcomes will remain unidentified. It is important that firms adopt a flexible approach to identifying product issues. A range of proactive and reactive indicators are likely to be more successful than relying on a single source of information in reducing the risk of poor customer outcomes.
- 3.33** For example, in 2011 a firm identified the impact that charges relating to a pension contract were having on its closed-book customers. As part of the firm's wider product review it proactively gathered intelligence from a variety of external sources, e.g. media articles and regulatory publications, and used this to inform its product review agenda. This prompted it to review the charges on its pension products to assess customer outcomes. The firm used quantitative and qualitative indicators to understand if the product charges were justifiable and to measure the impact on the customer's share of any growth. This element of the review considered the outcome the customer would receive in a variety of scenarios and confirmed that all contract charges had been levied in-line with T&Cs.
- 3.34** Three types of charge were identified where discretion could be exercised to provide a benefit to the customer. Subsequently, charges on approximately 21,000 policies were reduced by removing initial units or low allocation rate charges. Where it was not possible to reduce charges, the firm sent communications to customers outlining the impact the remaining policy charges may have over time (e.g. erosion of transfer value where the policy is paid-up), with clear signposting of options open to customers. The firm used this review to develop and enhance its wider product governance framework.
- 3.35** A small proportion of firms considered how and when different products (or groups of products) should be reviewed and, on average, were reviewing all products every three to five years. These firms had more clearly defined product review processes.

3.36 One firm thought some of its products were more sensitive to external changes over time which represented a higher risk of poor customer outcomes. So it reviewed these products more frequently, at least every 18 months. Conversely, one firm had set itself an extensive and challenging review schedule which required all 21 product groups to be reviewed within 12-18 months. This approach ran some risk of being ineffective due to time and resource constraints.

3.37 We consider that where firms are conducting periodic reviews of all products there is more opportunity to identify and rectify poor customer outcomes. But firms should consider carefully whether they provide adequate time and resource to allow the product reviews to be effective.

3.38 In summary, where firms have no systematic, demonstrable process in place for the periodic review of closed-book products, this falls short of our expectations. These weaknesses in firms' processes may lead to (or in some cases may have already led to) poor outcomes for closed-book customers.

How firms approached reviewing products

3.39 The way firms undertook systematic product reviews differed. Firms often employed a range of different checks to provide assurance that the product remained appropriate and continued to deliver fair customer outcomes.

3.40 Some firms' approach to product review included looking at the product with a '*customer focused lens*' through which the customer's actual experience could be gauged. This included assessing elements such as target market alignment, customers' feedback, complaints experience and the content of customer communications. These reviews often looked beyond the application of the firm's contractual T&Cs; we found examples where firms had identified that a narrow interpretation of their T&Cs would lead to less favourable outcomes for their closed-book customers. In these cases the firms had either over-ridden the T&Cs or had chosen not to rely on them in favour of their customers. For example one firm had opted to remove unit-linked switching costs. This change was potentially beneficial for around 1.5m in-force customers.

- We also saw examples where firms had additional tools they could use to enhance and complement the core product review framework:
- In one case a firm developed a framework to identify and act on unusual customer behaviour patterns which could indicate potential product-related issues.

3.41 In another example a firm developed a Value for Money assessment tool to consider if the product continues to provide good value for the customer in today's environment, recognising that products sold in a different era may have had poor value charging structures in 2014.

3.42 When we reviewed the outcomes that firms assess products against we frequently identified a lack of consideration of the impact of charges on product performance, and the subsequent investment return experienced by the customer. Cost is an important factor to the customer as this may erode any positive performance returns. A product review framework that does not assess cost or performance is unlikely to be sufficiently robust to ensure closed-book customers are being treated fairly.

3.43 In direct contrast to the customer-outcome-focused approaches described above, a smaller sample of firms felt their obligations towards closed-book customers were to ensure that contractual obligations were honoured without undertaking any wider assessment of customer outcomes. Where contract terms are fair ensuring such terms are honoured is an important

element of an effective product review process. However, it is unlikely to take account of the actual outcome the customer is receiving.

- 3.44** The potential for poor customer outcomes is increased in firms that adopted this narrow approach to product review. Where firms focus on contractual obligations rather than the customer outcome they risk adopting a 'tick box' mentality to the product review. In isolation this approach may constrain the firm's ability to identify wider issues that fall outside the T&Cs. It also does not recognise that what is required to treat customers fairly may have evolved over time.
- 3.45** For example, we saw one instance where the firm relied on a contractual term of increasing certain charges by inflation or 5%, whichever was highest. When the contract was set up interest rates and inflation were significantly higher than they are today. A minimum increase of 5% every year in certain charges now looks high in a climate of sustained low interest rates and there was no consideration by the firm whether this continued to be fair or reflected the actual cost to it.
- 3.46** We discovered the following two examples where firms' processes for reviewing products consisted only of reviewing compliance with contractual obligations and had not identified poor customer outcomes.

Example 1

- Our analysis highlighted a pension product that formed a significant proportion of a firm's closed-book and had a complex charging structure that saw charges increase for customers who reduced or ceased paying regular contributions. It did this by applying an increased Annual Management Charge (AMC).

A sample case we assessed found that £4,350 of contributions were made by 1992. The policy then became paid-up and the AMC increased by 6% to a total of 7.25%. The policy was valued at circa £3,300 which reduced to circa £1,500 when transferred to another product in 2014 and an exit charge applied. The firm's T&Cs review tested if the contractual charges were being applied correctly e.g. at the rates permissible under the contract terms. It did not consider the wider question of whether the charges provided a fair outcome for the customer. The firm was unable to demonstrate how the erosion of the product's value by the charging structure over time offered a fair outcome for that customer. Where a customer has invested into a savings and investment product, and the relevant market has, on average, returned strong performance over the investment period, it is reasonable for them to expect their policy to also have provided a positive return on their initial investment amount. This issue was compounded because the communications provided to the customer at the point the policy was made paid-up and, on an ongoing basis, did not make them aware they were paying an increased fee.

Example 2

- A firm did not consider whether its communications to customers at key event points (e.g. when the policy is converted to a paid-up policy) were clear, fair and not misleading. The communications to closed-booked customers, at key event points, did not adequately disclose to customers the implications of making the policy paid-up, including the charges that may apply which meant the customer was likely to be unaware of the increased charge and the action they could take to avoid it. This meant it did not identify the poor outcomes occurring at key event points for some closed-book customers, and so did not rectify the communications issues.

How firms approached resolving product issues

- 3.47** Most firms told us they had a process in place to address product issues they discovered through their product review processes. However, we found that the process was not always effective.
- 3.48** We were concerned that only a minority of firms had formal processes to assess and quantify customer detriment and had controls in place to ensure that the root causes of a problem (having been identified) could not continue to cause customer detriment and where detriment had occurred firms took steps to ensure these customers were appropriately compensated.
- 3.49** In the good practice example a firm had a framework to look '*through the eyes*' of the customer, the framework allowed the firm to consider the impact that changes to a product or process may have on closed-book customers and provided sign-posting to common issues customers may experience. The framework included an assessment of how complex a change could be from a customer's perspective and provided prompts to ensure that communications about the change were provided in a clear, fair and not-misleading way. The firm considered using additional tools or resources, such as setting up a dedicated Q&A helpline with sign-posting for call centre staff training.
- 3.50** Having identified an issue with a product, only one firm had considered how information could be shared with the wider organisation. In this case the firm had clear governance to ensure that issues identified by the product review process were shared with its complaints team. The complaints team was then able to integrate this into its current complaints experience and also consider if the issue had any relevance to recently refuted cases, ensuring complainants also benefited from the shared experience.
- 3.51** Where firms do not share experience from their product review assessments with the wider organisation there is a risk that poor customer outcomes may continue in other areas of the business where those findings may be relevant or useful – e.g. in dealing with complainants or when designing new products.

Firms' oversight of rectification of issues

- 3.52** We found examples where actions to address product issues that had been identified were not taken promptly. In some cases this was due to a lack of ownership within the firm for ensuring the successful resolution of identified issues. For example we found an issue with a product had been outstanding with the firm's Governance Committee for approximately 18 months. The firm was unable to explain why the issue had not been dealt with sooner.
- 3.53** Conversely we found another example where a firm's Executive Committee had clear oversight of the rectifications process by agreeing further actions to be taken and the most appropriate business area to take them. The Executive Committee got regular updates on the progress of any changes to products or ongoing rectifications.
- 3.54** Unreasonable delays in taking action to address problems are likely to result in continued poor outcomes for closed-book customers. A problem of this nature which has been outstanding for a continued period of time with no clear rationale may be indicative of weaknesses in the firm's governance and oversight arrangements.
- 3.55** We looked specifically at the role of effective governance and more detailed information can be found in sub-outcome 1.3.

Draft guidance: our expectations

As stated in the RPPD, and in line with Principle 6, we expect firms to review a product periodically to check whether it continues to meet the general needs of the target audience for whom it was designed. To do this, firms that have closed-book customers should have well defined and effective processes to ensure that products continue to meet customers' reasonable expectations and they have in place adequate risk management systems to ensure they can identify where poor outcomes may be occurring, and take appropriate action.

We expect firms to ensure that they periodically review closed-book products in a structured and consistent manner. Firms should ensure that the frequency of product reviews is appropriate. We expect that, save in exceptional circumstances, products are reviewed at least every five years with due regard paid to higher risk products which may require a more frequent review. We feel it would be highly unlikely that a five-yearly review will be sufficient for all products on a firm's book. There are also likely to be events that occur that give good reason for carrying out an ad-hoc review, e.g. a firm may highlight that its range of pensions require review due to recent legislative changes promoting increased freedoms to ensure that these products will continue to provide a fair outcome for customers in light of the changes made. If not, firms should take action to address this.

Firms should consider proactive and reactive indicators to inform their product review process. When informing their thinking firms should take account of all relevant sources of information that may be available to them, for example media articles that highlight a potentially poor customer outcome, regulatory publications, management information on how they treat their customers fairly and customer complaints data. Firms should not rely entirely on complaints data to identify issues with products or the processes that support them.

Firms should ensure that closed-book products are delivering fair outcomes for customers. This goes beyond solely looking at the strict application of the T&Cs, although we recognise that T&Cs should be taken into account when reviewing a product. Firms should be aware that some products were manufactured and sold in a different era, where, for example, economic conditions may have been fundamentally different. The risk that the passage of time could adversely impact on the outcome the customer receives is something firms should be aware of, and their processes should take this into consideration.

We expect firms to consider whether a product continues to provide a fair outcome to the customer. This may include assessing whether customers have received the investment return they could reasonably expect, or whether product charges consistently outweigh the performance being produced.

continued on page 30...

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When considering outcomes that closed-book customers may be experiencing, the firm should take into consideration all the relevant factors that could affect the product's performance. For example value for money, product performance, including the impact of charges, contractual obligations, communications to customers and complaints data are all likely to be relevant factors to assess, although this is by no means an exhaustive list. Firms should be able to articulate clearly the criteria that they assess products against and be able to explain what a fair outcome should be for each product (or group of products). This should take into account what a reasonable customer expectation should be, based on what the customer is likely to have understood by the information given to them at point of sale.

Where firms identify issues they should take appropriate and timely action to address them in line with the fair treatment of affected customers. We would normally expect the issue to have been addressed within six months of the firm identifying the issue, except in exceptional circumstances that can be clearly explained.

Where fundamental issues with a product are identified, the firm should ensure that the proposed changes or modifications do not create further poor outcomes. In addition, and where possible, firms should promptly contact customers and distributors to notify them of any remedial action including details of any changes or modifications to the product.

Firms should ensure that their rectifications processes are aligned with the fair treatment of closed-book customers. We also expect that firms will consider if other customers may be affected by an identified issue and where their findings may have a wider impact on other parts of the business they share information accordingly. As set out in our draft guidance for sub-outcome 2.1, firms should also take both the quality and contents of regular communications into consideration in the course of product reviews.

Sub-outcome 1.3: The firm has adequate governance arrangements for its closed-book business.

Background

- 3.56** Effective governance is essential to ensuring the fair treatment of closed-book customers. We require a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.²⁰
- 3.57** Firms can reinforce the right culture and business practices with effective systems and controls designed to identify and deal with conduct risks relating to closed-book customers. In particular, firms should have effective, independent controls, usually in the compliance, risk and internal audit functions that provide challenge to business units and assurance to senior management and board that the firm is operating as it should.

²⁰ Principle 3

3.58 Our aim was to assess if firms' governance and oversight processes were effective in ensuring fair treatment for closed-book customers. We also wanted to understand if some governance processes and practices are more successful than others in bringing about fair outcomes for closed-book customers.

3.59 In this paper the term 'governance' refers to a firm's processes, controls and management information, which aim to ensure fair treatment of customers.

Findings from our review of firm practices

3.60 Our overall conclusion is that in most cases governance structures were not always effective in ensuring the fair treatment of closed-book customers. While governance structures in some cases may have looked sufficient on paper, there was often evidence to demonstrate that they were ineffective in practice.

3.61 A firm's strategy and culture appeared to be the principal determinants of the effectiveness of governance in delivering fair outcomes to closed-book customers. Where a firm's strategy placed strong emphasis on delivering fair customer outcomes the governance also tended to be strong. We found in most cases that where a firm's strategy concentrated almost exclusively on generating revenue and cost cutting, with little or no mention of fairness to customers, we also rated their governance arrangements as ineffective.

3.62 One of the main shortcomings we identified was that firms were taking insufficient account of customer outcomes. Few firms were able to identify and define effectively the customer outcomes they were looking to achieve. They were also unable to articulate what action they had taken to achieve such outcomes and how they were monitoring the level of success.

3.63 All firms in the sample had governance processes with an appropriate overall structure. This includes committees and opportunities for challenge by people in the firm not directly involved in servicing closed-book customers. A number of firms had some examples of good practice, as they had clearly defined structures and processes for oversight over outsourced activities. We were assured by firms that their boards and relevant committees did consistently debate, discuss and challenge proposals relating to closed-book customers but there was very little evidence of this recorded in the minutes of such meetings.

3.64 We found that the strength or otherwise of a firm's governance depended to a significant extent on the levels of authority of the individuals involved. Some firms had delegated oversight of delivering fair customer outcomes to somebody of a more junior level. They were unable to evidence board level challenge and senior members of management were unable to talk about customer related issues in any detail. In most cases, boards had received customer MI on matters including closed-book business but there was little evidence of discussion and challenge in the minutes.

3.65 To an extent some firms had avoided such shortcomings by appointing individuals as consumer champions. This tended to be most effective where the individual was sufficiently senior, was assertive in driving forward the customer agenda and had access to sufficient resources. One firm had appointed a senior manager who headed up a large and well-resourced department to take account of the fair treatment of closed-book customers and because they reported directly to the board on this matter they delivered effective results. By contrast, where a firm had delegated responsibility for TCF to a committee of less senior staff they were generally unable to provide evidence of effective challenge.

- 3.66** Finally, governance and oversight controls tended to be stronger where firms believe there to be a detailed legal or regulatory requirement in operation. Almost all firms' governance processes had a strong focus on meeting contractual and regulatory requirements. However, firms did not take proper account of areas such as customer outcomes, or the content and frequency of customer communications.

Draft guidance: our expectations

Firms' governance processes should properly take into account customer outcomes as well as ensuring compliance with specific contractual and detailed regulatory requirements. This involves firms defining the customer outcomes they are aiming to deliver and that customers have been led to expect, and demonstrating whether they are achieving them. Where the intended outcomes are not being delivered we expect firms to be able to explain the mitigation actions they are taking. This action should be taken within a timescale consistent with the delivery of fair outcomes to customers. Unless there are exceptional circumstances, we expect the issue to be resolved within six months of discovery.

We expect firms to be able to demonstrate and clearly record that they have properly and adequately considered the Principles and other rules and customer outcomes, in relevant decisions taken by their Boards and other key committees. This may in some cases mean that minutes should record challenge where the papers themselves do not adequately demonstrate that these issues have been covered and properly taken into account and addressed.

This will involve making sure that the 'voice of the customer' is heard on key committees. One possible way of achieving this is for a firm to appoint a consumer champion, provided that person is sufficiently senior and is able to communicate effectively with the Board.

We expect it to be clear where consumer outcomes for closed-book customers are considered and how and when issues are escalated. This should involve appropriate oversight by someone who is at least a significant influence function holder.

Sub-outcome 1.4: The firm's remuneration, reward and performance management arrangements are consistent with the fair treatment of customers.

Background

- 3.67** In recent years we have carried out three pieces of thematic work on financial incentives and performance management, setting out our findings and expectations.²¹
- 3.68** We have also made clear in our 'Approach to Supervision' documents and in several speeches that a firm's culture is likely to have a significant influence on the behaviours of management and staff, and therefore on customer outcomes. We expect to see this followed through in the way in which firms conduct their performance management and employee development and through their reward programmes.²²

²¹ FSA Final Guidance – *Risks to customers from financial incentives* (January 2013); Thematic Review 14/4 *Risks to customers from financial incentives – an update* (March 2014); and Final Guidance 15/10 *Risks to customers from performance management at firms* (July 2015)

²² For example, speech by Clive Adamson, then FCA Director of Supervision, to the CFA Society, April 2013

3.69 In this review we aimed to establish whether staff dealing with customers contemplating surrender or transfer were subject to any incentives or performance management which was likely to increase the risk of poor customer outcomes.

3.70 For call handlers dealing with closed-book customers contemplating surrendering or transferring their policies, the main risk is that the call handler would be unduly influenced to retain that customer by persuading them not to surrender or transfer by inappropriate means. This could be done for example by providing an unbalanced description of the advantages and drawbacks of surrender, by applying undue pressure or by straying into advice in a non-advised process.

Findings from our review of firm practices

3.71 We found no evidence that individuals received direct incentives which provided specified monetary rewards in relation to the retention of closed-book customers seeking to surrender or transfer their policies.

3.72 Our findings relate to indirect incentives such as staff meeting potential retention targets even though these did not have a direct link to a financial reward. Some firms had some form of targets or material provided to call handlers that we considered created some risk of poor customer outcomes arising although in most cases we did not consider the resulting risk to be high.

3.73 In a minority of firms we saw retention targets being set by firms for their OSPs; and in turn the OSPs setting retention targets for their call handlers. We found examples of specific retention targets for individuals in contact with closed-book customers. Although retention of customers is a legitimate business objective, where OSPs and/or individual call handlers are given specific targets to retain closed-book customers this increases the risk that they may see their overriding objective as being to retain the customer rather than providing objective and balanced information as to the advantages and disadvantages of the customer options. For example some customer-facing teams were described as 'retention' teams and the wording of call scripts and other documentation encouraged staff to retain customers. We saw documentation referring to 'hooks' to highlight measures call handlers should take to try and retain customers.

3.74 We found examples where retention targets were contained in service level agreements (SLAs) between firms and OSPs. In one case there was a potential financial penalty for the OSP if it failed to achieve the retention target. This gave the OSP a direct incentive to ensure that as many customers as possible did not transfer or surrender their policies. We found examples where firms did not recognise that setting retention objectives for their own or OSP staff is likely to increase the risk of poor customer outcomes. We also found examples where firms had little information about targets and performance management at OSP firms.

3.75 In most cases, firms with higher risk practices had not identified the risk, did not have adequate oversight over remuneration, reward and performance management at OSPs and were not managing this risk as well as they should. Some members of a firm's management took the view that targets and incentives at OSPs were entirely a matter for the OSP even where there was an increased risk through the OSP having a retention target. The above risks were to some extent mitigated by firms setting objectives which had a focus on the quality of the call, requiring all relevant information to be presented in a fair and balanced way.

Draft guidance: our expectations

Firms should identify whether their approach to retentions could create an increased risk of leading to poor customer outcomes and manage this risk effectively.

In line with the January 2013 FSA guidance²³ we expect firms to:

- consider properly if their incentive schemes and performance management increase risks to customers
- review whether the governance and controls are adequate and
- take action to address any inadequacies

Examples of increased risk include retention targets for OSPs (particularly where there are financial penalties for failure to achieve such targets), retention targets for call handlers and referring to customer client-facing teams as 'retention' teams. Where these or other features likely to increase risk exist, we expect firms to ensure their controls and governance are adequate to manage these risks. This should involve firms having oversight of remuneration, reward and performance management structures at OSPs, particularly in respect of customer-facing staff.

We also expect firms to make sure that call scripts and other materials supplied to customer facing staff are balanced and do not encourage staff to influence closed-book customers unduly to stay with their current provider.

Firms should take into account the guidance published in July 2015²⁴ when considering how to manage the risks to customers from performance management measures.

Outcome 2: The firm's closed-book customers receive clear and timely communications about policy features at regular intervals and at key points in the product lifecycle to enable them to make informed decisions.

General findings

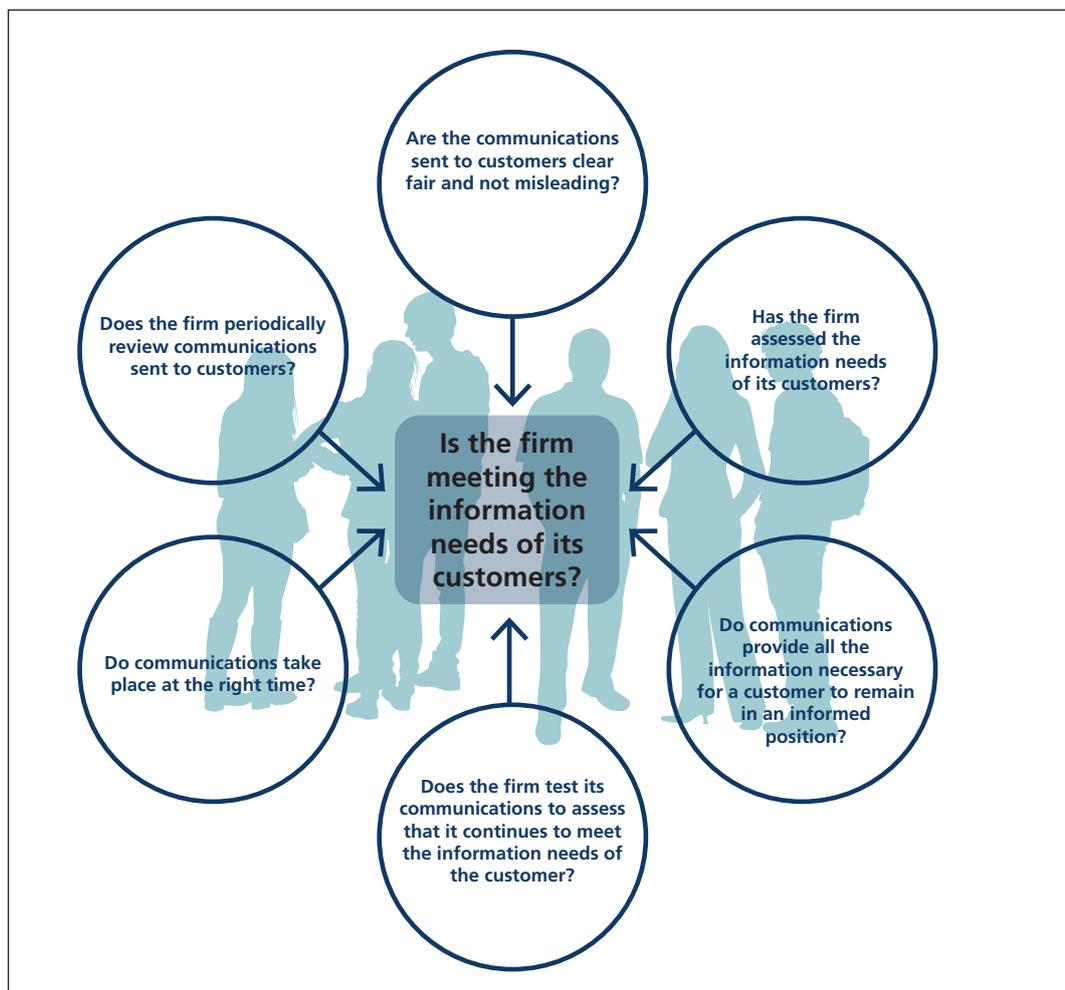
- 3.76** Poor communications forms one of the key thematic findings of this review, with communications activities not appropriately supporting the achievement of good outcomes by consumers. Figure 3 below, provides a summary of the key questions we sought to understand in our review of firms' communication with customers.
- 3.77** We saw clear examples of both regular and event-driven communications to closed-book customers which did not meet what has been said in previous regulatory communications and statements (which set out what was expected under the Principles).²⁵
- 3.78** Furthermore some firms had not identified the need for improvements or effectively considering the information needs of their customers.

²³ FSA Final Guidance FG13/1 – *Risks to customers from financial incentives* (January 2013) www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg131

²⁴ www.fca.org.uk/your-fca/documents/finalised-guidance/fg15-10

²⁵ Refer to *Insurance sector briefing 2007, With-profits review 2010*.

Figure 3 – Key questions we sought to answer during our review of customer communications



- 3.79** Some firms did not regularly send important policy information to some of their closed-book customers for much of the lifetime of their policies, or if they did send information it was generally of a poor quality and did not give customers enough information about their policies to keep them informed and help them make important decisions.
- 3.80** For event-driven communications, we observed instances of incomplete or insufficient information being provided to closed-book customers leading up to key events and shortcomings in communicating policy options and guarantees. Some firms did not adequately disclose charges that applied for early surrender or for making a policy paid-up, including cases where these charges had a substantial impact on the outcome delivered to closed-book customers. Some firms told us they rely on point-of-sale disclosure and/or the policy T&Cs to meet their disclosure obligations even though these were provided to the customer years earlier.
- 3.81** We also found poor customer outcomes being delivered through ineffective 'gone away' processes that did not use all relevant customer details to regain contact with customers with whom the firm had lost touch. Weaknesses in firms' 'gone away' processes meant they were less likely to find these customers and these customers were less likely to remain engaged with their policies.

Sub-outcome 2.1: Regular communications to customers provide them with sufficient information to make informed decisions.

Background

- 3.82** We wanted to assess if closed-book customers were receiving regular communications with enough information, presented in a clear, fair and not misleading way, to enable them to make informed decisions about their policies.
- 3.83** In our review of regular communications we aimed to establish whether all customers regularly received communications such as statements setting out the value and the performance of their policies. We also looked at the quality of these communications in terms of what information was presented as well as the layout and the ease of accessing key information.
- 3.84** Regular communication with closed-book customers serves a number of important functions in relation to Principle 7²⁶ and TCF outcome 3.²⁷ Firstly, it ensures that closed-book customers remain aware they hold a policy with the insurer and gives them an opportunity to engage with the value and performance of their policy and assess their need for financial advice. Secondly, regular communication reduces the likelihood of the insurer losing touch with the customer over time. Under Outcome 2.4 we discuss the importance of regularly communicating with customers in reducing the volume of correspondence that is returned to a firm marked 'gone away'.
- 3.85** As set out in the background chapter, both the FSA and the FCA have communicated their view to firms in relation to post-sale communications.²⁸ Moreover, the industry, through the Association of British Insurers (ABI), had developed previously published guidance on yearly statements that reflected a similar understanding to our expectations.²⁹

Findings from our review of firms' practices

- 3.86** We saw many examples in our sample of practices that had or were likely to result in poor customer outcomes. The quality of regular communications sent to closed-book customers fell short of what is necessary for these customers to be in an informed position regarding the performance and charges applicable to their policies.
- 3.87** We are concerned that some firms were determining what information to communicate, and the frequency with which the communication should take place, based on what they felt were the minimum detailed regulatory requirements and the T&Cs for the product. This meant some closed-book customers received no regular communications. In the absence of an appropriately detailed communication for an ongoing policy it is unclear how firms would be meeting their obligations under Principle 7 to provide adequate post-sale information to ensure customers understand how their investment is performing.
- 3.88** Many of the firms assessed produced regular communications that varied in quality in terms of both their layout and content across their closed-books. We found similar products in the same firm's closed-books applying inconsistent standards. Some firms told us their systems did not allow them to update their communications to closed-books customers. This is not

²⁶ A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

²⁷ Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.

²⁸ Insurance Sector Briefing: Quality of post-sale communications in the life sector and availability of ongoing advice to with-profits policyholders, May 2007: www.fsa.gov.uk/pubs/other/isb_quality.pdf

²⁹ Yearly statements – customer impact guide – 2006: <http://web.archive.org/web/20070614233550/http://www.customerimpact.org/main/guides/yearlystatements.aspx>

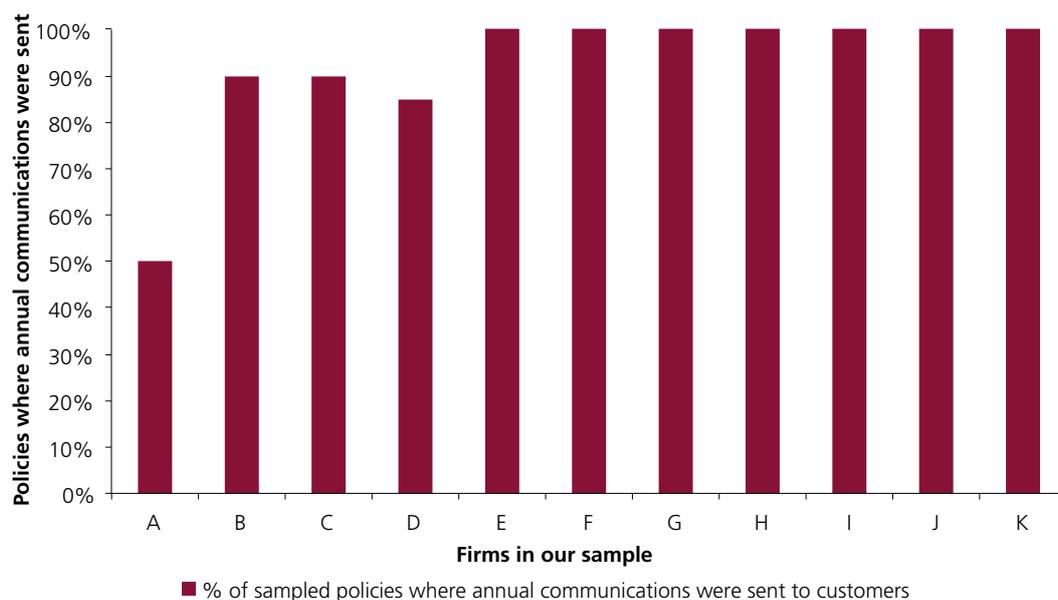
an acceptable reason for not meeting the information needs of customers and, indeed, we found that over half the firms in our sample have in place adequate systems, or have made the required investment in historic systems, to ensure communications can be improved if necessary.

3.89 However only a minority of firms in our sample assessed the information needs of their customers and made changes to regular communications to try to ensure that customers continued to be adequately informed about the key details of their policies and these changes did not always result in sufficient improvements.

Frequency of regular communications

3.90 Over half the firms in our sample provided policy information annually to all in-scope customers and we saw many examples of firms which sent annual policy information to personal pension customers. However, some firms did not send any policy information to customers of endowments³⁰, investment bonds and whole-of-life products. We observed two firms where this extended to retirement annuity contracts. Chart 1 below illustrates the proportion of sampled policies where annual communications were sent to customers.³¹

Chart 1 – Annual communications sent to customers in the sample³²



Annual communications for this purpose include annual statements, annual bonus statements, unit statements, Red/Amber/Green letters, and annual premium review notices for whole-of-life policies.

³⁰ Non-mortgage linked endowments.

³¹ Due to our sampling approach (refer to Chapter 2 on methodology) the proportion in our sample may not align with the total proportion of the firm's closed-book customers that would receive an annual statement.

³² This report denotes the 11 firms in the sample with letters (A-K). The letters assigned to each firm are randomised for each chart. For example Firm A in one chart does not necessarily correspond to Firm A in other charts.

3.91 We are concerned that the absence of regular communications reflects that, more broadly, some firms have not taken proper account of the importance of communications, with some unable to identify easily which products and customers are not receiving regular updates. Firms that did not send regular communications to customers were unable to demonstrate how they continued to meet the information needs of their customers on an ongoing basis.

3.92 In some instances, closed-book customers receive a bonus statement. Although this provides useful information, setting out the bonus applied to a policy, it is unlikely to be enough to put the customer in an informed position in the same way as an effective annual statement. A bonus statement may also omit information such as the level of life cover and contributions made during the year.

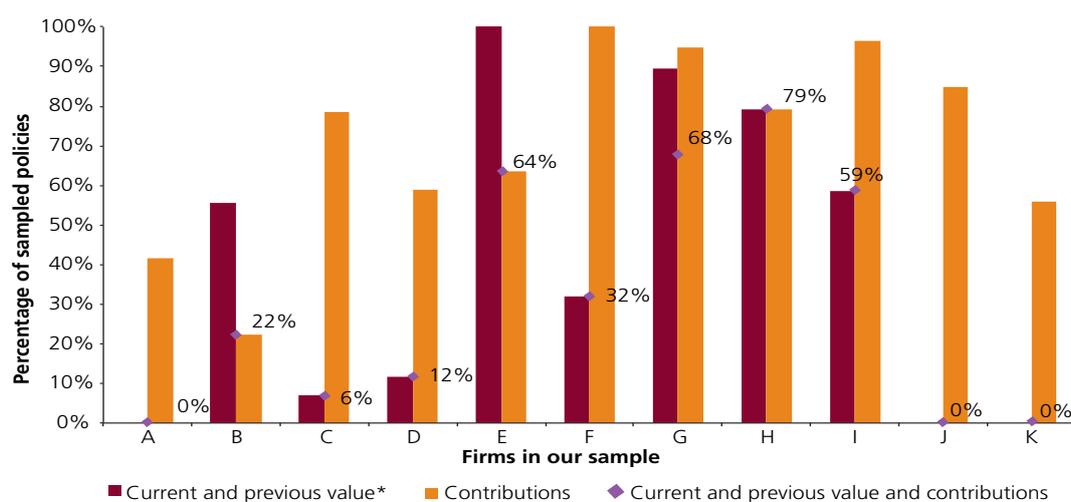
Quality and content of regular communications

3.93 Our findings in terms of the quality and content of annual communications are poor. Most firms in our sample fell short of our expectations.

3.94 Regular communications, in many instances, omitted key information and were less likely to enable customers to understand the performance of their policy over the period. Key omissions included information on charges, contributions in the period and the previous year's policy value.

3.95 Chart 2 summarises some of the key information that firms omitted in regular communications based on sampled policies.³³ It shows that only one firm included the current policy value and the policy value as at the previous statement date for all sampled policies, while only four other firms included this information in the majority of sampled policies. Further, only three firms included both the current and previous policy values as well as the contributions (either as regular contribution amount or over the period) for a majority of sampled policies. The table highlights that for most of the firms, key information such as contributions and policy values were omitted from a large proportion of sampled regular communications.

Chart 2 – Disclosure of policy performance in sampled policies

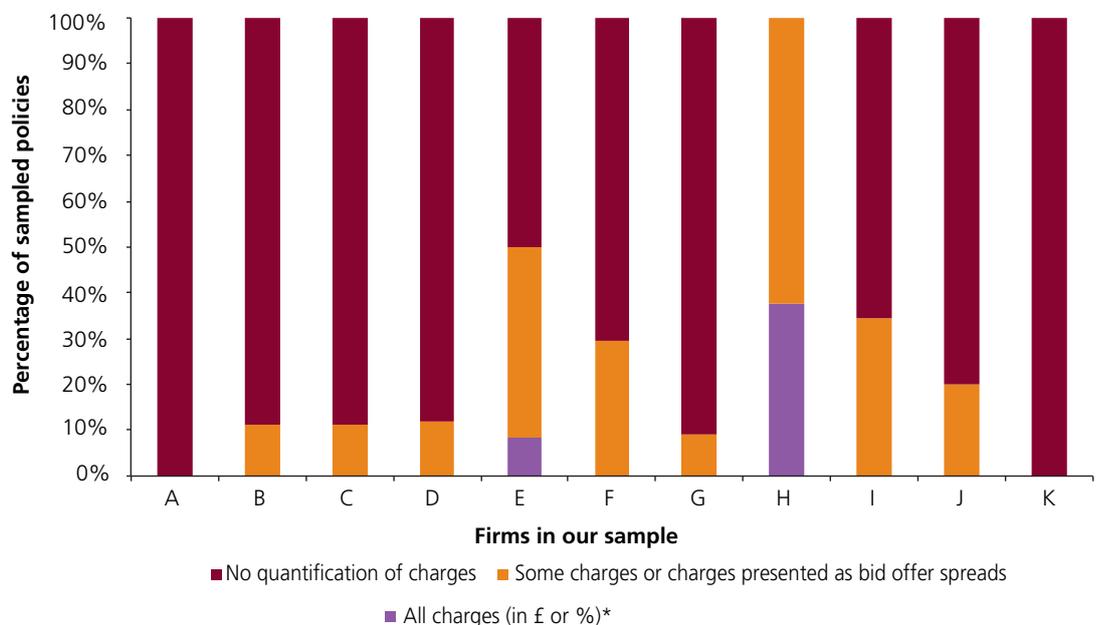


* Current value for whole-of-life policies is taken as cash in value.

³³ Some firms were unable to reproduce copies of regular statements sent to customers due to systems constraints. The chart is presented as a proportion of those policies where a regular statement was able to be reproduced.

- 3.96** Disclosure of on-going charges was particularly poor in many cases. Most firms did not provide any information on charges and fees to most closed-book customers, with some firms only partially disclosing the charges, this may have created a misleading view to the customer of the actual costs of maintaining the policies.
- 3.97** For example a firm referenced the cost of guarantees and the AMC but did not mention an annually inflating policy fee that was also applied. In another example, the firm noted that fees are applicable, and are reflected in the bid/offer spread. Charges implicit in bid/offer spreads are not a transparent means of communicating a policy cost to customers. Quoting charges in this format does not help the customer understand the impact of charges on their policies.
- 3.98** We are concerned that poor disclosure of charges also exists across products that have a capital unit structure³⁴ where certain units of investment are attracting a substantially higher AMC than is common in the current marketplace. Unless the customer is able to recall the point-of-sale information, or the product's T&Cs, they are unlikely to be aware that for an element of their policy they would be paying an AMC which is as high as 7.75% on the capital units in one product we reviewed.
- 3.99** Chart 3 provides an overview on the level of disclosure of charges across sampled policies. Only one firm in our sample provided information on charges in regular communications to all customers.³⁵ At the other extreme, two firms did not include any quantification of charges in any regular communications. For most firms only a very small proportion of sampled regular communication included some quantification of charges.

Chart 3 – Disclosure of charges in sampled policies



* For the purposes of this review we have not included disclosure of whole-of-life premiums as adequate disclosure of charges. These are included in the 'No quantification of charges' category.

³⁴ Refer to glossary section about capital units.

³⁵ Some firms were unable to reproduce copies of regular statements sent to customers due to systems constraints. The chart is presented as a proportion of those policies where a regular statement was able to be reproduced.

- 3.100** We also found firms providing varying levels of policy information to customers in regular communications, both across product types, and across similar products in different closed-books. This was more apparent in firms that had merged or purchased books of business and had continued the administration of these policies on the original systems. Regardless of where a closed-book originated, the firm which now owns the book is responsible for meeting the information needs of its customers.
- 3.101** Some firms were in the course of, or had recently completed, an upgrade to their systems with increased functionality, but had not taken the opportunity to review the quality and content of their communications and identify areas in need of improvement.
- 3.102** For example, a project to improve communication to customers in line with a systems migration in one firm resulted only in cosmetic improvements to the layout of statements. The firm did not consider the content of regular communications as part of a product review process and had not carried out any customer testing of existing communications.
- 3.103** We also saw a firm proactively reviewing its regular communications in light of findings from its product review process and customer research. It improved its regular statements, making them largely consistent across the firm. Its statements gave customers a good level of detail on policies including contributions, charges (or indicative charges for some policies), current value, the value at the previous statement date and the allocation of funds. Further findings with respect to disclosure of guarantees and benefits in regular communications are discussed under outcome 2.3.

Draft guidance: our expectations

We expect firms to ensure that they meet the information needs of all their customers on an ongoing basis, including closed-book customers.

Principle 7 of our Principles for Businesses requires firms to have due regard to the information needs of their customers. So, firms should have appropriate mechanisms in place to assess these information needs and ensure their communications meet these needs. To do this, firms should provide their closed-book customers with regular communications regarding their policies. We would expect this communication to be issued at least annually, unless the firm is able to justify how it is otherwise meeting the information needs of its customers.

In line with the Principle 7, firms should also ensure the content of these regular communications is consistent with their customers' information needs. So in their communications firms should include, for example, details on the performance of the product, its value and the impact of fees and charges.

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Principle 7 also requires communications to be fair, clear and not misleading. So, reflecting the nature of the policy sold, firms should include in the communication the following:

- The current value of the policy. The policy value may be different, due to charges or policy conditions, from the transfer or surrender value. Where this is the case firms should provide both the current and the surrender value of the policy. For whole-of-life policies with cash-in-value we expect this to be included as the current value. For conventional with-profits policies the current value may be challenging to calculate and in such cases firms should explain the impact of any likely terminal bonus on the current value and any reductions in asset share that will reduce the current value on surrender.
- The value at the previous communication date and the value of any premiums paid in over that period. This facilitates a broad comparison of the performance of the policy with reference to the current year's value.
- For unit-linked (non-profit) policies, charges incurred over the period in monetary figures. This includes setting out, in addition to the aggregate charge, a breakdown of the major components and the charge to the customer for benefits such as life cover and guarantees.
- For unitised and conventional with-profit policies an explanation of the charges being deducted, for example the guarantees that incur a charge and policy fees, and an indicative level of charge (in monetary terms) applicable to the policy.
- Where customers have specific options and benefits associated with a policy – for example life cover or a guaranteed minimum death benefit, a reminder of this in regular communications.
- As set out in our recent Smarter Consumer Communications³⁶ discussion paper, simply providing information to consumers is not enough to empower people to make effective decisions about the policies they hold. Firms should carefully consider the layout and structure of regular communications to ensure that information is easily accessible and key information is sufficiently prominent. Consumer testing is one approach to assessing the quality of communications; proactively engaging with consumers both during the initial development of communications and afterwards will help ensure all communications remain fit for purpose. Firms should also take both the quality and contents of regular communications into consideration when doing product reviews.

³⁶ www.fca.org.uk/news/dp15-05-smarter-consumer-communications

Sub-outcome 2.2: Communications to customers at the time of key policy events are clear, accurate and enable them to make informed decisions, and

Sub-outcome 2.3: Communications with customers make them aware of guarantees or options (whether time critical or not).

Background

- 3.104** We wanted to understand better how firms communicate key information to customers, including the comprehensiveness and timeliness of communications leading up to key policy events such as changes in premiums, surrenders, transfers and maturities.
- 3.105** We wanted to assess whether there was a lack of engagement with closed-book customers about the options and guarantees contained in their policies, which may be resulting in poor outcomes. Customers who bought policies over a decade ago may have been aware of the various benefits available to them at the point of sale, but may become less familiar with the details of the policy over time.
- 3.106** It is important that firms continue to remind closed-book customers of these benefits throughout the lifetime of their policies. It is also important that when customers are considering a change to their policy, for example surrendering or transferring their policy, they are clearly informed of the impact of their decision on these benefits.

Findings from our review of firms' practices

Quality and timeliness of event-driven communication

- 3.107** Communication surrounding key events needs to provide customers with a clear understanding of what the firm requires from the customer, the various options available, and the impact of each option on the policy value and benefits.
- 3.108** Some firms met our expectations in these areas across the range of policy events in our sample. We observed firms taking different approaches to ensuring customers were aware of their options and the impact on their policy of taking a particular course of action.
- 3.109** One firm reissued the Key Features Document and gave the customer a 30-day cooling-off period after deciding to increase their level of regular contributions. This information gives the customer an opportunity to review their policy conditions and reflect on their decision before fully committing to the premium increase. Some firms provided a brochure to their customers who were considering surrendering their policies setting out the benefits they would lose and the alternatives to consider.
- 3.110** We also reviewed the timeliness of communications in the lead up to policy maturity. Most firms engaged with their closed-book customers sufficiently early in the lead up to such an event to give them enough time to take action, and also provided reminders if there was no response.
- 3.111** However, we observed weaknesses across a small number of firms in the quality and comprehensiveness of communication for transfer requests for personal pensions. Firms provided only the information requested by the closed-book customer or requested by their financial adviser. Where the customer approached the firm to transact such a transfer but did not request any information, firms did not provide any information to explain the impact of the transfer on the policy value, for example due to an early surrender charge. This approach is likely to lead to poor outcomes for customers.

3.112 For example, one firm was asked for a transfer quote for a policy that contained a highly valuable guaranteed annuity rate (GAR). The customer did not specifically request information on any benefits or guarantees available to them under their policy. The firm sent the customer poor-quality documents, without highlighting key information – including the existence of the GAR – in the covering quotation. Furthermore, the more detailed documentation provided as part of the Transfer Quote Pack only noted that a GAR may apply without any indication of its value and the fact that it would be lost upon transfer, so a customer should consider the implications of this in their decision making.

3.113 We also observed some firms which did not present options in a balanced manner. When writing to closed-book customers leading up to a scheduled premium review for a whole-of-life policy, one firm set out the benefits of increasing the premium to maintain the level of cover. The firm did not clearly set out that the customer had the option also to lower the level of cover and maintain their current premium. Furthermore, the letter did not provide the customer with the cash-in-value of their policy.

Exit and paid-up charges

3.114 For the majority of firms that had an exit and paid-up charge we found indications that these charges were not disclosed to the customer either immediately before the charge being incurred or subsequently, unless the customer specifically asked for this information. For example, in one firm if a customer makes a policy paid-up an additional AMC is incurred on the policy. This additional AMC may be as high as 6.5% in comparison to the regular AMC of 0.75%. When receiving a request to make a policy paid-up, the firm did not highlight the impact of these charges to the customer either when making it paid-up, or in any future correspondence, unless it was specifically asked about the charges.

3.115 The firm also applied a surrender charge for this product. Where a surrender request was received from a customer the firm provided a quote for the expected surrender value (noting that market movements may impact the value) but did not make the surrender charge explicit unless specifically requested by the customer.

3.116 In another case, a firm, on its with-profits business, targets 95% of asset share on average for its policies on surrender compared with a target of 100% of asset share on average at maturity. When a customer was looking to surrender their policy and requested a quote the firm did not make this surrender charge explicit or explain the impact of this on their policy value. The firm also did not explain the action the customer could take to avoid such a charge, for example by making clear when such a charge would not be applicable.

3.117 Some firms took the view that because they had informed the customer of these charges at point of sale they did not need to inform them when they applied the charge. But if the customer is not told about such a charge when it is incurred, they are very unlikely to have all the relevant information to hand in order to make an informed decision about what action to take. If the customer is aware that a surrender/paid-up charge applies they may decide not to surrender their policy or make it paid-up until the time the charge does not apply, or they may consider taking a different course of action. Firms should not rely on closed-book customers recalling important information from the point of sale which in many cases may have been many years earlier, as this is more likely to result in a poor outcome for customers.

Communication of policy benefits, options and guarantees

3.118 We observed a range of practices; some firms disclosed various policy benefits, such as the level of life cover in regular communications and also reminded closed-book customers when considering surrendering their policy that they might not be able to obtain a similar level of cover at a similar cost due to changes in health and circumstances.

- 3.119** However, we found inadequate disclosure of benefits in regular communications which means it is highly unlikely that customers are aware of these key policy benefits. We also observed firms not highlighting the loss of benefits leading up to key events such as maturity or transfer.
- 3.120** In one example, a policy had an optional guaranteed level of death benefit that was purchased at the policy's inception. The firm, through its regular statements, informed customers that had selected this option of the value of the guarantee. However, in transfer requests the loss of this, often higher, level of cover was not highlighted to the customer.
- 3.121** We are concerned that not highlighting the existence and potential loss of benefits to closed-book customers in the lead up to policy events introduces a higher risk of poor outcomes, as customers may make a decision based on limited or partial information provided by the firm at the time of the event.
- 3.122** In another example, customers were not informed of the option to increase their level of life cover in line with inflation without underwriting. A firm decided not to disclose, or signpost, this option in its communication relating to premium reviews. As a firm is not in a position to assess the value attached to the increased life cover by individual customers, this approach may result in poor outcomes in cases where a customer would like to acquire additional life cover but is unable to do so elsewhere, for example, due to health reasons.

Draft guidance: our expectations

Principle 7 of our Principles for Businesses requires firms to have due regard to the information needs of their customers and communicate in a way which is clear, fair and not misleading.

In line with this we expect firms to ensure that closed-book customers are fully informed of the various options, features and guarantees that form part of their policies both on an ongoing basis and in the lead up to policy events. Firms should undertake an assessment of the product's benefits and determine how to ensure customers are kept informed.

In line with our requirement that firms' communications should be fair, clear and not misleading, we expect firms to be specific when setting out guarantees or benefits that are available to closed-book customers and avoid language that is ambiguous. For example, it would not be appropriate simply to provide statements such as 'you may have life cover as part of your policy'. Instead firms should state the level of cover provided as a monetary amount. Furthermore, firms should also not 'cherry pick' which benefits are to be disclosed. The needs of customers vary and benefits that are not of significance to one customer may be valuable to others.

In communications with customers surrounding a policy event firms should highlight the benefits that are likely to be impacted by the event in a sufficiently prominent and specific manner.

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Additionally, to be clear, fair and not misleading, we expect any communication surrounding a key event to:

- Set out clearly all options available to the customer in a balanced manner including both the risks and potential benefits of each option.
- Set out clearly any charges that may apply. Surrenders and/or paid-up charges should be presented as monetary figures so that the impact is clear.
- Provide sufficient notice to customers and provide clear time lines for when a decision is needed.
- Highlight where there may be a need for the customer to seek advice.
- Provide alternative options to incurring a paid-up/surrender charge, for example indicate if a customer could delay surrendering a policy so a charge would not apply.

Firms should carefully consider the layout and structure of event-driven communications to ensure that information is easily accessible and key information is sufficiently prominent. Consumer testing is one approach to assessing the quality of communications; proactively engaging with consumers both during the initial development of communications and afterwards will help ensure all communications remain fit for purpose. Firms should also take both the quality and contents of event-driven communications into consideration in the course of product reviews.

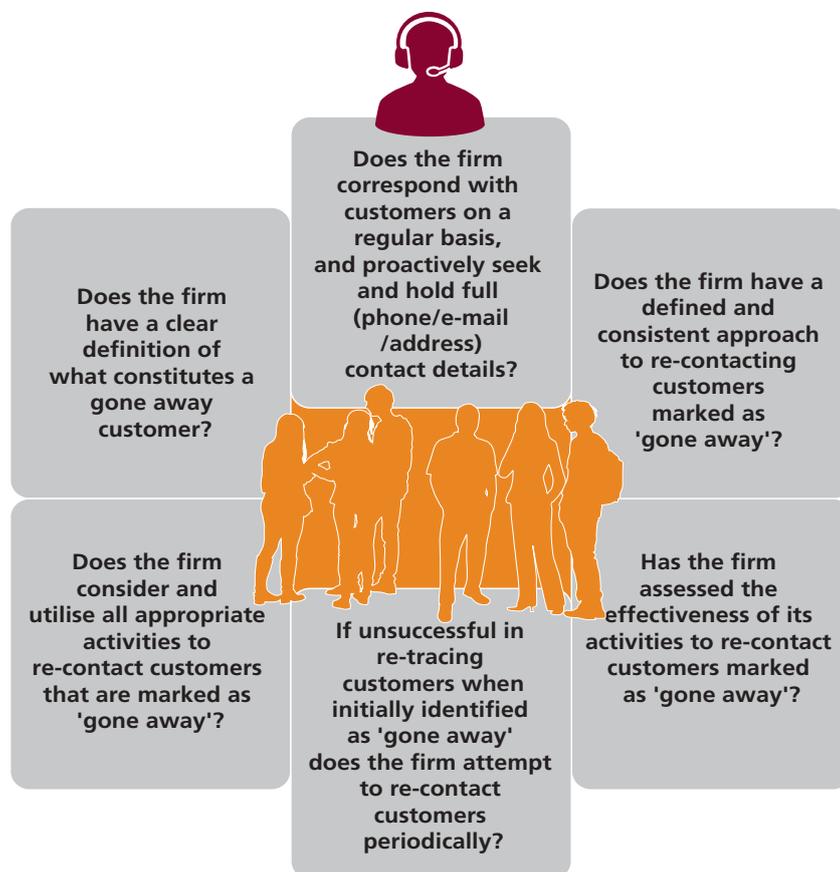
Firms should also be mindful of the requirement under COBS16.5.1R – which sets out that if a customer wishes to surrender a life policy which may be traded on an existing secondary market – it must, before accepting a surrender, make the customer aware they may be able to sell the policy instead, of how to do so, and that there may be financial benefits in doing so.

Sub-outcome 2.4: The firm takes effective action to locate and make contact with 'gone away' customers.

Background

- 3.123** We were concerned that an absence of effective systems and procedures to maintain, or re-establish contact with customers increased the risks that closed-book customers did not engage actively with their policies or forgot that they held a product and did not take the benefits provided by their policies. We wanted to gain an understanding of how firms tried to re-establish contact with customers with whom they had lost touch. Figure 4 below, provides a summary of the key questions we sought to understand in our assessment of firms' processes for maintaining and re-establishing contact with customers.

Figure 4 - Key questions we sought to answer during our review of 'gone away' processes



- 3.124** The scale of the total amount left unclaimed by customers is large. Estimates vary between £10 and £20 billion across the financial services industry. The Unclaimed Assets Register suggests there is approximately £4 billion in life assurance and pension schemes.
- 3.125** Firms that do not have a structured, dedicated and consistent approach for dealing with 'gone away' customers, but instead rely on ill-defined or inconsistently applied processes have a higher risk of not treating closed-book customers fairly.
- 3.126** Our review included firms using outsourced service providers as well as those that have retained this function in-house. We spoke to firms to assess how many of their in-scope customers they had lost contact with and assessed the systems and procedures for maintaining and re-establishing contact with customers.

Findings from our review of firms' practices

- 3.127** The overall picture is poor, with over half the firms demonstrating weaknesses which had resulted in, or were very likely to result in, poor customer outcomes. The primary driver for the weaknesses identified was that firms did not have well defined and effective processes in place. In addition, most of the firms in our sample did not measure the success or otherwise of their various 'gone away' activities, creating a significant risk that they did not re-establish contact with as many customers as otherwise may have been the case. For some firms this may have been very simple and straightforward as they held customer telephone numbers but did not use them.

3.128 Where firms displayed a lower risk of poor customer outcomes arising this was typically a by-product of other actions the firm had taken, rather than a specific proactive focus on this issue. One such example was where a firm had transferred a portfolio of insurance business to another entity (Part VII transfer) where firms are required, unless a court directs otherwise, to send notice of the transfer to all customers.

3.129 There were firms which had put in place well defined and effective processes. They were, however, in the minority.

Preventing customers from going away

3.130 There was evidence that firms were taking proactive steps to collect multiple customer contact data points to mitigate the often simple oversight of customers forgetting to inform them when moving address. For example, most of the firms in our sample sought to hold a customer's residential address, email address and telephone numbers (mobile and landline).

3.131 We saw some examples of good practice in this area. For example, we saw proactive checking of customer details against credit reference databases to anticipate 'gone away' customers before mail is returned. Some firms also included forms at the back of annual statements to remind customers to notify them of any change of address.

3.132 As set out in section 2.1, we found that some customers are not being communicated with regularly. This increases the risk that firms will lose contact with customers and will not necessarily be aware that customers have 'gone away'.

3.133 We also saw instances of where a firm's approach to 'gone away' customers was inconsistent across different parts of the business. Where a customer advised the firm of a change of address their details were only updated for the product and/or outsourced service provider contacted. If the customer held other products with the firm either administered on a different system or by a different outsourced service provider their details were not updated. This creates a risk that some customers will not be kept updated about all of their assets. When advising a firm about a change of address or other such important information, closed-book customers should not need to contact a firm multiple times to cover each product they hold.

Re-establishing contact with 'gone away' customers

3.134 Most of the firms in our sample used tracing agencies, which had access to external and proprietary data sources, to try to re-establish contact with customers. There was evidence that firms were conducting their own tracing activities by using for example, the Department for Work and Pensions and bank letter forwarding services. We are concerned, however, that several firms had encountered difficulties using bank letter forwarding services with several saying banks were uncooperative in forwarding letters to 'gone away' customers.

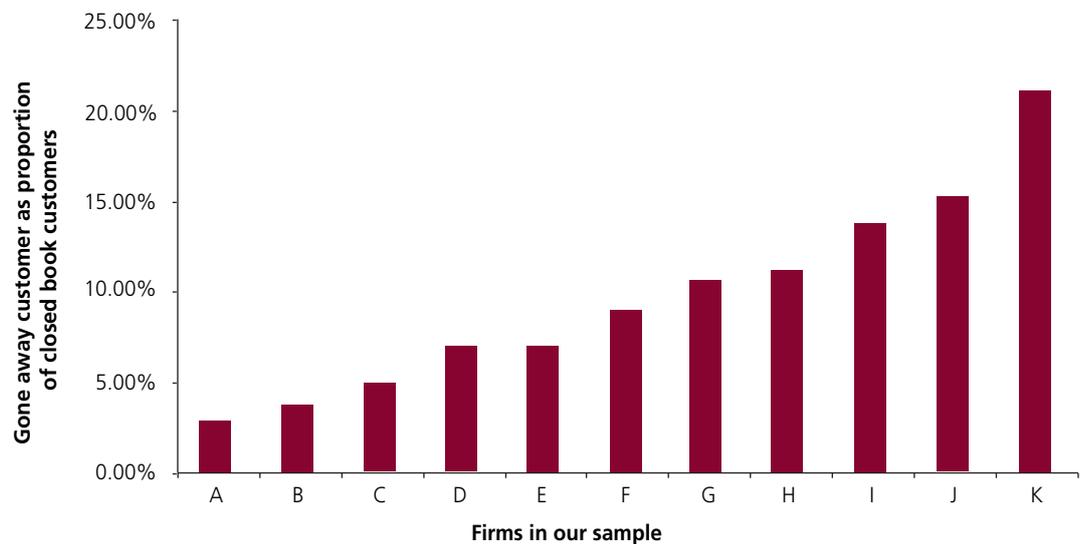
3.135 We also saw examples of practice which was unlikely to re-establish contact with customers. For example, a number of firms held multiple (phone/email/address) customer contact details but chose not to use these in their attempts to re-establish contact. We are concerned that there is likely to be a group of customers who are contactable through reasonable means but remain 'gone away'.

3.136 We found that a number of firms who were unsuccessful in re-establishing contact at the first attempt did not attempt to re-establish contact with customers again for significant periods of time. For example, several firms in our sample did not attempt any subsequent re-contact with customers until policy maturity. Such a delay increases the risk that customers will be unaware of the products they hold which can impact on their financial planning for the future.

3.137 We also saw some examples of practice which was more likely to re-establish contact with customers. For example, a firm attempted subsequent re-contact with customers every two years from first attempt.

3.138 Chart 4 summarises our findings for the rate and number of customers marked as 'gone away'. The highest 'gone away' rate was observed at 20.75%. A number of the weaknesses discussed above, including not using all customer contact information in the initial trace and potentially long periods between attempts to re-trace, were identified at this firm. The high gone away rate shows the impact on customers of a weak 'gone away' process. The chart indicates that we found a wide range of 'gone away' rates at firms. This suggests that the effectiveness or otherwise of firm processes could have a significant impact on the proportion of 'gone away' customers.

Chart 4 – 'Gone away' rate



Draft guidance: our expectations

In line with Principle 6, it is important that firms demonstrate their commitment to maintain effective dialogue with their closed-book customers by establishing systems and controls to proactively minimise the number of new 'gone away' customers.

Firms should have a clear definition of what constitutes a 'gone away' customer and a clearly defined process for dealing with products where customers could not be traced. We expect firms to consider and use all appropriate activities to contact closed-book customers.

Firms should correspond with their customers regularly, and proactively seek and hold full (phone/email/address) contact details. It is important when firms have multiple customer contact points and/or records (e.g. through different OSPs) that a single customer profile and/or multiple customer profiles for the same customer are maintained with consistent, up-to-date customer information.

It is important that firms attempt to re-establish contact with customers who have 'gone away'. Examples are:

- adopting a consistent 'one firm' approach
- assessing the effectiveness of 'gone away' activities and understanding the key drivers of success
- attempting re-contact at point of 'gone away' and, if unsuccessful, within 18 months of the first attempt and, if again unsuccessful, at least every three years after that, unless the firm can demonstrate why this will not be effective
- undertaking, as a minimum, electoral register and mortality checks, or using a third party to undertake this, in addition to leveraging their substantial databases, on the firm's behalf
- using, as a minimum, the Department for Work and Pensions' letter-forwarding service

Firms may also wish to undertake the following 'gone away' activities depending on the profile of their customers:

- BT directory enquiries, 192.com database search
- insolvency data
- internet research e.g. social networks
- bank letter-forwarding service
- beneficiary tracing services, e.g. heir hunters, probate researchers, professional genealogists.

Outcome 3: The firm gives adequate consideration to and takes proper account of fund performance and policy values in a way that ensures it treats its closed-book customers fairly and proportionately.

General findings

- 3.139** It was encouraging to see that firms in our sample did not differentiate between closed-book and new unit-linked funds when monitoring investment performance.
- 3.140** A number of firms nevertheless did not give unit-linked fund performance sufficient thought and had not put in place well-defined and effective processes for ongoing monitoring. Even where firms were successful in identifying poor performance they often did not take prompt mitigation action.
- 3.141** On the overall fairness of expense allocations and charges, we did not find any evidence to suggest that firms were deliberately allocating expenses unfairly to closed-book customers. We did find that firms generally were not proactive in reviewing expense allocations and charges, and did not generally make systematic use of benchmarking in order to satisfy themselves that their closed-book customers were receiving a fair outcome relative to other options in the market.
- 3.142** Most firms did not have a consistent or robust approach to assessing customer outcomes with respect to expense allocations and charges. Furthermore, we found that almost all firms did not appear to have a clear mechanism to assess whether actual individual maturity and surrender pay-outs represented fair outcomes, particularly on unit-linked business.
- 3.143** Finally, we found a range of practices on linking expense allocations and charges being incurred by customers to the actual expense experience of the firm. A particular area where practices differ greatly was on the review of mortality and other risk charges and whether firms passed on the benefit of generally lower mortality experience over time in the form of lower charges.

Sub-outcome 3.1: The firm takes steps to deal with poor performance with closed and actively marketed products given equal attention.

Background

- 3.144** The key factors affecting the value of a customer's closed-book product are the amount contributed into it, the impact of charges and the performance of funds held in the product. We wanted to assess whether firms were monitoring the performance of funds held in closed-book products and would therefore be able to identify consistently underperforming funds and take appropriate steps to address the drivers of the poor performance.
- 3.145** While fund performance is affected by the level of charges, our objective under this sub-outcome was to assess the approach of firms to monitoring gross fund performance on closed-book unit-linked funds i.e. performance before the impact of charges. We assess the approach of firms to charges more broadly under sub-outcomes 1.2, 3.2 and 3.4.
- 3.146** We looked solely at unit-linked funds and did not request fund performance information from firms with respect to their with-profits funds.

Fund types

- 3.147** Customers are able to invest in a variety of unit-linked funds through the firms in our sample which can be broadly broken down into two categories:
- Direct funds – funds over which the firm has direct control.

- Indirect funds – unit-linked funds which track the performance of a third party fund over which the life insurer has no direct control. Firms offer exposure to third party firms' collective investment schemes (CIS) through their own unit-linked funds (sometimes referred to as 'mirror funds') or provide access to other insurers' unit-linked funds (reinsured funds). Some firms also offer direct access to CIS of other firms. Such funds also fall into the indirect category.

3.148 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.

3.149 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. Our rules³⁷ require firms that enter into reinsurance arrangements for unit-linked funds to discharge their responsibilities as if no reinsurance contract was in place.

Findings from our review of firms' practices

3.150 Firms presented a mixed picture in the way they approached assessing performance with some firms demonstrating reasonable or good practice and others exhibiting weaknesses which had a higher risk of, or were very likely to, result in poor customer outcomes.

3.151 The primary area of risk is that firms appeared not to give fund performance sufficient thought and appeared not put in place well defined and effective processes. Even where firms displayed a lower risk of poor customer outcomes arising, this was typically undermined by the mitigation steps being taken. For example, one firm planned the closure of over 200 funds but was significantly behind in their closure programme.

3.152 We are concerned that many of the firms did not assess whether fund performance added value after the impact of charges, either while specifically reviewing fund performance, or as part of an ongoing product review process. As a result, the overall outcome to the customer, which is performance minus charges, is not being adequately assessed.

3.153 We found that firms gave equal oversight to closed-book and new funds.

Reviewing fund performance

3.154 One firm reviewed the performance of direct funds but did not review the performance of indirect (mirror) funds.³⁸ This firm expects customers to be aware that the firm merely provides access to these funds. This creates potential inconsistencies between the expectations of closed-book customers and firm actions. To meet our requirements we expect firms to review the performance of both direct and indirect funds in line with COBS 21.3.3R.

Correctly identifying poor performance

3.155 We saw some good practice in this area where firms were setting appropriate and relevant benchmarks in line with what had been communicated to their closed-book customers. There are dozens of indices that firms use to gauge the performance of any given investment and firms were giving consideration, not only to how appropriate their chosen benchmarks were, but also to what was communicated to customers.

³⁷ COBS 21.3.3R

³⁸ For mirror funds there are two elements to reviewing the performance of these funds: a) reviewing the performance of the underlying fund; and b) reviewing the performance of the mirror fund to see how closely it matches (and whether the reasons for the difference are justifiable).

3.156 For example, one firm clearly set out performance and volatility benchmarks in their Investment Guidelines. Clearly setting out the benchmarks against which funds will be measured aligns firm expectations with those of fund managers.

3.157 We observed firms typically considered funds to be underperforming when they were below the 60th-80th percentile; however, we identified some differences in a number of firms in respect of how they classified significant underperformance. One firm stated that only funds that are 5th or 95th percentile over three or five year periods warranted closer monitoring. This creates a risk that the firm may not identify and take action in respect of some funds that are underperforming.

Appropriate and effective mitigation

3.158 There is evidence from a number of firms that they did not put in place effective mitigation actions and did not measure the success or otherwise of their mitigation activities. One firm identified a poorly performing fund and took mitigation action, appointing a new fund manager in late 2013. The fund suffered a rating downgrade in Q3 2013 and eventually lost the rating altogether, leading the firm to take further mitigation action, deciding to close the fund in mid-2014. However, despite the fund delivering bottom decile performance in each of the last three discrete years it remained open (as at Q1 2015) with no indication of improving performance. There is a significant risk that firms may continue with ineffective activities, leaving customers in poorly performing funds for significant periods of time.

3.159 We did see some examples of firms taking action in this area such as one identifying poorly performing funds and triggering a cure period for the same in May 2013. At the end of the cure period in May 2014 most of the funds had not met the cure condition and the fund managers of those funds were eligible for termination. Clearly setting out and following a mitigation process from identification to resolution is more likely to ensure that poorly performing funds do not go unnoticed and/or unmanaged.

3.160 Some firms' oversight functions (e.g. Investment Committee and Compliance and Risk Departments) were unsighted as to the mitigation activities agreed or the progress of any such actions, so the lack of action was not adequately addressed by the firms. This meant the oversight function was not aware of the lack of action.

3.161 We are concerned that the reasons for continued poor performance, the mitigation steps being taken and the effectiveness of the mitigating actions are not visible in a number of firms. One firm identified 63 underperforming funds but its Investment Committee's notes did not set out, for each fund individually, the actions being taken or otherwise. This represents a higher risk that some funds may not receive the same level of attention as others.

Draft guidance: our expectations

We expect firms:

- to give due and appropriate oversight to each type of fund (e.g. closed, open, direct and indirect)
- not to give less oversight to a particular fund solely because of its type and
- to start from the presumption that each type of fund requires equal oversight and to be able to demonstrate that any difference in approach between funds is fully justifiable by reference to relevant regulatory requirements and guidance and possible conduct issues arising

We expect firms to have clearly described and effective processes for:

- Identifying poorly performing funds, including:
 - Appropriately frequent reviews. Reviewing funds that closed-book customers have access to less than quarterly gives rise to doubts as to whether firms have effective processes in place.
 - Using appropriate and relevant benchmarks against which to assess performance, in line with what has been communicated to closed-book customers.
 - Using appropriate triggers for signalling potential underperformance. Recognising significant underperformance when funds are below at least 75th percentile is likely to be a reasonable signal in line with industry practice.
 - A clear reporting framework setting out what metrics are expected from fund managers and on what frequency.
- Where poor performance is identified, taking appropriate and effective action including:
 - Having a defined mitigation process that continues through to resolution. Making fund managers aware of the identification/mitigation framework in which they are expected to perform is more likely to show an effective process.
 - Measuring the effectiveness or otherwise of mitigation actions and making changes as appropriate.
 - Appropriate oversight for each fund individually of the actions being taken or otherwise.
 - Setting appropriate timelines including identifying the stage in the mitigation action the fund is at and expected resolution dates.

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We expect firms to set appropriate and relevant benchmarks in line with what may have been communicated to their closed-book customers about performance and to have considered sufficient relevant and appropriate metrics available to them. Firms should use a mix of long- and short-term metrics to ensure they have appropriate measures for the particular funds in question having regard also to any relevant customer expectations. We have noted, in particular, the following metrics open to firms when assessing fund performance:

- Performance. By measuring fund value performance both over the longer term and the short term firms will have a more rounded picture and be able to make more informed decisions. For example, quarterly, half, five, ten or fifteen yearly benchmarks can bring an element of consistency to the review of fund performance.
- Volatility. By measuring volatility over the long- and short-term firms should avoid over-reacting to short term fluctuations and not be unnecessarily turning over fund managers or putting undue pressure on fund managers to turn over the portfolios held within funds.
- Sharpe ratios are a way to examine the performance of a fund by adjusting for its volatility risk. By measuring funds' Sharpe ratios over the long- and short-term firms are able to assess a large number of liquid funds quickly and this serves as a useful metric in this respect.

Sub-outcome 3.2: Overall expenses are allocated fairly to closed-book products.

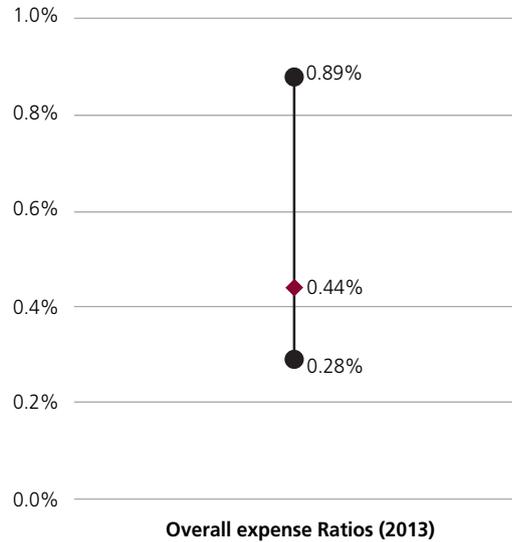
Background

- 3.162** We aimed to assess if firms are treating their closed-book customers fairly when allocating expenses to funds, products and individual policies, and when setting or reviewing charges. In our review, we considered expenses of all types – maintenance/administration expenses (whether directly attributable or not), investment management costs, investment administration costs, exceptional costs (such as for strategic IT spend, Solvency II preparation and pension scheme deficits) and transaction costs (such as for fund switching).
- 3.163** The approach to expense allocation is different for situations where a firm has an allocation methodology used to allocate the various expenses to customers regularly and for situations where they operate a structure under which charges are set by the contract at a particular level. In the latter scenario, any internal expense allocation has no direct bearing on the charges actually incurred by customers. Because of these complexities, we tested our information request in this area with a single firm in the sample as part of a pilot exercise. The results were used to refine our approach by reflecting lessons learned from the pilot.

Findings from our review of firms' practices

- 3.164** The extent of the discretion that firms had in allocating expenses to closed-book customers varied significantly depending on the nature of the business and the particular history of the firm and funds within which the business was written. The key scenarios that were evident at firms were:
- firms/funds with discretion in the allocation of expenses limited only by the constraints of COBS 20 (applied only to a small number of with-profits funds)
 - firms/funds with some discretion in the allocation of expenses, limited by the constraints
 - of COBS 20, a court scheme or expense agreements with respect to some or all of the expenses (applied to varying degrees to most with-profits funds) and
 - firms/funds where the allocation of expenses to customers was not seen as being of direct relevance to the charges incurred by customers, primarily due to charges being set by the contract at a particular level (applied to a large proportion of unitised with-profits business and all unit-linked business)
- 3.165** There was no evidence to suggest firms were deliberately allocating expenses unfairly to closed-book customers. The level of expenses being incurred by firms and the level of allocations/charges to customers varied between firms, funds and product types. While the level of some types of expense allocations/charges was relatively high at a few individual firms, there was no evidence to suggest that current expense allocations/charges were in general disproportionate or unfair.
- 3.166** The charts below illustrate the range in the levels of overall expenses, administration costs and investment costs in the various with-profits funds we considered at the firms in our sample. The charges on unit-linked and unitised with-profits business with contractual charging structures varied significantly between firms, but are harder to represent in graphic form as we have done below for with-profits business subject to annual expense allocations.
- 3.167** Chart 5 below shows the quartile distribution of with-profits fund overall expense ratios in 2013 for the funds in our sample firms. This illustrates the range in the level of overall expense allocations observed, measured as a proportion of the total customer asset shares in the funds. The lowest expense ratio we saw was 0.15% and the highest was in excess of 6%.

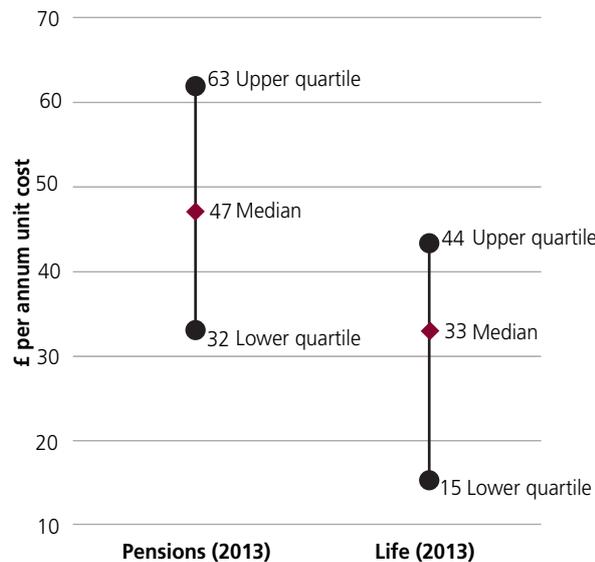
Chart 5 – With-profits expense ratios quartile distribution



3.168 Chart 6 shows the quartile distribution of conventional with-profits unit costs for administration in 2013 expressed as £ per annum per policy for the firms in our sample. The unit costs for pensions business are, as expected, generally higher than those for life (endowments, investment bonds, whole-of-life) business. The lowest unit costs we saw were £10 and £4 and the highest were £86 and almost £200, for pensions and life business respectively.

3.169 We consider that there is a need to improve disclosure of with-profits charges. We have set out our comments in this area under sub-outcome 2.1.

Chart 6 – Quartile distribution of unit costs on conventional with-profits business



- 3.170** Table 1 shows the allocated investment costs in 2013 (expressed in bps) for the various with-profits funds we considered at the firms in our sample. Not all firms were able to provide the data in a comparable form, so the table below is only in respect of some of the firms in our sample. It nevertheless illustrates the range in investment costs being incurred. This can be driven by different asset allocations, but is also a function of the investment management agreements struck by the firms involved.

Table 1 – Allocated with-profits investment cost (bps, 2013)

Lowest observed	Average observed	Highest observed
2.2 bps	14.5 bps	32 bps

Documentation of approach to expense allocation and charge setting

- 3.171** Most firms were able to articulate clearly the overall expense allocation principles they used. In the case of with-profits business, these were mostly documented in a combination of a firm's PPFM(s) and any court schemes governing the business. In contrast, the principles used to set and review charges on unit-linked business were not as clearly or consistently documented. Only a few firms had documented 'Standards and Practices' for managing unit-linked business, which aimed to set out the firm's approach to the setting and review of unit-linked charges of all types.

Fairness of overall expense allocations and charges

- 3.172** In those scenarios where a firm had discretion in allocating expenses to customers, there was no evidence that firms were loading costs unfairly onto closed-book customers such that they were bearing a disproportionate share of the business' costs. This was true for expense allocations of all types, including overhead and exceptional costs. This is broadly consistent with the findings of the FSA's 2010 review of the with-profits regime.³⁹
- 3.173** Where charges were largely set at a particular level in the contract, we found that most firms were not easily able to assess the extent to which the business was generating expense profits or losses. In practice this means that most firms are not in a position to assess the shape over time of both the expenses they are incurring and the charges they are receiving for this business, and how these compare to the initial assumptions made in pricing. While much of this business would have been written a long time ago and some firms had bought books of business from other providers over time, it may in some instances indicate a lack of adequate systems and controls.
- 3.174** In addition, a few firms made clear that they no longer have knowledge of what the initial pricing assumptions were. This makes it difficult for firms to exercise discretion in the review of charges in the interests of treating their closed-book customers fairly.

Use of 'in-house' service companies

- 3.175** Many firms make use of 'in-house' (i.e. intra-group) service companies to provide ongoing administration and servicing, which was often further outsourced to a non-group third party provider. While these structures are often used to provide valuable protection against expense risk to customers in closed-books that are shrinking over time, in some instances it was not completely clear how the level of charges being incurred by customers under this arrangement compared to the charges being paid to the non-group third party provider (i.e. whether there was in effect a positive margin earned by the 'in-house' service company for the provision of

³⁹ www.fca.org.uk/static/documents/fsa-with-profits-report.pdf

these services). Such a margin may not be permissible due to the requirement only to charge costs to a with-profits fund in accordance with COBS 20.2.23.

- 3.176** Also, as noted in FSA PS12/4⁴⁰, COBS 20 governance provisions include a focus on the fairness of charges to with-profits customers, so this area would require scrutiny within a firm's internal governance and we would also expect firms to consider it as they comply with COBS 20.2.1AR on unfair benefits. In any event, the level of any such effective margin (where allowed) should always be transparent and subject to scrutiny and challenge by the relevant governance structures in the firms given its impact on the costs incurred by closed-book customers.

Level of switching charges

- 3.177** We also considered charges for fund switching, applicable primarily to unit-linked and to some unitised with-profits business. While fund switching was not common practice, regularly applying switching charges can have a significant impact on the value of consumers' savings. We found that in most firms at least one free switch per year was provided, and that the level of charge after that did not appear unreasonable for an average-sized savings amount. However, at some firms we found that the charges for switches seemed relatively high when compared against other firms in the sample and that there was no allowance for at least one free switch per year.

Draft guidance: our expectations

When considering expense allocations and the setting and reviewing of charges, we expect firms to:

- be proactive in ensuring the ongoing fair treatment of closed-book customers
- appropriately factor into their review processes that expense allocations and/or levels of charges that were appropriate last year are not necessarily so this year and
- devote sufficient resources to appropriate ongoing assessments in this area

This should include, as appropriate, a clear assessment of whether the benefits arising from any costs incurred accrue fairly to those customers who are funding the costs through the charges they are paying. Also, given the impact on the costs incurred by closed-book customers of any effective margin (where allowed) earned by an 'in-house' service company, we would expect the relevant governance structures in firms to provide appropriate scrutiny and challenge in this area.

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⁴⁰ www.fca.org.uk/static/documents/policy-statements/fsa-ps12-04.pdf

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We do not expect firms to assert that they are constrained from making changes to charges by contract T&Cs where it is in their gift to waive or amend these, where appropriate, to ensure the fair treatment of customers (taking into account the impact on other customer groups). In considering fairness to customers, we expect firms to look further than at the level of a with-profits or non-profit fund. In particular, firms should consider fairness to different groups of customers within a fund as appropriate – different generations of customers, different policy types, and different premium statuses.

To show they have effective and reasonable controls, we also expect firms to have clearly documented approaches to the management of all books of business on expense allocations and the review and setting of charges. Firms should consider both their approach to the individual expense allocations and charges of various types as well as their approach to factoring in the aggregate impact on individual customers of all the expense allocations and charges incurred by them.

Finally, while acknowledging that firms have acquired different books of business at different points in time and on different terms, we nevertheless expect firms to identify areas where groups of customers are treated differently from each other in respect of expense allocation and to endeavour, where possible, to be consistent in their treatment of different groups of customers. Where a firm is making changes in order to move towards consistent treatment of different groups of customers, we expect it to do so in a way that does not treat any group of customers unfairly by, for example, moving them to a higher set of charges.

Sub-outcome 3.3: The firm regularly reviews the overall fairness of cost allocations and actual customer outcomes and applies a consistent basis for these reviews.

Background

3.178 This part of the assessment considered if firms are frequently reviewing the fairness of expense allocations and charges and applying sufficient care and attention to satisfy themselves that closed-book customers are receiving a fair outcome compared to what peer firms are providing. We wanted to understand what benchmarking of expenses and charges firms undertook, and how they assessed expenses and charges for fairness.

3.179 We also considered the approach of firms to assessing actual customer outcomes – focused on maturities and surrenders/transfers. We focused on understanding the extent to which firms monitored actual pay-outs not just in aggregate but also at an individual customer level, and attributed reasons for the results, be they purely due to investment performance or also due to the expense or charge levels. We considered whether firms had a well-reasoned and robust approach that would allow them to satisfy themselves that their closed-book customers were receiving reasonable and fair outcomes on maturity and surrender/transfer.

Findings from our review of firms' practices

3.180 We found that firms were not being very proactive in reviewing expense allocations and charges, including not generally making systematic use of benchmarking to satisfy themselves that their closed-book customers are receiving a fair outcome relative to other comparable options they

may have had at outset and potentially may have in today's market. Where benchmarking was taking place, this was often carried out on with-profits business and was due to the requirement of a court scheme or a Principles and Practices of Financial Management (PPFM).

3.181 Outside these scenarios, benchmarking was most commonly applied to the review of investment fees when renegotiating an investment management agreement. In those scenarios where the allocation of expenses to customers was not seen as being of direct relevance, primarily due to charges being set at a particular level in the contract, a common view expressed was that benchmarking served little purpose. Consequently, most firms were not in an informed position to gauge the extent to which their closed-book customers were receiving a fair outcome relative to other options in the market.

3.182 Most firms did not have a consistent or robust approach to assessing the fairness of expense allocations and charges. Furthermore, we found that almost all firms did not appear to have a clear mechanism to assess whether actual maturity and surrender pay-outs represented reasonable value, particularly on unit-linked business. Where they considered pay-outs, the focus was primarily on maturities and not on surrenders.

Regularity and quality of reviews of overall expense allocations and charges

3.183 We found a wide range of practices across firms with respect to the regularity and quality of their reviews of expense allocations and charges. There was some room for improvement in ensuring that their practices are sufficiently robust for them to be able to satisfy themselves that their closed-book customers are getting a fair outcome relative to other options in the market.

3.184 Some firms were relatively proactive in benchmarking the levels of expense allocations and/or charges incurred by customers, albeit that the subsequent actions that these firms took differed. There were equally firms which did not do very much (if anything at all) to assess the fairness of expense allocations and/or charges and to benchmark these against the market. These firms told us they either believed there were no true peers and therefore comparisons were not meaningful or they believed the relative levels of expenses and/or charges were not of particular interest, that is they simply 'are what they are'. Many firms appeared to take this latter view with respect to charges set at a particular level in the policy T&Cs – primarily unit-linked business and some unitised with-profits business.

3.185 It was more difficult for a firm to be able to assess whether its closed-book customers were getting a fair outcome on expense allocations and/or charges relative to other comparable investments and what was available in the market without some form of benchmarking activity. As set out in the findings of the FSA's review of the with-profits regime in 2010⁴¹, firms should be undertaking reasonable review and comparison of their expense allocations and charges.

3.186 Where benchmarking of expense allocations and/or charges was undertaken we found that:

- Firms usually only amended expense allocations and/or charges where a court scheme requires them to do so. There were a few cases where firms had taken more proactive steps to review and amend charges of their own accord in the interests of ensuring that their closed-book customers were getting fair outcomes, but this was not a practice we observed across firms generally.
- Firms tended to contract the services of an external expert in the area, typically a consultancy that has appropriate access to an industry-wide view of expenses and charges. The focus

⁴¹ www.fca.org.uk/static/documents/fsa-with-profits-report.pdf

was on maintenance/servicing expenses and charges, as well as investment management and administration fees. Only one firm had sought to benchmark the level of exceptional expenses being incurred. Many firms had not sought to benchmark the aggregate level of expenses and/or charges being incurred by individual customers, although one firm had set a specific overall reduction-in-yield target for a portion of its business.

- The frequency with which benchmarking was undertaken varied. A minority of firms in our sample had a clear and documented approach to the review and benchmarking of all expense allocations and charges, which specified the frequency with which this would be done. Some firms appeared to adopt a more mixed approach, choosing to review some expense allocations and charges on a regular basis and others on a more ad-hoc basis. When firms set up a servicing agreement with an OSP or internal service company, they generally benchmarked the level of maintenance/servicing charges at the outset. However, not all firms had a practice of ongoing periodic benchmarking reviews of these charges after that, and many of these agreements are very long term in nature. In contrast, when firms set up an investment management agreement with an asset manager or administrator, they generally negotiated the level of fees at the outset and also at the points of renegotiating the agreement. Firms appeared to be generally more proactive in considering whether the level of investment management and administration fees was competitive.

Reviews of actual customer outcomes

- 3.187** The results of our review of actual customer outcomes were consistent across firms. While some firms indicated that they intended to start considering customer outcomes more holistically for fairness, many firms in our sample were not actively doing this in any systematic way across all the policies in which closed-book customers were invested.
- 3.188** There was little evidence of firms assessing actual pay-outs on unit-linked business and on applicable unitised with-profits business, and considering whether the level of charges was contributing (positively or negatively) to the relative level of performance. Some firms indicated that they simply applied contractual provisions and had no current plans to do any additional work to consider actual customer outcomes.
- 3.189** Firms were focused mostly or exclusively on assessing pay-outs on with-profits business, in line with COBS 20.2.3R. This was often linked to the annual process of declaring bonuses, and many firms did compare the level of pay-outs relative to other firms offering similar with-profits products. These assessments were also primarily focused on assessing maturity pay-outs for standardised cases that allowed easy comparability with similar standardised cases from other firms. While this is a useful analysis to undertake, firms did not generally consider the fairness of pay-outs for individual cases that reflected the actual composition of their closed-books (including the mix of premium status between premium-paying, paid-up and single premium) and pay-outs on surrender/transfer.
- 3.190** While a few firms made use of additional reference returns such as market returns on a balanced portfolio of assets to compare with-profits pay-outs against, most firms did not do anything other than compare to pay-outs from peers. A few firms in our sample made use of cash-related returns as a comparison, regarding the primary alternative option available at the point of purchase as being a bank or building society cash savings account. These firms told us they would always expect to beat the returns on this alternative option. This is unlikely to be an appropriate benchmark in isolation given the long-term nature and associated asset mix of with-profits savings.

- 3.191** Firms also appear not to undertake a rigorous performance attribution analysis of the with-profits pay-outs being achieved, in particular the extent to which the level of expense allocations and/or charges is driving the relative level of pay-outs. The focus appeared to be on investment performance as the driver of pay-outs. While investment performance is a key driver of the pay-outs received by closed-book customers, an understanding of the relative impact of expense allocations and charges is also relevant in understanding the extent to which customers are receiving fair outcomes. This point applies both in situations of relatively good and relatively poor pay-outs. In the former case, the pay-outs might be even better if expenses or charges (both ongoing and exit charges) were at more competitive levels, while in the latter case expenses and charges could be one of the main contributing factors causing the poor outcomes.

Draft guidance: our expectations

The FCA expects that firms should review the different types of expense allocations and charges on both with-profits and unit-linked products according to an appropriately regular, formally documented and governed cycle. Firms should consider how they can satisfy themselves that the resulting charges are appropriate, for example, by external benchmarking with appropriately selected industry peers where possible. In doing this, firms should satisfy themselves that closed-book customers are being treated fairly in the expense allocations and charges (both of different types and in aggregate) they are incurring. This assessment of fairness should be broader than compliance with contractual T&Cs, and should factor in a consideration of whether the current and likely level of future expense allocations and charges is commensurate with customers achieving a fair outcome.

Firms should also have a regular cycle for reviewing actual customer pay-outs (covering maturities and surrenders/transfers) on all policy types (in keeping with RPPD 1.21(2)G and 1.21(4)G). It is important that firms have a documented and consistent approach in this regard. Firms should assess pay-outs relative to what a well-informed customer might reasonably expect from their investment over its full lifetime. For example, firms might consider whether pay-outs are providing positive real returns to customers and also how pay-outs compare to what might have been achieved in alternative investment portfolios (such as managed or other unit-linked funds) with comparable mixes of assets.

Sub-outcome 3.4: The firm proactively monitors the actual experience of its closed-books of business and consistently passes on benefits and costs to customers, to the extent permitted by policy conditions.

Background

- 3.192** We wanted to understand whether firms are actively monitoring customer expense allocations and charges relative to the actual corresponding costs being incurred by the firm. We were particularly interested in whether firms are consistently passing on to customers any benefits of actual experience being better than expected, or any costs of it being worse than expected. We considered expenses and charges of all types, including for insurance risk cover (mortality, morbidity etc.) and for guarantees. We also considered whether firms are calculating and applying any inflationary increases to charges in a consistent and fair manner from year to year.

Findings from our review of firms' practices

3.193 We found a range of practices with respect to linking expense allocations and charges being incurred by customers to the actual expense experience of the firm. Firms appeared to be most proactive and consistent in managing expense allocations and charges in line with actual experience on with-profits business. On unit-linked business and some unitised with-profits business, where the shareholder (or other with-profits customers if business is written within a with-profits fund) is carrying the expense risk, firms' practices varied most widely. This was particularly the case for the treatment of insurance risk charges for mortality and morbidity. While we saw no evidence of firms selectively reflecting actual experience in charges, given the improvements in mortality over time, a practice of not passing on the impact of actual experience to customers at some firms has generally been to the benefit of shareholders (or other with-profits customers if business is written within a with-profits fund).

Mortality charges

3.194 When we assessed mortality and other risk charges we found that firms were either consistently active in passing on the impact of actual experience to customers, or they did not vary these charges at all in spite of experience. For with-profits business, asset shares typically reflect actual experience over time. For unit-linked and some unitised with-profits business, customers of firms which did vary these charges in line with experience had generally benefited in the form of lower charges from improving mortality over time, while at firms which did not vary these charges in line with experience, shareholders or some with-profits customers had benefited at the expense of unit-linked and unitised with-profits customers. The main reasons given by firms not to vary these charges was either that they were simply applying the T&Cs of the policy, for example because they did not explicitly require a review of these charges, or that they wish to provide greater stability and certainty to customers in terms of the level of charges they are incurring. Where firms in our sample were varying these charges according to a regular cycle, it was typically a three or five year cycle.

Guarantee charges

3.195 Most firms were proactive in managing guarantee expenses and charge in line with experience, except where caps to the charges had been agreed. This was an area that appeared to get a significant amount of attention from firms, and mostly impacts with-profits business.

Maintenance expense allocations and charges

3.196 Our assessment of maintenance expense allocations and/or charges which are not contractually specified found that firms tended to reflect experience directly. Where expense allocations and/or charges are fixed or contractually specified, firms did not typically aim to link these back to actual experience in any explicit way. This applied primarily to unit-linked and some unitised with-profits business and, as mentioned under sub-outcome 3.2, most firms were not in a position to assess the shape over time of both the expenses they were incurring, and the charges they were receiving for this business. This means that firms could not easily assess the extent to which they may be able to vary these charges in the interests of enhancing customer value over time.

Investment expense allocations and charges

3.197 We found that investment management and administration expenses and/or charges are typically directly linked back to the actual fees agreed with the asset managers and investment administrators. In this sense, these expense allocations and charges do reflect actual experience directly.

Inflationary increases to charges

- 3.198** We saw many examples of firms which applied inflationary increases to some of the charges on their various products, the most typical example being the annual inflation of maintenance/policy fees on unit-linked and some unitised with-profits business. Firms typically inflate relative to either or both the Retail Prices Index (RPI) or the Average Weekly Earnings Index (AWE). We found no evidence to suggest that firms were applying their chosen indices in an inconsistent manner from year to year. We saw a few instances of fixed increases which resulted in quite high annual increases in the current low inflation environment. Only one firm in the sample appeared formally to adopt the practice of putting through charge reductions, to the benefit of customers, where their chosen index produced a negative inflation result.

Draft guidance: our expectations

We expect firms to monitor all types of expense allocations and charges incurred by closed-book customers relative to the actual level of expenses of various types incurred by the firm. Firms should have a consistent and documented approach for how and when they would pass on the benefits or costs of this actual experience being different from customer expense allocations and charges of all types. This approach should set out clearly how the fair treatment of closed-book customers would be factored into all decisions in this regard.

In the particular area of considering mortality and other risk charges in light of experience, we expect firms should be proactive and appropriately regular in their reviews. This is important given the long-term nature of contracts and the improvements in mortality over time. To facilitate this and ensure consistent application, we expect firms to have a suitably selected and documented cycle for the review of these charges across all relevant products. In line with the general practice we have observed, unless there are exceptional circumstances, a three-year cycle covering all products is appropriate. We expect firms to be clear how the fair treatment of all customers would be factored into any decision to vary charges as a result of such a review.

We also expect firms to review their basis for the variation of any charges that are inflated each year (e.g. policy fees, switching charges) to satisfy themselves that they are fair to closed-book customers (e.g. in light of the current low inflation environment) under Principle 6. Firms should consider the current and future levels of any such fees relative to actual experience with respect to incurred expenses in order to satisfy themselves that any inflationary increases remain in line with the fair treatment of their closed-book customers.

Outcome 4: The firm's closed-book customers are able to move from products which are no longer meeting their needs in a fair and reasonable manner.

General findings

- 3.199** Most policies being surrendered, transferred or going paid-up within our sample incurred no exit or paid-up charges in the sample period reviewed. Of the in-scope product lines, personal pension policies were most likely to experience an exit charge, with many of the higher exit charges the result of capital/accumulation charging structures. A number of firms had difficulty in providing full details of their paid-up charges. For example some applicable members of management had not realised their firms had exit charges.

- 3.200** In relation to with-profits business, there was a relative lack of focus given to paid-up bases across many firms in the sample and to surrender value bases in some firms. We found that firms focused predominantly on meeting target range requirements in aggregate and did not give as much attention to the level and fairness of individual pay-outs both within and outside of the target range.
- 3.201** Firms were not typically assessing whether exit or paid-up charges incurred by customers were resulting in unfair customer outcomes.

Sub-outcome 4.1: Exit and paid-up costs are not excessive and are not driving poor customer outcomes.

Background

- 3.202** Our aim was to assess if closed-book customers are receiving a return on their investment which is not unfairly affected by paid-up and/or exit charges. Exit charges may unfairly prevent a customer from moving away from a product that is not performing in line with their expectations. A customer may also feel they cannot stop paying into a product because of a high paid-up charge. The customer may want to stop premiums, especially if their circumstances have changed, for example they have lost their job and can no longer afford the premiums, have moved to a job which has a more advantageous pension scheme or have moved abroad and legally are no longer allowed to contribute to the product. We found product lines where firms would apply a significant paid-up charge if a customer has lost their job and could no longer afford to pay premiums.
- 3.203** We wanted to understand the range of impacts on closed-book customers to determine the extent of such charges and help identify outliers. While there were some differences in how firms provided information, particularly in relation to with-profits policies, these differences did not impact on our findings and conclusions.
- 3.204** We did a sample data review and talked to firms. Firms supplied data relating to actual surrender/transfer claims paid and policies becoming paid-up during a sample period. For most firms, this sample period was the first six months of 2014, while slightly different dates were agreed with two firms for practical reasons. The sampled data related only to policies that had actually been surrendered or transferred or gone paid-up. Any policies where the customer chose not to surrender, transfer or go paid-up due to the presence of a charge for doing so would not have been captured in our sample.
- 3.205** For with-profits business this outcome looked at whether firms were taking an explicit deduction from asset share on surrender/transfer and if so the degree of blending of surrender values into expected maturity value that occurred. This outcome did not look at the impact of smoothing or the fit of surrender/transfer value bases – these aspects are covered under sub-outcome 4.2. Market Value Reductions/Adjustments were outside of the scope of our review.
- Findings from our review of firms' practices**
- 3.206** While we observed one or more weaknesses in each firm, most policies in our sample incurred no exit or paid-up charges. Our findings will have been affected by the duration of the in-scope policies – we were looking at policies that had been in force for at least 14 years. The charging structures of the in-scope policies we assessed typically resulted in exit or paid-up charges decreasing as the duration increased and, in some cases, ceasing altogether after a certain time period.

3.207 However, the highest exit and paid-up charges we identified being levied by firms were more typically on personal pension policies. Combined with the poor findings for firms' communications, where we found some customers are not told about these charges, we are concerned that some closed-book customers are paying/have paid charges but have been unaware of doing so.

3.208 While a few firms have proactively acted to cap or remove certain exit charges in recent years it was evident that paid-up charges and firms' with-profits paid-up bases receive little attention across most firms.

Exit charges

3.209 The following table (Table 2) shows the distribution of exit charges by product type on unitised business (both unit linked and unitised with-profits) exiting within the sample period⁴² across all firms. Two firms in the sample had no exit charges on this type of business but are included in the table below. That these two firms had no exit charges is at least partially reflective of the limited nature of their in-scope unitised product range.

3.210 Table 2 illustrates that 77% of total exits from unitised policies (measured by policy count) incurred no exit charge, 97% incurred either no exit charge or an exit charge of below 5% and almost 99% incurred either no exit charge or an exit charge of below 15%. The level and prevalence of charges was greatest on personal pensions. While 96% of pension transfers incurred either no exit charge or an exit charge of below 5%, around 800 pension customers incurred an exit charge of 15% or greater during our sample period. Discussions of sample cases with firms indicated that those incurring the highest exit charge (as a % of fund value) were typically those transferring pension policies which became paid-up earlier in the term or those surrendering life policies with a high level of life cover and/or previous part surrenders. Other things being equal such policies would tend to have a smaller fund value and hence a given exit charge measured in monetary terms would have a larger percentage impact on fund value.

3.211 More generally it is worth noting that some of the large percentage reductions will translate to small monetary amounts, while some of the small percentage reductions could be quite significant in monetary terms.

Table 2 – Exit charges as a % of fund value

Product type	Total number of exits in sample	Exit charge as a % of fund value				
		0%	0% - 5%	5% - 15%	15% - 50%	>50%
Endowment	13,531	90%	9%	1%	0%	0.1%
Whole of life	12,055	94%	4%	1%	1%	0.2%
Investment bond	15,696	86%	13%	1%	0%	0.3%
Personal pension	55,253	68%	28%	3%	1%	0.1%
Total	96,535	77%	20%	2%	1%	0.2%

⁴² The first six months of 2014, except for two firms where slightly different dates were agreed for practical reasons.

3.212 An alternative way of looking at Table 2 is to consider that 23% of total surrendering/transferring policies (32% of surrendering/transferring pension policies) had an exit charge and look at how this varies by firm. The following charts show the pattern of charges across firms that had exit charges on unitised products.

3.213 Chart 7 shows that the overall proportion of transferred or surrendered policies incurring an exit charge of any size during our sample period ranged from 13% in the firm with the lowest prevalence of charges to 35% in the firm with the highest. The chart also shows the weighted average (including firms with no such exit charges) of 23%. The firm with the highest prevalence of charges greater than 5% of fund value had 9% of their total exits on which charges of this level were recorded. The firm with the highest prevalence of charges greater than 15% of fund value had 4% of their total exits on which charges of this level were recorded.

3.214 Chart 8 shows equivalent information for personal pensions only, highlighting the greater prevalence and size of exit charges on this product line.

Chart 7 – Spread of exit charges across firms (all products)

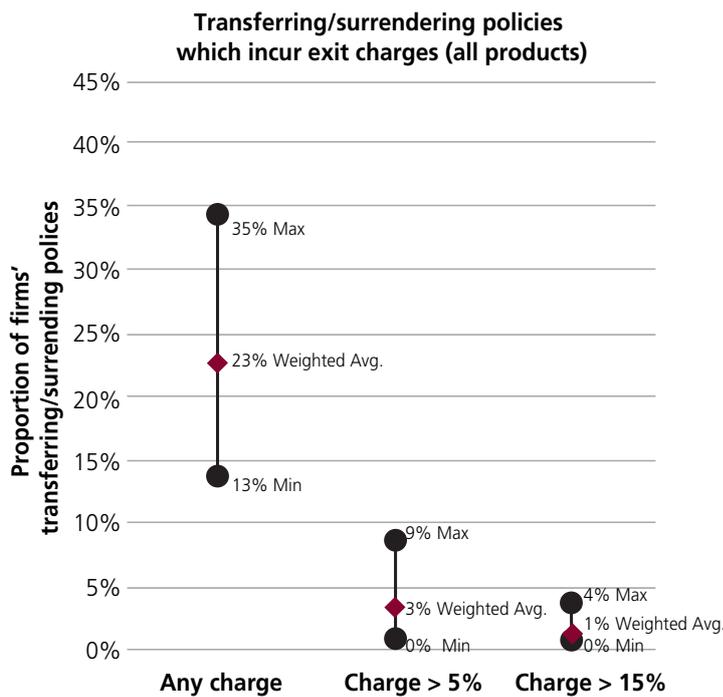
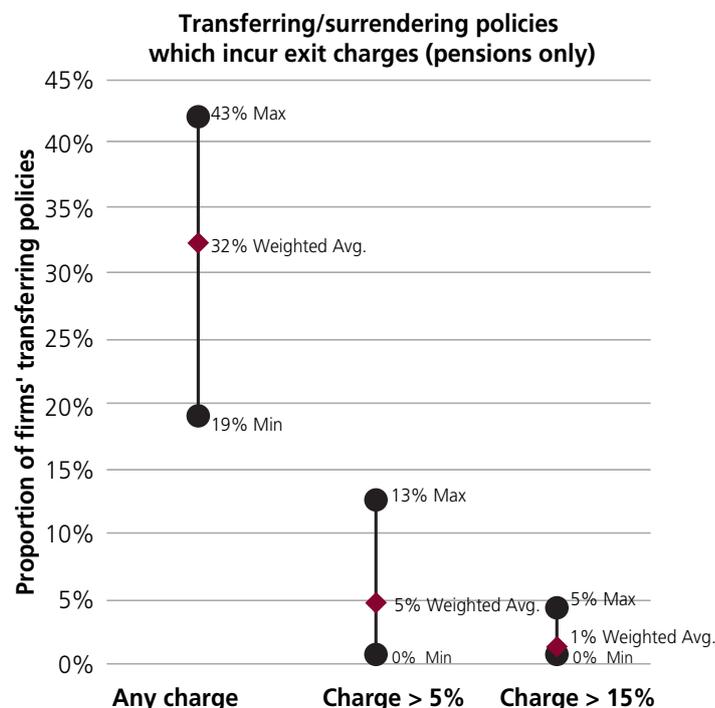


Chart 8 – Spread of exit charges across firms (pensions only)

3.215 Table 3 shows that across all firms, many customers exiting their policy during the sample period saw no exit charge or a relatively small charge (in terms of % of fund value), although there are obviously some outliers.

3.216 The distribution of charges differed quite significantly between firms with some firms' charges falling into a narrow band while others had larger tails. For instance, only 0.1% of the exits at the firm with the greatest prevalence of exit charges (Firm A) were greater than 5% of fund value, such was the narrow banding of their charges. However the firm with the lowest prevalence of charges overall (Firm I) had around 5% of exits with charges greater than this level. The distribution of total unitised exit charges across the 9 firms with such charges was as follows (ordered by decreasing prevalence of a charge of any size).

Table 3 – Exit charges (as a % of fund value) applied to transferring or surrendering policies by firm

		Proportion of firms' transferring /surrendering policies									
		Firm:	A	B	C	D	E	F	G	H	I
Exit charge as % of fund value	No exit charge		65%	72%	73%	79%	79%	81%	83%	86%	87%
	0-5%		35%	25%	17%	14%	13%	16%	14%	13%	8%
	5-15%		0%	2%	6%	5%	4%	2%	2%	1%	4%
	15-50%		0%	1%	3%	2%	4%	1%	0%	0%	1%
	50%+		0.0%	0.2%	0.4%	0.2%	0.3%	0.0%	0.2%	0.0%	0.0%
	Total		100%								

3.217 The picture differed across different product lines. While in most firms, personal pensions had the highest prevalence and level of exit charges, this wasn't universal. In one firm exit charges were more significant for whole-of-life policies compared with other products within that firm (and against the average for this product type in our review) and in another firm exit charges were much more prevalent on endowment policies than pensions policies.

Pension freedoms data collection exercise⁴³

3.218 The FCA pension freedoms data collection exercise (July 2015) had a different scope to our review.⁴⁴ However, this wider set of industry personal pensions data, detailed in table 4 below, showed not too dissimilar results to our review in terms of the size of exit charges measured as a percentage of fund value. While around 88% of the customers within the pension freedoms data request response would not have incurred any exit charge, relative to 68% of pension customers who exited without charge in the sample period of our review, in both samples around 95% of customers incurred (or in the case of pension freedoms data – would have incurred) either no charge or a charge of 5% or less.

3.219 The pension freedoms data collection exercise also provided exit charge information in the form of monetary amounts. Table 5 shows that around 93% of pension customers would have incurred no charge on exit or a charge of £250 or less and, while not evident from the grouped data within the table, the underlying data showed that 91% of pension customers would have experienced no exit charge or a charge of £100 or less on exit.

Table 4 – Pension customers – potential exit charges (charge as percentage of fund value)

Charge as % of fund value	Customers aged 55 or older		Customers aged under 55		Overall position	
	%	# ('000s)	%	# ('000s)	%	# ('000s)
No exit charge	83.6%	3,416	89.6%	13,684	88.4%	17,100
0-2%	8.8%	358	2.8%	431	4.1%	789
2-5%	4.0%	165	2.7%	408	3.0%	573
5-10%	2.0%	81	2.3%	345	2.2%	425
10-20%	1.1%	45	1.4%	216	1.3%	261
20-40%	0.4%	17	0.8%	128	0.7%	145
40% +	0.1%	4	0.4%	58	0.3%	62
Total	100%	4,086	100%	15,270	100%	19,356

⁴³ www.fca.org.uk/your-fca/documents/fca-pension-freedoms-data-collection-exercise

⁴⁴ In the pension freedoms data collection exercise firms were asked to provide information (by number of policies) as to the size of exit charges – both as a % of fund value and as a £ amount – should all their customers with unitised pension policies have transferred or cashed in their pension as at 30 June 2015. The data included in tables 4 and 5 covers a wider sample of firms than our review. It also differs from the data in our review as it includes personal pension policies regardless of when the products were sold and is a snap-shot at a point in time of what charges could have been incurred should customer have chosen to exit. Our review covered legacy pension policies which actually exited over the sample period of time agreed.

Table 5 – Pension customers – potential exit charges (charge as monetary value)

Size of Charge	Customers aged 55 or older		Customers aged under 55		Overall position	
	%	# ('000s)	%	# ('000s)	%	# ('000s)
No exit charge	83.6%	3,416	89.6%	13,684	88.4%	17,100
<£250	9.2%	375	4.0%	615	5.1%	990
£250-500	2.5%	103	1.9%	290	2.0%	393
£500-1,000	2.1%	86	2.1%	322	2.1%	408
£1,000-3,000	1.9%	77	1.9%	286	1.9%	363
£3,000-5,000	0.4%	15	0.3%	46	0.3%	61
>£5,000	0.3%	13	0.2%	26	0.2%	40
Total	100%	4,086	100%	15,270	100%	19,356

Paid-up charges

3.220 Our review also looked at the prevalence of paid-up charges on in-scope product lines. Despite policies within the scope of our project being in-force for at least 14 years at the time of our review, most firms had one or more in-scope product line(s) where an additional charge would apply should premiums cease or be reduced – a 'paid-up' charge. These charges typically take the form of either a one-off reduction in fund value or an increase in ongoing charges, although a less typical form was an ongoing charge which remained level but was taken for a longer period.

3.221 One-off reductions in fund value were typically less than 4% of fund value although some larger deductions were observed. Increases in ongoing charges varied from a fixed £1 per month to charge increases determined as a percentage of fund value which could amount to quite a significant amount in monetary terms for higher value policies. Paid-up charges typically decrease over the life of the policy; therefore policies going paid-up during our sample period were, in most cases, incurring lower charges than equivalent policies which had gone paid-up at an earlier date.

3.222 In the main, paid-up charges tended not to be particularly widespread. However, a number of firms were initially unable to provide full information in relation to products with paid-up charges. These firms may not be actively considering customer outcomes in relation to paid-up charges.

3.223 At each of two different firms one pension product line caused us greater concern with respect to the prevalence and potential impact of paid-up charges on customer outcomes. This is discussed in the next section.

Charging structures

3.224 It was apparent from our discussions across firms that there were a significant number of differing charging structures applicable to the range of in-scope policies. However, capital/accumulation units and high initial allocation rate structures appeared to be the most prevalent, with capital/accumulation unit charging structures responsible for many of the higher exit charges. This reflects the back-ended nature of this type of charging structure. Where charges are predominantly front-loaded, for example through low allocation rates in the early years of

a policy, exit charges are typically not applicable. Back-ended charging can be more difficult for customers to understand than charges immediately deducted from their policy. As set out under sub-outcome 2.1 we did not find that the back-ended charges were communicated clearly by firms.

- 3.225** As noted previously, discussions of sample cases with firms indicated that those incurring the highest exit charge (as a % of fund value) were typically those transferring pension policies which became paid-up earlier in the term or those surrendering life policies with a high level of life cover and/or previous part surrenders.
- 3.226** Two firms had unusual charging structures on their main personal pension product lines when compared to other firms in our sample, and this had led to some of the highest paid-up and exit charges we observed, particularly for policies which became paid-up early in the policy term. The charging structures for both of these product lines are complex and opaque, and in effect 'penalise' closed-book customers who increase and then reduce regular premiums, since the increases escalate any paid-up/exit charge (as a result of commission being paid or being assumed to be paid). In both cases making a policy paid-up early in the policy term could result in an AMC in excess of 7% per annum applying to their full fund. In both cases the exit charges effectively brought forward the paid-up charge so that closed-book customers could either remain invested with charges of a level likely to exceed any investment gains or incur a commensurately large exit charge in order to transfer the policy.
- 3.227** Firms frequently highlighted the contractual nature of surrender and paid-up charges and often reference was made to customers being aware of such charges through the T&Cs and disclosure at the outset of the contract. However, a number of firms did not alert customers to these charges at the point they were being incurred or subsequently. While firms were typically reviewing T&Cs as part of any product review process, most firms were not effectively reviewing the impact of charges on the delivery of fair customer outcomes.
- 3.228** More than one firm suggested that removing or reducing exit charges for in-scope policies would be unfair on customers who had taken out policies, perhaps at a relatively similar time, where charges were front-loaded and hence did not have an exit charge. While this might be a relevant consideration in some instances, for example where the various groups of customers are all invested in the same with-profits fund, it was not clear if the relative interests of the various customer groups were properly balanced by the firms making this argument. Furthermore, firms generally demonstrated little understanding of whether the exit charges they were applying were still needed to recoup initial expenses.
- 3.229** More than one firm made the point that reducing or removing charges applying to one set of customers in a with-profits fund would be at the expense of another set of customers. While we acknowledge this can be the case, it is important that firms consider fairness in the round, properly balancing the interests of various customer groups, and avoiding bias towards particular customers.

Deductions from asset share on with-profits policies

- 3.230** Some firms had one or more with-profits funds on which they were targeting surrender/transfer pay-outs of less than 100% of asset share on average. This compares to the position on maturities where, over time, pay-outs are targeted at 100% of asset share on average.
- 3.231** Typically these firms were targeting an average of 95% of asset share for policies some way from maturity. Effectively this meant an average charge of 5% is being incurred by surrendering/transferring customers. The blending of surrender pay-outs into expected maturity pay-outs occurs over varying periods across these firms. In one firm this blending towards the expected maturity value occurred over the final third of the term, while at the other extreme, blending

into the expected maturity value only occurred during the final year of the policy. Therefore in this latter case an average charge of 5% was being incurred by surrendering/transferring customers 12 months from maturity. Such a charge so close to maturity, and the consequent discontinuity in pay-outs, raises questions as to how such firms believe they have good reasons to consider that their pay-outs are fair, particularly if coupled with poor communications about the implications of taking a surrender/transfer pay-out.

With-profits paid-up bases

- 3.232** A number of firms were unclear about the paid-up basis of in-scope business lines and there appeared to be a relative lack of focus given to paid-up bases across many firms, which represented a risk to customers to the extent that firms were not regularly reviewing these for fairness. In one case a firm acknowledged its paid-up basis was inefficient due to the use of a common final bonus scale which reduced fund values on becoming paid-up. Another firm recognised that its paid-up basis offered poor value and hence didn't market this as an option, although it still allowed it.

Proactive removal of charges

- 3.233** There was little evidence of active reviews of exit/paid-up bases to assess fairness having taken place historically. However, a few firms had taken actions in recent years to reduce exit charges. One firm in our review had proactively acted to remove capital/accumulation unit structures which resulted in the complete removal of surrender charges across a large block of their personal pensions business. In addition, two further firms had removed surrender deductions on conventional with-profits business in recent years meaning that all their with-profits business is targeting 100% of asset share on average.
- 3.234** Although a large majority of customers within our sample were not subject to an exit or paid up charge, we noted that the highest level of exit and paid up charges most typically applied to, but were not restricted to, personal pension policies. These could act as a barrier to consumers shopping around or switching their investments. We consider it important for the industry to consider whether these are still appropriate and the impact these are having on customers. We intend to initiate an open debate with industry and other stakeholders on this.

Draft guidance: our expectations

We expect firms to assess whether outcomes for customers paying exit or paid-up charges are fair. We expect firms to take action where paid-up or exit charges are the cause of poor customer outcomes, for example charges which consistently drive poor performance or are disproportionate relative to the purpose for which they are intended. Examples of actions that firms should take are exercising any discretion or judgement regarding the level of the charge in a way that treats the customer fairly, and ensuring the customer is fully aware of the charge and the action they can take to avoid such a charge. Other actions that firms should consider, for example, are allowing the customer to move to a different product at no or minimal charge, reducing the charge that is causing the poor outcome, and enhancing the policy value.

We also expect firms, over the lifetime of the policy, to review contracts for fairness in line with the Unfair Terms in Consumer Contract Regulations⁴⁵ or subsequent legislation, such as the Consumer Rights Act 2015, which applies to contracts concluded from 1 October 2015. Firms should have regard to developments such as legislative changes, court decisions, guidance issued by regulators (including the FCA and Competition Market Authority) and any undertakings published by these bodies. A term is not binding on a consumer if it is contained within a contract concluded from 1 July 1995 and is deemed unfair. We expect firms to consider what action they should take to address any reliance they have placed on any such term they deem as unfair where that reliance has resulted in potential consumer detriment.

Firms also need to consider what action they need to take going forward for contracts with existing customers impacted by the same term. If the contract was taken out before 1 July 1995 we still expect firms when carrying out a product review and assessing whether the customer is receiving a fair outcome in line with Principle 6⁴⁶, to take into account the drivers of that outcome which would include an assessment of the impact of the T&Cs.

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45 The Unfair Terms in Consumer Contract Regulations 1994 and the Unfair Terms in Consumer Contract Regulations 1999 (www.legislation.gov.uk/ukksi/1999/2083/pdfs/ukksi_19992083_en.pdf) which revoked and replaced the 1994 versions.

46 Principle 6 (Customer Interests) – A firm must pay due regard to the interests of its customers and treat them fairly.

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Whether the UTCCRs apply or not, the firm should be able to justify the way in which a term is applied in practice to ensure it is applied fairly. If the justification for it being fair is that it is to recover set-up costs not yet recouped, rather than assume that this is the case, we expect firms to be able to satisfy themselves that this is a supportable position and be able to demonstrate this is the case on an ongoing basis. We expect firms to be able to show that their management and controls are responsible and effective.

We expect firms to review products periodically to check whether they are meeting the general needs of the target audience, or whether their performance will be significantly different from what the firm originally expected and communicated to the customer.⁴⁷ For example, for pension products we expect firms to consider whether contracts, which incur charges when contributions reduce/cease or the policy exits ahead of a retirement date selected at outset, continue to meet the needs of customers, particularly in light of current pension reforms and continuing changes to employment patterns.

In line with TCF Outcome 6⁴⁸ we also expect firms to monitor the extent to which paid-up and exit charges result in unreasonable barriers to changing product or switching provider and consider appropriate action as a result. An example of this is to monitor customer's exit requests/enquiries and whether they proceed once they become aware of the exit charge, or whether the firm receives complaints about the level of such charges, once the customer has been made aware of them.

Under Principle 7, firms are required to have due regard to the information needs of their customers. Firms should make clear to their customers if they are going to incur an exit or paid-up charge at the point of the charge being incurred. Reliance on what the customer was told in the original T&Cs, or reference back to this alone, is likely to be insufficient as set out under the RPPD 1.21(3) G. We consider there is a high risk of an unfair outcome where a firm levies an exit or paid-up charge, unless the customer has been made aware of the charge, and its potential effect, where relevant, at the point of it being incurred so alternative action can be considered.

For products where exit and paid-up charges have not yet been applied but where there is potential for them to apply we expect firms to consider whether any such charge was made sufficiently clear to the customer at outset or other relevant points in time, in line with the relevant standards in place at the time. If not, the firm should take appropriate action to remedy our concerns which might include not applying the charge and/or making the charge sufficiently clear.

⁴⁷ RPPD paragraph 1.21(2)

⁴⁸ Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

Sub-outcome 4.2: Target ranges for with-profits pay-outs appear reasonable and firms meet these target ranges without the variation of pay-outs being too wide

Background

- 3.235** We wanted to understand whether target ranges for with-profits exits appear reasonable and whether firms are meeting these target ranges without too wide a variation of pay-outs. Our review was focused on surrender/transfer pay-outs. However, much of this section is also applicable to maturity pay-outs.
- 3.236** This outcome was assessed through review and discussion with firms in relation to their data request response, as well as examination of publicly available PPFMs and PPFM compliance reports. In some cases this was supported by firms' internal target range and/or bonus declaration reports. The assessment of the target ranges extended across all a firm's funds, and not just the particular funds within the scope of the data request.
- 3.237** One firm was excluded from our assessment of this outcome as it had no with-profits business. Not all firms within our sample had with-profits business to which a target range applied. However, as this outcome looks more widely at what with-profits pay-outs are being made, such firms are included in this outcome as some of the findings and draft guidance which follow are relevant to this situation.

Findings from our review of firms' practices

- 3.238** Firms were aiming to ensure pay-outs are within a specified proportion of the underlying asset share - the 'target range'. We found that almost all the firms had target ranges of 40% or wider. A narrower target range was only observed for unitised with-profits business. A minority of firms had one or more ranges with a width of 70% or more. The most common target range for surrender pay-outs was 80-120% and in most cases the same pay-out range was used for both surrenders and maturities. Where the width of surrender and maturity ranges differed, typically it was the range for surrenders that was wider. There was some evidence that funds with more intermediary business were managed to a tighter target range.
- 3.239** Wider ranges increase the risk that pay-outs at extreme ends of the range, or indeed outside of it, are unfair to either exiting customers or to those remaining in the fund. We found examples of asymmetrical ranges which also increased the risk of pay-outs being further away from the asset share for some customers. Where surrender pay-outs are subject to a wider range than maturity pay-outs this increases the risk that surrender pay-outs are unfair.
- 3.240** The rationale for how the target ranges have been set is frequently not clearly documented and justified in the PPFM. In many cases target ranges appeared to have remained unchanged since the inception of the relevant rules⁴⁹, with the range determined at that time as one with which the firm considered it could reasonably comply. However, one firm with multiple funds had taken action to align its funds to a common range across all business lines on both surrenders and maturities.
- 3.241** While firms were, to differing extents, excluding certain policy types (e.g. guaranteed, paid-ups, altered policies, whole-of-life policies) from their target range analysis, most firms appeared to be ensuring that on average at least 90% of surrender claims fall within range. However, we found that most firms focused predominantly on meeting target range requirements in aggregate and did not give sufficient attention to the level of individual pay-outs both within and outside of the target range. Such attention would allow a clearer sight of poor customer

⁴⁹ COBS 20.2.4 et seq.

outcomes and their cause. For instance, poor customer outcomes within the range may suggest that the target range is itself not appropriate.

- 3.242** We also found that some firms either did not review their surrender value bases frequently or did not prioritise updates where it had been recognised that the fit of a surrender basis had become increasingly poor.

Target ranges, monitoring and compliance

- 3.243** A number of firms maintained complex – and in some cases very wide – ranges, with surrender/transfer pay-outs sometimes subject to a wider range than maturity pay-outs. Typically these ranges were unchanged since inception of the rules⁵⁰ that introduced target ranges, and little was provided in the way of rationale for requiring a wider range. This suggests to us that these firms have not actively considered the ongoing appropriateness of their surrender pay-out target range for the fair treatment of all customers.

- 3.244** In contrast, one firm had taken action to standardise and, where necessary, reduce its target range to a common range of 80-120% across all its funds, on both surrenders and maturities. The firm chose this range as being realistically achievable given the cross-subsidies inherent in with-profits.

- 3.245** One firm had a narrower range for a fund which related, in part, to the fact that it contained predominantly intermediary business. This may result in relatively more favourable outcomes for certain customers and it also acts to demonstrate that firms are able to manage pay-outs more actively should they choose to do so.

- 3.246** In monitoring the level of pay-outs against the applicable target range, a number of firms used pay-outs determined with reference to specimen policies rather than actual claims. This adds risk in relation to ensuring the specimen policies are representative of existing policies and makes it more difficult to identify what pay-out ratios are actually being achieved and which actual claims are falling out of range. This risk is higher in firms which do not actively monitor claims throughout the year and rely on annual retrospective monitoring. A number of deficiencies were identified in firms' monitoring processes. One firm is aware that their asset share calculations are incorrect but have not acted to correct them. Another firm's process of checking compliance, which used beginning and end of year pay-out ratios, may not be robust in the event of less benign investment conditions.

- 3.247** In the main, firms did not provide much detail in relation to pay-outs in their public PPFM Compliance reports and a minority of firms were completely silent on their target range compliance, making it difficult for customers and advisers to gauge the extent to which the firm was providing fair value.

Outliers and excluded policies

- 3.248** Based on the way data was presented to us by some firms the extent of any outliers⁵¹ in pay-out ratios was not always clear; however, it was evident that the analysis of outliers was an area that few firms focused on.

- 3.249** In some firms there was limited evidence of any investigation of outliers or a proactive approach to considering fairness of individual pay-outs. One firm, which otherwise appeared to have reasonable processes, employed extremely restrictive criteria in defining outliers such that it

⁵⁰ COBS 20.2

⁵¹ Claim pay-outs which are a particularly high or low proportion of their underlying asset share. In terms of the data request we were looking specifically at those with a particularly low pay-out relative to asset share.

looked unlikely that any great number of pay-outs would be identified for further analysis, creating a risk of not identifying poor customer outcomes.

- 3.250** As permitted by our rules⁵², firms typically exclude policy types which are not amenable to asset-share calculations from target range analysis. There is some degree of variation in exclusions across firms. The greater the number of exclusions the greater the risk pay-outs are unfair to either exiting customers or to those remaining in the fund, unless the firm is actively considering the fairness of pay-outs from these policy types by other means.

Surrender value bases

- 3.251** There was evidence of good practice in this area, with some firms frequently reviewing their surrender value bases and some evidence of more detailed reviews of the underlying methodology. For instance, in light of the run-off of endowments, one firm had recently changed the methodology for the whole-of-life surrender basis to one which was expected to produce more appropriate pay-outs for these customers. However, a number of firms did not review their surrender value bases frequently or were slow to act when it became evident that the fit of a basis had become increasingly poor. Firms gave several reasons for ill-fitting surrender bases, including inflexible IT systems, the existence of non-standard policies, and resource conflicts.
- 3.252** In one firm we discovered an error in a surrender value basis. The firm was unaware of the issue having not updated the basis for several years and was, on average, paying out significantly less than 100% of asset share on surrenders on the affected product line. The firm committed to taking action to address this following our review.
- 3.253** One firm was aware of an issue with the fit of a particular surrender value basis but had not taken action to rectify the issue. Our review highlighted another surrender basis which, while targeting 100% of asset share on average, produced significant outlier payments at both extremes which the firm had not acted to address. To an extent the wide target range in place may have allowed the firm to deprioritise this work, since it wasn't affecting compliance with target range requirements. This further highlights the importance of setting a target range that is consistent with fair treatment of customers rather than one that is consistent with the pay-outs being produced by the current surrender value basis.

⁵² COBS 20.2.5

Draft guidance: our expectations

We expect firms to be monitoring pay-outs of all types to satisfy themselves that they have good reason to believe pay-outs on individual with-profits policies are fair.

Target ranges, monitoring & compliance

Target ranges are designed to minimise the risk that firms might underpay, or overpay, customers in either the shorter or longer term. Tightly set target ranges should result in more consistent pay-outs to customers. While our rules allow some flexibility and discretion in setting target ranges, overly wide ranges increase the risk that pay-outs at extreme ends of the range, or indeed outside of it, are unfair to either exiting customers or to those remaining in the fund. As detailed in the 'With-profits regime review report' (June 2010) the FSA anticipated that over the longer term average pay-outs would be within a much narrower range.

We expect firms to satisfy themselves that the width of the target range is appropriate in light of COBS 20.2.3R, 20.2.5R and 20.2.6R. Such a target range is likely to be one which can be met in benign-to-moderate investment conditions with the expectation that there is greater possibility of falling out of range in more extreme investment conditions which would be mitigated to an appropriate extent by active management of bonus rates and surrender value bases.

There may be situations where extreme investment conditions mean that, for a limited period or at a particular point in time, the firm is paying less than 90% of payments within the target range, but where the firm is satisfied that payments will revert in the near future so that 90% will be paid within the target range. We consider that even in these situations it is possible for a firm to have good reason to believe that pay-outs on individual with-profits policies are fair (20.2.3R), and also still to have good reason to believe that at least 90% of payments will fall within the target range (COBS 20.2.6R).

For example, provided bonus rates and surrender bases are set in line with our rules, if markets crashed and smoothing rules prevented claim payments falling fast enough to ensure compliance, this would in fact demonstrate the benefits of smoothing. It is, however, important for firms to understand the factors underlying their target range results.

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53 COBS 20.2.3

54 COBS 20.2

55 www.fca.org.uk/static/documents/fsa-with-profits-report.pdf

56 In line with COBS 20.2.1A R

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We expect that in line with the better practices we have observed, unless there are particular fund-specific circumstances that prevent it, 80-120% is an achievable range for all funds, consistent with the fair treatment of customers. For some funds a narrower range may be appropriate. To ensure firms can demonstrate they are treating customers fairly, they should be able to justify clearly why their target ranges are capable of generating appropriate and fair outcomes for their with-profits customers in reasonable scenarios and include this information in the PPFM. Firms should have a robust target range monitoring process in place to support this. While we would not expect the target range to change frequently it is appropriate for a firm to consider its appropriateness from time to time. In line with the 'With-profits regime review report' we expect the width to reduce over time as targeting and systems improve.

We also expect the same attention and focus to be given to ensuring the fair treatment of surrendering/transferring customers, as to those holding maturing policies.

We expect that the annual report to customers (see COBS 20.4.7R), when describing compliance with the obligations in its PPFM and in particular addressing issues regarding the methods used to guide determination of appropriate pay-outs per COBS 20.3.6R(1)(a) and COBS 20.3.8G(1), should:

- explicitly reference compliance with target ranges
- provide commentary in relation to outliers
- detail any proactive steps taken to ensure ongoing compliance
- describe any redress work required as a result of finding crystallised issues.

Outliers and excluded policies

Although firms are typically targeting compliance with the 90% rule, our view is that all customers are entitled to an appropriate and fair outcome and we expect firms to ensure they have good reason to believe that this is the case in line with COBS 20.2.3R. To do this, we expect firms to have the systems and processes that allow them to identify and analyse outliers and to analyse policy types (e.g. paid-ups, altered policies, whole-of-life policies) which fall outside of target range monitoring, before considering taking action where appropriate.

In particular, in light of the run-off of endowments, firms should consider specifically appropriate bonus and surrender value methodologies for whole-of-life policies where they are currently extrapolated from those used for endowments.

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While it is appropriate to check compliance with a target range retrospectively, it is important to check for potential outliers at the time of setting bonus rates and the surrender value basis and to check claims periodically throughout the period for which the bonus rates/surrender basis applies. We consider that an appropriate period, as observed in some firms, over which to check claims is quarterly unless there are exceptional circumstances.

To ensure that specimen policies remain representative of the underlying business, we consider that checking some actual claims is necessary. This can also enhance a firm's understanding of its business which can then be applied to ensure fairer outcomes for customers going forward. We consider it may be prudent for firms also to check at least some actual claims as part of demonstrating appropriate management controls and that this checking would include both outliers and excluded policy types.

Depending on the findings, the analysis of outliers and excluded policies may not result in any action being taken by firms. However we would expect firms to record such investigations and the resulting decisions on whether any action is required and for there to be appropriate input and challenge from the with-profits actuary and with-profits governance arrangement (taking independent advice where appropriate).

Surrender value bases

To ensure fair outcomes are occurring, we expect that surrender value bases are reviewed whenever bonus rates are reviewed, hence this is anticipated to be at least once per year, in line with practice we saw at some firms. In addition, we would expect that if the fit of a basis is deteriorating, firms act to review the methodology itself to ensure that it remains fit for purpose and fair to customers.

To support this, firms should demonstrate clearly that they have appropriate systems and controls to show compliance with relevant requirements. We would expect firms to:

- have a clear written policy around the frequency of surrender basis review which specifies the point at which a full methodology review might be required
- ensure that resources are available so that updates are made ahead of the basis causing actual consumer detriment and
- be able to show that the policy is clear as to how customer outcomes, including those related to paid-up or altered policies, are factored into the reviews

Annex 1

List of questions we are consulting on

Do you have any comments on our Draft Guidance: our expectations as set out under sub-outcome:

- Q1:** The firm's overarching strategy, including any outsourcing arrangements, takes proper account of the fair treatment of customers?
- Q2:** The firm checks, through periodic product reviews that closed-book products remain fit for purpose and continue to provide the benefits they were originally designed to?
- Q3:** The firm has adequate governance arrangements for its closed-book business?
- Q4:** The firm's remuneration, reward and performance management arrangements are consistent with the fair treatment of customers?
- Q5:** Regular communications to customers provide them with sufficient information to make informed decisions?
- Q6:** Communications to customers at the time of key policy events are clear, accurate and enable them to make informed decisions?
- Q7:** Communications with customers make them aware of guarantees or options (whether time critical or not)?
- Q8:** The firm takes effective action to locate and make contact with 'gone away' customers?
- Q9:** The firm takes steps to deal with poor performance with closed and actively marketed products given equal attention?
- Q10:** Overall expenses are allocated fairly to closed-book products?
- Q11:** The firm regularly reviews the overall fairness of cost allocations and actual customer outcomes and applies a consistent basis for these reviews?

- Q12:** The firm proactively monitors the actual experience of its closed-books of business and consistently passes on benefits and costs to customers, to the extent permitted by policy conditions?
- Q13:** Exit and paid-up costs are not excessive and are not driving poor customer outcomes?
- Q14:** Target ranges for with-profits pay-outs appear reasonable and firms meet these target ranges without the variation of pay-outs being too wide?

Annex 2

Good and poor practice tables

Some specific examples of good and poor practice identified in our review. In labelling something as 'good practice' we are not confirming that it meets all the requirements under our rules and our labelling something as 'poor practice' does not necessarily mean it is a breach of our rules.

Outcome 1: The firm's strategy and governance framework results in the fair treatment of closed-book customers

Sub-outcome 1.1: The firm's overarching strategy, including any outsourcing arrangements, takes proper account of the fair treatment of customers.

Good practice	<ul style="list-style-type: none"> • A firm's written strategy placed strong emphasis on the fair treatment of closed-book customers as well as commercial considerations and incorporated a customer plan which set out strategic aims designed to improve the outcomes customers were receiving. Examples were objectives to keep all customers properly informed and for the firm to understand customer needs. The firm had a well-resourced Customer Function headed up by a senior member of management with direct access to the board. Objectives of the Customer Function included, for example, reviewing the terms and charges of products to ensure they remained current and appropriate. • A firm had separated its new and existing business lines, creating a closed-book division, focusing on identifying and responding to the needs of closed-book customers, to make them feel engaged, in control, secure and confident. At the time of the visit the firm was carrying out a specific exercise to understand better what its customers (including closed-book customers) want. • A firm had established clear contractual terms with OSPs which were aligned to the fair treatment of customers and allowed the firm to maintain control over the quality of customer outcomes through appropriate SLAs and Key Performance Indicators. For example, the firm made the quality of communication with customers a key measure of the OSP's performance. OSP interactions with customers were assessed for fairness using mystery shopping.
Poor practice	<ul style="list-style-type: none"> • A firm did not acknowledge that different customer groups may have different needs. Its strategy did state that delivering appropriate products to legacy customers was as important as reaching out to new customers. However, in the absence of a focus on the outcomes the firm wanted to achieve for closed-book customers it was unclear to the firm's employees how this was to be achieved. For example responsibility for the key area of customer communications was fragmented and unclear. • A firm had no explicit focus on achieving fair outcomes for customers (including closed-book customers) within its strategy as its primary focus was to meet commercial objectives (e.g. maintaining financial strength and managing expenses). In so far as there was consideration of fair treatment of customers at all the focus was purely on administering policies in line with T&Cs.

Sub-outcome 1.2: The firm checks, through periodic product review, that closed-book products remain fit for purpose and continue to provide the benefits they were originally designed to.

Good practice

- A firm's product review framework risk-weighted all closed-book products to develop a product review schedule. For example products that were considered to be more sensitive to regulatory or legal changes were given a more frequent review time-table. This approach allowed the firm to use its limited resources more effectively and ensured that the products that were most at risk of delivering poor customer outcomes were reviewed more frequently while also ensuring that all products were subject to regular reviews.
- A firm conducted product reviews through grouping products into 'product families' and all product families were subject to periodic review. The grouping of products into product families allowed the firm to look across similar features between products and identify areas where customers in one product may have received worse outcomes than customers in another product. For example the firm identified that the rate charged for policy loans to customers in one product was significantly higher than that for other products in a similar category.
- A firm had developed a 'Value for Money' framework to assess the customer outcomes being delivered through their closed-book products including consideration of overall costs against product performance to identify products that may have offered poor value to consumers. This allowed the firm to consider the overall fairness of the propositions as opposed to the fairness of individual charges.
- A firm had developed a framework for identifying unusual customer behaviours, where for example customers were making decisions that were apparently not in their best interests. This complemented the existing product review framework and could be used to drive a reactive review into a specific product. This allowed the firm to identify proactively products which were not performing in line with customer expectations or where customers did not have enough product understanding to make informed decisions.
- A firm risk rated their products into high, medium and low risk. Higher risk products were reviewed annually, medium risk products were reviewed every 18 months and lower risk products were reviewed on a 24-month cycle. This approach, when combined with an effective process, ensured that all products received a periodic review, with higher risk products receiving more attention, making it more likely that poor customer outcomes were quickly identified.
- A firm used a 'customer focused lens' to assess the rectifications necessary after identifying issues with a product. This allowed the firm to assess how complex the change was and therefore the most effective way of communicating the change to customers, pulling in other resource mechanisms if necessary such as creating Q&A 'hotlines' in its call centre.

Poor practice

- A firm did not periodically review any of its products. This meant it was not aware whether products remained fit for purpose and delivered fair customer outcomes. This created a high risk that the firm would not identify poor outcomes.
- A firm that had consolidated several closed-books had a different process to review each business book. Some processes were more effective and comprehensive than others. This resulted in different products, and therefore different groups of customers, receiving differing levels of attention from the firm. This created the risk that customers with products with a less rigorous product review process were likely to be worse off (as the firm was less likely to identify any weaknesses) than those in other books subject to more robust product review processes.
- Some firms adopted a product review process that only focused on ensuring compliance with contractual obligations, relevant regulations or internal processes with no assessment of wider customer outcomes. Our review found examples where issues that may be delivering poor customer outcomes were not addressed as firms were content that they were in line with contractual obligations.
- A firm's product review process did not identify a product where charges had outstripped growth over a period of time. This was due to having inadequate resourcing and prioritisation within the business and the product review being carried out using a 'tick box' approach. The firm was unable to provide any examples of issues their product reviews had identified and put right.
- A firm had identified a wide range of issues through their regular product review process but did not take appropriate and effective action in a timely manner. In one example, an issue of customers being provided with inadequate information had been outstanding with the firm's Governance Committee for 18 months.

Sub-outcome 1.3: The firm has adequate governance arrangements for its closed-book business

Good practice

Appropriate overall structure

- A firm had clear lines of responsibility both within the firm and within the control frameworks for the Outsourced Service Providers (OSPs). The roles of the Product Governance Framework, the TCF Committees and the Operations Committee were important to the maintenance of this oversight. The network of front-line meetings, and the MI that supported them, were key to the effective management of the OSP relationships and there was evidence that these meetings highlighted key issues and drove actions in response to them. The OSP Report to the Risk Committee and the OSP customer pack considered an extensive range of customer indicators and drove positive actions in response to them.
- A firm had established a dedicated supplier management function with responsibility to oversee: OSP performance and service; transformation and change; customer experience; TCF and complaints and assurance. An independent customer governance function set companywide policies and frameworks to ensure that customers were treated in a fair and consistent manner, regardless of service provider. The two key service providers were contractually bound to comply with the group policies and frameworks. A more ad hoc approach was adopted for other outsourced suppliers through regular management relationships. The firm had a Group Risk Change team that had oversight of regulatory change across the group including OSPs. This included oversight of process changes, training and communications.
- A firm engaged a market research company to conduct telephone surveys to monitor the quality of customer experience provided by OSPs. There were also customer satisfaction service level targets with financial consequences for the OSPs.

Focus on outcomes

- T&Cs allowed a firm to charge interest at rates of 10% to 12% a year in respect of policy loans. In practice, the rate was set in line with guidelines set by the TCF Committee and was at the time of the visit significantly lower than the rate allowed in the T&Cs.

High-level focus on customers

- A key element of governance was the Customer Function, under the leadership of the Customer Director, with responsibility for managing risks, appetite and minimum control standards as defined in the Customer Policy and for overseeing the OSPs. The Customer Director was a member of the Management Board and reported through to the Chief Executive. Customer function representatives attended the key Board and Committee meetings; there were five sub-elements, covering Product Management, Customer Oversight, Customer Relations, Customer Engagement and Customer Operations. This infrastructure represented a comprehensive and integrated approach to customer oversight and served as a mechanism for ensuring that all aspects of customer fairness were considered.
- An Insurance Committee signed off all major decisions which have an impact of customers. A Non-Executive Director was designated as a TCF champion and was a member of the Insurance Committee. He prepared and submitted to the Insurance Committee an annual report on fair treatment of customers. The TCF champion had input to and provided challenge on decisions including strategy, new products and pricing.

Poor practice	<p><i>Lack of focus on customers</i></p> <ul style="list-style-type: none"> • Governance focused on a large outsourcing project, which the firm did not expect to make any difference to customer outcomes. Where customer issues were considered, the firm equated complying with policy T&Cs with delivery of fair customer outcomes. Although the TCF Committee did receive TCF MI, such MI measured process rather than customer outcomes. No action was taken on poor customer outcomes where no breach of T&Cs was identified. • Board oversight of customer matters was cursory. The minutes of meetings showed little record of discussion, debate or the creation of actions for customer matters. For two consecutive board meetings the TCF section of the board pack was limited to the words: 'TCF – no issues of note.' <p><i>Delegation</i></p> <ul style="list-style-type: none"> • A firm formed a TCF Committee from members of middle management. The MI received by the committee was voluminous but did not focus on customer outcomes. While members of the TCF committee were well-intentioned, there was no evidence that they were involved in key decisions. The firm's management were unable to give any example of beneficial change brought about by the committee. <p><i>Issues identified but not resolved</i></p> <ul style="list-style-type: none"> • A firm had a significant number of issues which had been identified by product review and Compliance and Internal Audit reports. Discussions with management indicated it was not clear who was responsible for ensuring that the necessary actions were taken. Minutes of key meetings revealed that the identification of shortcomings tended to lead to further reviews and discussions rather than to robust remediation action. As a result problems such as incomplete or inaccurate customer communications were not speedily resolved.
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Sub-outcome 1.4: The firm's remuneration, reward and performance management arrangements are consistent with the fair treatment of customers.	
Good practice	<ul style="list-style-type: none"> • SLAs for a firm's OSP did not contain any retention target. The SLAs did contain some objectives which are likely to reduce the risk of customer detriment as follows: quality sampling success rate, call abandonment rate, regulatory changes implemented on due date and maturities and claims paid on time. • The objectives for OSP staff handling potential surrenders did not include any retention target. The team had a balanced scorecard which focused on call quality, customer service, providing correct information, customer satisfaction and other areas such as colleague engagement.
Poor practice	<ul style="list-style-type: none"> • A firm's SLAs with its OSP contained a target to retain a percentage of customers expressing an interest in surrender. There was a potential financial penalty for the OSP in the event of failure to achieve the target. The OSP had retention targets for call handlers talking to customers potentially interested in surrender. The firm did not have oversight over performance management at the OSP so had not been aware of the target for call handlers. • A firm used process flows which made reference to 'hooks' and appeared to encourage their use to retain customers. The information given to the customer focused mainly on the advantages of keeping the policy rather than encouraging a balanced conversation taking account of the specific customer needs. • A firm had an SLA with its OSP which contained retention targets. The OSP staff had retention objectives. Call structures were weighted towards retention, referring for example to 'reasons to retain.' Management of the firm had not been aware of this as a result of having inadequate oversight. For this reason management had not taken effective mitigation action. • A firm thought that they did not have any direct or indirect incentives. Our review identified that the Head of Customer Services did have objectives in respect of customer reinvestment at maturity. The firm had not recognised that this posed a risk of poor behaviour and had not taken any action to mitigate the resulting risk.

Outcome 2: The firm's closed-book customers receive clear and timely communications about policy features at regular intervals and key points in the product lifecycle that enable them to make informed decisions

Sub-outcome 2.1: Regular communications to customers provide them with sufficient information to make informed decisions.

Good practice

- A firm had reviewed communications sent to its customers with a focus on whether the information needs of their customers had been met. The firm used findings from its product reviews to achieve this. As a result of actions arising from this review, all customers received statements annually and statements set out key policy information in a format that was accessible to customers. This allowed customers to engage with the performance of their policy and make informed decisions.
- A firm had reviewed its disclosure of charges for products invested in its with-profits fund and at the time of the visit annual statements quantified an estimated total policy charge. Quantifying charges and presenting these in an aggregate figure provided customers with a clear understanding of the impact of charges on their policy.
- A number of firms carried out customer testing when designing regular statements and undertook periodic subsequent testing to ensure regular statements remained fit for purpose. In designing changes to communications, a firm accessed an online community of customers to test whether the changes made would achieve the firm's objectives and meet the needs of the customers.
- A firm had taken steps to ensure that its IT systems designs facilitated alterations to statements. This enabled the firm to make regular changes to its statements so they could easily take into account customer feedback and make sure all statements were in line with the statements for newer products.

<p>Poor practice</p>	<ul style="list-style-type: none"> • Some firms did not send regular communications to all customers with some customers not receiving any policy specific communications from the firm for several years or the life of their policy. This created a high risk of customers losing contact with the firm and being unsighted on the performance of their policy and valuable features it offered. • Firms adopted a prescriptive approach to regular communications providing communications only where the firm perceived a requirement to do so due to policy conditions or specific regulations. This did not take into account the FCA's requirement for treating customers fairly and resulted in a risk of these firms not meeting the information needs of a significant number of their customers. • Regular communications did not contain sufficient information to allow customers to understand the performance and value of their policy. For example: <ul style="list-style-type: none"> – Firms did not include the total customer contribution over the period in regular statements meaning that customers could not easily assess how much of the growth in their policy value was derived from investment return and how much due to additional premiums over the period. – Firms did not include the policy value as at the previous statement date. This meant customers were unable to assess easily how their policy had performed without referring to their previous statements. • The layout of regular statements made it difficult for customers to identify key information. For example a firm listed each contribution received over the period and the allocation of the contribution to funds, but did not provide a total contributions figure or the total amount invested in each fund. • Some firms had not assessed the information needs of their customers in designing regular statements and had not engaged directly with customers when deciding what content and layout was appropriate for regular statements. • Firms did not clearly disclose charges or the impact of these charges on performance, including: <ul style="list-style-type: none"> – Some firms referred customers to their Key Features Documents (KFDs) which provided details of the nature of charges that were to be incurred. However, due to the long term nature of these products it was likely that KFDs were issued decades ago and therefore highly likely that those customers would not be able to access these KFDs easily. – Customer communications were silent on charges that apply. – Firms quantified some charges but not others. This creates a potentially misleading picture for customers on the cost of their policy and the impact of charges. • A firm stopped sending regular statements to customers if they made their policy paid-up. While customers were no longer contributing premiums they retained their policies for which the product provider was still deducting a charge. Even after going paid-up, customers still require information about their policy to allow them to make informed decisions. • Some firms had no proactive program for improvements to regular statements and relied on reactive indicators such as complaints to identify if changes are necessary. These products were often complex and customers were highly disengaged. Relying solely on reactive measures such as complaints may have resulted in weaknesses being unidentified and therefore not addressed.
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Sub-outcome 2.2: Communications to customers at the time of key policy events are clear, accurate and enable them to make informed decisions; and

Sub-outcome 2.3: Communications with customers make them aware of guarantees or options (whether time critical or not).

Good practice

- A firm engaged early with customers, up to three months before key policy events. This gave customers enough time to understand the decisions they would need to make, the options available and to seek advice if necessary.
- A firm, when a customer nominated an increase in regular pension contributions, re-issued the key features documents with a 30 day period for the customer to revise their decision. This allowed customers time following a decision to reevaluate and seek advice if necessary.
- Some firms issued a 'Pause for Thought' brochure after receiving a request to surrender a policy setting out the other options that may have been available to customers and the impact of these options on benefits. This ensured the customer was fully informed of alternatives to surrendering their policy such as carrying out a partial surrender, going paid-up or reducing contributions.
- A firm reminded customers of both key options and guarantees in regular communications. It also highlighted the impact of key policy events on these options in the pre-event communications. Having disclosures in both regular and key event communications meant that these customers were able to understand the value offered by these policies throughout the life of their policy and fully engage with the various policy options.

Poor practice

- At some firms, communication to customers setting out the options available before a key policy event did not contain sufficient information. For example in a policy with an option for a ten-year extension the investment risk associated with the decision was not mentioned or not sufficiently prominent in the documentation. This meant a customer taking up the ten-year extension may have done so without fully understanding the risks associated with their decision.
- At one firm pre-event communications did not contain all the information necessary for customers to make informed decisions. For example one firm did not remind the customer that they had a guaranteed bonus to be added to the policy value at maturity which would be lost if the policy was surrendered. A customer may therefore have surrendered their policy without understanding that in doing so they were giving up the value of the guaranteed bonus.
- At some firms pre-event communication required customers to refer to a number of additional documents, including the T&Cs provided at the point of sale over a decade ago, to establish the impact of various options. This resulted in a high likelihood that customers would have made decisions without being fully informed about policy options and benefits.
- Some firms restricted the information provided to customers to what was specifically requested, omitting information pertinent to decision making. For example, one firm provided a breakdown of the surrender quote to show surrender charges only when specifically requested by customers. A customer unaware that a surrender charge applied would have been unlikely to seek this information specifically. So customers may have surrendered their policies without fully understanding the impact on their value.
- At some firms surrender charges and increases in charges on making a policy paid-up were not clearly disclosed to customers prior to a policy event. These firms relied on disclosures made at the point of sale, which in these cases was at least a decade ago. Customers therefore were likely to have surrendered or ceased contributing premiums into their policy without understanding the effect on their policy value.
- Some firms lacked a standardised approach to the information to be provided to customers requesting pension transfers, resulting in key information, such as charges or loss of valuable options such as GARs, not being sufficiently highlighted in the communication. Not setting out options clearly was likely to result in customers being unable to understand the value of their policy benefits.
- A firm first contacted customers three weeks before the policy matured, leading to delays in maturity pay-outs due to the need to verify customer details such as changes in address. This meant that customers were unnecessarily delayed in receiving their policy benefits.
- At some firms disclosures of guarantees were general, using language such as 'a GAR may apply to your policy' which did not allow a customer to understand readily whether this guarantee applied to their policy or how it added value. Some customers may not have been in a position to make fully informed decisions and may have missed out on valuable benefits as a result.
- Some firms did not disclose guarantees and benefits in regular communications – for example statements did not specify the level of life cover available. This meant that customers may not have been aware on an ongoing basis that they had access to these benefits, reducing the likelihood that they would take them into account when making decisions about their policy and broader financial and insurance needs.

	<ul style="list-style-type: none"> • Some firms did not highlight the impact of guarantees and options in the course of key policy events. For example the firms did not highlight that by surrendering a policy a customer would lose their life cover and may have been unable to procure a similar level of cover in the future. This meant that customers could have made a surrender decision without fully understanding the impact on their financial and insurance needs. • A firm 'cherry picked' which options to notify customers about, with certain options being considered unattractive to the firm and therefore not disclosed. For example the firm opted to remove disclosures relating to a guaranteed option to increase life cover which was available to some customers. This approach may have resulted in poor customer outcomes for those customers that required additional life cover but could not obtain cover on the same terms from other firms due to medical conditions or increased age.
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Sub-Outcome 2.4: The firm takes effective action to locate and make contact with 'gone away' customers.

Good practice	<ul style="list-style-type: none"> • One firm in our sample, regardless of 'gone away' status, automatically checked details held against electoral roll information on Experian biannually. This anticipated 'gone away' customers, reducing reliance on customers notifying the firm or mail being returned. • One firm in our sample included a form with annual statements to remind customers to notify the firm of changes in addresses. This approach accepted that notifying firms may not have been a high priority for customers when moving address and sought to make this easier for them. • Some firms adopted a timely approach to re-establishing contact with customers. Examples of good practice in this area that we observed at different firms are: <ul style="list-style-type: none"> – a firm's first attempt to re-establish contact with customers was at the point they become aware that a customer had 'gone away'. – where a firm's first attempt to re-establish contact was unsuccessful the firm attempted subsequent regular re-contact at least every two years; and – at maturity, a firm attempted again to re-establish contact. <p>These approaches acknowledged that customers' recollection of products held typically deteriorated with time and sought to re-establish contact immediately. Where this was unsuccessful the approaches left sufficient time for customers to re-appear on government or other registers but not so much time that a customer was unlikely to recall the product held. Subsequent key event and regular attempts to re-establish contact acknowledged the firms' ongoing obligations to customers and the fact that customers may not have appeared on Government or other registers for considerable periods of time. For example some customers may have moved abroad and returned some years later.</p>
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Poor practice

- Some firms exhibited ill-defined or inconsistent approaches for dealing with 'gone away' customers. For example, the documented processes provided by one firm in our sample differed from team to team and the firm was unable to confirm whether these processes reflected actual practice. The lack of clear and well substantiated processes made it impossible for management to know whether actions taken were effective or not.
- Some firms did not have adequate oversight of the number and composition of 'gone away' customers. For example, one firm in our sample collected 'gone away' customer MI but this was not shared upwards in the organisation and there was no interest on obtaining this figure at a senior level. This meant that the MI was not acted on and the firm were not able to point to activities undertaken which improved the 'gone away' rate.
- Some firms solely relied on returned letters or statements to identify 'gone away' customers but did not have regular communication with a significant number of customers. This increased the risk of losing contact with customers and raised the concern that these firms may not necessarily have been aware that customers had 'gone away'.
- Some firms held multiple contact details (email, telephone numbers, etc.) for customers but did not utilise these in tracing activities. This meant a number of customers were categorised as 'gone away' when in fact they may have been easily contacted.
- One firm in our sample did not facilitate outsourced service providers cross referencing customers across all books. This created the risk that one part of a firm may have lost contact with a customer while another part of the firm was still in contact. The customer may not have understood, and should not have needed to understand that different policies held by them may have been administered at different OSPs and the customer would have expected that they only needed to contact a firm once to change contact details.

Sub-outcome 3.1: The firm takes steps to deal with poor performance with closed and actively marketed products given equal attention.

<p>Good practice</p>	<ul style="list-style-type: none"> • Firms gave equal oversight to closed-book and new funds. This approach negated the risk that closed-book customers did not receive the same level of attention as others. • One firm had a clear definition of what constituted underperformance over a reasonable time period, using the following metrics when assessing performance: <ul style="list-style-type: none"> – long-term performance (examined the previous three quarters performance over a rolling three-year period) – short-term performance (examined six quarters discrete quarterly performance) – long-term volatility (measured three-year volatility compared to peer group) – short-term volatility (examined the change in volatility from the previous six months) – long-term Sharpe ratio (measured the three-year Sharpe ratio) – long-term drawdown (examined the maximum value in funds over the previous five years) <p>This approach could quickly identify long- and short-term issues, gave warning signs, put performance into context and highlighted funds where customers were likely to have experienced financial loss.</p> • Some firms followed a structured and dedicated approach for dealing with significant underperformance. For example, one firm in our sample identified funds below the 80th percentile over a three-year period which triggered a 12-month cure period. If, by the end of the cure period the relative fund performance remained below the 80th percentile over a three-year period or below the 60th percentile over the cure period the firm was entitled to terminate the relevant fund. This approach balanced long and short term performance and clearly set out expectations and consequences.
<p>Poor practice</p>	<ul style="list-style-type: none"> • Some firms did not apply appropriate and relevant benchmarks in line with what had been communicated with customers. For example, one firm in our sample was clear that while customers invested in funds measured against Association of British Insurers (ABI) benchmarks, the firm did not consider these benchmarks to be useful in measuring fund performance as they were too broad. This created a contradiction between customer expectations and firm actions. • A firm did not identify significant underperformance. The firm policy was that only funds that were in the 5th or 95th percentile over three or five year periods warranted closer monitoring. A customer might have reasonably considered that action would be taken in respect of less significant underperformance than that indicated by funds performing at the 95th percentile. • A firm, while reviewing the performance of direct funds, did not review the performance of mirror funds and expected customers to be aware that the firm merely provided access to such indirect funds. The firm did not review either the performance of the mirror funds or how closely their funds tracked the third party fund. Customers investing in funds through a firm's product might reasonably expect the firm to review the performance of these funds. • A firm identified an example of poor performance but it was unclear what action would be taken. The fund remained open despite delivering bottom decile performance in each of the last three discrete years with no indicators of improvement.

Sub-outcome 3.2: Overall expenses are allocated fairly to closed-book products.**Good practice**

- Some firms with unit-linked business clearly documented their approaches to expense allocation/charges in a 'Standards and Practices' document for the management of unit-linked business covering both the underlying unit-linked funds and the overall unit-linked policies. With respect to expense allocations and charges, the best of these considered (inter alia):

- which areas the firm had discretion in
- the frequency and form of any reviews of expense allocations and/or charges, covering both unit-linked fund charges (e.g. AMCs, bid/offer spreads) as well as policy charges (e.g. policy fees, mortality charges, switching fees, surrender and paid-up charges), and
- how fairness to customers was factored into all reviews.

Similar to the role of the PPFM on with-profits business, these documented 'Standards and Practices' documents provided greater transparency and allowed for more effective governance of unit-linked business with respect to the exercise of discretion and the fair treatment of customers.

- Some firms formalised their approach to weighing up the expenses and associated benefits of a particular service to customers. We observed this, for example, in the context of deciding the amount of strategic IT spend to allocate and whether to allocate it to asset shares or the estate of a with-profits fund. It was also observed in a change to the equity investment strategy from passive to active in a with-profits fund, buying out of future regulatory risk from a with-profits fund, and considering whether there would be sufficient customer benefit in incurring the costs of allocating expenses at a more granular product level. In each of these scenarios, the firms formally incorporated this thinking into their governance and decision-making processes and through this were able to decide expense allocations that were consistent with the fair treatment of customers.
- While many with-profits funds had formal shareholder agreements to manage expense risk, which could be of value to customers, one firm demonstrated particularly good practice in considering customer risk in the round in structuring and continuing to refine these agreements. For example, the firm was making use of regulatory cost and other risk buy-outs as part of the agreements in place with the shareholder to protect customers in the funds in run-off.

Poor practice

- Most firms are not easily able to assess the extent to which their unit-linked and unitised with-profits business with contractual charging structures was generating expense profits or losses. In practice this meant they were not in a position to assess the shape over time of the expenses they were incurring in running the business and the charges they were receiving for doing so, as well as how these compared to the initial pricing assumptions. This lack of clear expense allocation over time made it difficult for firms to exercise discretion in the review of charges being incurred by customers.
- Where firms made use of 'in-house' service companies, the level of margin earned by the service company was not always completely transparent. The level of any such effective margin (where allowed) should always be transparent and subject to scrutiny and challenge by the relevant governance structures in the firms given its impact on the costs incurred by closed-book customers.
- We identified instances where the cost of switching between unit-linked investment funds within a product might have been high. One firm with comparatively high switching costs acknowledged the costs as high but believed this would not negatively impact customers because the rate of switching was low. For those customers who did switch, high switching charges could have had a significant impact on the value of their savings. There was no evidence that the firm had reviewed these charges for fairness to customers who do switch.
- A few firms' PPFMs for with-profits business or 'Standards and Practices' for the management of unit-linked business communicated that they may have varied charges if there was an exceptional increase in cost but there was no mention of an exceptional decrease in costs. We consider this approach is one-sided in the sense that it only provides protection to shareholders against the risk of an exceptional increase in costs, but does not also provide protection to customers against the reverse scenario where the firm's costs turn out to be significantly lower than anticipated.
- A firm paid insufficient attention to the fairness of the relative levels of charges/expense allocations at product level and between policies with a different premium status (premium-paying, paid-up and single premium) within a fund. This resulted in a substantial difference in the expense allocations between premium-paying policies and paid-up policies, which was not justified by the difference in administration cost.
- We saw evidence of inconsistent treatment of different books of business within a few firms. For example, some firms had clear inconsistencies in expense agreements (both management service agreements for administration and investment management agreements) between different with-profits funds, but with no clear plan to either address this and/or clarify as to whether the differences were appropriate. These inconsistencies included both the terms of the agreements and whether agreements were in place at all.

Sub-outcome 3.3: The firm regularly reviews the overall fairness of cost allocations and actual customer outcomes and applies a consistent basis for these reviews.

Good practice

- Some firms formally reviewed and externally benchmarked the level of with-profits maintenance charges against industry levels obtained regularly from independent experts. The best firms then formally integrated the results of these reviews into agreements on the level of expense allocations to customers. While required in some cases by court schemes, this represented good practice in protecting customers from drifting out of line with industry norms.
- One firm had externally benchmarked the level of exceptional expenses incurred by customers in its with-profits funds. While levels of exceptional expenses were not entirely comparable with other firms, this benchmarking gave the firm some comfort that its customers were not incurring charges in respect of exceptional expenditure that were significantly out of line with customers at other firms.
- Some firms had taken proactive steps to deliver fair customer outcomes by addressing charge levels incurred by unit-linked customers. In one case, a firm acted to address the impact of fixed charges within the TERs of small funds. Another firm took proactive steps to reduce the capital unit charges on a large portion of its unit-linked pensions business, even though they were contractually entitled to apply the previous level of charging.
- At one firm, the Board set and monitored progress towards a target in terms of customer 'value-for-money' on with-profits savings products, expressed in terms of a reduction-in-yield. This target applied to both new and existing customers.
- Some firms had a formally documented approach to expense charge reviews, which covered frequency and the way in which they factored in fair treatment of customers.

Poor practice

- In many cases there was a lack of regular, external benchmarking on the aggregate impact of charges of all types on customers in the various different product types. While individual charge types on a customer's product appeared competitive, it was the aggregate impact of charges that determined the outcomes that customers ultimately achieved.
- At a few firms expense allocations on with-profits business were benchmarked only on an ad-hoc, reactive basis. There was no formal agreed cycle for conducting these benchmarking exercises. This occurred at a number of firms which had longer term management service agreements for the provision of administration services and investment management agreements for the provision of investment services. These firms often relied on benchmarking exercises carried out at the point the agreement was established, but did not regularly review the agreement over time.
- Most firms did not generally review and externally benchmark charges on business where the various charges were specified in contractual terms. A few firms in the sample applied this approach particularly rigidly, even in cases where evidence suggested that customers were not getting particularly good value.
- A few firms did not conduct any formal assessments of the ongoing fairness of the expense allocation methodology within the firm, even though it had a bearing on the expense allocations to customers. This was particularly evident on unit-linked business, where although the link between ongoing expense allocations and contractual charges was often indirect, it was still nevertheless often a factor in deciding on any variations in charges incurred by customers.
- Many firms did not regularly review actual customer pay-outs on unit-linked business and some firms did not regularly review such payouts on unitised with-profits business. Consequently, firms were not in a position to understand the ongoing extent to which the level of expense allocations and/or charges were impacting actual customer outcomes and whether the outcomes being delivered for these products were fair under different sets of customer circumstances.
- Where firms set reference investment returns to compare actual with-profits pay-outs to, they often chose cash returns. While these firms maintained that they would expect to beat these returns, this appeared to be an inappropriate reference point for customers invested in long-term with-profits investments with exposure to growth assets such as equity and property.
- Where firms assessed actual customer pay-outs on with-profits business, they tended to focus primarily or exclusively on standardised (in terms of premium size and term) maturities to enable easy comparison to other firms, and did not assess surrenders/transfers in the same way. They also tended to focus on premium-paying cases only. This approach ignored the actual composition of the firm's book and the fact that large proportions of customers did not remain until maturity and did not remain premium-paying throughout the term of their investment.
- A number of firms relied exclusively on industry-wide with-profits pay-out analyses to gain comfort that their customers were getting reasonable outcomes. While this was a useful lens, a few firms were not able to attribute the reasons for their relative position compared to other firms. For example, one firm with relatively poor pay-outs was not aware of the reasons for this, including the extent to which expense allocations and charges were driving the results. Another firm simply relied on 'gut feel' to gauge whether the results seemed reasonable.

Sub-outcome 3.4: The firm proactively monitors the actual experience of its closed-books of business and consistently passes on benefits and costs to customers, to the extent permitted by policy conditions.

Good practice

- Some firms had clear cycles for the review of risk (mortality, morbidity etc.) charges across all products, including unit-linked products, and were consistent in passing on the benefits of lighter than expected mortality experience over time. For these firms, this approach was driven by the intention to ensure that customers were treated fairly in the risk charges they are paying, by sharing the benefits of lighter mortality experience than was initially anticipated at the point of sale.
- Most firms were consistent in their application of inflation indices to increase charges such as policy fees and switch fees over time, and used a simple and transparent basis to do this. This provided useful certainty to customers regarding the level of their policy fees in particular.
- One firm allowed policy fees to fall if the applicable inflation index produced a negative inflation result for the period, something which has happened in recent times. This meant that applicable customers had benefited from slightly lower policy fees on their policies.

Poor practice

- Some firms had not passed on the benefit of lighter than initially assumed mortality experience to customers in the form of lower charges on unit-linked and unitised with-profits business where the shareholder carried the risk. These firms had not carried out and documented appropriately regular reviews to assess the fairness of this practice to customers. The reasons were, for example, a stated desire to provide greater stability to customers in terms of charges, no explicit contractual provision to require this on all policies, or continuation of the firm's past practice even though this could have resulted in poor outcomes. Given the long-term nature of contracts and the improvements in mortality over time, this had probably resulted in many customers at these firms paying more for the insurance cover on their policies than the true underlying risk to the firm justified.
- A few firms used a variety of different bases for applying inflationary increases to policy fees across different books of business, some of which were quite complex. This was driven primarily by historic practice. We identified levels of annual increase to policy fees that seemed high in the context of a low inflation environment. There was no evidence to suggest that these firms proactively considered the fairness of the inflation bases or their relation to the actual rate of increase in associated costs.

Outcome 4: The firm's closed-book customers are able to move from products which are no longer meeting their needs in a fair and reasonable manner

Sub-outcome 4.1: Exit and paid-up costs are not excessive and are not driving poor customer outcomes.

Good practice

- Some firms considered the impact of exit charges on the outcomes their conventional with-profits customers were receiving. They removed the charge through targeting surrender/transfer values at 100% of asset share on average rather than the lower percentage that their previous practice targeted. This ensured that customers in these products received better outcomes as they were able to move to a product that better suited their needs, or to cash-in their policy, without charge.
- One firm considered the impact of a capital/accumulation charging structure on the outcomes their unit-linked pension customers were receiving. Finding that the charging structure could result in poor outcomes, particularly when policies became paid-up early, the firm acted to remove the additional AMC payable in respect of capital units; this removed exit charges on the impacted product lines. This action ensured that customers with those products received better outcomes. Those choosing to continue with the policy until retirement would benefit in terms of a higher pay-out as a result of the lower AMC on capital units while the policy was in-force, and those wishing to transfer their policy were able to move to a product which more suited their needs with no barrier to exit.

Poor practice

- Some firms relied on the contractual nature of exit and paid-up charges to justify their fairness regardless of the outcome being provided or whether the charge represented an unreasonable barrier to exit. We found examples of some customers at a firm where any product performance was outweighed by the level of charges imposed on the product. This was largely due to the impact of additional charges applied when the customer converted their policy to paid-up. The firm insisted that because this was in line with the T&Cs it would automatically be a fair customer outcome.
- Some firms were unaware of the paid-up charges present on their products. It was evident from the difficulties encountered in supplying us with information on paid-up charges and in the surprise at the results of our data request that a number of firms were not fully sighted on these charges. This typically reflected a poor product review process or a lack of focus on actual customer outcomes. Such firms were not in a position to demonstrate that the paid-up charges applied to certain product lines did not result in unfair customer outcomes.
- A firm was blending conventional with-profits surrender values targeted at less than 100% of asset share into expected maturity values over a short time period. A number of firms targeted 95% of asset share on average when determining surrender values of policies some way from maturity. While some blended the surrender value into the expected maturity value over a period of five years or more, one firm blended the values over a much shorter period which resulted in average exit charges of up to 5% close to maturity.
- Some firms did not review their with-profits paid-up bases or did not act when they were aware of a poor value or inefficient basis. Firms which did not review their bases could not assess whether they remained fit for purpose and provided fair customer outcomes. Not acting when there were known issues with a basis could have resulted in customer detriment.
- Some firms were not clearly communicating the impact of exit or paid-up charges at the point these were incurred, or on an ongoing basis. This did not put the customers in an informed position, which may have resulted in customers making sub-optimal decisions about their policy. For example, if a customer would not have incurred an exit charge by maintaining the policy for another year they may have decided this was preferable rather than surrendering the policy at that time. Similarly, if a customer realised the level of paid-up charge that would be applied they may have decided it was preferable to maintain premiums to the policy or take alternative action.
- A firm applied charges on policies which their systems have automatically surrendered, for instance when fund values dropped below a certain level after becoming paid-up. This practice, which resulted in an exit charge being applied which the customer may have been unaware of, could have resulted in poor customer outcomes and appeared symptomatic of a firm assuming that a practice was automatically fair if it was in line with the T&Cs.

Sub-outcome 4.2: Target ranges for with-profits pay-outs appear reasonable and firms meet these target ranges without the variation of pay-outs being too wide.

<p>Good practice</p>	<ul style="list-style-type: none"> • A firm had actively reviewed its target ranges for ongoing appropriateness for the fair treatment of customers. It had taken action to standardise and, where necessary, reduce its target range to a common range of 80-120% across all business lines, on both surrenders and maturities. The firm chose this range as being realistically achievable given the cross-subsidies inherent in with-profits. • Some firms used actual claims within their target range monitoring. This allowed easier identification of outliers and the pay-out ratios achieved. • Some firms actively identified, investigated and acted on outliers. For instance one firm carried out an investigation in order to confirm whether there were any systemic issues causing outliers. Another firm regularly investigated (and acted upon) outliers and significant, unexpected changes in pay-out ratios using a variety of methods, incorporating customer feedback in the process. • A firm gave consideration to customer outcomes on policy types excluded from target range monitoring. It recently revised its whole-of-life surrender basis methodology (in light of the run-off of endowments) to give more appropriate pay-outs to customers holding these policies.
<p>Poor practice</p>	<ul style="list-style-type: none"> • Some firms maintained target ranges that were wide, complex or asymmetric, or which differed between maturities and other exits, and were not able to provide a rationale as to how the target ranges resulted in fair outcomes for all customers. • Firms did not provide a detailed rationale in relation to pay-outs in their public PPFM Compliance report which made it difficult for customers and advisers to be able to gauge the extent to which the firm was providing fair value. • A firm was not acting to ensure that 90% of exits fell within target range. While firms might have fallen outside target range on occasion, persistently missing the 90% compliance target suggested that this firm was not actively considering fair customer outcomes. • Some firms did not review surrender bases frequently or did not prioritise updates where the fit of a basis had become increasingly poor. Specific examples included: <ul style="list-style-type: none"> – An error in the surrender value basis. Having not updated the basis for a number of years the firm was, on average, paying out significantly less than 100% of asset share on surrenders on a particular product line. – Another firm, which did not use asset shares in determining its surrender pay-outs, had identified some time ago that they ought to review their surrender value methodologies and bases to ensure fair outcomes for customers but had not yet commenced this work. – One firm was aware of an issue with the fit of a particular surrender value basis but had not yet had agreement through their governance process to rectify the issue. Our review highlighted another surrender basis which, while targeting 100% of asset share on average, produced significant outlier payments at both extremes which the firm was not acting to address. • Some firms had deficiencies in target range monitoring processes that limit their effectiveness and robustness. These included: <ul style="list-style-type: none"> – incorrect asset share calculations – compliance checking using specimen policies and pay-out ratios only at beginning and end of year and – extremely strict criteria used in defining outliers which may have led to unfair customer outcomes not being identified

Annex 3

Examples of good and poor practice across regular statements

Not all examples are relevant for all products and policy details are fictional and for illustrative purposes only. These examples do not represent a template which we expect firms to replicate, but we hope they lead firms to think differently about how they communicate with customers.

Examples of good practice

Disclosure of policy value and contributions

Your plan value as at 31 August 2014

Plan value	£313.51
Last year's value as at 31 August 2013	£209.82
Guaranteed minimum death benefit	£145,445.00

The customer can clearly identify the change in their policy value over the previous year.

Payments and withdrawal summary

Total payments and withdrawals since your last statement date	
Regular monthly contribution	£124.83
Payments made by you	£1,498.00
Withdrawals made by you	£0.00

The firm provides a monthly and a total figure which makes the total amount that the customer has contributed to the policy clear.

Explanation of capital and accumulation units

Fund name	Number of units	Price of one unit (£)	Value
Fund XYZ Capital units	230.0011	18.2600	£4,200
Fund XYZ Accumulation units	1,157.7218	18.2600	£21,140
Total			£25,340

In this example the firm provides a clear breakdown between capital and accumulation units and highlights the differences in charging structure to customers.

Explanation of unit types

- Initial units or Capital units are units allocated to your Plan in the first one or two years. These units are subject to extra charges to cover the selling and set up costs of your Plan.
- Accumulation units are units allocated to your Plan after charges to cover selling and set up costs of your Plan have been met. These units usually have lower management charges than Capital or Initial units.
- Fund XYZ Capital Units have a management charge of 6.5%.
- Fund XYZ Accumulation Units have a management charge of 0.75%

Disclosure of charges

- Units to the value of £1504.09 were allocated to your Policy in the last 12 months
- Units to the value of £327.01 were deducted during the last 12 months to cover the protection benefits your Policy provides and the costs of servicing your Policy.

The firm provides an aggregate view of the cost of the policy. Firms should also provide a breakdown of the costs.

Charges

From 1 May 2014, the yearly charge went up to £14.14.

We won't charge you for changing your payments but we do make a charge of 0.75% to cover the cost of providing a guaranteed minimum pay-out. This charge is taken as a deduction from investment returns we achieve. For example, if the underlying investment return of the fund is 5%, your plan grows by 4.25%.

For more information on charges refer to our website at www.xyz.com.uk
Or contact us on xxx xxxx xxx

This example shows a clear disclosure of the yearly charge in pounds.

The customer is also told about the cost of a policy guarantee.

There is clear signposting of where a customer can obtain further information and this does not require the customer to locate and interpret the KFD that they were issued at the policy's outset.

Red, amber and green endowment re-projection letter

Summary of your plan from 2 November 2012 to 1 November 2013

Plan start date	Plan end date	Monthly payment	Previous plan value	Current plan value	Guaranteed minimum value
13.05.98	13.05.14	£15.08	£3,946.23	£4,637.92	£3,786.86

This letter provides customers with the current value of the policy. We have seen many examples where firms do not include the current value of the plan in RAG letters. The absence of a current value would not provide customers with sufficient information to make a decision about their policy.

What you might get back if our investments grow at

Target amount	3.1 % a year	4.65% a year	6.30 % a year
£6,168	£4,460	£4,570	£4,670
Projected Shortfall	£1,708	£1,598	£1,498

Poor practice
Previous year's policy value

Your plan value as at 31 August 2014

Plan value	£32,313.51
Regular monthly contribution	£23.86
Guaranteed minimum death benefit	£145,445.00

This statement does not tell the customer the value of their policy at the previous statement date. For the customer to understand how their policy has performed they will need to locate their previous statement which they may no longer have access to.

Disclosure of charges

Charges
The charges we make vary between products. Full details are set out in product literature.

Disclosure of this nature does not help the customer understand what charges are applied or how they impact the performance of their policy and the customer may not have access to documents issued at the time the policy was purchased.

Transaction	Fund	Amount (£)	Price per unit	Number of units
Charge – policy fee	XYZ managed fund	16.40	310.50	5.362
Charge policy fee	ABC life series 3	10.11	293.60	3.540

This policy also incurs an indexed administration charge and there are deductions made from the policy to cover the cost of life cover. These charges are not mentioned in the annual statement which may result in the customer not seeing the full cost of maintaining their policy.

Red, amber and green endowment re-projection letter

Start date	Maturity Date	Payment frequency	Current premium	Target amount
01/07/1992	30/06/2014	M	£20	£10,000

This statement does not inform the customer of the current value of their policy or provide information on the value at the previous statement date. So the customer is not placed in an informed position about how their policy has performed.

Current value – whole-of-life policies

Sum assured as at 23 March 2013	£15,000
Monthly Contributions	£44.23
Lives assured	Mr A Smith

This WoL statement does not include the cash-in-value for the policy. The levels of cash-in-value for WoL policies vary. However it forms a feature of the policy and it is important that customers remain sighted on all available features offered by their policies.

Life cover**Your plan value as at 31 August 2014**

Plan value	£32,313.51
Regular monthly contribution	£23.86

This policy also includes a level of life cover in the form of a guaranteed minimum death benefit which is not disclosed to the customer in regular statements. This may result in the customer not being aware of the level of cover included in the policy so they are less likely to be able to make an informed decision on their insurance needs.

Annex 4

Cost benefit analysis

1. As we are not making any new rules, our statutory cost benefit analysis (CBA) requirements do not apply. This proposed guidance seeks to support existing FCA Principles, rather than establish new policy. We consider that the expectations set out in this document are reasonably predictable from existing FCA rules and Principles.
2. We do not consider that we should account for costs incurred by firms knowingly not complying with our existing requirements, so the costs to firms of correcting practices that do not meet the relevant rules and Principles have not been quantified.
3. However, based on the findings of the project on *Fair treatment of long-standing customers in the life insurance sector* it is likely that some firms will be expected to make changes that will result in significant additional costs relative to their existing processes. For this reason we think it would be helpful for us to provide a brief analysis.

Costs

Costs to firms

4. Firms are likely to incur some additional costs by undertaking the activities listed below. Depending on the resources available some firms may carry out tasks in-house. Others are likely to outsource. Even where tasks are carried out in-house it is likely that there will be an opportunity cost for the staff involved.
 - i. **Product review:** We expect this guidance to result in firms doing more product reviews than they have in the past. Additional costs are likely to vary depending on a firm's existing processes. Some firms already incur costs carrying out regular product reviews.

Where firms already carry out regular product reviews our expectation of increased focus on customer outcomes is likely to expand the scope of such reviews. For example we expect firms to review exit and paid-up charges for fairness. Additionally if any charges are identified as not complying with legal requirements this may necessitate changes which result in a direct cost to the firm.
 - ii. **Communications:** Our expectation that firms will communicate regularly with all customers will result in some firms having to send more communications than they currently do. Where firms already communicate regularly with customers, statements will need to include more information such as charges and fund performance. There will be a necessity to calculate this information and amend the format of statements to include it. Some firms have made recent improvements to their communications at a cost which they found acceptable.
 - iii. **'Gone aways':** We are expecting most firms to carry out more work to re-establish contact both at the time the customer initially goes away and periodically thereafter. Some firms already have processes in this area that we consider to be adequate at a relatively low cost per policy holder. These firms are unlikely to incur additional costs.

5. We have identified two additional areas where we expect further costs to be incurred, although they may be relatively small amounts.
 - i. **Benchmarking:** We are encouraging firms to carry out more benchmarking of costs. This is likely to involve employing an external consultant.
 - ii. **Review of with-profits surrender and paid-up bases:** We expect firms to carry out such reviews more regularly to ensure fairness in future.
6. In other areas such as strategy, governance, remuneration, reward and employee performance management and fund performance management we expect any additional costs to be minimal for most firms. For example a firm always incurs costs developing its strategy and increased focus on fair treatment of customers is unlikely to change this.
7. The structure of with-profits policies means that it is likely that a significant proportion of additional costs to firms will be borne by with-profits customers. For unit-linked policies there may also be scope for firms to pass some costs on to customers.

Costs to consumers

8. As described in the 'Costs to Firms' section above firms may pass on some of their additional costs to customers. We do not expect customers to incur any additional direct costs.

Costs to the FCA

9. There could be an opportunity cost from supervisory time being spent assessing firms' processes and associated governance and controls relating to product review, communications, exit charges and other processes aimed at ensuring fair treatment of long-standing customers. We expect this to be included in normal supervisory activities. Additionally, the increased clarity of our requirements may lessen the time our supervisors need to spend assessing firms' systems and controls in this area. As such, we expect any incremental costs to the FCA to be small.

Benefits

10. We expect action taken by firms following the proposed guidance will result in significant benefits to many customers. In particular: a) products are more likely to remain fit for purpose and to deliver the benefits originally intended; b) communications will make customers better able to make informed decisions; c) customers are less likely to 'go away.' A customer who goes away and cannot be re-contacted is likely to lose all the benefits of the policy; and d) customers are less likely to suffer exit and paid-up charges which drive poor outcomes.
11. We would expect the changes described above as a whole to result in more effective competition, which should benefit consumers.
12. We welcome any views or comments on the CBA for this proposed guidance including your thoughts on any costs or benefits we have not taken into account.

Annex 5

Glossary

This glossary sets out the key terms we use and how we have defined them for this report.

Accumulation units – Units with relatively low charges. For some unitised policies premiums for an initial period are allocated to capital units for the purpose of recovering the product provider's initial costs. After the initial period subsequent premiums are invested in accumulation units which have lower charges.

Altered policies – For the purposes of this review, altered policies refer to policies that customers have made changes to since inception, such as changes to policy term, the level of life cover or the level of premiums.

Annual management charge (AMC) – Charge levied by the firm in respect of management and administration of the policy, typically expressed as a percentage per annum.

Asset share – This represents the underlying value of a with-profits policy as calculated by a firm, taking into account (inter alia) premiums paid and withdrawals made, expense deductions and the returns on the assets in the with-profits fund. Depending on the context, the asset share may also allow for any smoothing of returns.

Average Weekly Earnings Index (AWE) – United Kingdom Office for National Statistics' indicator of short-term changes in earnings.

Back-ended charging structure – A charging structure on a policy whereby most or all of the initial costs incurred by the firm are recovered over the full expected lifetime of the policy, typically through ongoing charges such as the AMC. Policies with capital and accumulation units are an example of this type of charging structure. In contrast to front-loaded charging structures, 100% (or more) of the customer's premiums are typically allocated to their chosen investment fund(s) from inception of the policy.

Basis points (bps) – A basis point is one hundredth of one percent.

Capital units – Units that carry relatively high charges. For some unitised policies premiums for an initial period are allocated to capital units for the purpose of recovering the product provider's initial costs. After the initial period subsequent premiums are invested in accumulation units which have lower charges.

Cash-in value – The amount a customer would receive if they surrender their policy.

Closed-book customers – Customers with products within the scope of the project. Generally this applies to products sold before 2000 and which are closed to new business. Where firms had slightly different definitions we accepted the firms' definitions.

Consolidators – Firms which take over and manage existing books of business previously managed by other firms.

Conventional with-profits policy – A policy with an initial sum assured which is increased by the addition of bonuses. Any annual or reversionary bonuses and terminal bonuses are declared as a percentage of the sum assured or the sum assured plus attaching bonuses.

Cross-subsidies – For the purposes of this review, subsidies between policies within a with-profits fund. Cross-subsidies are a result of the grouping of policies and other aspects inherent to with-profits management. The financial management principles and practices that result in cross-subsidies are set out in a firm's PPFM.

Cure period – A provision in a contract allowing a defaulting party to fix the cause of a default, for example a repayment grace period. In the context of fund management this would mean a period of time within which a fund manager is required to rectify poor performance to avoid being eligible for termination of their contract.

Decile – Any of the nine values that divide the sorted data into ten equal parts, so that each part represents 1/10 of the sample. For example, bottom decile fund performance means that 90% of funds have better performance.

Direct funds – Funds over which the firm has direct control.

Direct incentives – Incentives where there is a direct link between achieving a specific target and receiving a defined bonus. An example would be where an employee has a numerical target for their number or percentage of retentions and receive a specified monetary amount if they achieve the target.

Expense ratio – For the purposes of this review, expense ratio refers to the level of overall expense allocations observed in a with-profits fund, expressed as a proportion of the total customer asset shares in the fund.

Front-loaded charging structure – A charging structure on a policy whereby most or all of the initial costs incurred by the firm are recovered during the first few years of the policy, typically through allocating a low percentage of the customer's initial premiums to their chosen investment fund(s).

'Gone away' customer – For the purpose of this review 'gone away' customers are all customers firms have lost contact with or are unable to contact (excluding Industrial Branch business). This includes customers acquired as part of Part VII transfers where firms were unable to trace customers and obtained a waiver⁵⁷ and those whose assets have been placed on the Unclaimed Assets Register.

Guaranteed annuity rate (GAR) – A guaranteed minimum annuity rate specified in a personal pension contract. GARs can be very valuable to customers because they often provide higher income in retirement than annuity rates currently available in the market.

Guaranteed minimum death benefit – A minimum level of death benefit specified in the contract. In some cases this can be more than the investment value of the policy.

Hybrid firms – Firms with both closed-book life business and life business that is being actively marketed.

⁵⁷ The legislation requires that all policyholders of the transferor and transferee are notified individually. In practice, however, it is often impossible to comply with strictly. As a result, the practice has evolved of seeking a waiver from this notification requirement where it may be impossible. For example the firm's database may not hold all of the information required to enable compliance.

Indirect funds – Unit-linked funds which track the performance of a third party fund over which the life insurer has no direct control. Funds are invested in a regulated collective investment scheme or another insurer's fund (a reinsured fund). Rather than directly investing in the underlying third party fund customers are investing in the life insurer's 'external funds' version. External funds are sometimes referred to as 'mirror funds.'

Indirect incentives – Incentives where remuneration received may be influenced by achievement of a target but there is no direct link. An example would be where an employee has a retention target and receives a bonus but there is no direct link between achieving the target and receiving a specified level of bonus.

Industrial branch business – Life insurance business where door-to-door sales people collected small value premiums at the customer's home.

Market value reduction/adjustment (MVR/MVA) – A deduction which product providers may make on certain withdrawals or switches from or between with-profits funds. The deduction reflects a disparity between pre-deduction value of the policy and the market value of the underlying investments.

Median – A measure used in statistics indicating the midpoint of a range of observed values, such that there is an equal probability of values falling above or below it.

Outlier – Individual with-profits claim pay-outs (at maturity or surrender/transfer) that are a particularly high or low proportion of their underlying asset share. For the purposes of this review, we were looking specifically at those instances of particularly low pay-out relative to asset share.

Paid-up – A policy is made paid-up when a customer ceases to pay premiums before the end of the term but continues to hold the policy. Where premiums are reduced rather than ceased this is sometimes referred to as being 'partially paid-up'.

Paid-up basis – The methodology and assumptions used by a firm to calculate the value of a policy immediately following a customer making the policy paid-up.

Part VII transfer – A Part VII transfer is the common name for the transfer of a portfolio of contracts from one entity to another under Part VII (Control of Business Transfers) of the Financial Services and Markets Act 2000 (FSMA 2000). A transfer is typically used to consolidate acquisitions or run-off portfolios and to generate capital and operational efficiencies.

Percentile – A measure used in statistics indicating the value below which a given percentage of observations in a group of observations fall. For example fund performance below at least the 75th percentile means that at least 75% of funds have better performance.

Premium cessation – For the purpose of this paper premium cessation means the same thing as 'paid-up.'

Principles and Practices of Financial Management (PPFM) – A document containing with-profits principles and practices which a firm carrying on with-profits business must establish, maintain and record under COBS 20.3.

Quartile – A measure used in statistics indicating the division of a set of data into four parts each containing a quarter of the observations in a group. For example, the upper quartile value represents the observation above which a quarter of the observations fell, and the lower quartile value represents the observation below which a quarter of the observations fell.

Reduction-in-yield (RIY) – An industry standard figure given to show the effect the total charges applied to a policy will have on its potential rate of growth.

Retail Prices Index (RPI) – One of the two main measures of consumer inflation produced by the United Kingdom's Office for National Statistics.

Sharpe ratio – A measure of the risk-adjusted return of an investment. It measures the excess return for every unit of risk that is taken in order to achieve the return.

Smoothing – A standard practice used by firms in the operation of with-profits policies with the aim of smoothing out fluctuations in investment returns, through holding back some of the profit in good years in order to ensure that a reasonable return can be paid during years of poor performance.

Surrender – Surrender occurs when a customer cashes in a policy before the specified maturity date. The customer normally receives a cash amount derived from the value of the policy. The customer may be charged an exit penalty.

Surrender value basis – The methodology and assumptions used by a firm to calculate the surrender value on a policy.

Target range – The target range relative to asset share set by the firm within which it is targeting individual with-profits maturity pay-outs should fall, as per COBS 20.2.5R – 20.2.6R.

Total Expense Ratio (TER) – The ratio of a fund's total operating costs to its average net assets.

Transfer – Transfer occurs when a customer transfers a personal pension product from one provider to another.

Transfer value basis – The methodology and assumptions used by a firm to calculate the transfer value on a policy.

Unitised with-profit policy – A with-profits investment where premiums buy units in a with-profit fund. The value of the units increases in line with bonuses declared, either through the addition of units at a fixed price or through increases to the unit price.

Unit-linked policy – A policy giving access to a unit-linked fund. A Unit-linked fund is a type of pooled investment offered by insurance companies through their life or pension policies. With a unit-linked policy the premiums buy units in a fund of the investor's choice. The value of the policy is measured by the total value of the units allocated to it.

Weighted average – A measure used in statistics indicating an average from a group of observed data resulting from the multiplication of each component data item by a factor reflecting its importance (such as, in the context of our review, the number of policies in each firm).

With-profits policy – A contract falling within a class of long-term insurance business which is eligible to participate in any part of any established surplus. Bonuses, if declared, are added to the value of the policy annually. The bonuses are based on a number of factors, the most important being the fund's profits from its investments. With-profits policies can be conventional or unitised.



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