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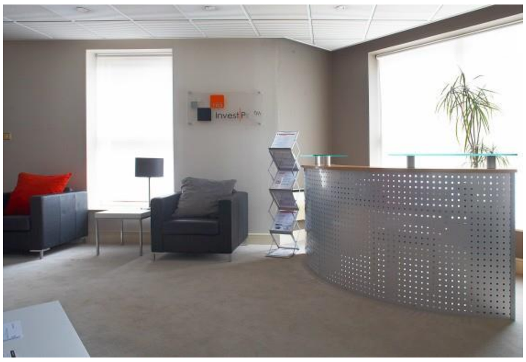

Research Update: October 2013

Thematic Review of Unit Linked Funds: Summary of FCA Findings

Unit-Linked Funds

George McCutcheon MSc FIA summarises the findings of the FCA thematic review.

Background

The FCA has today (10 October 2013) published the findings of its thematic review of unit linked funds. In this article, George McCutcheon provides an initial summary of the key findings.

The Financial Conduct Authority (FCA) findings on its thematic review of unit linked funds are consistent with Financial Risk Solutions (FRS) original expectations. In our Research Update of April 2013 we stated that "FRS anticipates that the thematic review findings will confirm that the governance of unit-linked funds in in general robust but that some issues might be identified where there is scope for improvement".
Potential issues for improvement identified in the FRS Research Update included governance structure, counterparty credit risk, outsourcing and historic pricing and these broadly correspond to the substantive issues identified in the FCA findings.
FRS will be issuing a more detailed research update on the FCA findings in due course.

Background

The FCA's Thematic Review of the management and governance of unit-linked funds commenced in Q4 2012 and became public knowledge in January 2013. The thematic review was to assess whether:

a. Firms have adequate systems and controls in place to ensure that funds are administered and managed fairly and in accordance with customer expectations;
b. Assets backing unit-linked policies are appropriate for policyholders; and
c. Policyholder benefits are calculated fairly and accurately.

Speaking at an ABI conference in July, the Financial Conduct Authority chief executive Martin Wheatley highlighted some key issues:

a) Are firms allocating a fair proportion of revenue received from stock-lending to the fund or are they recycling too much to the shareholder?
b) Are providers of unit-linked funds managing them in line with the stated investment objectives?
c) Are they transferring counterparty credit risk from reinsured funds to policyholders without asking them and without obtaining their express consent?

The FCA reviewed 12 firms, which between them manage a significant proportion of the total amount invested in unit-linked funds. It selected a broad range of firms of varying size, type and business model to ensure it was a representative picture of the sector as a whole.

Executive Summary

- The FCA found no material issues evident throughout the sample of firms that could have posed a serious threat to customers' investments. So it does not believe there are any significant widespread, systemic failings in the sector.
- The FCA did find some specific problems in individual firms, which if left unchecked could have led to customers being disadvantaged:
    - Poor oversight of an outsource service provider;
    - Insufficient controls over permitted assets; and
    - Overly-stretched operational capacity in a pricing team.

  In these cases, the FCA required Skilled Persons Reports to investigate whether customers have lost out and whether compensation is required. The FCA required the firms to make improvements in response to the detailed findings and much of this work has now been completed
- The FCA also found other areas where firms in general need to make improvements to ensure that customers are treated fairly:
    - Fair allocation of tax and stock lending revenues between customers and shareholders;
    - The identification and rectification of errors; and

- The management of potential conflicts of interest.

Next Steps

- It appears that there will be no change to regulations arising from the thematic review.
- The FCA will continue to work with the Association of British Insurers (ABI) which has committed to enhance its 'Guide to good practice for unit-linked funds' in light of the thematic review findings. This will make it clearer what good practice looks like and help introduce improvements across the whole of the unit-linked industry.

Biography; George McCutcheon MSc FIA:

Mr. McCutcheon is a graduate of University College Dublin in Mathematical Science and is a Fellow of the Institute of Actuaries. He is a director and co-founder of Financial Risk Solutions (FRS), a software company specialising in the licensing of fund administration software to life assurance companies.

He has presented a number of papers at the Life Convention of the Institute of Actuaries and has co-authored a number of papers for the Society of Actuaries in Ireland, including a 2011 paper on placing value on tax losses in unit linked funds.

About Financial Risk Solutions (FRS)

Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund accounting software to the Life Assurance and Pensions industries. It was founded in 1999 by actuaries and IT specialists and is one of the leading software providers in its sector. Its Invest|Pro™ product family is a recognised leading benchmark in the investment fund accounting area and customers are some of the biggest brands in Life Assurance and Third Party Administration including MetLife, SEB, IFDS Percana, and Accenture Insurance Services.

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

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

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