

Treating Customers Fairly (TCF): Theory and UK Practice

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Introduction:

I will start off by going back to the basics – the theme of the Conference.

Fair treatment of customers is the bedrock of any commercial or business proposition – it should be an obvious self-evident objective for every business. If the customers believe that they are receiving unfair treatment they will go elsewhere with their custom and the business will collapse. Why should it bother the regulator of any industry? Is there a presumption that, but for regulatory pressure, the industry as a whole or some part of it will treat customers (general public) unfairly and escape any adverse consequences? Or is it a political agenda on the part of the government (the real masters of every regulator) to mould business in its own image in the name of ensuing fairness? After all, like beauty, fairness is often in the eye of the beholder.

Financial Services Authority (FSA), the super regulator of UK Financial Services Industry covering banking, investment, insurance and mortgage industry, has the following Principals of Business (adopted in 2001) making specific reference to fairness.

- Principal 6: “A firm must pay due regard to the interests of its customers and treat them fairly.”
- Principal 7: Communications with Customers “A firm must pay due regard to the information needs of its customers and communicate information to them in a way which is clear fair and not mis-leading.”
- Principal 8: Conflict of Interest “A firm must manage conflicts of interest fairly, both between itself and its customers and between one customer and another.”

In addition, Principle 9 on Customers: Relationships of Trust requires: “A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.”

In 2001 not many would have anticipated these principals would become major regulatory tools in the armoury of FSA. Treating Customers Fairly (TCF) remains a high-level principle and is not capable of any precise definition: “We conclude that “fairness” is not a definitive concept. Instead it represents a series of values, which help us to decide how to behave and treat others.” (FSA: June 2001)

In 2004 FSA started shifting its focus from Rule Based Regulations to Principle Based Regulation and TCF became a main weapon of change, at least for the Life Insurance industry. Unfortunately, thanks to an endless flow of Rule based Regulation from EU headquarters in Brussels, the UK industry is now blessed with enormous rule books topped up by Principle based (and hence uncertain) Regulations.

Is TCF of any relevance for the Indian Industry?

Why should these developments in the UK market be of any interest to the industry and profession in India? Apart from strong historical links with the UK and the presence of major UK life

companies in the Indian market, can there be any other reason? You only need to look at the mission statement of Insurance Regulatory and Development Authority of India (IRDA) to see the connection (underlined by me):

*(1) "To protect the interest of and secure fair treatment to policyholders."

*(3) "To set, promote, monitor and enforce high standards of integrity, financial soundness, fair dealing and competence of those it regulates."

*(5) "To promote fairness, transparency and orderly conduct in financial markets dealing in insurance and build a reliable management information system....."

*(6) "To take action where such standards are inadequate or ineffectively enforced."

Clearly TCF is "embedded" in the IRDA mission statement and may one day come back into the limelight. IRDA is an important member of the International Association of Insurance Supervisors (IAIS). "the Authority is enriched by way of exchanges of ideas and regulatory approach amongst its members through their participation" (IRDA Annual Report 2005-2006, page 84). Compared to FSA, IRDA has adopted a light touch and more pragmatic approach to regulation. This may however change. "While the Authority has been contemplating commencement of comprehensive on-site inspection, it was considered that the registered entities should be allowed time to stabilise operations prior to taking on full scale inspection." (IRDA Annual Report 2005/06, page 47)

"The Authority proposes to put in place a comprehensive supervisory process to evaluate operations of the companies and their compliance with the supervisory and regulatory prescriptions on both financial and non-financial matters" (IRDA Annual Report 2005/06, page 48).

"The mission statement of the Authority attaches a lot of importance to the protection of the Interests of policyholders" (same: page 78).

"While framing the regulations for the insurers, the Authority keeps in mind the primary objective of protecting the interests of and secure fair treatment to policyholders" (same: pages 69 & 70).

IRDA clearly recognises the need for making market conduct regulations. However its approach so far is very pragmatic. "Market disciplines can provide right incentives for companies to act prudently and in the interest of owners and customers. This requires free and open information exchange. (IRDA) is ascribing high priority for information dissemination as an effective check against improper market behaviour." (page 89) IRDA recognises that this can be done either through regulations issued by the Authority or through a self-regulatory regime put in place by the insurers – it is enshrined in the last of the principles in IRDA's mission statement. This is consistent with Principle 2 of the IRDA mission statement: "to bring about speedy and orderly growth of the insurance industry....." The Annual Report 2005/06 says: "The Authority believes that too many regulations have the potential to compromise competition and perhaps even endorse unwanted entry barriers, restrictive practices and other anti-competitive measures. It is therefore becoming difficult to assess optimum areas for which regulations can be made when the country is moving towards a free market regime. An optimum market structure can be achieved with some trade offs between security and competition." (page 89).

The Life Insurance council plays an important role in delivering on this objective of IRDA. "The Life Insurance Council has been tackling issues of significance like mis-selling and disclosure". On Corporate Governance IRDA relies on corporate management "to conduct their business in a fair manner while keeping in view the bottom line." (page 89)

Personally I completely agree with the vision propagated by IRDA and lament that the actions and outcome of UK Regulation has moved away from such a vision. However, I have an apprehension. Is the day of judgment still to come for the Industry in India? The industry in India witnessed massive growth and changes in a very short period of time. Was this growth compliant with this regulatory vision?

What is TCF in Theory?

As already mentioned, TCF has not been defined by FSA and it thinks "that 'fairness' is not a definitive concept". It remains a high level principle, represented "by a series of values, which helps us to decide how to behave and treat others". There is also an overlap with other legal requirements like Unfair Terms in Consumer Contract Regulations, use of plain language in customer communication and any general legal duty of care. In practice, this can be a dangerous exposure for a regulated firm. Any action by the firm is open to judgment at a later date, usually with the huge benefit of hindsight, and declared as unfair. The test of fairness will ultimately be decided by the court of law. In UK that is unlikely to happen soon; firms rarely go to court against the regulator. The FSA and the Financial Services Ombudsman (FOS) will decide whether a treatment or conduct by a firm was fair or not. The firm hardly has any realistic opportunity of appeal if it does not like the decision.

Actuarial View of TCF: Life TCF Working Party Report (2007)

The UK Actuarial Profession has dealt with the concept in two reports of the Customer Interests Working Party (November 2002) and the Life Treating Customers Fairly Working Party (March 2007). The second working party's primary objective was "to understand and promote the implications of the TCF initiative to actuaries working in financial institutions" The profession wanted to "help define 'fairness' and the principles of 'fairness'." The Working Party's attempt to define TCF as a generic issue was unsuccessful, as they "kept returning to what the principle of TCF might mean in different situation". The Working Party therefore decided to consider "TCF issues in certain specific areas" and then seek and identify "common themes and high level conclusions". The focus was Non Profit (mostly unit linked) business and excluded With Profit (which has detailed and prescribed regulation leaving not much scope of discretion by the company) and the interface between the Life Offices and the Independent Financial Advisors (and other distributors). No major company in the UK market has a tied Agency force any more. The Working Party considered and reported on the following areas: Unit Pricing; Non-Profit surrender, paid-up and alteration values; Reviewable premium rates; Unit-linked discretionary charges; Critical illness business; and Product Disclosure. I recommend that all actuaries working in life offices read these carefully. These provide great insight into many practical issues relevant to actuaries in day to day operations of unit linked business. The report has one chapter on "Generic Findings". It goes on to add: "TCF is far-reaching and evolving...this paper should not be regarded as providing a definitive view. This is perhaps not surprising given that TCF is so subjective."(Italics by me)

The following characteristics of Treating Customers Fairly identified by the Customer Interest Working Party (2002), though not exhaustive, was adopted by the TCF working Party:

- Honesty, openness and transparency;
- Disclosure, on a continuing basis, of material information;
- Honouring representations, assurances and guarantees which create legitimate expectations;
- Treating like situations like and vice versa;
- Acting impartially and reasonably, having regard only to relevant issues;
- Acting with integrity and in good faith;

- Acting with reasonable competence and diligence;
- Refraining from exploiting customers or acting capriciously;
- Being reasonable about putting things right if there is a problem for which the firm is responsible;
- Being accessible to customers.

The application of fairness in real life will therefore “vary in different circumstances” and “will vary over time”.

Both working parties recognized many similarities between TCF and the concept of Policyholders’ Reasonable Expectations (PRE) that was enshrined in previous UK Regulations. PRE too was never precisely defined and it caused grief to Equitable Life when finally the Court took a view. Failure to meet PRE was a ground of regulatory intervention, as is now failure to meet TCF. The Appointed Actuary (or the current Actuarial Function Holder) has a responsibility to take into account PRE (or now TCF).

TCF has however much wider scope: it applies to a “far wider range of decisions” and applies to all financial services institutions regulated by FSA and not life offices only.

The Generic Findings of the TCF Working Party is worth summarizing:

1. Customer Knowledge and Understanding:
 - Imbalance in knowledge of insurance products between the firms and the consumers. TCF imposes an obligation on firms not to make use of the additional knowledge to the detriment of customers.
 - Discretion in non-profit products in areas like unit pricing, discretionary charges, surrender value, reviewable premium etc. Any discretion should be used fairly; discretions were often incorporated in policy terms to protect the firm’s and not the policyholder’s interest.
 - Implications for product design. TCF would mean keeping products simple, product meets consumers needs, right level of disclosures, a robust process of review that ensures delivery of the product to the right target market
2. Documentation and Communication:
 - Comprehensive Internal documentation of how discretion is exercised and how practices are applied; to be maintained and updated regularly; evidence of governance arrangements for approval of material changes.
 - Communication with customers; at the point of sale and then through out the life cycle of the product; to decide what needs communication: policy features, risks, costs, potential benefits; fund updates etc. Timely communication, concise, clear, plain language, consistent, relevant, compliant with regulations.
 - Constraints from past documentation and communication. What was considered suitable in the past may now be considered inadequate, causing unwanted and undesirable constraints for the firm. The firm may not be able to increase premium on review or may be forced to give unintended guarantees.
3. Retrospection: Firm’s and Regulators practices and standards change over time. The customer may expect today’s standard and the regulators or the ombudsman may directly or indirectly force the firm to accept today’s standard (mostly on ground of ‘inadequate’ record keeping). The firm may as a result incur a cost that was not provided for when the contract was sold. The standard may even apply to past customers, whose policy matured or was

surrendered some years back. Retrospective review or compensation has blighted the UK Life offices in last two decades.

4. Materiality and small group of customers.
5. Impact of TCF on Reserves and Profitability.
6. Governance:
 - Governance from the firm's perspective. Responsibility of the firm's governing body; actuaries will have significant roles to play. The firm should have a formalized and documented process on their own interpretation of TCF; legal advice will be essential. System and Controls; regular review and reassessment of the frame work.
 - Role of the Actuarial Function Holder
 - Reference to 'Actuary' in policy conditions
 - Actuarial guidance
 - Third parties: Involvement of a Third party like service provider, outsourcers etc does not lessen the TCF responsibility of the firm.

TCF in Practice

Compliance Professional View of TCF.

A friend of mine, a well known compliance professional with experiences of working in UK regulator and large consultancy firms like PwC and KPMG, is currently part of a specialist regulatory consulting firm called Beachcroft Regulatory consulting. I will quote from Beachcroft's electronic news bulletins and survey to give another perspective of TCF. The news bulletin is for information only, some of the views are mine and the said company assumes no responsibility for any opinion or view.

November 2007 Beachcroft News Bulletin: The FSA TCF Conference

"The FSA held their third annual TCF conference... Sadly, we are not aware of anyone in the audience rating this a rollicking success. Indeed, there is a muttering that the FSA is losing its way on TCF. There seem to us signs of firms and the FSA becoming frustrated with one another. The FSA is fed up with what it sees as lack of progress and engagement. Firms are fed up that they are not sure what the FSA wants exactly and in the drive towards culture change it has offended some whose culture is fine as it is and made no impact on others who should be changing.

We think some quite deep seated problems here are beginning to surface. FSA are not wrong to seek the changes they seek in some cases, but they can not get their message across to the right people and the message is not quite right either..."

"To understand the issues here it is necessary to go back to what the conduct of business regulatory regime is. Simply, it is to address the problem of incentive caused bias. It is important to keep in view that it is nothing more and nothing less than that.....this dysfunction is exemplified by well known phenomena such as product providers increasing commission to increase market share...."

"FSA should confine its analysis of market failure ... focusing (on conflict of interest arising from) incentive caused bias..."

October 2006 News Bulletin: Principle Based Regulation and COB Simplification:

"FSA (just) published its massive consultation papers (CPs) which consult on COB Simplification and implementation of MiFID requirements... FSA clearly regard the current regime as being out of balance and see a need to shift from prescription and towards principles. They think this will take some time to achieve. Perhaps more significantly, they believe prescriptive regulation has potential to grow exponentially and this is reason enough, on practical grounds, to move away from prescriptions..."

However, the FSA is "finding it difficult to resist the pressure to extend (rule based) regime... because the principle of detailed prescriptive rules have been conceded elsewhere in the regime...Europe was unlikely to embrace principle based regulation all that quickly. MiFID in particular contains high levels of prescriptions, limiting the scope for FSA to exercise risk-based judgment....The Consultation Papers show just how the FSA's hands are tied." [CPS had 350 pages of NEWCOB, 400 pages of draft rules and 82 pages on Fin Prom. What a simplification!!]

Survey on Management Information used to measure TCF: November 06.

(Note: Due to relentless FSA hammering in 2006/07, the position should have improved/ changed significantly by the end of 2007)

The participants were spread over the financial services industry, including well known institutions, covering Life and General Insurance, Banks and Building Societies.

The questions and the responses are summarized below

Q1. Who receives TCF MI and how often?

Only half the respondents specifically indicated that the Board and Executive Committee of the Board. This may represent insufficient challenge and direction to the Management by the Board on TCF issues. Most (over 80%) of Senior Management receives TCF MI, mostly on a monthly basis, though some data may be available only on quarterly basis depending on the type of information and business units. Only a minority of respondents indicated line management as the recipient of TCF MI. This might have been an understatement. However, there may be a danger that the line managers and the staff with day to day direct contact with customers are not fully engaged in TCF initiative, resulting into a disconnect between the executives/senior management and what happens in practice.

Q2: What area of the business do you get information on to assess your status on TCF?

All firms obtained Complaints Management information. 80% obtained Sales Standard information and On-going Surveys. 70% got New Product Launches (rest were closed to NB and hence not applicable) and Claims Management Information (not applicable for the rest).

Q3: What do you analyse?

3.1. New Product Launches. 60% of the respondents indicated that they undertake a post launch analysis for TCF purposes; 20% open to new business did not. "FSA would regard post launch analysis of the actual sales population against the originally targeted and anticipated ad a key tool in monitoring the effectiveness of TCF vis a vis new product launches."

One life office uses the following additional information for this analysis: Complaints, Persistency, Client profile, Technical/ Product queries and Performance against service standards.

3.2. Sales Standards: The nature of any sales complaints, particularly by tied agents, is consistently analysed. Tricky area is the sales by IFAs. Some companies monitor complaints, customer feedback and technical queries by IFAs. FSA is particularly concerned that the providers are not monitoring the quality of IFA sales more closely to ensure that customers are treated fairly.

Other information gathered in respect of sales standard is: sales quality error; persistency; and Training of sales and related staff (pass rates etc).

3.3 Existing/ Past Product Review. The respondents are generally proactive in their review of existing / past products, with one life office running a specific project on looking at the past product obligations to the customers. The type of information analysed are: Servicing standards and actual customer experience; adherence to contract terms and promises; and whether policyholders reflect original target population.

3.4. Fund performance: By ranking; Duration of Ranking; and Investment Management Staff turnaround. All life/ investment offices do such analysis.

3.5 Service Standard

3.6 Claim Management; All firms analyse claims complaints in some details. 20% unfortunately did not analyse the declinature rates. This has become an area of focus by FSA and Office of Fair Trading (OFT).

3.7 Complaint management: 100% firms make detailed analysis of Complaints data. Type of analysis is: Backlog and time taken to complete investigation; FOS Overturn rates; Complaints satisfaction level; root cause analyse; Breaches of Complaints Rules

3.8 Other General Information analysed for TCF purposes: Customer Survey Reports: Employee Survey Reports: Audit/ Monitoring Reports; Regulatory feedback; Product/ Technical queries; Salary, incentive and other remuneration levels; Exit interview of staff.

Q4: How do you obtain information on Customers being treated 'fairly' as opposed to being simply content?

- Use of Statistics 70%
- Mystery shopping 60%
- Customer Feedback 60%
- Staff Feedback 60%
- Independent reviews 50%
- Remote Listening 40%
- Press Coverage 40%
- IFA Feedback/Loyalty 30%

Q5: How do you assess success in implanting TCF?

- Score card 60%
- Comparatives over time 80%
- Comparatives against peers 40%

Q6: How will you know when you are TCF Complaint?

This was a deliberately provocative question! The responses were non-statistical, in the form of statements. Some viewed it as an ongoing process of improvement. Most relied on subjective judgment by management that TCF is actually embedded in business; external review; difficult to judge etc.

The survey concluded with the following: "We remain nervous as to how principle based regulation, and the TCF Principle in particular, will be applied in practice... while it is right for firms to recognize that TCF is an ongoing process, firms should give greater thought as to how they can say, with confidence, that they are complying with the TCF principle."

A Reinsurers' point of view:

Source: In Focus, Issue No.32, December 2007, Hannover Life Re: 2007 and Beyond (for the UK Market) by David Brand, MD for UK.

"Non disclosure is more of a problem than ever. The protection gap shows no sign of narrowing (life protection market is not growing, inspite of endemic rate cutting in term insurance market)... income protection is still not selling. Is there an underlying problem there?.. I believe there is. Quite simply: the public don't trust us. Unless we begin to improve the public's perception of this industry...we will still be confronting a very similar set of problems for many years to come....This time last year I remember arguing that a 20% rate of claim declinature in the critical illness arena was unsustainable. This year the issue has broadened to take in how and why claims are turned down.....Grieving wives and ombudsman have equal difficulty in understanding why a husband's non-disclosure of an apparently minor and unrelated condition- bad back for example- should result in non-payment of a death claim when he dies in a car crash two years later...."

".. We have failed to convince our target market as to the value of health products we see as essential.. So where do we go from here? The imperative of Treating Customers fairly (TCF) is a well known concept in the insurance market. How do we treat our customers fairly? In a nutshell, by designing new worthwhile products that customers want to buy and that pay out benefits when they expect. Can we ever get away from the idea that insurance is sold and not bought? (Italics by David Brand; underline by me) May be not, but if we can regain the customer's trust it needn't be quite such a hard sell."

FSA TCF Reviews:

In 2004 FSA Published "Treating Customers Fairly- progress and next steps", presenting the product life cycle as a frame work for assessing different aspects of TCF and suggesting that the senior management consider, at each stage of the cycle, whether enough attention is being paid the fair treatment of customers.

In 2005 FSA published "Treating Customers fairly- building on progress", results of their investigation and weakness that needed to be addressed. In 2005 FSA also published a product design cluster report detailing good and bad practices on product design. They also produced case studies on product design in 2005 and 2006.

In July 2006, FSA published "Treating Customers Fairly- towards fair outcomes for Consumers" This paper developed six outcomes for customers and stressed that the firms should focus on achieving these outcomes. One outcome relates to product design. More on this report will follow.

In May 2007 FSA published the results in relation to the progress of firms against the March 2007 deadline that all firms should be implementing TCF “in substantial part of their business” It highlighted the importance of MI in proving that the firms were treating customer fairly and to show that they are delivering on these six outcomes.

More Regulatory Guides were published in Mid 2007 on responsibilities of Providers and the distributors. In July 2007 it also published findings on “TCF on product Design”. It described considerations for treating customers fairly in product design. This merits a separate paper on TCF and product design. I strongly recommend any actuary with responsibility for product development publications to study these and other relevant FSA papers; regulatory obligations apart I believe these recommend very desirable and good commercial practices.

The sheer volume of these and other publications rule out any attempt by me to even capture the essences of all these initiatives/ reviews/ reports.

I will now come back to the July 2006 FSA Paper. In this paper, FSA postulated six desired improved outcome for the consumers if TCF is fully embedded in a business. These outcomes are:

- *Culture*: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- *Product Design*: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumers groups and targeted accordingly.
- *Customer Information*: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- *Advice*: Where consumers receive advice, the advice is suitable and takes account of their circumstances.
- *Service*: Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect.
- *Post Sale Barrier*: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

FSA then described what a firm that has successfully embedded TCF would look like.

- Fair treatment of consumers is established throughout the firm: in system & control, business culture including strategy, training, remuneration, governance and staff behaviors.
- Recognition that TCF is an on-going continuous process and not an one-off project; TCF should be built into all major processes and should automatically be taken into account in all business decisions.
- Adequate Management Information is available for the firm to monitor delivery of TCF and
- Demonstrated improved quality of outcome actually experienced by the firm’s customers.

Based on MI received and other works, FSA survey findings of actual state of the industry on implementation of TCF were:

- FSA was pleased with the senior management involvement on TCF initiative, but had doubts how far TCF is embedded in the corporate culture; for example in HR policies, remuneration structure and Training & competence of front line staff.
- Significant shortcomings in the clarity of communication and documentation provided to the customers, before, during and after the point of sale
- Indicators suggested that the overall quality of advice given to consumers needs more attention and that some firms are not taking steps to limit the risk of mis-selling.

- Progress of implementing TCF MI was not consistent across all firms. Many firms had difficulty differentiating the evidence they use for measuring TCF are in fact delivering fair outcomes. It is not clear that the MI is capturing fairness instead of customer satisfaction. Sales and Complaints MI are getting collected, but not enough MI was available on product design, financial promotion and post-sale communications.
- Not enough evidence that the firms are using the MI and lessons learnt in product development process and monitoring of any remedial action required.

Things have moved on since July 2006, as indicated earlier.

How does the firm demonstrate that FSA desired outcomes are getting delivered?

Every firm, depending on its business model & strategy, target market, operational plan and organization structure, will have to design its own response to the challenge of demonstrating that these six desired outcomes are actually getting delivered. Based on my experience I would describe one such approach.

To start with, each of these high level outcomes should be broken down into a more detailed list of desired outcomes. Next step would be to identify how to measure a desired outcome and what would be an appropriate bench mark for a satisfactory performance. The bench mark measure is to be periodically compared with the actual and any shortcoming be identified, followed by rapid remedial actions.

I will give one example on the outcome 'Culture'. Corporate Governance may or may not be included in this category; it is a separate agenda for FSA anyway. In really good governance is central to the culture issue. Is there sufficient evidence of a culture of challenge built into the decision making processes right from the floor level to the Board level? I will ignore this issue and concentrate on three other dimensions of company culture: People, System and Control. Here are a few examples of desired outcomes:

- Do the staff members view the company as treating its customers fairly in day to day operation? This can be measured by regular staff surveys, asking a specific question on this line. The participation rate in the survey itself is a good indicator of staff involvement in the working of a company. A low participation rate would indicate a problem. An 85% positive response to the specific question may be the benchmark for satisfactory outcome. A lower figure should trigger investigation. Exit interviews done when an employee leaves the company voluntarily is another measure. Any adverse comment on less than fair treatment of customers should be investigated. The employees should be encouraged to bring to the attention of management (often on a no name basis to protect the identity of the person) any perceived unfair treatment by another colleague or manager. A voice box or a post box can be provided for the purpose. Or a designated official should be available for notifying any failure.
- Periodic and Regular Customer surveys: this is a powerful tool. Surveys should cover a range of customers who came in contact of the company in a period, say previous 3 months. All major areas like NB, claims, surrenders, premium and other enquiries should be covered. Adverse comments should be investigated and actioned appropriately.
- Survey of Sales Intermediaries: Separately for tied Agents and IFAs; by other distribution channel. In addition to specific surveys related to sales or product design, more general survey on consumer satisfaction and fair treatment should be done from time to time. Do

they and their clients find it easy to deal with the firm in doing business? Industry awards/recognition by the IFAs is also a measure to a limited extent.

- **Complaints handling:** Are the front line staff, including call centre staff, trained to recognize a complaint? Complaint is an expression of dissatisfaction, right or wrong, done verbally or in writing, some time not explicit but demonstrated by the tone of a letter or conversation. Are all complaints received recorded in a complaint data base and then investigated? A sample check of all letters or calls made in a random past period can be a measure and a recognition failure rate of say over 10% can be the bench mark.
- **Staff communication:** Is there a set structure of cascading information from the top to the bottom of the organization? Is it functioning properly? Is it adequate? Is staff communication clear and effective? Does staff communication explicitly and regularly draw attention to their TCF obligations? Regular staff survey is a measure and 85% positive response to one or more specific questions in the survey may be the bench mark.
- **Staff Training and Competence;** for new staff as well as existing staff. Is a proper T&C Scheme in place? Does it cover technical and other general skills? Targeted training on specific areas of concern/risk? Are staffs encouraged to acquire external professional qualifications? Is voluntary turn over of staff excessive?
- **Remuneration and Reward Structure:** Is it likely to cause any bias against fair treatment of customers? Excluding remuneration to sales people, is the staff bonus /reward scheme aligned to the TCF principle?

A similar exercise is to be done for the other five areas of FSA desired outcomes. December 2008 is the FSA set target date for firms to demonstrate that TCF is fully embedded in their business. The day of judgment will arrive in 2009.

Is there any lesson for the Insurance Industry in India?

Fairness is a good business Principle & Practice anyway:

Forget the regulator for the time being. No one in business will seriously argue that it does not wish to treat its customers fairly. No individual business or industry will survive for long if the customers feel that they are not getting fairness in dealing. Instead of FSA if some of these reports were commissioned or produced by the industry body or by management consultants, many of the suggestions/solutions would have been accepted anyway by a serious player in any market. The work done by FSA provides a template for the management of Insurance and Financial Services companies anywhere in the world to check whether fair treatment of customers is embedded in their business and if not, what changes are required in the way business is currently being conducted. I certainly recommend the senior management and actuaries working in Life and Non-Life Insurance in India to study these works from that perspective.

It is all very good in theory, but the voluntary practice may be more problematic. What about possible conflict of interest with other stake holders in the company like shareholders, employees, third party providers etc? It is not always easy to resolve such conflicts delivering fairness to all parties. There is always a trade off between cost and what can be done realistically and voluntarily. For example, a fault free super star post sale service standard will drive up operational cost and may actually be detrimental to the interest of the company and the customers. This is particularly true if there are constraints like maximum cap on expenses due to regulatory pressure or competition.

There are other difficulties too. The Insurance industry has and always had a serious existential problem; the manner in which its products are sold. For over a century or two, it was accepted through out the world that insurance is sold and not bought. Is it fair or acceptable any more? I suspect some regulators do not like any insurance product to be sold if it is not bought. They want the insurance agent to give advice only and not sell. Not many however pay for advice, particularly if the advice after hours of discussions and analysis is to put your money in bank deposits. Further, a commission based agency force (tied or independent) with a serious upfront cost is not exactly a cost effective and efficient way of selling a product that allows recovery of the initial cost only if there is a sale and then if the contract runs for at least a few months/ years. Even if the company's upfront cost is recovered fully with early termination of a contract (due to surrender or lapse) the customer is likely to loose heavily. Is it fair to pay NIL cash to a customer who paid premiums under a with profit endowment policy for 2 years and 10 months? Or a fraction of the premium paid in case of a unit linked contract? If he/she had taken a term insurance and invested the rest in a monthly deposit account in a bank or in a post office, he/she would have been far better off. The problem of bias gets worse if there is a differential structure of commission. Is there a problem of fairness at the heart of insurance selling?

In my view, the UK regulation has killed off Insurance agency force tied to individual life companies. Today's IFAs are yesterday's tied agents and with tied agency disappearing they too may face extinction in due course. No viable alternative way of selling insurance has emerged. As a result, inspite of rising income and full employment, insurance and other forms of savings has collapsed in the UK in the past decade.

The state of the industry in India since liberalization:

From the IRDA Annual Report 2005/06, I have summarised the state of the industry since the entry of private insurers in 2001. I apologies for not making use of the latest data due to lack of time and other resource constraints. But I believe the shape of the industry, in substance, has not changed in the past one year and the following themes are still valid.

1. Since the opening of the Indian market to private insurers in 2001, 15 life and 11 General Insurance Companies started new operations, mostly in joint venture with well known Insurance Companies from Europe and North America.
2. Since the opening of the market, in six years (info 2006) the annual growth of First Year Premiums was 37% in the life segment and 15.72% in the non-life segment of the industry. Life Insurance penetration has increased from 2% in 2001 to 2.53% in 2005. The proportion of insurance funds to financial savings was 14.2% in 2005-2006 which is 2.4% of the GDP at current market prices.
3. The private companies grew at a much faster rate than the existing public sector companies.
4. Single Premium business has increased massively since the private players entered the market. The growth in Life Premiums was driven by the rise of unit-linked business, "possibly the single largest innovation in the field of Life Insurance." Pension products have become significant – 15.55% of FYP in 2004/2005 and 22.1% of FYP in 2005/2006. Annuity business constituted 6.7% and 4.3% of FYP in these years.

5. "Growth in the insurance industry has been spurred by product innovation, sales and distribution channels being put in place by the industry coupled with targeted advertising and marketing campaigns launched by them."

"While agency force remains the mainstay of most insurance companies, insurers are making efforts to explore new channels." Alternative channels of distribution like bancassurance, direct marketing, internet and telemarketing was introduced – "Most companies have successfully tapped the bancassurance route both with commercial and co-operative banks." One significant deliverance of competition is the large reduction in pure protection (Term Assurance) cover.

6. There has been a shift of investment of Life Funds in favour of Unit Linked Funds – "more pronounced in the case of private insurers, in whose case the investment out of Unit Linked Funds accounted for 61.85% (2005/06) as against 46.92% in the previous year."
7. Micro-insurance: IRDA introduced regulation in November 2005 providing a framework for insurers to provide insurance products through micro-insurance agents like, Non-Government Organisations (NGO) and Self Help Groups (SHG). Minimum Qualification and Training requirements were relaxed for Micro-insurance Agents.

8. Life Insurance sales by sales channels (2005/06)

	Tied Individual Agents	Corporate Agents		Brokers	Referrals	Direct Business
		Banks	Others			
Private Sector	59.71%	16.87%	8.92%	0.83%	7.06%	6.61%
LIC	98.37%	1.25%	0.32%	0.06%	0	0

9. a) "At present there are more than 20 lakhs (2 million) individual agents and nearly 5,000 Corporate Agents."

b) Agents licensed by IRDA in 2005/06 for Life Insurance:

	Individual Agents		Corporate Agents		Urban	Rural	Total
	New	Renewal	New	Renewal			
Private Sector	239,080	10,398	74	67	222,508	27,112	249,620
LIC	155,250	316,752	16	59	186,919	285,157	472,076
Total	394,330	327,150	90	126	409,427	312,269	721,696

Of the new Private Sector Insurers, the number of New Individual Agents recorded in 2005/06 (over 10,000) were:

Allianz & Bajaj	78,826		AMP Sanmar	14,034
ICICI Prudential	41,552		ING Vysya	13,689
Tata AIG	18,051		Max New York	11,941
HDFC Standard Life	14,762		Birla Sun Life	11,101

10. While expressing great satisfaction over the progress made by the industry in the recent past, in the "Concluding Remarks" IRDA Annual Report expresses the following concerns:
- a) "The sudden demand for a large Tied Agency force had an adverse affect on the quality of the training imparted by the Institutes.....resources of the Institutes are overstretched.....some did not have the infrastructure to conduct classes and the faculty was drawn on an adhoc basis; and courses were conducted in a short span as a result of which many agents did not receive adequate training.....The insurers, in their anxiety to recruit agents, did not pay any attention to the quality of training imparted."
 - b) "It will be in the interest of all that the agency force is properly equipped with the insurance knowledge, as the insurance products are no longer simple and the agents are supposed to advise the consumers over the appropriate policy considering their requirements."
 - c) "Instances have been noticed where the sanctity of the examination process was compromised by a few interested parties."
 - d) "of late, the Authority has come across cases where corporate agents have resorted to use of introducers or finders or sub agents who, in fact sold the contracts and the corporate agent passed on varying levels of commission to them."
 - e) "Though aggressive selling of insurance in the short run may help rapid growth, in the long run it might lead to a situation where the insurers may not be able to honour their commitments."
 - f) "The language of the insurance contract has traditionally been unfathomable except to a privileged few!" The insurance contract is a promise that should be clear and precise (in plain language) "describing what is being promised and when and under what circumstances those promises would be honoured" and "limitations of the contract. This becomes important because the insured does not have the complete information and the wherewithal at his disposal to understand fully what he is buying. Because of this the insured has to rely totally on the insurer."
 - g) IRDA realises the importance of market conduct regulations, but at present would prefer self regulation by the industry, as it believes too many regulations will lead to "unwanted entry barriers, restrictive practices and other anti competitive measures. The Life Insurance Council representing the industry has been tackling issues of significance like mis-selling and disclosure." IRDA is clearly aware of potential mis-selling.
 - h) IRDA talked about the importance of Corporate Governance, the need to conduct business "in a fair manner", challenge to and scrutiny of the CEO by the Board, prudent investment management with integrity and public accountability, fiduciary duty owned by the insurers and transparent conduct of business.

Concluding Remarks: "Ashani Sanket" (Distant Thunder):

Ashani Sanket (Danger Signal) is a novel by Bengali writer Bibhuti Bhushan Bandopadhyaya, author of Pather Panchali and Aparjito, all three made into well known films by internationally acclaimed film director Satyajit Ray. The bright clear sky of a rapidly expanding, growing and changing Life Insurance Industry in the equally impressively growing economy of India may have the distant thunder of a gathering cloud. Every smoke has the potential of causing a wild fire. The IRDA Report

does mention a few potential areas of concern, as stated earlier. I have witnessed a gathering storm suddenly bursting into a deluge in the UK industry. The new dawn of personal pension introduced in 1988 as a liberating event turned into the worst nightmare in 1993/94 for the entire Life & Pension industry in its two centuries of existence. When millions of ordinary people were getting out of company pension schemes and buying personal pensions instead, the actuaries working in Life Offices mostly remained silent and did not flag any potential pension mis-selling problem. Same was the story when hundreds of thousands of newly introduced Low cost or worse still Low cost Low start Endowment Policies were sold in the eighties and nineties as repayment vehicles of housing loans/ mortgages. When interest rates were high and the stock market was booming, these policies delivered good results. By Y2000, with declining interest rates, and reducing return from stock market, bonus for endowment policies started falling sharply and the Mortgage Endowment mis-selling finally arrived in public domain to haunt the product designers. Till 1999, the actuaries or the management did not investigate whether these products were suitable during their life cycle for the purpose of repaying housing loan for all clients who were sold such policies as alternative to repayment mortgage. The UK regulators too did not cry foul for a long time. When they eventually did, they did so with vengeance and the consequence is decimation of endowment policies and massive compensation bills for the companies...

Fair treatment of customers is clearly and explicitly enshrined in the Mission Statement of IRDA. Till now it seems IRDA has no TCF type initiative in mind; the Authority does not talk about principle based regulation instead of (or in addition to) rule based regulation. But things may change in the future; say due to pressure from consumer groups or legal activism and the rise of compensation culture. If, following the lead by FSA, the IRDA (and some other members of International Association of Insurance Supervisors) decides to introduce TCF type tests, will you be able to demonstrate that you are TCF Compliant? That too retrospectively?

TCF or no TCF, some day in the future IRDA will start company visit to assess regulatory compliance and may find things that might require retrospective corrective action and redress. Are you confident that the massive growth of agency force and business, introduction of innovative but more complex products were all done in full compliance with IRDA Regulations? Was fair treatment of consumers compromised to any significant degree? Did the product design process specifically identify the suitable target client group? What were the risks (and probabilities) that the client's objectives for taking the insurance contract would not be met? Was there any post-sale analysis of New Business done by the company to demonstrate that the actual sales were confined to the target group only? What evidence do you have to show that the sales person properly understood the risks of the products from the client's perspective? Did they correctly consider the risk appetite (ability to bear the down side risk of unit linked investment for example), priorities and affordability of the client? Is there evidence that the risks were discussed with the clients? All these questions should be examined from the point of view of ordinary consumers, not from the company's view or from the view point of an actuary or an accountant or a PhD in Economics.

Before I stop, I will pose a few other questions to ponder.

- Life Insurance agents tied to a Life office have disappeared in the UK market. None of the UK Based Life Insurances Companies operating in India run any tied agency force in their home market. All of them disbanded their agency net work and now rely on getting business from independent brokers. Most European and North American companies operating in India have either sold their UK business or stopped selling using their own agents. Yet all of them (in agreement with their JV partners of course) have recruited vast numbers of individual agent in a short time to sell large number of insurance policies, often new products not familiar to the consumers in India. If tied Insurance agents are unsuitable for UK, why not so in India?

- With Profit Endowments, the bread and butter business for more than a century for life insurance industry everywhere in the world, have suddenly fallen out of favour in the UK market. Hardly anyone sells new With Profit policies these days. Why did it become an unsuitable product in the UK market? With Profits are still sold in large quantities elsewhere, including in India. What is so different in UK compared to the rest of the world?
- The statistics in IRDA 2006/06 reports give information on complaints from the Ombudsman's office. The numbers are growing, but are still relatively small. Most complaints are related to claim settlement, delay or repudiations of claims. A significant number of complains to the Ombudsman are either upheld or settled 'out of court'. Mis-selling is dealt with by the Life Council and no data was supplied in the report. Individual companies must have received many more complaints of all types. Do the actuaries get involved or receive feedback of complaint experience analysis? Have you done root cause analysis and used the information in reviewing product design and development processes?
- Persistency Statistics: A very powerful and critical indicator of 'churning' leading to serious losses to the customers and also of mis-selling. What is individual company experience by source of business, by salesman, by product, by duration or by any other cause/factor?
- Massive growth of unit linked business is a good story as long as the stock market is growing. It may turn into a nightmare if the equity market in India suffers a down turn. Have you considered offering some form of guarantees to protect the customers from down side risks? Why not Variable Annuity for Indian market? These are neither variable nor annuities; these products are simply unit linked investments in Life Insurance or Pension wrapper with four major types of guarantees, administered by dynamic hedging. Some of the foreign companies operating in India are enthusiastically promoting these unit linked products with guarantees in American, European, UK and Japanese markets on the understanding that consumers like some form of guarantee.
- What distinguishes Life Insurance and Pension companies from an Investment company like Mutual Fund or a Savings Bank? If we don't provide risk cover against death, longevity, morbidity or investment risks, why should we exist as a separate industry? In one extreme, some Life Insurance and Pension companies in UK market only sell products under insurance or pension wrapper, with very little or no risk cover at all.

I have ended up with a long article. Nothing original, but my intention is to stimulate a dispassionate debate in the right quarters. As I am deeply indebted to the Life Insurance Industry and the Actuarial Profession in India, I wanted to draw attention to potential pitfalls when the going is very good indeed. Recent success of the profession and the industry in India deserves admiration and congratulation, but it is also the time for sober introspection.

About the Author:

Dilip Charan Chakraborty currently works at the UK operation of Canada Life as its Finance Director for UK Life Insurance and Pension Business. Amongst other things he is responsible for the Actuarial Product Design team, the Central Technical Unit and all pension related issues of the company. His previous assignment was that of Actuarial Controller responsible for corporate actuarial, valuation and regulatory return activities. Earlier he was the Head of Pension Mis-selling Review and other Past Business Reviews.

After doing M Sc in Physics from the Calcutta University Dilip Chakraborty joined LIC in November 1969 as a Direct Recruit Officer and worked in various operational areas in India till he took over in 1991 as the Chief Manager of LIC's UK Branch. He was also the Surrogate UK Appointed Actuary for the office from 1993 to 1998. He returned to India in 1998 as the Chief (Pension & Group) of LIC. He took early retirement from LIC in 1999 and joined Canada Life in UK

Dilip Chakraborty started actuarial studies in 1981. He was awarded a bursary for his performance in the early part of the examinations. He is the representative of Indian actuarial profession in the EU, including UK.