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Impact on the UK market of "Treating Customers Fairly"

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Impact on the UK market of "Treating Customers Fairly"

- A brief history of UK regulation
- What does "TCF" mean
- Implications of TCF for insurers
- Risks and issues arising from TCF
- Case Study 1 – Management of with profits business
- Case Study 2 – Reviewable Rates
- Conclusions

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A brief history of UK regulation

- Policyholders' Reasonable Expectations (1973)
- Financial Services Act (1986)
 - Polarisation
- Hard disclosure (1994)
- Financial Services Authority takes powers (2001)
 - **Founding principle 6:** A firm must pay due regard to the interests of its customers and treat them fairly
 - "Treating Customer Fairly" launched
- Depolarisation (2005)

What does "Treating Customers Fairly" mean

- Principles-based regulation
- Applies to all regulated retail financial business
- Fair treatment of customers must be embedded throughout business
- Likely to be a process of continuous improvement
- "Fairness" is not defined
- "Complex products and poor customer capability leads to an imbalance of information and understanding" (FSA)

Implications for insurers

- Good common sense customer focused decision making
- Need to “look through” to end customers – relying on distributors alone to ensure understanding and suitability is not enough
- TCF is big – consideration of all stages of product life-cycle
 - corporate strategy and culture;
 - product design and governance;
 - identified target markets;
 - marketing and financial promotions;
 - sales and advice process;
 - remuneration of sales force and advisers;
 - information provided after the point of sale; and
 - complaint handling procedure
- On the agenda for FSA visits
- Evidence of effective delivery required

TCF responsibilities

- Board
 - “The responsibility for delivering TCF lies with firms’ senior management, who need to be intelligent, thoughtful and effective in their implementation of the TCF requirement” (FSA):
 - Develop culture that meets TCF at all levels
 - Establish TCF programmes and set key guidelines
 - Monitor achievement
 - Delegate powers to meet TCF
- Actuaries do not have any specific responsibilities but:
 - Advice must take account of the interests of policyholders
 - Ensure that management information is available to monitor all aspects of relations with policyholders throughout the life of the policy

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Achieving TCF

“Blend of regulatory and market -based solutions”

Several sticks:

- Authorisation
- Standard setting
- Supervision
- Enforcement
- Statements of good practice
- Lots of documents illustrating good and bad TCF

Two carrots:

- If firms treat customers fairly this will increase consumer confidence in the firm and the industry
- Increased consumer confidence will be good for firms as it will mean
 - Higher sales from happier customers
 - Less intrusive and less costly regulation

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How do you evidence effective delivery across whole business?

- Establishing TCF programmes
- Formal committees with documented decisions
- Product development check lists
- Research projects to evidence customer understanding
- Systematic consumer risk “brainstorming” meetings
- Comprehensive reviews of existing products and processes
- Processes to ensure learning points remembered and addressed
- Reviews of all literature and documentation
- Training for staff on TCF
- Internal communication programmes
- Formal sign off for all external communication
- Complaint handling processes and training

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Requirement to Treat Customers Fairly

Product development

- Need to research target market
- Need to stress test the product from a consumer's point of view
- Need to test that literature clearly communicates the risks and benefits of the product to target consumers
- After-sale surveys to test the level of understanding amongst customers
- Check that purchasers fit into target market

Requirement to Treat Customers Fairly

Administration and policyholder communications

- Good clear information at all stages
 - Information on policy anniversaries
 - including minimum factual information on changes in policy value as well as contributions, withdrawals and deductions during the year
 - Information must relate to reason for purchase
 - Options highlighted
 - When options become exercisable
 - Maturity and claims
 - Surrenders
 - Information on alternatives
 - Fairness between contract types and policyholders
 - Market Value Reductions (MVRs) for with-profits policies
 - Policy reviews
- Complaints
 - Define complaint types carefully and distinctively
 - Admit mistakes quickly and settle early
 - Monitor complaints by volume, product and issue
 - Establish feedback loops

Risks and Issues arising from “Treating Customers Fairly”

- Concept of fairness changing over time
- Consumer understanding
 - Prevailing customer apathy towards financial products
 - Enabling customer understanding of unavoidably complex products
- Retrospective tests by regulators
- Changing organisational culture
- Third party outsourcing
- Reinsurance arrangements
- Documentation of sales
- Lack of data on existing business
- Seen as a “fad”

Case Study 1 – TCF and the Management of with profits business

- Governance arrangements
 - With Profits Committee
 - With Profits Actuary
 - Policyholder representative if carrying out estate attribution or financial restructuring
- Principles & Practices of Financial Management (PPFM)
 - Sets out the discretion retained by the insurer
 - Explains how this discretion will be exercised
 - Principles are broad standards reflecting the insurer’s approach to longer-term changes in the business and economic environment
 - Practices describe the insurer’s approach to short-term changes and must contain sufficient detail to enable a knowledgeable observer to understand the risks and rewards inherent in taking out a with-profits policy

Case Study 1 – Implications for financial management of with-profits funds (1)

- **Estate**
 - No longer able to reduce payouts to build estate
 - No longer able to maintain estate in excess of financial requirements
- **Smoothing Policy**
 - Maturity payouts to fall within a target range expressed as a percentage of unsmoothed asset shares
 - Constraints on the term over which payouts smoothed and how fast maturity payouts can be cut
 - Reversionary bonuses vs Terminal Bonuses
 - Market Value Reductions (MVRs) and surrender penalties must reflect surrender volumes and the impact on remaining policyholders

Case Study 1 – Implications for financial management of with-profits funds (2)

- **Investment policy**
 - Proportion of real assets (equity, property)
 - Management of guarantee costs
- **Costs charged to asset shares:**
 - Retrospective guarantees costs generally not appropriate
 - Expenses must relate to the operation of the with-profits fund
- **Ability to write new business**
 - Impact of new business on existing policyholders must not be negative
 - Regularly review whether closing to new business is in the interest of existing policyholders

Case Study 2 – TCF and Reviewable Rates

- Reviewable rates (or charges) used to protect insurer against unforeseen changes
- Often intended to only be used in extreme circumstances ...
- ... and only to increase rates/charges
- Circumstances not well-defined
- Changes often at the discretion of the actuary
- Reviews may not have been undertaken if “extreme circumstances” have not arisen

Implications for New Business

- Customers need to understand the bargain they are entering into
- Communication that premiums are reviewable must be as clear as possible (quote, KFD, Policy document)
- Beneficial to explain the choice between guaranteed and reviewable
- Need to be explicit about the “valid reasons” for a change in premium
- Beneficial to offer options to policyholder at review (lower benefit?)
- Amount of discretion in process needs to be minimised:
 - Verifiable mechanism for calculating the premium
 - Clear statement of minimum and maximum changes
- Documentation is vital
- Alignment of reinsurance treaty and customer documentation
- Take legal advice

Implications at review

- Think about review in plenty of time – need to provide notice
- Undertake the review – even if downwards!
- External peer review?
- Clear communication of the reasons for changes in premiums
- Provide options for the policyholder
- Documentation is vital
- Expect interest from FSA if increases in existing premiums are out of line with the market or new business premiums
- Expect complaints if increase rates!
- No wording and process can be incapable of challenge but substantial steps can be taken to attempt to mitigate risks of challenge
- Take legal advice

Implications for existing business

- How unclear was literature?
- Were “valid reasons” specified? (Or “..at the discretion of the actuary...”?)
- Documentation???
- Reinsurance???
- Expect interest from FSA if increases in existing premiums are out of line with the market or new business premiums
- No wording and process can be incapable of challenge but operating the review fairly may reduce the risk of challenge
- Take legal advice

Impact of TCF on Reviewable rates

Consumers

- Literature clearer and more explicit
- Simpler more transparent products
- Fewer products?
- Higher premiums to pay for higher costs?

Distributors

- Need to understand companies' review clauses
- Stronger preference for guarantees

Providers

- Less discretion in management of products
- Higher costs
- Inhibition to innovation on products

Impact on the UK market of "Treating Customers Fairly"

- Too early for full impact to be assessed
- A huge programme of change within UK insurers
- Some initial observations on consumer impact
 - Products, literature and processes influenced by consumer research
 - Literature clearer and more explicit
 - Better customer experience throughout life of product
 - Simpler more transparent products
 - Less discretion in management of products
 - Fewer products?
 - Less guarantees and or cover?
 - Higher premiums to pay for higher costs?
 - Fewer providers – only the big can afford the high fixed cost of product manufacture?

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Impact on the UK market of "Treating Customers Fairly"

Lesson from UK experience:

Treat your customers fairly before regulators oblige you to "Treat Customers Fairly"

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About the Author:

Rajeev Shah

EDUCATION

September 1998

Qualified as Fellow of Institute of Actuaries

June 1993

1st Class degree in Actuarial Science from the London School of Economics & Political Science.

EMPLOYMENT

Oct 2000 - Barnett Waddingham & Co as Actuary and now Partner - Life Team Experience

- Forensic Actuarial and Expert Witness work.
- Secretary to CMIB Mortality and Income Protection Committees including Mortality and Morbidity investigations and research for the CMIB.
- Actuarial advice on the management of mortality and morbidity risks.
- Actuarial advice on the financial management of life offices including financial reporting, product development and risk management.
- Actuarial advice for charities and friendly societies.

June 1999 – Sep 2000 Prudential Assurance Company as Team Leader (Actuarial Projects Team) and later Actuary (Pricing Team)

Experience

- Monitor and present profitability and shareholder value.
- Develop and maintain pricing models.
- Develop new products.
- Develop new and maintain existing actuarial systems.
- Act as internal actuarial consultant.

Oct 1997 - Jul 1999 London School of Economics & Political Science as Part-time Lecturer, Statistics Department

Experience

- Teaching Actuarial Science to 2nd and 3rd year undergraduate students.
- Assisting in setting the course syllabus.
- Setting and marking examinations for Actuarial Science students.

Nov 1994 - Jun 1998 Prudential Assurance Company as Actuarial Trainee and later Actuarial Project Leader

Experience

- Project Management
- Providing technical support to other actuarial and non-actuarial departments.
- Develop and maintain model offices.
- Monitor realistic profitability.
- Statutory valuation

Sep 1993 - Oct 1994 Black Horse Life Assurance Company as Actuarial Trainee

- Product Pricing

OTHER PROFESSIONAL EXPERIENCE

- Member of the CMIB Mortality Projections Working Party.
- Member of Faculty and Institute of Actuaries Chronic Diseases Working Party
- Past committee member of Staple Inn Actuarial Society