Unit-linked governance – regulatory expectations

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Regulators have significantly increased the focus placed on unit pricing practices within insurance undertakings. Over the past few years the Australian Prudential Regulatory Authority (APRA), the Financial Conduct Authority (FCA) in the UK and most recently the Central Bank of Ireland (CBI) have each conducted thematic reviews that were focused on unit-linked governance.

Each of the reviews examined the operations of a sample of insurers selected to represent the market. The feedback and conclusions from these reviews can provide guidance for assessing some of the more common pitfalls that companies face. This briefing note summarises some of the common themes and issues that appeared across the three regulatory reviews – what may be considered the missing links in unit pricing. The briefing note also sets out some of the most important questions companies should be ready to answer.

For your reference a link to the complete findings from the Australian and UK reviews, which have been publicly disclosed, is provided below. The findings from the CBI review have been communicated directly to companies and have not been made publicly available to date.

CONFLICTS OF INTEREST

While companies typically had conflict of interest policies in place, regulators were concerned that many were too general, often focusing on 'gifts and entertainment' or 'directors' interests' policies. These policies often failed to specifically address conflicts as they may develop and affect unit-linked operations.

Specific concerns included:

- A company's inability to identify unit pricing conflicts of interest
- Senior management's lack of awareness of the nature of conflicts of interest in unit pricing operations
- A lack of mechanisms to deal with identified breaches in policy
- Inadequate controls to manage the seeding for unit-linked funds and relationships within group companies (such as group investment management providers)
- Shortcomings in managing issues related to different terms and conditions of different customer policies over generations

Conflicts of interest – Key considerations

Does your company's conflict of interest policy address unit pricing specifically? Or does your company have a separate policy on it?

Does senior management understand the nature of conflicts that could arise in unit pricing arrangements?

Does your company have a strategy for managing conflicts of interest when they are identified?

GOVERNANCE

Companies typically have regular reporting arrangements with their board, but some regulators were concerned about the lack of senior management's attention to unit pricing. One regulator indicated that insurers could do more to define the terms of reference of the board or sub-committees, especially with respect to internal controls, investment strategy, asset management and key roles and responsibilities.

Other regulatory concerns included the lack of consideration for unit pricing in business continuity planning, especially for any period during which systems are not functioning.

Governance – Key considerations

Does your company's sub-committee for unit pricing regularly report to senior management?

Has your company established unit-pricing benchmarks?

Are fund managers encouraged to attend committee meetings and challenge pricing policies?

OUTSOURCING

A common theme in regulatory reviews was the lack of oversight of service providers. Deficiencies ranged from insufficient access to a service provider's policies and procedures, to a lack of attention given to the service provider's level of compliance with mandates, to a blanket handoff of responsibilities that were not well understood by the insurer. But no matter what form the deficiency took, the lack of oversight typically led to an over-reliance on the service provider's operations and controls. Ignorance of the provider's operations was viewed as a poor excuse for a lack of due diligence.

More specific regulatory concerns included:

- Deficiencies in oversight of chain outsourcing arrangements that could cause gaps in monitoring when downstream service providers perform critical operations
- Inability of the company's risk or compliance units to provide assurance that the service provider's controls were adequate
- An informality of controls when operations were outsourced to other companies in the same group
- Inadequate consideration of exit strategies if changing provider

Outsourcing – Key considerations

Have you sufficient information on processes?

Have you specified and agreed performance standards with the service provider?

Have you attempted to identify potential gaps in oversight of chain outsourcing arrangements?

Have you developed an exit or transitional strategy if a change of provider is needed?

Does the service provider have a business continuity plan?

RISK MANAGEMENT

Regulators found that the number of pricing errors for a company tended to be inversely proportional to the priority the company placed on risk management. This observation was reflected in the finding that companies which experienced significant unit pricing errors on several occasions were seen as giving a low priority to operational risk management throughout the organisation and not just in the unit pricing space.

Specific risk management concerns related to:

- Inadequate segregation of duties
- A lack of independent management or board oversight
- Product development that takes place outside of regular channels or processes
- Multiple systems (often related to legacy business) that typically had separate sets of rules, which increased the probability of human errors
- The use of manual adjustments and spreadsheet models, sometimes with low levels of documentation and limited controls in place

UNIT PRICING

Risk Management – Key considerations

Are clear roles and responsibilities set?

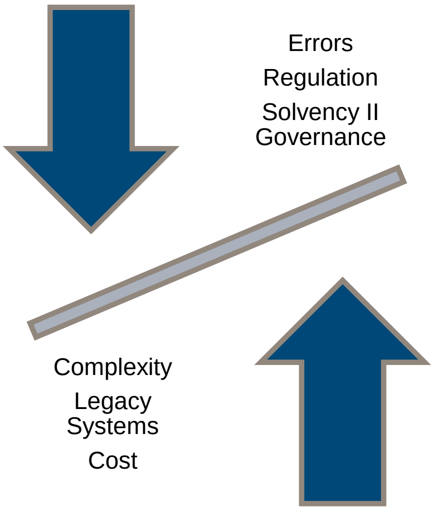
Are there multiple systems in operation and if so how are these risks managed?

The complexity and reliability of pricing methodologies and the relentless need to update pricing information was an overriding issue among regulators who were concerned about the length of time that could elapse before an error is discovered and the complexity of then resolving the error. The FCA said that half of the firms it reviewed "could have worked more quickly to correct errors and compensate customers."[1]

The regulators also pointed to the risk posed by overstretched pricing teams who could be unable to complete tasks in a timely matter and the subjectivity that is sometimes applied to apportioning costs to customers' units.

[1] The governance of unit-linked funds. October 2013, The Financial Conduct Authority, page 9.

Change - Drivers & Obstacles



Regulators specifically noted a number of ways in which companies' pricing practices could lead to unfair treatment of policyholders. These include:

- Overdependence on a limited number of key people who have exclusive knowledge of highly customized spreadsheets for unit pricing
- The use of multiple systems which increases the likelihood that practices and controls will be inconsistently applied across product lines
- The infrequent calculation of unit prices, which in some cases were performed weekly or less often because of resource constraints or significant exposure to international or illiquid assets
- Use of last sale prices or other 'stale' valuation proxies for thinly traded assets. There was a lack of documentation on how to value assets when no market value is available.
- The use of historic pricing (which is often relied on because of system constraints) without appropriate controls and safeguards to protect existing policyholders from arbitrage risk
- The inability of a company to adapt its swing price practices used in dual priced funds when a material transaction arises
- A company's ability to clearly disclose often sophisticated taxation approaches within the pricing process to policyholders

Unit pricing – Key considerations

Does your company have a formal sign off process for unit pricing processes?

Does your company have a process for identifying errors?

Does the process include a way to detect small errors that fall within tolerance levels but can build over time?

Does your company track compensable errors?

Are unit pricing processes reviewed at least once per year?

MANDATE COMPLIANCE

Existing controls usually focused on accounting-related controls and monitoring, while companies were not as involved in less clear-cut processes such as investment mandate compliance. If a mandate is not correctly implemented, the gap between the actual performance of the fund and the performance of a fund with the mandate that was promised to policyholders can quickly widen into a sizeable and costly correction exercise.

Companies should have an asset review process to ensure investment policies comply with mandates and need to perform appropriate levels of due diligence when changing investment strategies or altering fund choices.

Mandate Compliance – key considerations

How does your company satisfy itself that investment mandates are followed?

OTHER CONCERNS

Assets that back unit-linked policies: Regulators were generally satisfied with the security of assets used by firms in the retail market to back unit-linked policies of their customers but had some concerns about firms in the institutional market. These firms were more likely to invest in more exotic, and potentially risker, assets and legal arrangements, which ultimately could jeopardize downstream customers of financial instruments such as pension funds. Regulators suggested that firms could improve their analysis of these riskier products in determining whether their use as permitted links is appropriate.

Stock lending: Regulators found the collateral requirements and monitoring controls that companies used to safeguard customers from the risk that a borrowing party might fail or be unable to return the borrowed security were generally adequate. A more immediate concern was insurers' ability to fairly apportion revenues paid by the borrower to the insurer and the level of disclosure of risk if customers have an exposure.

Timely resolution of breaches: The loss caused by a unit pricing error tends to be a function of the length of time over which the error has persisted. Because both the error and the cost of correction tend to compound over time, unravelling and correcting such mistakes requires extremely detailed analysis of the errors and is highly labour intensive. The FCA acknowledged that "inevitably, errors can occur." For this reason, the FCA and other regulators stressed that companies should have appropriate arrangements in place to identify and rectify errors in a timely manner and recommended that companies perform periodic quarterly or annual reviews to help to identify these issues rather than simply using daily checks.

Business continuity planning: All three reviews noted weaknesses in the area of business continuity planning (BCP) and concern over whether contingency plans were in place. BCPs often focused on recovery of IT systems with little or no consideration for unit pricing issues. This was a particular concern when outsourcing was used as companies often did not have enough insight or control over the contingency plans of the service providers.

For more information you can access the complete reviews of the APRA and FCA.

WHAT TO DO NEXT?

Regulators are clearly expecting a higher level of due diligence from companies in this area, which is one reason companies should re-examine their unit pricing practices and move towards best practice standards. Aside from this regulatory focus, the benefits of improved unit pricing practices should flow through to the company and ultimately its customers.

The APRA pointed out that in the absence of effective market discipline, unit holders typically have no way of detecting errors that have occurred except in the most extreme situations. This situation places an onus on companies to ensure unit-linked prices and practices are correct and customers are treated fairly.

Several practical steps that companies can initially focus on to improve unit pricing practices include:

- Developing policies and practices that are transparent and easy to follow
- Performing regular audits and external reviews
- Increasing efforts to mitigate risky practices such as undue reliance on key individuals or corporate memory
- Reviewing various guidance notes published on unit pricing practices. The APRA and the Association of British Insurers (ABI) have both published detailed guides in recent years.

Even the most thorough preventive measures cannot account for every contingency, so insurers should be prepared to deal with unit pricing errors, which could have persisted for years. The hard reality is: determining whether an error has even been made can be a painstaking and uncertain process, a possibility that was discussed a number of times in regulators' reviews. Sound analysis is therefore critical to avoiding a costly, misinformed decision.

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