FINANCIAL CONDUCT AUTHORITY

Review of the fair treatment of with-profits customers

Thematic Review
TR19/3

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1 Introduction

1.1 We have conducted a thematic review into the fair treatment of with-profits customers. We focused on the areas of with-profits fund management we assessed as presenting the highest risk of customer harm at present. We also considered the effectiveness and independence of with-profits governance arrangements in achieving good outcomes for consumers.

> A with-profits policy is a long-term insurance contract. It provides benefits to customers through eligibility to participate in discretionary distributions based on profits arising from the life insurer's business or from a particular part of the life insurer's business. Distributions are typically made in the form of bonuses that are added to the value of the policy annually.

1.2 With-profits is a key area of focus for the FCA in the supervision of life insurers. The potential for conflicts of interest to arise in the management of with-profits funds, the inherent complexity of this business and the lack of strong demand-side pressure from long-standing customers, mean that there may be increased risk of customer harm.

Executive summary

1.3 This review intends to help firms continue to evaluate their own with-profits fund management practices to ensure that they are complying with FCA rules and treating their with-profits customers fairly. It details our key findings and gives examples of good and poor practice that we observed.

Background

1.4 With-profits products provide a significant portion of the long-term savings, pension and retirement income provisions of customers in the UK. At the end of 2017, about £274bn was invested in with-profits funds, compared with about £1,147bn in unit-linked funds. During 2017, customers invested approximately £16bn into with-profits funds and received approximately £23bn in claims paid out. (Source: 2017 Solvency II returns)

1.5 The amounts invested in with-profits funds have been decreasing. Total with-profits assets were approximately £426bn as at 2001, £411bn as at 2005, £333bn as at 2010 and £296bn as at 2015 (Source Regulatory Returns). These numbers reflect declining levels of customer demand for investment in with-profits funds and the prevalence of funds closed to new business and in run-off. These changes create new challenges for managers of with-profits funds.

Our findings

1.6 Our main findings from the review are:

- Most firms we assessed are taking reasonable care to manage the risk of customer harm in their with-profits business. Our findings for investment strategy and management and overall governance underline this.
- We identified a widespread need for firms to do more to use their run-off plans (ROPs) fully as intended and described in our rules and guidance. In particular, many firms were not keeping their ROPs up to date and not using them as living documents in their day-to-day management of with-profits funds.
- We found specific areas of poor practice that might lead to customer harm. Namely:
  - weaknesses in assessments for, and distribution of, excess surplus in funds
  - insufficiently robust fund-level capital management approaches

  In a small number of these cases, there were signs that firms were not complying with FCA rules for their with-profits business.

- In most cases, there was no evidence of actual customer harm having arisen. However, customer harm may occur in the future if these practices continue. In some instances, our concern centred on firms being unable to show clearly that their actions were fair to different groups of with-profits customers.
- In the limited instances where we found practices presenting a higher risk of customer harm, a key cause was a failure of governance. In particular we identified ineffective oversight and challenge by senior individuals and the Board.

Next steps

1.7 We expect with-profits operators to use this review to improve how they work, and in turn to improve outcomes for customers. The messages in this review will be useful to all such firms, regardless of size or structure. We expect all firms managing with-profits business to consider the findings and examples of good and poor practice and assess whether they need to make any changes to their management of with-profits business.

1.8 We are taking the following actions:

- We have provided firm specific feedback to firms in our sample.
- We have requested actions of firms in our sample where we have identified poor practice.
- We will engage with certain senior managers across firms through round-table discussions later this year. We want to hear their views on our findings and understand what actions are being taken across the industry in response to these.
- We will discuss the findings from this review with firms operating with-profits business as part of our normal supervisory processes.
- If firms do not address the areas of poor practice highlighted in this review we will consider further action.

1.9 We are also considering carrying out some focused work about the use of With-Profits Advisory Arrangements (WPAAs).

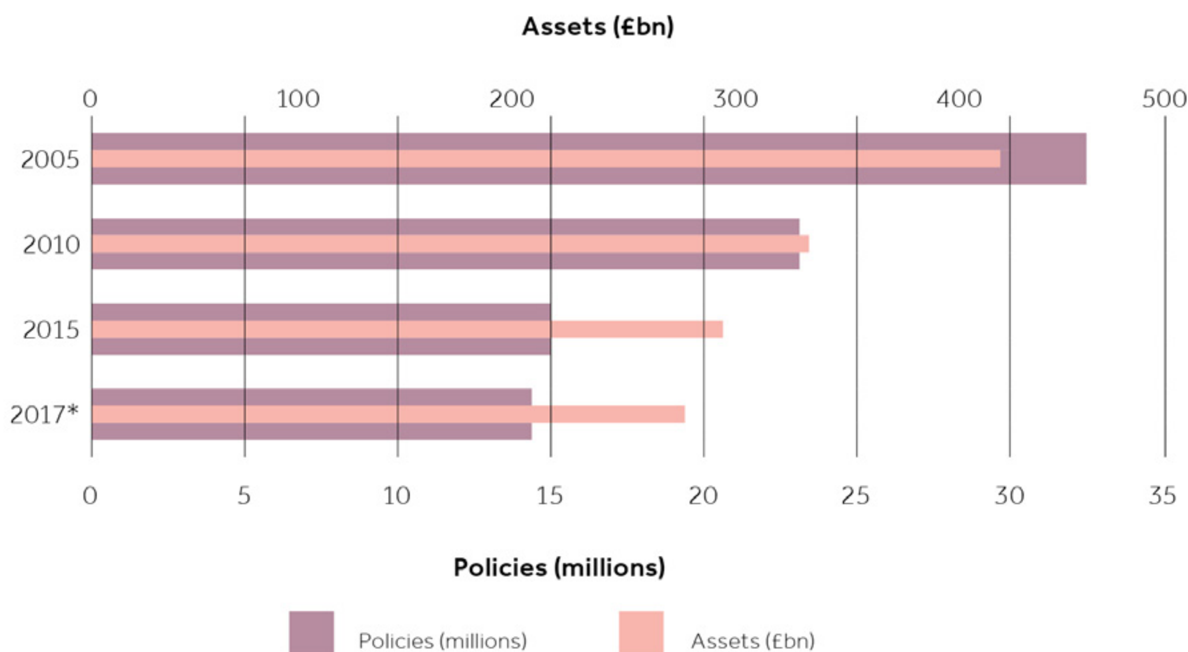
1.10 The actions noted above form part of our work in relation to existing customers, which is a cross-sector priority for the FCA.

1.11 We are not proposing to consult on new rules and guidance on the basis of the findings of this review.

2 Market context

2.1 At the end of 2017, 98 with-profits funds operated across 37 firms (Source Thematic Review: Fair Treatment of With-Profits Customers – Phase 1 Information Request). Changes to the number of policies and assets in with-profits funds are shown in the chart below. There has been a steady fall in the number of customers as shown by the fall in policy numbers and assets.

Run-off of with-profits funds



* For 2017, Solvency II technical provisions are used to allow reasonable comparison with the pre-Solvency II with-profits assets shown for previous years.

2.2 With-profits fund operators need to take account of a range of interests, all of which must be appropriately considered and weighted to ensure fair outcomes. This includes considering the interests of customers relative to those of shareholders (in proprietary firms), members (in mutual firms), management and staff. Additionally, different groups of customers (eg customers currently exiting and customers remaining invested with the fund, or with-profits customers and non-profits customers) may have different interests. Failure to manage these interests appropriately in line with FCA Principle for Business 8 could result in with-profits customers receiving unfair pay-outs or being exposed to levels or types of risk that are out of line with reasonable expectations.

2.3 The relatively complex nature of with-profits products and general lack of customer engagement with long-term savings products reduces the likelihood of customers identifying and acting in response to unfair treatment. This was identified as a factor that increases the risk of poor outcomes in TR16/2: Fair treatment of long-standing customers in the life insurance sector. It may also be difficult for with-profits

customers to find an equivalent product with another provider. In addition, a significant proportion of with-profits customers are likely to be elderly and potentially vulnerable. Our assessment is that without effective with-profits governance, the risk of harm to with-profits customers may be increasing primarily for the following reasons:

- With-profits business continues to be of decreasing importance to many firms, as it is mainly legacy business in run-off. This can lead to a lack of management attention focused on with-profits customer outcomes. This was evidenced to some extent in the thematic review into the fair treatment of long-standing customers, which was published in 2016. Additionally, funds in run-off do not need to attract new business. This reduces the impact of one typical market-based driver for firms to review their products and increases the importance of other processes to ensure fair treatment of customers within firms.
- The nature of with-profits funds makes them challenging to manage. These challenges are increased by the fact that many funds are in run-off, potentially making past practice no longer appropriate. For example, as run-off progresses, product mixes change. This can necessitate changes to investment strategies, which can impact bonus rates. Funds in run-off must also manage the distribution of any estate. Additionally, run-off potentially creates diseconomies of scale for fund operators, resulting in increased pressure to cut costs or find other ways to manage expense risk.
- The Solvency II regime is changing the way with-profits funds are managed. For example, some funds are moving certain types of non-profit business out of their with-profits funds for capital efficiency reasons under Solvency II. Changes to the business environment, including regulatory changes such as this, carry risks for the customer if a firm does not adapt appropriately and ensure that customers continue to be treated fairly.

3 Regulatory context

3.1 The FCA supervises the conduct of life insurers managing with-profits funds. Boards and senior managers, under the Senior Managers and Certification Regime (SM&CR) from December 2018, are accountable for the fair treatment of with-profits customers. Under the SM&CR the role of WPAA is now treated as a senior manager role for the first time.

3.2 The last thematic assessment of the with-profits market was done in 2010 by the Financial Services Authority (FSA).

3.3 In preparing this review, we have considered the FCA's regulatory framework. This includes but is not limited to, the Principles for Business (Principles), COBS, SUP and SYSC rules and guidance and other non-Handbook published materials referred to below. We have also considered relevant rules, guidance and publications from the Prudential Regulation Authority.

3.4 The Principles that are most relevant in this review are:

- Principle 2, which requires a firm to conduct its business with due skill, care and diligence.
- Principle 3, which requires a firm to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- Principle 6, which requires a firm to pay due regard to the interests of its customers and treat them fairly.
- Principle 7, which requires a firm to 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.
- Principle 8, which requires a firm to manage conflicts of interest fairly, both between itself and its customers, and between a customer and another client.

3.5 Our predecessor, the FSA, published a range of communications that clearly set out how customers should be treated. In particular, the papers entitled 'With-profits regime review report' and 'PS12/4 – Protecting with-profits policyholders' published in June 2010 and March 2012, respectively, included specific considerations for with-profits customers focusing on ensuring that firms operating in the with-profits sector do so fairly and transparently.

3.6 In December 2016, the FCA published finalised guidance entitled 'FG 16/8 Fair treatment of long-standing customers in the life insurance sector'. This guidance sets out actions life insurance firms should consider taking to treat their closed-book customers fairly. This includes ensuring customers are being treated fairly regarding investment performance, expense allocation and charges. These expected outcomes and actions have also been considered in reaching our conclusions for this thematic review.

3.7 We expect firms to consider professional best practice standards and guidance in managing their business, in line with Principle 2. We have considered views from external stakeholders, such as through our With-Profits Forum held on 5 July 2017, and external publications from other professional bodies. For example, in November 2014 the Institute and Faculty of Actuaries published a working party report entitled 'The Management of With-Profits Funds in Run-off'. This allowed us to take account of practices being adopted by professionals and firms in the market and assess whether they are resulting in fairer outcomes for with-profits customers when implemented.

4 Our approach

4.1 Our thematic work is being carried out in 3 phases. This consists of identifying potential harms to with-profits customers, assessing firms' treatment of with-profits customers at a sample of firms and implementing mitigation actions where appropriate. The first 2 phases of the review are now complete. The publication of this review forms part of the third phase.

4.2 In the first phase, we looked across the market to identify all areas of with-profits management that could lead to customer harm. We then assessed which of these we believed presented the highest potential risk of significant harm to with-profits customers. We also developed a complete view of the issues on which firms were focused across the market. To inform this work, we requested information from most firms operating with-profits business and spoke to key with-profits practitioners from across the industry.

4.3 This allowed us to focus our work in the second phase of our review on the assessment of firms' treatment of with-profits customers in 4 key areas of potential harm to customers. Namely:

- investment strategy and management
- capital management as it relates to key areas such as estate distribution and fund resolution
- fair allocation of risk and reward between stakeholders in capital management decisions
- governance of with-profits business, particularly for decisions on the above 3 areas

4.4 Our first phase of work allowed us to select a sample of 8 firms to provide a representative view across the market for our second phase assessment. These 8 firms represent approximately 80% of total with-profits assets held and constitute a mixture of funds closed and open to new business, mutual and proprietary firms, and funds and firms of varying sizes.

4.5 For each firm in the sample we issued an information request and carried out a desk-based review of selected funds. This review included an assessment of case studies of with-profits decisions or issues specific to each firm in the sample in our areas of focus. This was followed with further tailored interaction with each firm through a combination of firm visits, meetings at FCA premises, and telephone calls.

4.6 We did not review customer communications as part of this review, although we did consider the clarity and level of detail of applicable sections of Principles and Practices of Financial Management (PPFMs). This is because customer communications was a significant focus of the guidance contained in FG16/8 Fair treatment of long-standing customers in the life insurance sector. We encourage firms to remind themselves of the expectations of firms set out in FG16/8.

4.7 We identified the following outcomes firms should aim to achieve in line with our existing rules and guidance for with-profits firms. Our assessment looked across each of these outcomes, and this review sets out our findings on the extent to which firms are achieving these outcomes.

Outcome	
1	The firm has implemented an appropriate investment strategy for the fund and regularly monitors its ongoing appropriateness and the terms on which it is implemented.
Sub-outcomes	
1.1	The firm checks, through periodic reviews, that the investment strategy for the fund is consistent with its financial position and appropriately balances maximising expected returns and achieving security of customer benefits.
1.2	The firm adequately considers the level of hypothecation[1] of assets required to ensure different groups of with-profits customers are treated fairly.
1.3	The firm checks through regular reviews that the fund management company(ies) used remains appropriate to implement the investment strategy and takes appropriate steps to deal with any areas of underperformance.

Outcome	
2	The firm has an overall capital management approach for the with-profits fund that fairly balances the interests of different generations of with-profits customers.
Sub-outcomes	
2.1	The firm can show that its estate distribution approach is fair to different generations of with-profits customers.
2.2	The firm can show it has implemented appropriate policies and procedures to ensure it strikes a balance between ensuring fair pay-outs for exiting customers and the security of benefits for continuing customers in a fund.
2.3	The firm shows that the run-off plan is used to support on-going decision-making and that it is updated regularly in line with emerging experience and the changing operating environment.
2.4	The firm annually assesses if an excess surplus is present and appropriately considers the merits of its distribution/retention from a customer fairness perspective.
2.5	The firm has a clear approach/plan for how and when the fund will be terminated, which appropriately considers the fair treatment of with-profits customers.

1 Hypothecation is a widely accepted way of managing the investment risks in a with-profits fund whilst managing the different needs across classes of policyholders. A simple hypothecation strategy would involve a company using fixed interest assets of appropriate term to match the guaranteed liabilities reducing the overall risk profile of the fund. (Source Institute and Faculty of Actuaries 2014 Report – The Management of With-Profits Funds in Run-Off)

Outcome	
3	The firm appropriately considers the risk borne by different stakeholders in allocating rewards from use of with-profits fund capital.
Sub-outcomes	
3.1	The firm has a good understanding of the fund's assets and liabilities, capital resources and capital requirements (including the impact of any capital support arrangements) and considers all such relevant information when making decisions affecting the with-profits fund.
3.2	The firm adequately and appropriately considers the management actions that would be taken in times of stress in determining its capital requirements.
3.3	The firm adequately considers the interests of different stakeholders in decisions about the use of with-profits fund capital and the allocation of consequent gains and losses.

Outcome	
4	The firm's governance framework results in the fair treatment of with-profits customers.
Sub-outcomes	
4.1	The with-profits governance structure is appropriate to the size and complexity of the with-profits fund, allows for timely consideration of issues and facilitates effective discussion and challenge.
4.2	The firm's operating practices are fair and do not result in undisclosed or otherwise unfair benefits to shareholders or to others with an interest in the with-profits fund(s).
4.3	The firm's governing body is provided with appropriate advice and gives this adequate weight in reaching its decisions on the management of with-profits business.

5 Our findings

5.1 We set out below our comments on individual outcomes and provide examples of good and poor practices we observed. The good practice examples are illustrative and may describe one of a number of ways in which firms can meet our expectations.

5.2 The examples of poor practices illustrate issues where we had cause for concern that good customer outcomes were not being achieved. Not every instance of poor practice necessarily amounts to a breach of our rules or principles. Where we had concerns around non-compliance, we have raised those issues with the firm(s) concerned and asked the firm to take immediate action. All firms should reflect on whether any similar practices may be affecting fair outcomes for customers in their with-profits business.

5.3 Some firms have argued that certain FCA rules, to which they are subject, are not relevant to them because of the specific circumstances of their with-profits funds. If a firm considers that an FCA rule is unduly burdensome or does not achieve the purpose for which it was made and that waiver or modification of that rule would not adversely affect the FCA's operational objectives, it can apply for a waiver. A firm must continue to comply with our rules unless and until a waiver is granted.

5.4 **Outcome 1 - The firm has implemented an appropriate investment strategy for the fund and regularly monitors its ongoing appropriateness and the terms on which it is implemented.**

5.5 Our work on this outcome focused on firms' approaches to investment strategy and management and associated governance. We did not assess the actual investment performance of each with-profits fund.

5.6 For firms' approaches to formulating and monitoring an appropriate ongoing investment strategy for the fund(s), we identified examples of good practice. For example, most firms employ different asset mixes for different funds and/or different cohorts of customers within each fund. This is appropriate as it enables those firms to tailor their investment approaches to take account of factors such as the duration of policies, capital position of the fund, and the prevalence of guarantees. This use of investment hypothecation reduces the potential for harm to different groups of with-profits customers through exposure to inappropriate asset mixes.

5.7 Where they have one, it is common practice for firms to employ their in-house fund managers to manage the investments of their with-profits funds. We assessed whether firms were managing the potential conflicts of interest that can arise in these circumstances. We found that firms did carry out reasonable governance and oversight over in-house fund managers (covering areas such as fees and performance) to satisfy themselves that customers were not disadvantaged by the use of an in-house fund manager.

5.8 We also found that firms were regularly monitoring the performance of with-profits investments and taking action where they identified poor performance.

Monitoring of performance - good practice example
A firm carried out regular investment performance monitoring. As a result, it identified persistent poor performance of a section of its equities portfolio against its benchmark. The section of the portfolio involved was managed by the group's in-house fund manager.

The firm held discussions with its in-house fund manager and made clear that, if action was not taken to improve performance, it would consider offerings from other providers. As a result, the in-house fund manager made changes that included: a) maximising exposure to the fund manager's list of best stock picks; b) changing the individual employed as fund manager; and c) improving engagement with the firm, including discussing fund positioning and management.

The firm continued to monitor performance, which showed some improvement following the actions described above.

Fund management fees - good practice example
A firm had different fund management fees for different with-profits funds for a number of historical reasons. It commissioned a review of both levels and structures of fees against market practice. The review was carried out by an external firm. In response to the review the firm implemented changes to fee levels and structures (both increases and decreases) to make practices more consistent between different with-profits funds, better aligned with market practice and to reflect better the work carried out by the fund manager. The With-Profits Committee (WPC) was closely involved, providing oversight over the process. Changes were made in response to challenges from the WPC.

5.9 **Outcome 2 - The firm has an overall capital management approach for the with-profits fund that fairly balances the interests of different generations of with-profits customers.**

5.10 Our work on this outcome covered run-off plans ('ROPs'), fund level capital management, processes for identifying and distributing inherited estate and other surpluses and (where applicable) plans for fund cessation.

Use of run-off plans for closed with-profits funds

5.11 Most firms with closed with-profits funds were not using their ROPs fully as intended and described in our rules and guidance, namely as a tool to manage the ongoing run-off of a closed with-profits fund in a fair manner.

5.12 A ROP is required to show how a firm will ensure fair and full distribution of the closed with-profits fund and any inherited estate. It should cover (among other things), investment strategy, governance, and financial projections. If a ROP is not up-to-date, or does not contain all the expected information, as described in COBS 20.2.56R and SUP App 2.15G, there is a risk that a firm's approach to distribution of the fund and inherited estate is either not fair, or cannot be shown to be fair, to different groups of customers.

5.13 There is also an increased risk that different aspects of fund run-off may not fit with each other. For example, the investment strategy may not fit with the duration of existing policies. Again, this can adversely affect customer outcomes.

5.14 Firms seemed to make little use of ROPs as living documents in their day-to-day management of with-profits funds. This was evidenced in several instances where firms had not updated their ROPs for periods of up to 10 years.

5.15 In addition, if firms are not using ROPs as living documents, they may deviate from the agreed plan for a fair run-off of the fund and may not identify any unintentional significant departures from the plan. This increases the risk of unfair treatment of different generations of with-profits customers. This may also result in these firms not notifying the FCA of significant changes to, or departures from, the run-off plan, as expected in SUP App 2.15.15G.

5.16 Some firms did not undertake scenario analysis at all in their ROPs. Others included it, but with a focus on solvency as opposed to considering how they would ensure a fair distribution of the estate in these scenarios. FCA guidance refers (in a non-exhaustive list in SUP App 2.15.7G) specifically to consideration of adverse scenarios for annuity payments. However, firms should also consider whether a ROP can show how a firm will ensure a fair distribution of the estate if it does not consider broader scenarios relevant to the risks associated with run-off of the fund. Under SUP App 2.15.13G a firm's ROP would usually be expected to include any other information the firm considers relevant to the run-off of the closed with-profits fund. Under SUP App 2.15.2G(3) details should be given of the firm's future strategy for managing the risks associated with the run-off of the fund.

5.17 Most firms without up-to-date ROPs use a variety of other reports or short-term analyses when making decisions about the fair run-off of the with-profits fund(s). However, our policy intention behind the requirement for a ROP is that firms would have comprehensive and up-to-date plans for each with-profits fund. These plans should give management and the Board a holistic and long-term view, allowing them to manage the run-off of the fund in the interests of all with-profits customers. Without this there is an increased risk of poor customer outcomes through, for example, an inappropriate investment strategy, or unfair estate distribution, due to changes in the fund or external operating environment. This presents risks that a firm may not manage a closed with-profits fund in line with Principles 6 and 8.

Run-off plans - good practice example
At one firm, the ROP was reviewed annually and updated where necessary. The annual review was carried out by the With-Profits Actuary (WPA) and submitted to the WPC. The plan showed how the firm would ensure an equitable distribution of its estate. This was done by looking at the pattern of pay-outs over the lifetime of the fund to ensure this aligned with the firm's views of a fair distribution and minimising 'tontine'[2] risks.

The plan considered scenarios for key risks faced by the fund and looked at the impact they would have on the distribution of the estate, and whether this distribution would still be fair.

The WPA regularly monitored compliance with the plan. Having an up-to-date plan, and ensuring compliance with it, reduces the risk of an inequitable distribution of the estate.

Run-off plans - poor practice example
One fund's ROP was not reviewed and updated regularly. The firm did produce an annual report on the solvency and management of the fund (to which the ROP referred) covering some of the key elements of the plan for run-off, such as estate distribution. However, the annual report focused on short-term decisions and did not provide a longer-term view on the management of the fund. It did not contain any longer-term projections.

There was some evidence, in the firm's estate distribution decisions, of potential 'tontine' issues being recognised. However, the lack of longer-term projections in the ROP meant it was not evident that these were being considered adequately and on a timely basis. The ROP did not include scenario analysis or consider adverse circumstances, and the firm was unable to demonstrate sufficient consideration of how its approach to estate distribution for the fund would produce fair outcomes in different environments.

It was not clear the fund's ROP was being kept up-to-date. Further, it was not evident that the annual reports were being used by the firm to bring together the various elements of managing a with-profits fund, such as how the firm aligned investment strategy with the plan for estate distribution. The WPC focused on the current position of the fund, without giving sufficient attention to the impact of current decisions on the longer-term projections or run-off of the fund.

Fund-level capital management approaches

5.18 Some firms could show they had implemented appropriate policies and procedures to ensure they struck a balance between ensuring fair pay-outs for exiting customers and the security of benefits for continuing customers.

5.19 However, some firms lacked a clear definition of the desired level of reserves to protect against risks in their funds. This could have been provided by, for example, establishing fund-level capital risk appetites as was the case at some other firms. The absence of clear fund-level risk appetites or similar processes and practices increases the risk of firms not balancing appropriately fairness of pay-outs for exiting customers and the security of benefits for continuing customers.

2 A tontine is, in simple terms, a scheme for life assurance in which the beneficiaries are those who survive and maintain a policy to the end of a given period. (Source Institute and Faculty of Actuaries – Value of with-profits to consumers – Phase 1 report). In the context of with-profits, a tontine risk is that those customers who exit the fund last receive an unfairly large portion of the profits available to be distributed to all with-profits customers.

5.20 Setting a capital risk appetite for a fund was considered an important tool by some firms to help ensure a fund's approach to distribution, and other aspects of capital management, are fair to different groups of customers and also (where applicable) to other stakeholders, such as shareholders. If, for example, the fund's approach to distribution is too cautious, customers exiting now may receive unfairly low pay-outs. If too much risk is taken, and risks then crystallise, this may reduce pay-outs for customers exiting in future.

5.21 Firms adopted a range of approaches to setting capital risk appetite at fund-level. Some firms had not defined fund-level risk appetites, or had defined fund-level risk appetites for some, but not all, of their funds. In some cases, fund-level risk appetites did exist, but it was not clear how they had been arrived at or why firms considered them to be fair to customers.

5.22 Our rules do not specifically require fund-level risk appetites. However, in the absence of well-defined fund-level capital risk appetites or equivalent policies or controls, it is likely to be more difficult for firms to show that their approaches to estate distribution and excess surplus assessments are fair to customers. Further, without a fund-level risk appetite or similar framework in place, it may be more challenging for firms to show appropriate planning and governance for actions they would take in stressed situations.

Fund-level capital management - poor practice example
A firm did not manage solvency risk at fund level and lacked a clear framework for making decisions about estate distribution, excess surplus, and deployment of management actions.

The firm, as a whole, aimed to hold a minimum buffer, calculated as a percentage of the solvency capital requirement (SCR), at firm-level. It was unclear why the firm considered this to be fair and appropriate. Setting the capital requirement at firm, rather than fund-level creates a risk that 'unders' and 'overs' at individual fund level may go unchallenged. At this firm 1 fund held less than the specified percentage of SCR. Other funds held more than the specified percentage of SCR without making the coverage for the firm, as a whole, look excessive. Additionally, the firm had no clear rationale as to why the specified coverage was appropriate by reference, for example, to asset mix. This could have led to unfairness to with-profits customers in certain funds, as the firm was unable to demonstrate appropriately that it was actively considering the appropriate capital coverage for each fund's risks.

For 1 fund, the level of estate distribution was not actively reviewed for a 4-year period, despite the level of surplus increasing. The firm's approach to managing solvency risk/the risk of being over-capitalised for this fund was unclear. The firm appeared to have targeted a more prudent risk appetite for this fund than for the firm as a whole. When the firm realised that the fund was over-capitalised, they did seek to distribute some of the excess surplus. However, it was unclear how they had determined their approach or what they considered the appropriate level of surplus to be.

As a result, there was a high risk that customers exiting the fund during the 4-year period may not have received a fair share of the estate.

5.23 We did find some examples where firms had implemented well-defined risk appetites for all their funds. They also had clear rationale as to how they balanced the need to provide adequate pay-outs to exiting customers with providing a reasonable level of security for remaining customers.

Fund-level capital management - good practice example
A firm had 2 tests for its solvency risk appetite: the estate distribution test and the solvency test. Both tests had a red, amber, green (RAG) rating. There was then a 'Solvency Intervention Ladder' set out as a matrix between these RAG ratings. This provided a clear framework that balanced fairness to both exiting and continuing with-profits customers.

The firm had performed stress & scenario testing to assess the reasonableness of the buffer in the solvency test. This had involved testing whether operation in line with the risk appetite framework led to the fair treatment of customers under stressed scenarios by, for example, looking at the resulting pattern of estate distribution.

The firm regularly reviewed the appropriateness of the solvency risk appetite for the fund. The review was carried out by the WPA and senior risk managers. We also saw evidence of updates following significant changes to the fund (such as de-risking) and to the operating environment.

Estate distribution

5.24 Firms adopted a range of approaches to estate distribution. Some funds evidenced they had carried out ad-hoc reviews of the estate distribution methodology. For the majority, we saw no evidence of them carrying out recent monitoring for fairness of the estate distribution approach against actual developments. Some firms relied on historical court-approved schemes to determine distribution of the estate with no, or limited, indication of having recently assessed whether these approaches continued to give fair customer outcomes. We comment further on the need to assess continuation of past practice for fairness in our comments on Outcome 3 below.

5.25 We do not advocate a particular approach to estate distribution. We expect firms to ensure they have good reason to believe that pay-outs on individual with-profits policies are fair in line with COBS 20.2.3R.

Estate distribution - poor practice example
A firm decided to extend estate distribution to non-profit customers in response to a developing 'tontine' in a with-profits fund. While the firm considered this to be fair, it was contrary to the PPFM, which stated as a principle that all the surplus would be distributed among the fund's with-profits customers. The firm did not consider the extent to which their actions redefined the rights and interests of with-profits customers to the estate. The firm did not: a) notify or consult the FCA on its plans; b) consider whether FCA re-attribution rules applied and ensure that it complied with such rules or the need for a scheme of arrangement; and c) change its PPFM and notify its with-profits customers in advance of this change in principle.

Assessments of excess surplus

5.26 Several firms were not carrying out assessments of excess surplus as required by FCA rules. COBS 20.2.21R requires firms to carry out at least annual assessments for both open and closed funds. Failure to identify an excess surplus,[3] where one exists, may result in surplus that should be distributed being retained. Timely distribution may be necessary to ensure inter-generational fairness among with-profits customers. Not carrying out an annual assessment of excess surplus carries a high risk of customer harm. This is due to customers exiting the fund in the short-term not receiving a fair share of the fund's estate; and customers remaining longest in the fund receiving unfairly large distributions. Failure to distribute an excess surplus, which has been identified and is not fair to retain, may indicate a breach of Principle 6.

5.27 Reasons given by some firms as to why they considered that they did not need to assess annually whether they have an excess surplus, included because their distribution approach aimed to distribute the entire estate, or because it was self-evident they did not have an excess surplus. COBS 20.2.21R makes no reference to the requirement for an annual assessment for excess surplus not applying for these reasons. A formal excess surplus assessment should allow firms to consider, in a consistent manner, both the presence, or absence, of an excess surplus in the current year. Additionally, the speed with which any excess surplus should be distributed to ensure inter-generational fairness for with-profits customers should be assessed.

Assessments of excess surplus - good practice example

A firm had a clearly-defined policy for the identification and distribution of excess surplus in the fund, which related to its capital management plan/risk appetite framework. The firm had defined its approach to evaluating the elements of the FCA Handbook's definition of excess surplus that are set by a firm, rather than by regulatory rules. For example, the capital provision determined for the fund was evaluated using the fund-level solvency risk appetite. The firm's policy included principles to guide the appropriate pace of distribution of excess surplus identified.

When the firm identified an excess surplus on its fund, it took action to distribute it equitably. The firm put in place a distribution plan, in line with the principles in its excess surplus policy, to ensure the excess surplus was distributed to its with-profits customers in a timely manner. This plan was considered and agreed by both the WPC and the Board. The WPA confirmed that the firm actively manages estate distribution to avoid over-capitalisation.

3 The FCA Handbook Glossary indicates that a Solvency II firm will have an excess surplus in a with-profits fund if, and to the extent that:
(i) the with-profits fund surplus in that with-profits fund; and
(ii) any other financial resources applied to, or expected to be applied to, that with-profits fund; exceed:
(iii) the amount required to meet the higher of any notional SCR in relation to that with-profits fund and any capital provision determined in relation to the with-profits fund at the firm's own risk appetite, as reflected in the firm's own risk and solvency assessment carried out from time to time as detailed in the PRA Rulebook: Solvency II Firms: Conditions Governing Business rules 3.8 to 3.10; and
(iv) any further amount necessary to support the new business plans of that with-profits fund.

Assessments of excess surplus - poor practice example
A firm was unable to show that it was carrying out an annual assessment of excess surplus. COBS20.2.21R requires a firm's governing body to determine at least once a year whether a with-profits fund has an excess surplus. The firm's justification for the apparent absence of an annual excess surplus assessment was that the fund aimed to distribute the whole of its surplus over the lifetime of the fund.

The firm had not evaluated the elements of the FCA Handbook's definition of excess surplus that are set by the firm, rather than by regulatory rules, such as the capital provision being determined for the fund at the firm's risk appetite. As a result, it was not possible to determine whether the fund had an excess surplus, or whether the pace of distribution of the surplus was fair to different groups of customers.

Sunset clauses

5.28 A sunset clause defines the trigger point after which the governing body either can, or must, restructure a with-profits fund (for instance through conversion to a non-profit fund). Most closed funds we reviewed had a sunset clause. In most cases, the sunset clause was part of a court-approved scheme. Some sunset clauses were set more than 20 years ago and, in some cases, firms had not carried out any recent work to determine whether sunset clauses, and the expected approaches to their operation, were fair to customers.

5.29 There is a risk of customer harm if a fund is restructured too early or too late. For example, if a fund is restructured too late, customers may incur excessive costs due to loss of economies of scale for fixed-costs, or may have weaker bargaining power regarding the method/terms of the eventual restructuring. If a fund is restructured too early, and the policies made non-profit, customers may miss out on investment returns they would otherwise potentially have received.

Sunset clauses - good practice example
A firm had taken action to review whether the trigger point contained in the scheme for 1 fund was still appropriate. The fund was in the advanced stages of run-off. The firm considered both expected levels of costs and information on customers' objectives, which it had obtained through customer research. The firm decided not to take immediate action to bring forward restructuring of the fund as the associated cost would not have been justified by the expected benefit to with-profits customers in the fund. Also, customer research indicated that action to bring forward payment of benefits would not be in line with customer objectives. The firm are keeping the possibility of earlier restructuring of the fund under regular review.

5.30 **Outcome 3 - The firm appropriately considers the risk borne by different stakeholders in allocating rewards from use of with-profits fund capital.**

5.31 Our review of this outcome focused on assessing whether firms adequately considered the interests of different stakeholders in decisions about the use of with-profits fund capital, and the allocation of consequent gains and losses. For example, where a firm incurred expenditure that was likely to benefit both shareholders and with-profits customers, we assessed whether the allocation of both costs and associated benefits was fair to with-profits customers.

5.32 Most firms had taken reasonable care to ensure that risk and reward were distributed fairly between shareholders, with-profits customers, and other stakeholders such as non-profit customers.

Controls over expenditure

5.33 We did, however, see examples where firms' controls over expenditure incurred by with-profits funds were insufficiently robust.

Controls over expenditure - poor practice example

One firm undertook a regulatory change project, which included significant costs being charged to the with-profits funds' estates. The project went significantly over the original budget. We acknowledge this project was required and that there appeared to have been governance in place around requests for additional spend. However, it was not clear that sufficient resource and controls were in place both to determine, and to agree, an appropriate original budget, to monitor and/or limit spending, and to ensure efficiency.

The information the firm provided on the cost allocation between with-profits funds for the regulatory change project included some discussion of why certain measures would not have resulted in a fair allocation between the funds. For example, it was noted that policy count would result in an unfairly large allocation of costs to funds containing large numbers of low-value policies. However, the firm had not clearly articulated why the chosen allocation method was agreed to be the fairest approach for the with-profits customers in different funds.

Management information ('MI')

5.34 We saw examples of good and poor MI provided to the WPC and the Board. Regular, good-quality, MI is key to a firm's understanding of a fund's capital resources. Poor-quality MI can lead to firms making decisions based on inadequate information or in untimely decisions. Poor MI tended to correlate with a less robust approach to ensuring that there was an appropriate balancing of the interests of different groups of policyholders, including the lack of, or limited, definition of a fund-level capital risk appetite. (See feedback on Outcome 2).

Management information - good practice example

At one firm capital MI provided to the WPC and to the Board had a good level of detail. It was sufficiently detailed to provide the required information without providing so much that it would be unrealistic to expect members to read it. The MI covered the capital position relative to the solvency risk appetite. It had a clear link to the decisions that needed to be made for the management of the fund. The MI also included a summary of the key drivers of changes in surplus between periods. As a result, the WPC and Board had sufficient information to have a good understanding of the assets, liabilities and recent changes to the fund.

Continuation of past practice

5.35 Some firms relied too much on continuing application of provisions in court-approved schemes, without carrying out on-going reviews of whether these practices resulted in fair outcomes. In some cases, firms seemed to assume that compliance with scheme provisions

would, in itself, always ensure fair customer outcomes and/or compliance with FCA rules. They were not checking to ensure this was the case. It may be difficult for firms to show fair treatment of customers if they do not carry out on-going reviews of provisions in court-approved schemes. If firms identify that the current application of scheme rules results in a risk of unfair outcomes, firms can explore whether such issues could be addressed in a cost-effective manner. For example, possible actions include making use of discretion allowed by the scheme, exercising variation provisions where they exist or, if necessary, going back to court to apply to have the scheme amended.

5.36 We saw some examples where firms had continued past practice without adequately considering customer fairness. We set out these examples below.

Continuation of past practice - poor practice example
In 1 case charges payable by a sub-fund to the firm's main fund were set for a period in a transfer scheme. The period set in the transfer scheme had come to an end by the time of this review.

The transfer scheme required such charges then to be reviewed and adjusted (if required) to reflect the costs actually incurred by the main fund. This was to ensure that the sub-fund bears no more than its proportionate share of such administration costs. COBS 20.2.23R similarly states that a firm must only charge costs to a with-profits fund that have been, or will be, incurred in operating the with-profits fund.

On expiry of the period, a review of the charges was carried out. It indicated charges were historically significantly more than the costs incurred by the main fund in administering the sub-fund's business. Further, the firm did not assess expected future costs to determine fairness of continuing the proposed charging structure. The WPA did not recommend any change to the level of charges. The firm's governing processes did not challenge this recommendation.

As a result, the sub-fund continued to incur a level of charges that may have been in excess of those permitted by either the Transfer Scheme or COBS 20.2.23R.

Continuation of past practice - poor practice example
At another firm the main fund provided capital support to a sub-fund via a related capital fund under the terms of a previous scheme. The annual charge for the support was set as a fixed percentage of the value of the capital fund. The charge was deducted from asset shares in the sub-fund. This charge was agreed at the time the scheme was sanctioned, which was more than 20 years before the date of our review. The terms had not been reviewed. It was not clear whether the charge remained appropriate for the with-profits customers in both the main fund and the sub-fund.

Management actions

5.37 For some funds, management actions were not clearly set out in the PPFM. COBS rules do not have specific requirements for inclusion of information on management actions in the PPFM beyond the general requirement in COBS 20.3.5R. However, their absence creates the risk that management actions in stressed situations may be taken by firms without adequate governance and/or sufficient time to consider fairness to different groups of customers. This could result in unfair outcomes for policyholders.

Management actions - good practice example
One fund had a section of its PPFM devoted to management actions. It explained why management actions were needed and when they would be taken, in line with the firm's risk appetite. This included listing certain management actions that the firm may take, such as reducing the proportion of riskier assets such as shares and property held in the fund, setting future rates of annual bonus to zero and increasing guarantee charges. It gave different gradations for actions depending on how stressed conditions are.

5.38 **Outcome 4 - The firm's governance framework results in the fair treatment of with-profits customers.**

5.39 COBS 20 rules set out a range of with-profits specific governance requirements. Our work on this outcome covered firm processes, both in terms of documented structures and how effective governance was in practice.

5.40 All firms in the sample had governance structures that, on paper, were in line with the requirements of our rules in COBS 20. Where we had concerns, these tended to relate to the application of governance arrangements in practice, rather than to the structure of these arrangements. For example, firms often had structures to provide independent challenge but for some decisions we found little evidence of effective challenge having taken place.

5.41 Most firms had strong governance and appropriately considered issues such as whether risk and reward were fairly allocated between customers and shareholders, and whether in-house fund managers were delivering value for money.

5.42 Some firms' governance processes had resulted in changes to firm practices/proposals to make them fairer to customers. For example, in one case, representations from the WPC caused the firm to offer a discount on its annuity prices charged to the with-profits fund.

Independent review of governance structure

5.43 We also found examples where firms had improved their governance.

Independent review of governance structure - good practice example
A firm initiated an independent review of its governance structure. The review highlighted a number of improvements which lead to the firm setting up a new team to improve the timeliness and quality of MI available to the WPA. Due to these changes, the overall resource within the Chief Actuary's team increased considerably and the WPA had more relevant information to help him make decisions. The WPA's role was also restructured to ensure that responsibilities were more clearly defined so that there was greater focus on customer fairness issues and less on operational considerations.

Resource stretch

5.44 We found indications of resource stretch in with-profits fund management at some firms. Our discussions with firms during the review suggest to us that some of the issues we identified elsewhere in this review (eg failure to update ROPs and inadequate minutes) may reflect a lack of resources. This point is not limited to firms with multiple funds. It could

also be related to complexity of funds. We did, however, observe examples of higher resource stretch where firms had multiple with-profits funds.

5.45 In line with COBS 20.5.5R (2), firms should ensure that the WPC or WPAA has sufficient staff and other resources to enable them to fulfil their approved role to the standard that customers in each fund may reasonably expect. This includes ensuring that internal support, including access to the WPA, is adequate. We accept that firms need to control costs, particularly where they may fall on with-profits customers. However, a lack of resources is not an acceptable reason for failing to comply with FCA rules or not ensuring that a firm's with-profits customers are treated fairly.

Board and WPC processes

5.46 The standard of documentation for Board and WPC meetings and other key parts of governance was mixed. For some firms, minutes and Board/committee papers provided comprehensive information about the factors considered and the challenge presented during the decision-making process. We also saw other examples where minutes provided little information other than decisions reached. As a result, in some cases it was difficult for management to show that sufficiently robust challenge had taken place, and to ensure that future decision-makers would fully understand the reasons behind past decisions. Firms should keep records sufficient to show that they comply with the requirements of the regulatory system.

5.47 In some instances, WPC meetings were held very close to Board meetings. This creates a risk that the WPC may not have time to give sufficient challenge, or that there may not be enough time to resolve any WPC queries before the Board makes a decision. While we do not wish to suggest a specific minimum time period between WPC and Board meetings, it is important that firms satisfy themselves that the timing of meetings does not present a barrier to effective challenge by the WPC in line with COBS 20.5.5R(1)(b).

6 Conclusion

6.1 Our review indicated that firms are, in most cases, carrying out appropriate governance to ensure fair treatment of with-profits customers.

6.2 In the limited instances where we found practices presenting a higher risk of customer harm, a key cause was a failure of governance. In particular we found ineffective oversight and challenge by senior individuals and the Board.

6.3 While we have not found evidence of widespread failure to deliver fair outcomes for with-profits customers, we can see areas for improvement.

6.4 We expect firms to take account of our findings, including good and poor practices set out in this review to ensure they meet the requirements as set out in our existing rules and guidance and so ensure fair outcomes for consumers.

6.5 We do not propose new rules or guidance arising from the findings of this thematic review at this time.

7 Next steps

7.1 We are now continuing with the third phase of the review, taking steps to remediate the risks of harm to with-profits customers we identified at individual firms and across the market.

7.2 As funds continue to run-off we expect the challenges involved in ensuring fair treatment of with-profits customers to continue. We will continue to assess firms' treatment of their with-profits customers through our ongoing supervision of firms and senior managers within firms that have with-profits business.

7.3 We expect with-profits operators to use this review to improve how they work, and in turn to improve outcomes for with-profits customers. The messages in this review will be useful to firms of all sizes and structures. In particular, we expect all firms managing with-profits business to consider the findings and examples of good and poor practice and assess whether they need to make any changes to their management of with-profits business.

7.4 We are taking the following actions:

- We have provided firm specific feedback to firms in our sample.
- We have requested actions of firms in our sample where we have identified poor practice. We have asked these firms to tell us what actions they have taken.
- We will engage with certain senior managers across firms through round-table discussions later this year. We want to hear their views on our findings and understand what actions are being taken across the industry in response to these.
- We will discuss the findings from this review with firms operating with-profits business as part of our normal supervisory processes.
- If firms do not address the areas of poor practice highlighted in this review we will consider the need for further action.

7.5 We are also considering carrying out some focused work about the use of With-Profits Advisory Arrangements (WPAAs) before the end of the FCA's 2019/20 business year. This will give further insight into the conduct of smaller firms which manage with-profits funds, and allow us to evaluate the impact of WPAAs now being senior managers for the first time under the SM&CR.

7.6 We will evaluate the effectiveness of our mitigation actions in a proportionate manner. This will involve ongoing supervisory interaction with firms and engagement with key senior managers at future round-table discussions in 2020. We do not plan to issue a formal evaluation paper.

Annex 1
Abbreviations used in this paper

COBS	Conduct of Business Sourcebook
FCA	Financial Conduct Authority
FSA	Financial Services Authority
MI	Management Information
PPFM	Principles and Practices of Financial Management
ROP	Run-Off Plan
SCR	Solvency Capital Requirement
SM&CR	Senior Managers and Certification Regime
SUP	Supervision
SYSC	Senior Management Arrangements, Systems and Controls
WPA	With-Profits Actuary
WPC	With-Profits Committee
WPAA	With-Profits Advisory Arrangement

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