Navigating the new
UK life, pensions and investments in a new regulatory environment
## Contents

<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Looking ahead</td>
<td>3</td>
</tr>
<tr>
<td>RDR — the first 100 days</td>
<td>4</td>
</tr>
<tr>
<td>Platforms — if it is not one thing it’s another</td>
<td>6</td>
</tr>
<tr>
<td>Closing the advice gap</td>
<td>8</td>
</tr>
<tr>
<td>Simplification: a strategy for sustainable success</td>
<td>12</td>
</tr>
<tr>
<td>Focus on protection: an interview with Tom Baigrie</td>
<td>18</td>
</tr>
<tr>
<td>Recovery and resolution planning: the spotlight moves to insurers</td>
<td>22</td>
</tr>
<tr>
<td>The twin-peaks regulatory framework: into uncharted waters</td>
<td>24</td>
</tr>
<tr>
<td>What is conduct risk?</td>
<td>30</td>
</tr>
<tr>
<td>Making care fair?</td>
<td>32</td>
</tr>
<tr>
<td>The mutual sector: forging a sustainable future</td>
<td>36</td>
</tr>
<tr>
<td>Aligning risk management with business strategy</td>
<td>40</td>
</tr>
<tr>
<td>How the financial crisis is shaping the global insurance market</td>
<td>44</td>
</tr>
<tr>
<td>Ernst &amp; Young authors</td>
<td>48</td>
</tr>
</tbody>
</table>
In autumn last year, we published *One step beyond*, which presented our latest insights at a time of enormous change in the life, pensions and investments market. Whilst *One step beyond* is still relevant, we thought an update was necessary as a lot has happened since we published this. *Navigating the new* presents our take on the latest challenges the industry is facing and our point of view on the best ways to succeed in the post-RDR world.

As advisors to this industry sector, we continue to help organisations make sense of this rapidly changing environment and to support firms as they seek to position their businesses for success. We hope the articles in this publication provide some insights for those who are operating in the new regulatory environment.
“We remain of the view that advisor numbers will continue to fall for some time. And we think our 2009 forecast of 20,000 by year end remains realistic.”
Looking ahead

By Trevor Hatton

Since moving to Ernst & Young to lead our UK life and pensions business, I have been struck by the wide range of different responses the industry has to its new regulatory environment.

The past year or so has been particularly challenging for life companies, asset managers, platform providers and distributors. Preparing for RDR, re-shaping plans for Solvency II, reflecting the impact of taxation changes and the gender neutrality directive on product pricing and strategy have used up already scarce technology and management bandwidth. In spite of this, the industry has moved forward. And the shares of the listed providers have performed exceptionally well. In fact, from 1 January 2012 to the end of March the average share price increase for the relevant players is 44% compared with 15% for the FTSE as a whole.

Anecdotal evidence suggests that, following an excellent Q4 2012, new business for many players during Q1 2013 has been slow. This is unsurprising given the fundamental change to market dynamics driven by RDR, and we expect to see a steady improvement as the year progresses and as consumers and advisors get to grips with the new environment. However, we remain of the view that advisor numbers will continue to fall for some time. And we think our 2009 forecast of 20,000 by year end remains realistic.

Last month saw the final report from the Sergeant Review of Simple Financial Products. The terms of reference for the project were that simple products must help consumers benchmark and compare other products on the market; be understandable and accessible to the mass market; must not be tailored to meet individual needs, but provide consumers with confidence that a simple financial product will meet their basic needs and offer them a fair deal. And be a viable commercial proposition for providers.

The recommendation for the Simple Life Cover Policy is for single life, fixed term, guaranteed premiums with monthly payments. At this stage, income protection is not included but work continues to assess whether a simple version of this important cover can be developed. In the meantime, providers will be encouraged to develop policies in line with the recommendations and apply for a British Standards Institution (BSI) simple products badge.

Other Simple Products recommended in the review are an easy access savings account, a 30-day notice savings account, and a regular savings account. Our immediate reaction is that it will take some time for these products to gain traction and that Simple Life Cover, if launched, could gain share most swiftly. In any event the Sergeant Review throws down the gauntlet for life companies and we expect to see a positive reaction.

On the subject of simplification, our work on understanding the operational impact continues. And our research reveals a 24% return on equity (ROE) gap between the most simple and the most complex insurers.

Of course, we now have new regulatory bodies and we anticipate changes in approach compared with the Financial Services Authority (FSA). For example, our early engagement with Financial Conduct Authority (FCA) reinforces the view that they will be more interventionist and intrusive with a significantly increased use of thematic reviews and section 166 reports. Areas of concern identified in their first risk outlook include complex charging structures, incentive schemes, and the need for increased consumer financial capability if non-advised investment sales increase in the post-RDR world.

Finally, may I say that we would very much welcome your feedback on this publication and if you could spare a couple of minutes to send me an email with any comments, it would be very much appreciated. My contact details are at the back of the document along with all the other contributors.
As anticipated, most organisations were compliant with the statutory RDR requirements on day one and about 85% of advisors had gained the required qualifications and statements of professional practice.

Clearly, some intermediary firms have been selling fee-based propositions for many years. But for life companies and intermediaries embarking on RDR transition, we estimate that the best prepared were at least 12 months ahead of the pack. However, we know that a number of players were burning the midnight oil between Christmas and New Year’s Eve. And it is clear that many are still in transition to the post-RDR world in terms of culture and, indeed, proposition.

We have identified some weaknesses in many of the post-RDR service propositions we have seen. In particular some fee structures and rates seem to represent transition rather than the probable end-game, some ongoing service propositions do not appear compelling and there seems to be an absence of fail-safe systems and controls to ensure that what is promised is actually delivered.

**Initial advice fees**

In the old world, the basic model was no transaction = no revenue to the advisor. And the standard commission was a minimum of ‘three plus a half.’ Here we are in the new world and the preferred investment advice model appears to be ‘three plus a half’ contingent on a transaction – with a reduction for clients investing over, say £250,000.

Clearly, an element of fee linked to the size of investment makes sense, as the advice risk and potential remediation cost are to an extent proportionate. However:

► Most intermediaries are suggesting they intend to move up-market, yet fee structures as a percentage of investment means that the £50,000 investor can get a better deal value than the £200,000 investor. Bluntly, some fee structures are not yet aligned with the strategies – or indeed with the cost of delivering the service.

► All firms – vertically integrated or not – must understand how much it costs them to deliver advice, add margin and price accordingly. They can package this up to a fixed price if that is the preferred option for their clients or charge by the hour. And they can also charge a fee related to the size of any implemented investment.

► A fee solely based on a percentage of a transaction perpetuates the cross-subsidies of commission. People that execute subsidise those that don’t. Larger investors subsidise smaller investors. In the post-RDR world these subsidies will be clearly visible and, over time, seem to be unattractive.

“A fee solely based on a percentage of a transaction perpetuates the cross-subsidies of commission.”
No transaction = no fee also creates a conflict of interest. And this will need to be monitored and managed carefully.

Organisations need to sell the advice service up-front and agree an appropriate fee structure that offers fair value to both parties. Working 100% on contingency is not likely to create a sustainable business for most advisors or an acceptable economic model for vertically integrated firms unless they have a particularly strong consumer franchise.

Advisors will, over time, gain the confidence and skills to sell advice propositions which do not rely upon selling a product. Looking at the market today, it seems this may take longer than we anticipated.

Ongoing services

Every service proposition we have seen has a strong focus on ongoing service. The underlying business plans for vertically integrated firms and the exit strategies (where they exist) for intermediaries reflect the importance of revenues from this source.

In common with initial advice, fees are tiered so that larger investors pay a lower percentage with 1% as a typical maximum and 50 basis points (bps) as standard. However:

- It is not always clear what service is provided to clients who do not wish to pay for an ongoing fee. If, for example, they still have free access to an advisor and online valuations why are others paying for these services?
- Equally if a client invests say £50,000 initially and then a further £100,000 the ongoing fee will triple with the propositions we have seen. The extra benefit that will be provided to the client in return for the extra fee is unclear.

Unlike existing trail commissions, if a client cancels the ongoing service they gain the benefit. For people in retirement, 50bps could be 20% of their investment income. As such advisors will need to work hard to justify the payments. And they will need to evidence their value to the client and demonstrate controls in order to satisfy the regulator that they are delivering on their promise.

Engaging with less affluent consumers

Investment advisors will tend to focus on mature, wealthy consumers going forward. And many retail banks have concluded that offering face-to-face advice to their mass market customers is not practical in the RDR world. Commentators have pointed to the investment advice vacuum that will be left. We take the view that this vacuum is less of a problem than most suggest. In fact it represents an opportunity.

Nature abhors a vacuum. And if one does appear, a number of players are already considering how to fill it via a range of business models. Insurance companies are at the forefront, some asset managers are also working their way to the start line. New brands are also emerging. Potential business models include: face-to-face and/or online protection advice propositions, online guided and/or full investment advice propositions, investment into intermediary businesses or any combination of the above.

We look at this issue in more detail in Closing the Advice Gap on page 8.
Platforms – if it is not one thing it’s another

By Sara McLeish and Malcolm Kerr

At Ernst & Young, we had hoped that the industry would by now be in possession of a final FSA policy statement on platform regulation for the post-RDR world. Instead, on March 25 2013 we received Revenue and Customs Brief 04/13, which sets out HMRC’s view on the tax treatment of payments of rebates and trail commission passed to investors in funds and other associated investment products (including life policies).

HMRC’s view

HMRC has stated that it never officially opined on the treatment of ongoing trail and rebates, and that the statement of practice from 1997 does not cover them either. Having reviewed the nature of these payments, HMRC has concluded they are ‘annual payments’, which is a term of art in the tax world. This conclusion has two main consequences:

- The payments are taxable receipts in the hands of the investor
- The payer is obliged to withhold and pay over to HMRC basic rate income tax on the payments

HMRC accepts that this conclusion does not agree with current market practice, and further accept that it has not challenged this treatment in the past (indeed it does state that it may have given unclear advice to some taxpayers). On this basis, HMRC does not think it is justified to go back and reopen past payments. However, HMRC has a duty to apply the law as it interprets it, and therefore has stated that its interpretation should be applied for all payments made on or after 6 April 2013.

HMRC also states that this treatment applies whether the trail or rebate is paid to the investor in cash or in kind; for example, through the issue of additional fund units, or by being passed to an advisor to settle their fees.

It should be noted that where these payments are made to a tax free account such as an ISA or SIPP, no tax will be due and nothing need be withheld. In relation to payments to ISAs, so long as the payment does not leave the control of the ISA manager, HMRC accepts that this is not an additional subscription for the purposes of the annual investment limits.

“We believe all providers will need to transition to ‘clean’ share classes without rebates by the end of this financial year.”
Market impact

The timing of this brief is very unfortunate coming hot on the heels of the Budget, the launch of the UK Investment Management Strategy and the commitment to make the UK one of the most competitive places in the world for asset management.

In terms of next steps, it is clear that asset managers, platforms and intermediaries need to review to what extent they are making payments direct to end investors and whether these are likely to be treated as annual payments. Processes and controls will need to be developed to ensure that the appropriate tax treatment is applied and the necessary reporting to investors and HMRC is also carried out.

Intermediary impact

We believe all providers will need to transition to ‘clean’ share classes without rebates by the end of this financial year. And as far as legacy business is concerned, advisors will need to consider whether an immediate transfer is appropriate for clients. If this is the case, legacy trail will be lost and fees for ongoing services will have to be agreed. This could pose serious issues for some firms including reduced revenue and — until fee arrangements are put in place — revised assumptions around business valuations.
The term 'advice gap' has entered common parlance in relation to the RDR. Recent research (our own included) shows that many customers are unwilling to pay for advice, at least at the level that advisors are currently charging post-RDR. They appeared happy to believe that advice came 'free' with product purchases and RDR focuses their attention on the explicit cost.

The RDR ‘advice gap’ creates the need for new customer propositions

Many banks – previously the main channel for advice to mainstream customers – are either withdrawing or retreating to the wealth segment. This is driven by the economic impact of unbundling advice from product sales, as well as customer reluctance to pay explicitly for advice, and indeed the risk that the cost of advice may lead to what the regulator calls ‘self-defeating transactions.’

At the same time, research also reveals that few customers are happy to buy without some sort of support or guidance. They find it difficult to make the right decisions on their own. This appears particularly true for mass and mass affluent customers. A recent study by Fidelity and Cass Business School estimates that some 26 million people could fall into what they call the ‘guidance gap’ – people who need help to buy but are effectively excluded from advice. These customers typically have relatively straightforward needs and small sums to invest; so simple product solutions such as ISAs are likely to be appropriate. However, they still need guidance to help them make a well-informed decision.

Non-advised channels have, of course, been available for decades. And more recently sophisticated on-line investment services have been developed. Typically, these have been aimed at higher wealth ‘self-directed’ customers who possess the motivation to research a wide range of product wrapper and fund options before making their decision. These services tend to be too complex for less sophisticated customers with simpler needs. Therefore, online services tailored for the simpler need are springing up to address the guidance gap, either through fund providers themselves or intermediary services like nutmeg.com or moneyvista.com.

Other new solutions tap into the increased willingness of customers to research and buy online, encouraged by the great service provided by retail sites outside of financial services, such as Amazon. However, customer use of these solutions appears limited to date and our research indicates that whilst these types of services have interesting features, they are not yet delivering the sort of holistic experience that will be sufficient to fill the guidance gap. In other words, there is no killer app.
Winning propositions need a distinct and stretching set of characteristics

It is easy to list the characteristics a winning guidance model would need to have – but a lot harder to make these work in practice. We think a winning solution would need to:

► **Develop a reputation as a customer champion:** to stand out in a crowded market place where many providers are promising similar things, customers will need to believe the service is genuinely designed to put them in control and serve their interests, not just those of the providers. This status is won not by self-assertion but by independent recognition which highlights examples of real customer needs being met.

► **Deliver effective guidance:** it is hard to do this well in a way that the customer can understand without incurring the risk of implied advice. Even where customer needs are simple, the factors that should be taken into account are not. Although guidance does not involve a personal recommendation, the outcome still needs to be appropriate to the customer and make them feel empowered to make their selection with confidence.

► **Deliver an engaging customer experience:** financial services shopping is not an enticing subject for most customers. Keeping them interested and confident as they negotiate the inevitably complex process of identifying their real needs and selecting the right product requires innovative design. Personal contact (such as web chat) is likely to be an essential factor, to move the process on where customers get stuck.

► **Align the revenue model to customers’ perceptions of value:** many current online financial and non-financial propositions are challenged by the need to set a price, which is seen to be good value, and also generates sufficient margins for the business. The increasing transparency of product pricing, combined with the reluctance of customers to pay for ‘advice’ (which they are unlikely to clearly differentiate from ‘guidance’) makes generating a viable revenue stream extremely challenging, as some early entrants have already found.

“... there is no ‘killer app’.”
Building the capabilities required to deliver the proposition is challenging

Traditional providers of retail financial services are generally not well equipped to succeed in this market, which is why many current contenders are either independent start ups or distinct greenfield operations separate from the host provider. The capabilities we think are needed include:

► Customer insight based on sophisticated analytical capability, to understand customer attitudes and behaviours and the flexibility to design and adapt customer propositions accordingly.

► Online marketing skills to develop the right brand positioning and visibility to attract target customers and create loyalty and advocacy.

► Innovative digital design capability to deliver the required customer experience and engagement.

► Strong insight into the regulatory environment and the creativity to design guidance solutions that are simple enough to work online whilst delivering acceptable customer outcomes.

► Access to a broad range of products designed to meet target customer needs, which customers perceive as simple and easy to understand.

► An ultra low cost structure to achieve sustainable profitability with a revenue model which is likely to involve low levels of income per customer, with customer value building over the long term.

► Willingness to invest for the long term (given likely long payback on brand building and customer acquisition) and the flexibility to change based on detailed testing and close attention to customer analytics.

In our view, there isn’t likely to be a single killer app which will dominate this market. It is more about getting a lot of detailed operational requirements right and building a customer reputation over time through consistent delivery of a clearly perceived value. Just as in any other consumer business: ‘retail is detail.’
Navigating the new UK life, pensions and investments in a new regulatory environment
So what is the key to success in an environment with a sluggish economy, low investment returns, price erosion, and ever increasing regulatory intervention? We believe the answer to this is business simplification.

By simplification, we mean clarity of purpose underpinned by a clearly articulated strategy (that all employees can mobilise around) and the elimination of operational complexity in order to achieve a more stable platform for growth. Our hypothesis is that simpler organisations tend to outperform overly complex ones both in growth and profitability, and an analysis we’ve conducted appears to support this correlation (more details below).

There are a few important points to mention here: we are not saying that small simple businesses will always outperform large ones, but rather that we’ve demonstrated that large multi-line, multi-geography businesses can also benefit from relative simplicity to outperform their peers. We also understand that no senior executive deliberately chooses to operate in a highly fragmented, multi-dimensional matrix business with duplication of processes, a vast array of legal entities and a lack of consistent and transparent performance metrics. However, many organisations find themselves grappling with this challenge because they have made decisions that are individually sensible in their own right, but when added together create an organisational burden which is just too complex to lead. In this article, we present the benefits of business simplification as we see them.

Context

When we originally decided to test our hypothesis that more simple businesses would outperform relatively more complex ones, we expected there to be a correlation. But the extent of some of the findings, and the scale of performance variation that we found, surprised even us. In order to test our hypothesis we looked at a sample of 32 insurers and brokers of varying scale and on a cross section of geographic coverage.
Relatively simple businesses sustain growth more effectively than more complex ones

Our research found that insurers with simpler operating models are more likely to deliver higher sustainable growth through a challenging financial period (see figure below). By contrast, more complex insurers generally display lower growth rates over the same period. The most successful examples have implemented a cycle of growth and simplification to promote ongoing 'external agility.' This has allowed them to respond to changing market conditions to sustain higher performance more effectively, realise value from opportunities more quickly and inspire confidence in shareholders and analysts in order to maintain a consistent valuation.

Strategies that focus on the fundamentals, such as sophisticated underwriting, operational excellence, or focused distribution, ensure that incremental complexity doesn't creep in. By diversifying successfully, for example, into businesses that can be integrated easily and create synergy, acquisitions don't have to increase complexity. Simplicity can be maintained through clarity of purpose, and speed and repeatability of assimilation.

Graph 1: Insurers’ performance variation – compound annual growth rate (CAGR) versus complexity

Source: Ernst & Young analysis
Simplification increases profitability

Simplified insurers maintain stronger profitability than more complex insurers, as well as stronger growth. There can be as much as a 24% gap in ROE between the simplest insurers and the most complex (graph 2).

**Graph 2: % gap in ROE performance by level of complexity**

![Graph showing the percentage gap in ROE performance by level of complexity.](source: Ernst & Young analysis)
This is because they have combined their ‘external agility’ with ‘internal agility’ and use simplification to address internal cost drivers more effectively. Simplification activities have included streamlining of management structure and decision making processes, avoiding the formation of convoluted management hierarchies. This enables faster decision making to respond quickly to changes in customer needs.

Simplified insurers have also tightened control over technology and processes – aiming to evolve in line with ongoing developments in the marketplace; whilst ensuring each improvement is integrated based on ‘simplification principles’. Finally, as part of their simplification efforts, some insurers have minimised ‘non-productive’ costs by ensuring investments and resource efforts are always targeted at driving core value, not getting diluted by internal complexities.

**Traditional life companies’ positions are increasingly threatened by more focused and agile ‘new models’**

The benchmark for simplicity in the life and pensions sector is increasingly being set by non-traditional companies (some without specific regulatory life insurance approval). These companies have been able to achieve higher levels of growth and ROE than traditional companies by rigorously focusing on a limited number of core competencies and through the effective targeting of customers (see graph 3).

Although these new players do not benefit from the cash flows generated by large legacy books of business, they also avoid the cost and complexity of having to support the complex, out-of-date IT systems that generally come with them. This helps support an entrepreneurial culture that enables fast decision making and further increases internal and external agility.

Rather than adopting a ‘me-too’ approach to competing with these new models, the more successful ‘traditional’ life companies focus on understanding their own sources of competitive advantage and then eliminating any activities which do not directly support this advantage.
“There can be as much as a 24% gap in ROE between the simplest insurers and the most complex.”

Graph 3: Performance comparison of traditional life companies versus ‘new models’

Source: Ernst & Young analysis
A thematic, enterprise level response to insurance regulation drives business simplification

Some insurers have successfully turned the increasing burden of regulation into an opportunity to simplify their capital, entity and organisational structure, as well as their operating processes. They have embedded their response to multiple finance themed regulations within a broad finance, risk and actuarial transformation programme. They are delivering sustainable value by combining the organisational response to multiple complex regulations, incorporating this response with other required finance change (e.g., system replacement) and targeting specific benefit delivery through simplification.

Conclusions

Clearly, this article presents only a snapshot of some of our findings around business simplification and we are not able to cover them all here. There is a large technology element, for example, to achieving simplification which we’ve not touched upon in much detail. Our key challenge to companies at this time is: in this current period of sustained economic turmoil, can you afford not to simplify?
An interview with Tom Baigrie

Focus on protection

LifeSearch CEO Tom Baigrie speaks to Ernst & Young about the business he founded and still runs. As a beacon of success in the market, LifeSearch now sits at the forefront of the protection space; selling up to 1200 policies a week whilst still remaining true to its founding values. Here – in his forthright words – Tom talks to us about how he sees things...

How did LifeSearch enter the market?

“When we started in 1998, it was off the back of 20 years of face to face advice, and a realisation that more and more consumers preferred to deal over the phone. Our leads came from national press advertising and PR. But in 2001-02 yields dropped off a cliff. Front page spread advertising in the national press money sections on a Sunday, fell from making us between £20–30,000 gross per insertion to less than half that.”

“That incredible change was the arrival of the internet and so we moved swiftly on to pay per click (PPC) advertising. We must have been just about the first people to ask an internet lead to give us a phone number before a quote was provided so we could phone potential clients to try and go beyond just giving a quote online. We would ascertain their needs and recommend the best solution. The conversion rates achieved made the online route viable in protection. PPC worked well as a lead source until three or four years ago when we began to see rising costs and lower results from many of the smaller online affiliates (some of which were generating thousands of leads a week for us through search engine optimisation and PPC and editorial links). This rising cost of lead generation encouraged us to build a new model serving sites which actively collect customer leads themselves, such as Go Compare, Compare the Market and MoneySupermarket. The life business from these sites is largely free to market as a result of their overall marketing spend and the customer flow they get through their sites as a result.”
To what do you attribute your success?

“Whilst our customer acquisitions process has changed hugely over the years, our customer engagement process has always remained 100% constant. The core strength of LifeSearch is that our values haven’t changed from the day we started. They are really very simple: we are committed to ensuring that as many consumers as possible come away with the right protection solution for them. Sometimes that is what they need, rather than what they first wanted. That’s the role of a professional advisor. And it’s clear this works. Recent client research showed that 95% of clients who answered the question said, ‘Yes’ they would recommend LifeSearch to family and friends.”

Ernst & Young’s Global Insurance Customer Survey (2012) found that consumers don’t compare financial services organisations with other financial service organisations – they compare them with other organisations full stop. Does this surprise you?

“No. If you buy a consumer goods product and it doesn’t satisfy you, the retailer and manufacturer will soon have to withdraw that product line. It just fails fast. There are many examples of products leaving the market every day. In financial services though, the failure point cannot be assessed by the consumer i.e., they cannot become dissatisfied with it, until its yield point. For life insurance policies this could be 25 years away. So regulation has stepped in to force the issue. But this hasn’t happened swiftly – it was perhaps five years too late, as with PPI. That is a very poor method of replicating what fast moving consumer goods markets deal with every day. It is therefore up to the market professionals to ensure that products are suitable, which is what I believe the FCA intends to enforce in a way the FSA has not.”

The protection market has been pretty flat for several years, yet there is a common acceptance that people are under insured. What do you think the industry could do to galvanise consumers to think more about protection and what could the regulator do?

“There are lots of things the industry can do. Consumers seem to feel they need a product a little less every year, and whenever you see new research it shows that trend is remarkably consistent across different product and consumer ranges. But for any given individual that is certainly not true, so there remains a desperate need for the industry to communicate more with consumers – whether that be through advertising, social media or more journalistic effort. In terms of what government can do, the Treasury has started to help simplify products in general so that customers can better understand what they are buying. However, this will not change the world. If anything deserves tax relief it is surely a policy that will stop you claiming on the welfare state if you cannot work, or one that stops your dependants becoming destitute if you die. However, I won’t be holding my breath.”

“Our products very much do what they say they are going to do. They pay out 90%+ of the time, which is far beyond consumers’ expectations, and they pay out to people who really need the money. However, one thing I would ask the regulator to do is to simplify the process so that essentially my duty can be summed up in one line: to set very clear expectations with the customer as to what this product will or won’t do for them, and then to ensure the product delivers on that. Between me and the manufacturer that should be the only thing we have to do in terms of regulatory rules, rather than the vast contractual communication duties the FSA has imposed upon us; none of which actually achieve their aim. The sheer number of words required to comply makes the process near-impossible for ordinary consumers to read through and thus fully understand.”

“The mission of the FCA is to ensure consumers get a fair deal. My contention to the FCA would be that a fair deal has to be simple enough for consumers to understand and that regulation should not force unnecessary complexity of explanation upon us in order to meet the goal.”

What do you think of the simple term insurance product recommendation from the Sergeant Report?

“It is a term insurance policy with some useful add-ons stripped out, so it has to be less expensive than current best-of-breed term insurance policies in order to be seen as good value. I wholeheartedly endorse the ambitions of the simplification programme and quite like the delivery mechanism that Carol Sergeant has proposed, but we were very disappointed that the process failed to deliver the one key consumer need – a simple income protection product. The sooner they can achieve this, the better.”
Meeting the needs of ever more demanding customers

“The consumer is becoming an infinitely more challenging client – they demand that their expectations from financial services products and services, including non-advice services, are met absolutely. All of us in financial services know that technically that is almost impossible. Whether it’s variable investment returns or, in my world, adverse underwriting decisions, our goal must be to manage expectations such that we end up doing what we have led the client to expect we will. For example, at LifeSearch we will be trailing adding an advisory back up call to policies bought online so as to help protect that new route against the reputational damage that has afflicted its predecessors.”

The age of insurance price comparison non-advised websites

“Will these dominate the life and protection market in years to come? Well, I’ve voted with my feet and formed partnerships with several of them. Our strategy is to provide families and individuals with protection as best we can. Sometimes this can be through a non-advised process, because as consumers it can make sense to do your own research and make your own decisions in areas where you feel confident to do so. But where consumers want advice, or where they can be made aware of its importance to them, we advise. The problem is that consumers can overestimate their ability to evaluate a product. We are therefore working closely with our key aggregator partners in that space to improve consumer outcomes.”
And for you in the future ... say when you are 60 in 2021?

"It may surprise those that know me, but I’d like to be on the board of the FCA (if that is what it is called then). It’s a long way off and I have much to be getting on with, but I would like to think that regulation will have matured to a point where a reasonably successful practitioner, who has managed his financial services businesses through what would then be something like 40 years of regulation, could find himself where it matters, trying to make sure that consumers still have a viable profession to engage with when they need financial advice. It may be too late by then of course."
Recovery and resolution planning: the spotlight moves to insurers

By Kabari Bhattacharya

In the wake of the global financial crisis of 2008, governments and regulators recognised that there was an urgent need to address firms being ‘too big to fail.’ They believe that if government financial assistance may be necessary to support institutions under extreme stress, they should have a stronger ability to influence the reorganisation and recovery of such groups.

Recovery and resolution planning is therefore being introduced so that governments may avoid having to bail out systemically important financial institutions in a crisis. The plans are essentially blueprints for emergency actions to be taken in case of severe distress and, if necessary, to enable an institution to be liquidated in a way that limits the impact on retail customers and the global financial system. After a long, hard period of scrutiny of banks, regulators are now turning to insurers.

The International Association of Insurance Supervisors (IAIS) will shortly deliver a list of global systemically important insurers (G-SIIs) to the Financial Stability Board (FSB), which will be published towards the end of the first half of 2013. The G-SIIs will be required to submit detailed recovery and resolution plans and systemic risk reduction plans. At a global level, the IAIS, under the tight remit of the FSB and the watchful gaze of the G20, is now assessing 48 insurers for systemic risk across five key factors: size, global activity, interconnectedness with the financial markets, ease of substitutability of cover, and non-traditional and non-insurance activity.

Whilst those being targeted in this first round of designations (more rounds will follow) may already know who they are, companies that are planning their responses need to formalise these plans, and those who have not yet begun to plan need to do so right away. Once the designations are announced, insurers will have 18 months to develop and complete a recovery plan, a resolution plan and a systemic risk reduction plan. This will be challenging for most.

If the equivalent banking timetable is anything to go by, the insurance recovery and resolution planning timetable is likely to remain fixed. Implementation of the systemic risk reduction plan will be expected in the following 18 months and could include restructuring, improvement of liquidity planning and improved governance – some insurers are already considering ring-fencing areas of the business, which may be deemed by the regulator as generating systemic risk.

The insurance industry’s reaction to recovery and resolution planning is mixed: whilst some object to the prospect of yet more regulatory pressure and continue to lobby against global systemically important financial institution (G-SIFI) designation, others recognise that the global reach, size and level of diversification they enjoy are contributing towards a more cautious approach. Some insurers can see that recovery and resolution plans are perceived as a good thing for the market and that there are obvious strategic opportunities to position their products as recovery solutions. In addition, many insurers can build on the preparation work
they have already undertaken for a series of other initiatives, notably Solvency II. Whatever an insurer’s opinion, those who think there’s a reasonable chance they’ll be designated as G-SIIs are gearing up and designing programmes to prepare ahead of the announcement of the first cohort of G-SII designation.

The EC is currently considering its approach to systemic risk in non-banking financial institutions, such as insurance. National policymakers also are paying greater attention to this area. Even if an insurer is not designated as a G-SII, regional or national supervision still means it must contemplate its potential failure. Regulators are likely to require evidence of credible planning covering core business units and jurisdictions. Developing a consolidated approach that addresses global, regional and national systemic risks means the impact on insurers will be substantial. Insurers must look at the contingency plans they have in place and make them more robust, identifying the risks and dependencies to which they are subject, the available options and necessary decisions.

Whilst all the work already completed with respect to programmes such as Solvency II preparation and enterprise risk management (ERM) provides many groups with a good foundation for recovery and resolution planning, the exercise is far from trivial, given the complexity of insurance regimes in many countries and the degree of connectivity in some insurance groups. Banks have found that addressing these areas requires the involvement of many specialist skills and needs sponsorship from the top. This is hard to achieve when many countries are evolving their insurance regulation. However, the greater risk to insurers in the next few months is not engaging with the process on a timely basis and at a sufficiently high level.
In October 2012, the Bank of England and the FSA published *The Journey to the FCA and The Bank of England, Prudential Regulatory Authority – The PRA’s approach to insurance supervision*. This was in anticipation of ‘twin-peaks’ regulation which begins this month with the legal cutover from the Financial Services Authority to Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA). These amendments will drive significant changes in the way insurers and others manage both prudential and conduct risk.

**An overview of the 'Twin-Peaks' regulatory framework**

Under the new system, the prudential supervision of banks, insurers and major investment firms will be the responsibility of a subsidiary of the Bank of England, the PRA. The Bank of England will focus on macro-prudential supervision and the PRA micro-prudential supervision of individual firms. The FCA will focus on consumer protection and market regulation and be responsible for brokers, intermediaries and fund managers.

Within the Bank of England, the Financial Policy Committee will be responsible for working internationally with national regulators. As the prudential regulator, the PRA will represent the UK on the new European supervisory authorities for banking, the European Banking Authority, and insurance, the European Insurance and Occupational Pensions Authority (EIOPA). The markets division of the FCA will represent the UK at the new European Securities & Markets Authority.

The common themes across both the PRA and FCA in terms of supervisory approach are:

► A judgement led, forward-looking approach
► A greater focus on business model analysis
► A more risk based regime
► The end of traditional ARROW risk assessments
► An increase in the use of skilled person reports (s166) and thematic reviews
However, beyond these common themes, the regulators will operate in different ways to achieve their respective objectives:

**FCA**

<table>
<thead>
<tr>
<th>Single strategic objective</th>
<th>Approach to supervision</th>
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<tbody>
<tr>
<td>► Making markets work well</td>
<td>► A ‘risks not rules’ based approach seeking to focus on key conduct risks at both a firm and sector level</td>
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<table>
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<th>Three operational objectives</th>
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<tr>
<td>► Consumer protection</td>
<td>► More forward-looking in the assessment of emerging conduct risk</td>
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<tr>
<td>► Market integrity, focusing on:</td>
<td>► Early intervention to ban misleading promotions and unacceptable products</td>
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<td>► Soundness, stability and resilience of firms</td>
<td>► Advising the public when proposing to take enforcement action against a firm</td>
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<tr>
<td>► Preventing financial crime</td>
<td>► Greater focus on product ‘value’</td>
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<tr>
<td>► Preventing market abuse</td>
<td>► Greater use of data to anticipate risks and trigger responses</td>
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<tr>
<td>► Transparency of price formation</td>
<td>► Risk assessment visits to individual firms will continue but there will be an increase in both the frequency of and breadth of thematic reviews</td>
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<tr>
<td>► Encouraging competition in the interests of the consumer</td>
<td>► Increased use of skilled person (s166) reviews to supplement supervision</td>
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In addition to the strategic and operational objectives, the FCA will have a duty to discharge its general functions in a way that promotes competition, insofar as is compatible with its objectives.

**FCA risk outlook**

The main risks identified for the coming year are:

- Firms not designing products and services that respond to real consumer needs or are in consumers’ long-term interests
- Distribution channels not promoting transparency for consumers on financial products and services
- Over-reliance on, and inadequate oversight of, payment and product technologies
- A shift towards more innovative, complex or risky funding strategies or structures that lack oversight, posing risks to market integrity and consumer protection
- Poor understanding of risk and return, combined with the search for yield or income, leading consumers to take on more risk than is appropriate

**PRA**

<table>
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<th>Two complementary objectives</th>
<th>Approach to supervision</th>
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<tbody>
<tr>
<td>To promote insurers’ safety and soundness, thereby supporting stability of UK financial system</td>
<td>Focus on issues and insurers that pose greatest risk</td>
</tr>
<tr>
<td>To secure an appropriate degree of protection for those who are or may become policyholders</td>
<td>Ongoing dialogue and analysis, rather than individual firm visits</td>
</tr>
<tr>
<td>Greater engagement with the board and senior management of a firm’s Chief Risk Officer, Actuary and Auditor</td>
<td>Focus on key prudential risks (rather than all)</td>
</tr>
<tr>
<td>Focus on prevention rather than cure with enforcement action relatively rare</td>
<td>Greater use of skilled person (s166) reviews on prudential issues to supplement supervision</td>
</tr>
<tr>
<td>Greater use of skilled person (s166) reviews on prudential issues to supplement supervision</td>
<td>Approach based judgement rather than narrow rules-based, and will be forward-looking</td>
</tr>
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</table>

The split between prudential and conduct supervision allows each regulator to develop its own policy and focus on the issues and risks that matter to each.
What you need to consider

Organisation

Review the management of the regulatory relationships: with two regulators rather than one to manage, firms will need to consider whether their existing model, often built around a single point of contact such as the Compliance Director, is still appropriate. The PRA expects most of its dialogue to be with the Chief Risk Officer, Chief Actuary or Chief Financial Officer and it may therefore be appropriate that, for example, the Chief Risk Officer picks up the relationship role with the PRA whilst the Compliance Director manages the relationship with the FCA.

Evaluate your compliance and risk functions: firms may also wish to consider whether the term ‘Compliance’ appropriately reflects the breadth of the role required in the future. A number of firms already have a regulatory risk function, instead of compliance. This reflects the greater risk, rather than legal, focus and the need for regulatory risk to be managed within the overall risk appetite and framework in the same way as other risks.

Business model assessment

Assess the risks in your business model: one of the essential differences will be the extent to which a firm’s business model and product-set will be challenged, in terms of both the prudential and conduct risks inherent within each.

Unsustainable business models have often been cited as one of the causes of the financial crisis, business models have also led to systemic conduct risks in recent years – for example, selling secondary products to generate profits on the back of loss making primary products, such as payment protection insurance sold on the back of loans. The board and senior management team will need to understand the key prudential and conduct risks inherent in their business model – and any strategic changes to that model, planned or required.

Development processes

Review development processes: as expected, there is an even greater risk element to the strategy development process and greater scrutiny of potential conduct risks in terms of new strategic initiatives. Examples include new products, new distribution channels or targeting new customer segments. There is, therefore, a need for insurers to consider whether they can evidence:

► Sufficient product oversight and monitoring of practical outcomes for consumers and appropriate distribution strategies
► How they incorporate assessment and review of those risks into their strategy planning and review process
► How actions are allocated and tracked in terms of better understanding and managing those risks
Navigating the new UK life, pensions and investments in a new regulatory environment

Risk framework

Re-tune your risk framework: whilst Solvency II has increased the importance of risk management in the running of an insurer, twin-peaks regulation is driving a number of changes within the risk framework. For example, a need to:

► Ensure risk frameworks are proportionate to the firm’s nature and size of its business
► Review control functions and frameworks to ensure these are comprehensive and commensurate
► Articulate the firm’s risk appetite and operate within this appetite, with risk decisions appropriately escalated
► Assess and articulate the key business model risks within the risk register
► Divide the risk register between prudential and conduct risks
► Articulate, and monitor against, the firms’ conduct risk appetite
► Create or revise the conduct risk element of the risk register – typically to articulate the key risks of not delivering an appropriate customer outcome rather than simply not complying with a rule (see our next article)

The third peak – the European angle

As insurers come to terms with twin-peaks regulation, they should not forget an important third peak. The new European regulatory framework gives greater legal authority to the European Supervisory Authorities over national regulators, compared with the previous regime. For the insurance industry, the European supervisory authority is EIOPA and it defines the technical (regulatory) standards across Europe with national regulators, such as the PRA and FCA, being responsible for implementing them. A critical element of understanding, and influencing, future prudential and conduct risks will therefore require closer relationships with the European Commission, the European Parliament and EIOPA.

Conclusion

The move to a twin-peaks regulatory framework is a watershed moment in the development of the UK regulatory environment. How the framework will work in practice will become clear in the coming months, but firms should, by now, have positioned themselves in terms of their control frameworks to meet the challenges to come.
Martin Wheatley in his introduction for *Journey to the FCA* noted that “the creation of the FCA is an opportunity to reset conduct standards for the financial services industry” and “the way firms treat their customers, their behaviour towards each other and the way they operate in the market; is what we mean by conduct.” Essentially the FCA will be looking for firms to base their business model, their culture, and how they run the business, on a foundation of fair treatment of customers.

The FSA, now the FCA, defined conduct risk as ‘the risk of a firm failing to treat its customers fairly and delivering inappropriate outcomes.’ The regulator is increasingly asking firms to articulate and agree their conduct risk appetite.

In their guidance consultation published in December 2011, the FSA wrote to firms about its expectations of non-executive directors (NEDs) in delivering the proper management of retail conduct risk. Although this was centred around the responsibilities of NEDs, the principles apply across the whole of the firm, with the key questions for firms to ask themselves being:

► Are the business proposals aligned with the firm’s conduct risk strategy and within its stated conduct risk appetite?
► Is the firm’s culture such that it delivers good behaviours and outcomes, both prudentially and for customers?
► Has the right information been made available to the board to enable them to make robust decisions?
► Have the risks to customers been identified?
► Are appropriate actions in place to mitigate and monitor such risks?
► Does the board support the identification and escalation of issues when they go wrong and ensure appropriate resolution?
► Does the business learn from identified issues and draw out the wider implications?

The increased focus on conduct risk raises a number of issues, notably:

► The definition of ‘failure to deliver fair outcomes’ should, in our view, extend to cover financial loss as a result of failure to deliver fair outcomes. Failure to deliver fair outcomes may arise as a result of accidental failures due to human error, or consistent or systemic failures due to cultural, process or control failures. Financial loss will arise not just through regulatory intervention or fines but through the loss of customers or distributors.
Almost all firms will have a conduct risk appetite of zero, other than a small tolerance for human error, so the focus of any conduct risk policy should be on understanding the controls that are in place to keep within that appetite.

How does conduct risk, and in particular conduct risk management information, relate to Treating Customers Fairly (TCF)? Most firms have spent considerable time and money on developing their TCF policy, framework and management information and will be looking to leverage that investment in any conduct risk framework.

The regulator has stated that it will be carrying out retail conduct risk governance assessments. Through these, it will gather information, which it will combine with other data held on a firm to form a judgement on the culture of a firm and whether the regulator believes that it facilitates good behaviours which lead to judgements that deliver fair outcomes for customers.
Making care fair?

By Dan Mahony

In February, the government finally announced its proposals for the future funding of Long Term Care (LTC), following on from the findings of the Dilnot Commission in 2011. Reactions have so far been mixed, varying from:

‘... potentially a positive step forward in tackling the challenges of an ageing society’ (Association of British Insurers) to:

‘... about as credible as a Findus lasagne’ (National Pensioners Convention)

As society seeks to tackle this most crucial and emotive of issues, will these proposals lead to meaningful improvements and what, if any, is the role for insurers in delivering this change?

The proposals

The Dilnot Commission’s final report was fairly unequivocal regarding the state of care funding in England. It stated:

“The current adult social care funding system in England is not fit for purpose and needs urgent and lasting reform. [The system] is confusing, unfair and unsustainable. People are unable to plan ahead to meet their future care needs. Assessment processes are complex and opaque.”

The report put forward a number of proposals to address the inadequacies of the current system, most notably the need to introduce a cap on the amount an individual could be expected to pay to fund their own care, and a recommendation to increase the minimum level of assets which could be held before people would be compelled to self-fund. Both of these proposals were accepted by the government and announced in the March budget, albeit with the caps slightly less generous than those proposed by Dilnot (due to the continuing parlous state of public finances).

“The reforms proposed by the coalition do not overcome the principal objections to purchasing a pre-funded care plan.”
In summary, the headline government reforms (to be introduced in 2016) are as follows:

- A cap on costs of £72,000 incurred for the provision of care (not living expenses)
- A rise in the means test threshold to £118,000 (it is currently set at £23,000)
- The right to defer costs until after death, in order that no one should have to sell their home in their lifetime to pay for care expenses

The message from the government is that these changes will protect people from high and unpredictable social care costs (ending the tyranny of uncertainty), and creating more of a level playing field between those who have worked hard to accrue assets (e.g., via home ownership) and those who have not. Whilst these announcements have broadly been welcomed by most as a step in the right direction, there remain a number of issues:

- The proposals only place a cap on the cost of provision of social care. If the individual requires residential care, accommodation and food (as opposed to so called ‘hotel costs’) these are not covered by the cap even though these expenses may be greater than the cost of care.
- Relatively few people will ever actually exceed the cap; over half of the population will incur care costs of <£20,000 with fewer than 1 in 10 exceeding £100,000 in care spend.

In the case of this second objection, the government’s position is that the primary aim of the reforms is not necessarily to reduce the financial burden faced by the average individual, but rather to remove the fear and uncertainty inherent in the current system.

Both Dilnot and the government suggest that reducing the maximum liability will create a new space for financial products to support people in making their contribution. Indeed, the Health Secretary stated: “Just as people make provision for their pensions, so we also need to be a country where people prepare for their social care as well.” The Prime Minister has gone even further, stating that the capped cost model will “open up an enormous insurance market so that people can insure against [catastrophic loss].”
Long term scare

The idea of creating a market for people to ‘pre-fund’ their care requirements will not excite many industry veterans. Identified as a growth market in the late 90s, many insurers launched pre-funded care products in the expectation that, as the population aged, many more would see the value in care planning. Millions were spent on developing and delivering products to the advised market. However, the market failed to take off and when the final provider withdrew from the market in 2010, a spokesman stated (whilst revealing sales of just 21 policies in the preceding 12 months): “No-one wants to pay for a product they may never use.” So will these changes make any material difference to overcoming the challenges faced by providers?

In short, our view is ‘no.’ The reforms proposed by the coalition do not overcome the principal objections to purchasing a pre-funded care plan. In a market where it is difficult enough to persuade people to make adequate provision for their income in retirement, expecting a significant number of customers to save or set aside funds for the possibility they will require long term care is a huge leap of faith. These changes, despite providing marginally more certainty over the potential costs, do very little to make the pre-funded option a more attractive prospect – not least because the ‘hotel’ costs remain uncapped as a potential liability. There also remain significant supply side challenges, not least in definition, measurement and assessment of disability. Indeed, other international markets, where pre-funded LTC products have been more successful, have also been declining in recent years. In the US, where uptake is around 10% (compared to a peak of 0.5% in the UK) a number of major providers have withdrawn their products in recent months, with the Wall Street Journal observing: “Insurers have frequently failed over the years to charge enough for long-term care coverage. They have underestimated health-care costs [and] been surprised by claims patterns ...”

Intuitively, it would seem logical that there should be a way for the private sector to facilitate risk pooling for the funding of long term care. As Dilnot puts it “… This is the only major area in which everyone faces significant financial risk, but are unable to protect themselves against it.” However, due to the persisting supply and demand barriers which exist we believe that providers must innovate to have any chance of building a market for pre-funded solutions. Further government incentives (e.g., via tax breaks or contribution matching) are likely to be unaffordable in the current environment. However, government
Navigating the new UK life, pensions and investments in a new regulatory environment could look to offer greater flexibility with pension usage, creating the potential to earmark pension savings for LTC (although this would still only benefit the relatively small proportion of individuals with adequate pension provision). Providers should also look to the potential for individuals to leverage all of their assets across pensions, savings and property towards LTC planning.

Immediate needs

Whilst we view significant growth of the pre-funded market as unlikely in the short term, the reverse is true of the ‘immediate needs’ product. We believe that these products, purchased by the customer at the point of need (for example, when they enter a care home), can offer certainty and peace of mind. These are effectively underwritten annuity contracts (sometimes with a deferred period), and they represent a tax efficient and straightforward way to pay care fees. However, the lack of providers and a scarcity of advice in this area have suppressed demand.

Dilnot stated: “… a lack of appropriate financial advice [is] a real problem within the current system.” The report went on to suggest “… Government should work with the FSA and other partners to develop greater support for those seeking information on financial planning for older age.” Whilst there is a role for government initiatives such as the Money Advice Service, in our view an improved national register of LTC advisors should be established and care providers compelled to refer customers (and their families) towards planning advice at the point a care need arises. Following the implementation of the RDR, there is also greater incentive for fee charging advisors to become active in the provision of ‘later life’ financial planning, even where a need for a financial product may not arise.

We expect new providers to enter the immediate needs market in the coming months. Whilst the government proposals do not improve the affordability of the product the increasing public awareness of the issue suggests that the market is ready to grow. There is an opportunity for providers to deliver holistic later-years solutions, combining elements of equity release and LTC propositions to meet customer needs.
The mutual sector: forging a sustainable future

By Sara McLeish and Dan Diggins

Back in 2008, Ernst & Young and the (now) Association of Financial Mutuals (AFM) undertook a survey amongst the leadership of the mutual insurance sector. The results revealed a real sense of optimism and a belief that the ‘mutual charter’ would find greater resonance than ever before given the prevailing economic climate. Five years on, the mutual insurance sector has weathered the storm relatively well. But the anticipated ‘mutual renaissance’ has not yet materialised.

Of course, back in 2008, few could have predicted the eventual depth, breadth and duration of the economic recession. And the mutual insurance sector, like all others in the industry, has been preoccupied with the relentless wave of regulatory challenges that have characterised the past five years. Furthermore, the mutual sector has been distracted by a very specific challenge of its own – ‘Project Chrysalis’ or the ‘with-profits issue.’

The genesis of Project Chrysalis

Management of with-profits funds has been a concern of the FSA’s for a number of years, and in 2005 the regulator introduced specific rules and guidance in chapter 20 of the Conduct of Business Sourcebook 20. The FSA was later criticised by the Treasury Select Committee for failing to put in place a robust framework for managing conflicts of interests in with-profits funds, and suggested a complete overhaul of the with-profits regulatory regime. In response, the FSA launched a further review of this sector in 2008.

Since then, the long period of engagement between the mutual sector and the regulator on these issues has been referred to as ‘Project Chrysalis’, and has represented a significant source of uncertainty and distraction for the management teams of UK mutuals. However, in December 2012, there was cause for optimism as the regulator published some fresh new thinking on Chrysalis, potentially opening up what they regarded as a new way forward for mutuals.

CP 12/38 – a fresh approach

In our view, CP 12/38 represents by far the most proportionate and pragmatic stance to date on the Chrysalis issue. Essentially, the regulator has indicated that mutual insurers can develop a supervisory-led and tailored solution that would likely involve separating and ring-fencing the various interests in a with profits fund, without the need for court intervention. In other words, the regulator has proposed allowing mutuals to determine for themselves how to create separate pots for with-profits policyholder funds, non-profit policyholder funds, and mutual members’ (capital) funds. Mutuals that are faced with declining with-profits books but that have viable business plans for selling non-profit business will be able to use this mutual members’ fund to support their business plans, and will not find themselves forced into closure and run-off.
Treat customers fairly will, of course, be paramount, and the mutuals will need to satisfy the FCA that their respective solutions are fair to all the policyholders impacted. At the same time, the PRA will need to be assured that the mutual remains financially sound.

We believe the proposals are to be welcomed. Importantly, they should remove the need for a with-profits mutual to have to wind up – provided there is a robust strategic and business plan, and if it can demonstrate that it is fully accountable to all its members.

It seems likely that – for many mutuals – the with-profits fund separation proposals will compare favourably with alternative courses of action, such as:

► A formal separation of ownership of capital via a court scheme – likely to be a costly and long drawn out process
► Increased participation and membership in conventional with-profit business – likely to be very challenging in the current low yield environment

A(nother) mutual moment?

At Ernst & Young, we are optimistic about the new outlook for the mutual sector, and are supporting a number of mutuals in understanding both the technical implications of CP 12/38, and the broader strategic opportunities that it opens up. In terms of the technical detail, the Consultation Paper leaves many questions unanswered and presents significant room for interpretation. How, for example, should a mutual demonstrate that its with-profits policyholders and other policyholders have been ‘appropriately’ engaged in the exercise? How can this engagement be achieved in a cost-effective fashion? We would urge mutuals to use this current window of time to explore fully these types of issues and, where possible, to look to influence the regulatory agenda and the final Policy Statement.

The FCA will no doubt take a close interest in the longer term strategic and business plans of mutual insurers. Now is the ideal time for mutuals to revisit their plans for driving their organisation forward. And there is good

“The FCA will no doubt take a close interest in the longer term strategic and business plans of mutual insurers.”
reason to believe that consumer sentiment will be as receptive to the ‘mutual charter’ as it was back in 2008 at the start of the economic crisis. Public confidence in other sectors of the financial services industry has been eroded by episodes such as PPI mis-selling and the ‘city bonus’ debates. At a time when consumers are questioning the legitimacy of financial services, mutual organisations should be well positioned. Trends in public policy also appear to favour the mutual sector with the government openly proclaiming their objective of fostering diversity and encouraging mutuality in financial services.

The challenge is to compellingly articulate the ‘meaning’ and ethos of mutuality. Mutuals must consider carefully how they might differentiate themselves from their PLC competitors. Clearly, competing on the basis of cost will be challenging. However, most mutuals have a real head start on the competition in terms of their affinity relationships and their ability to take control of the customer/member relationship. Building trust and shared interest with customers is key to driving value, and we are working with a number of organisations to explore how they can retain and reward their existing customers better, as well as attract new ones.

Mutuals may also be considered well positioned – both philosophically and in terms of their existing relationships – to serve the mass market, to re-engage with the vast number of ‘orphan clients’, to address the ‘advice gap’ opened up by RDR and even to serve the financially disenfranchised. Indeed, many UK mutuals were founded on the principle of helping individuals to help themselves.

The survival and success of the mutual sector will not, however, be assured simply by virtue of being mutual. Just like their PLC competitors, mutuals need to be financially robust, well-run and deliver excellent and competitive products to their members and customers. However, they should also be more capable of collaboration and co-operation with other mutuals than their proprietary rivals. Partnering amongst the mutual sector to offer a broader range of propositions or simply to streamline processes could provide a real source of competitive advantage.

The opportunities are many and varied, and we look forward to working with our clients in the mutual sector to navigate the post-Chrysalis waters.
Navigating the new UK life, pensions and investments in a new regulatory environment

To maximise risk-adjusted returns and to perform well under regulatory scrutiny, life insurance firms continue to look for better ways to manage risk.

One way for insurers to improve their risk management performance is to address the processes through which risks are identified, assessed and controlled with direct consideration of corporate strategy. In the life insurance market at the moment, there are significant strategic uncertainties and therefore using major areas of strategic risk as the basis for all risk management activity would appear to be a logical way ahead.

Aligning business strategy and risk management provides common reference points for the interface between CEOs and CROs, enabling a sharper focus for related discussions. And getting this right subsequently enables risk activities to be locked in to the ‘strategic pulse’ of the company.

There is appetite for progress but current practice varies considerably

Business events around the world have increased insurers’ awareness of how the scale and complexity of risk can influence the strategic and operational confidence of the business. And whilst there is greater appetite for understanding the linkages between risk and strategy, insurers typically exhibit varying degrees of maturity in this respect.

For example:

► Risk frameworks are sometimes developed in isolation of a firm’s strategic business objectives, with only informal input from the risk function.

► In situations where the CRO is involved in the strategic business planning process, there is often a desire to improve the quality of the involvement.

► Risk framework components can sometimes be inherited from legacy firms and systems, and may not yet have evolved to meet the new business model and strategy of the firm.

Despite encouraging greater consideration of risk in strategy setting for life insurance firms, Solvency II guidance has not yet resulted in a consistent approach across the industry — even within countries.

Aligning risk management with business strategy

By Clive Martin and Luke Strange
Three key considerations for a top-down strategic approach

In order for the risk management activity to properly support the corporate strategy, the link between the two needs to be made explicit from the outset. The following three-step methodology can be useful to support a proper exploration of the issues.

The methodology involves addressing three main questions:

**Q1** What is of greatest strategic importance for the firm in executing its strategy?

This involves defining and documenting the building blocks, drivers and levers of success. What capabilities need to be in place and operating effectively to ensure success (e.g., infrastructure, people, technology or acquisition)? This information is usually available but not always captured effectively so usually existing information may have to be reformatted.

**Q2** What are the key risks that could prevent the insurer from being successful?

The strategic top-down approach usually requires a workshop with targeted senior management representation from across the business. The workshop should address each of the items identified in question 1, and then (in a structured way) work through business uncertainties that could impact each of the strategic success drivers. Thus, risks are arrived at via consideration of strategic success drivers. This typically provides a more comprehensive and better focused set of risks to address.

The following data might prove useful in the discussion:

- Results from stress testing and scenario analysis
- Movements in risk appetite
- Previous risk reports
- Regulatory and internal audit reports
- Loss event or external event data
- Underwriting, claims and reinsurance performance information

Where each of these data inputs exist today they should be utilised by insurers to arrive at the most definitive set of top risks. In carrying out their assessment process however, firms should assess and feedback on the quality of the data provided.
Q3: How do our existing risk management capabilities support the management of the most significant risks to strategic success?

Once an insurer has articulated its business strategy and material risks to that strategy (through linking risk to drivers of success) an important follow up question is: how well do existing risk management capabilities support the strategic ambitions and uncertainties of the firm? For example, if a strategic objective is to grow the business through the development of a new product, then, given the increase in risk this ambition might bring to the firm (e.g., increased underwriting, claims and operational risk), how well does the current risk infrastructure support this growth? How would improvements to the risk infrastructure help manage these changes in risk levels?

Conclusion

To improve decision-making in life insurance firms, risk management tools, the people using them, and their application to particular business processes and situations, all need to be optimised.

To achieve the highest impact on business performance, risk management activities should be prioritised in terms of their effectiveness and weighted against the most important drivers of strategic business success. In this difficult business environment, those who prioritise risk management improvement activity best will gain an advantage when grappling with the strategic uncertainty the industry faces.
How the financial crisis is shaping the global insurance market

By Shaun Crawford

The global financial crisis continues to shape life insurers’ business performance. Given the ongoing uncertainty around the ‘fiscal cliff’ in the US, and the prevailing Euro problems, we expect it will continue to affect profitability for the foreseeable future. Here we take a closer look at how the crisis is affecting insurers’ performance outlook and predict the strategic priorities for life insurers in 2013.

So, what happened to insurers globally?

Before the crisis, ultra loose monetary conditions created unreasonably tight credit spreads, so insurers reached for yield in structured securities. Booming equity markets created escalating product competition in unit linked products’ benefit provisions.

When the bubble burst, it transformed the economic environment and devastated insurers’ financial performance. Mortgage Backed Securities and fixed income prices collapsed as the credit spreads exploded, variable annuity (VA) liabilities soared, driven by a 50% fall in equity markets, and capital levels dropped precipitously. Life insurance sales collapsed as customers became highly risk averse and then cost pressure intensified as capacity greatly exceeded new business flows.

The crisis reshaped the operating environment and suppressed earnings. The historically low interest rates and credit spreads saw margins shrink and guarantees could not be supported. Greater volatility in the equity markets increased capital requirements, creating earnings volatility.

Naturally, regulatory requirements increased, so more capital (of higher quality) was demanded by regulators and customers, with the result that calls for better risk management and consumer protection began. With weak customer financial conditions, life sales became more difficult, which pressured agency channel effectiveness and enterprise cost structures.

How have UK insurers responded?

UK life insurers have focused on core businesses, shedding products, cutting costs and in some cases selling legacy business. Asset risk profiles have been better understood, with insurers de-risking product portfolios to protect capital. Costly new hedging strategies have been adopted by some to combat the increased equity volatility and price risk, with annuity products being de-risked and prices increased. Two insurers exited the VA market – others have reduced capacity. Life product guarantees remain attractive but expensive to deliver.
Low interest rates and portfolio turnover have depressed earnings and pushed insurers to search for yield. As a result of this, we have seen insurers starting to create gradually more risky asset portfolios again. However, the increased capital demands make it very challenging for most companies to create less capital intensive propositions as they are more likely to utilise the opportunity to deploy capital in more risky markets that offer higher returns.

All of the above has reduced consumer demand for core products. Weak customer income growth and product re-pricing makes products less attractive, whilst the middle market remains significantly underinsured. Affordability and profitability become difficult to balance and the implementation of the RDR is also having a significant impact on insurers’ investment products.

What new strategies can we expect from UK insurers?

New strategies have been focused around capital, products, distribution and operations. Top of the agenda are capital adequacy and rigorous risk management, stronger risk-based product design and pricing. Improving distribution effectiveness is also a priority area, as is having a relentless focus on costs along with the strengthening of groups’ oversight functions.

We’d expect to see a number of strategies to maximise profitability and growth going forward. These include:

1. **Assuring financial robustness and strengthening the corporate function.** Insurers need to intensely manage risk and capital, regardless of regulatory minimums with a greater reliance on Economic Capital measures and enhanced risk management processes, including board oversight. Priority will be given to strengthening business unit oversight through more demanding planning, reporting and performance management processes as well as establishing and managing a more aggressive capital allocation process.

2. **Adopting a balanced product mix, avoiding a high concentration of savings products.** This will involve shifting the product focus away from investment to protection in order to avoid competition and greater volatility but achieving higher protection margins.

3. **Creating a flexible and rapid product development process as well as offering new products that are better suited to current market conditions.** Insurers will increase prices and reduce guarantees on existing adjustable products— but maintain affordability.

“Data analytics and consumer management strategies that improve persistency, retention and cross sales will become a greater priority.”
4. **Redesigning products to minimise capital utilisation, exiting fixed price products and possibly introducing equity indexed life and annuity products plus unit linked products with embedded LTC benefits.** We may also see more focus on immediate and deferred income annuities for the retirement market and guaranteed withdrawal benefits wrapped around mutual funds. Advanced underwriting technology will enable the introduction of affordable mid market products as well as short duration term products.

5. **Responding to evolving customer preferences.** Consumers desire simple, transparent products. They are more price sensitive, but price is not the primary buying factor. They also require ‘any time/any mode’ of communications, loyalty schemes and demand fair treatment in service issues and claims. Data analytics and consumer management strategies that improve persistency, retention and cross sales will become a greater priority.

6. **Expanding and improving the effectiveness of distribution models as well as investing in alternate channels.** Leveraging new digital strategies and integrating distribution strategies through greater use of direct and online channels and social media will become an area of great focus for:

   a. **Aggressively managing costs.** Using shared service concepts to reduce business unit cost structures and pursuing sustainable cost reductions, including significant out-sourcing through off-shoring. Simplifying and modernising the IT environment is likely to be a major focus.

   b. **Data analytics and consumer management strategies that improve persistency, retention and cross sales.**

   c. **Carefully exploring expanded investment allocation strategies by growing the range of fixed income investments leading to more credit and duration risk.** Expanding ‘alternative investments’ may add to earnings volatility and enhancing hedge programmes will add costs and may increase earnings volatility. This can be supported with robust Asset Liability Management programmes but will put pressure on margins.

Of course, the strategy of some UK insurers is to focus on platforms rather than the traditional but capital intensive risk propositions. Such a strategy, with its increasingly thin margins requires a very different operating model and culture which creates a different but equally challenging programme of change.
Navigating the new UK life, pensions and investments in a new regulatory environment
Please feel free to get in touch with our authors, or your usual Ernst & Young contact, to discuss any of the topics raised in this publication.

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