4.4 Unfair Outcomes for Individuals

Hotspot Description

The risk that actuaries may not act in the best interests of customers, either intentionally or unintentionally, for financial or other motives, which may result in unfair treatment of some subgroups in favour of other subgroups.

Current Influences

Climate change (discussed more-extensively in Climate-Related Risk (including Biodiversity), Section 4.1, Page 8), perhaps the biggest systemic risk of our times, is also an issue of inequality which could lead to unfair outcomes for some groups. The UN says:[119]

"The impacts of climate change will not be borne equally or fairly, between rich and poor, women and men, and older and younger generations."

Impacts fall most heavily on those who are already more vulnerable, and with the least resources to respond. This affects the work of actuaries in all areas of insurance, investments, and pensions, whether in product design, pricing, reserving, investment management, or governance. Actuaries engaged in the public debate on the consequences and impacts of potential responses to climate change also need to be alert to the risk of unfair outcomes from this overarching inequality.

There are risks associated with increasing access to Big Data,[120] including the need for the actuary to consider the rights of competing groups of people. The increasing power of technology and access to more data than ever before mean that actuaries can identify ever-smaller homogeneous groups. This has led to a greater focus on pricing factors and the trade-off between risk-based pricing and risk pooling.

The risks are that:

- insurers may cherry-pick the good risks leaving some people effectively uninsurable (or facing higher prices when potentially already financially vulnerable);
- the statistics may prove to be unreliable; and
- certain groups are known to have a higher propensity to pay and may therefore be charged excessively.

All of these have the potential to alter the balance between broad customer fairness and commercial objectives. Additionally, telematics[121] (in general insurance) create ethical problems of disclosure to third parties and privacy issues. While the General Data Protection Regulation[122] (GDPR) may address some of these issues, the general issue remains of whether customers are aware of how their data is being used.

119 https://www.un.org/sustainabledevelopment/blog/2019/05/climate-justice/
120 https://en.wikipedia.org/wiki/Big_data
121 https://www.gpsinsight.com/blog/what-is-telematics/
122 https://ico.org.uk/for-organisations/guide-to-data-protection/guide-to-the-general-data-protection-regulation-gdpr/

A noticeable trend in recent years has been the transfer of risk from institutions – such as employers, the state, and financial services firms – to individuals. The causes are complex and cover a variety of factors from increasing longevity to technological advances, the low interest rate environment, and changes in financial regulation. Prominent examples of the trend include the steady shift from defined benefit (DB) to defined contribution (DC) pension schemes and from annuities to drawdown, fewer investment products with guarantees, and insurance products that are increasingly priced based on the risk profiles of individuals as opposed to groups. The COVID-19 pandemic has heightened the risks for individuals as they are confronted by the need to manage risks they did not have to worry about previously. Actuaries, as advisers and designers of products for consumers, have an important role to play in developing practical solutions.

Much activity in pensions involves competing rights, and judgements made may have the effect of favouring some individuals or groups against others. Even though the primary duty of the actuary is to their client (the pension scheme's trustees or sponsoring employer), in advising the client the actuary may need to bring to their attention any impact on the wider stakeholders[123] (including different groups of pension scheme members). Some examples are:

- DB to DC transfers require balancing the rights of competing groups (the leavers and the stayers) and are therefore a further source of potential unfairness.
- Addressing deficits in DB pension schemes requires balancing the demands on the sponsoring employer against the needs of the pension scheme, at a time when COVID-19 and post-EU-Exit-related uncertainty may have put strain on the sponsoring employer. The risk is that the pension scheme's trustees may be put under undue pressure to relent on deficit recovery programmes, thus exposing the pension scheme's members to further risk.
- Emerging economic difficulties may lead companies to manage their dividend policy to favour the shareholders in such a way as to create unfairness for pension scheme members of pension schemes they sponsor.
- Investment strategies in DB pension schemes require a balance between the sponsoring employer's ongoing ability to support the underlying risks over time and potential losses to pension scheme members from events which prevent the sponsoring employer from providing this support.

All these areas may impose pressure on the actuary to balance the commercial and professional aspects of their role.

Actuaries also have to confront competing rights with respect to Pension Superfunds,[124] needing to balance the needs of investors in the superfunds with outcomes for pension scheme members and the Pension Protection Fund[125] (PPF). While these requirements are not new in principle superfunds may introduce sharper polarisation of needs. Actuaries may face increased pressure to satisfy client demands against a background of wider stakeholder detriment.

Key developments and JFAR member regulators' actions during 2020/21

The great risk transfer (GRT)

In July 2020 the IFoA published its interim campaign report exploring the trend to transfer risk from institutions to individuals.

123 The Actuaries' Code (paragraphs 3 and 3.1) states "Members must ensure that their professional judgement is not compromised, and cannot reasonably be seen to be compromised, by bias, conflict of interest, or the undue influence of others. Members must take reasonable steps to ensure that they are aware of any relevant interests that might create a conflict."

124 https://www.ft.com/content/7fa8de0c-d645-42d6-99ea-125e0a3d2a0f

125 https://www.ppf.co.uk/

The IFoA summarised the findings of their call for evidence, and they followed up with roundtable sessions on the key themes with the purpose of developing practical recommendations. In April 2021 the IFoA published its recommendations[126] under the two broad themes of rebalancing risks through structural changes to markets, products and services, as well as by helping consumers manage financial risk effectively and affordably through good decision making. Further work is planned with stakeholders, including actuaries.

Fair treatment of With-Profits customers

With-profits is a key area of focus 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 financial harm.

The FCA published its findings on the review of fair treatment of with-profits customers[127] in April 2019. These findings give examples of good and poor practice. Most firms assessed were taking reasonable care to manage the risk of customer harm. There were though some areas of poor practice that may lead to customer harm. There are implications for the With-Profits Actuary who has a reserved role in this area.

Fairness in pricing and product value

Fairness in pricing has been an issue of trust between customers and insurers. The practice of dual pricing in personal lines insurance, whereby long-standing loyal customers are charged higher prices than offered to potential new customers because existing customers are considered to be less price sensitive, has been acute. The actuary needs to ensure they are balancing the commercial and professional aspects of their role if they are involved in the pricing of these products, and should consider and apply the new regulations in this area set out below.

The FCA published an evaluation paper[128] in October 2019 that considered the impact of rules to increase transparency and engagement at renewal in general insurance markets. These rules required firms to show both the renewal premium and the previous year's premium on the renewal notice. In addition, in September 2020 the FCA published its final report[129] on its market study into general insurance pricing practices. This report concluded that these markets could be made to work better for customers, and the FCA published a consultation on proposed measures to support effective competition and good customer outcomes. Final rules (PS21/5)[130] to address the harms identified were published in May 2021. The rules aim to ensure that renewing home and motor insurance consumers are quoted prices that are no more than they would be quoted as a new customer through the same channel. They are also designed to make it simpler for customers to stop automatic renewals if they wish to do so, and they introduce new product governance rules to ensure that firms deliver fair value on all their insurance products. Some of these rules also apply to insurers and intermediaries of other general insurance and protection products. The FCA also published a research paper[131] alongside this policy statement, containing the results of an experiment they conducted looking at consumer perceptions of, and response to, discounts and incentives.

The IFoA completed a Thematic Review[132] on 21 June 2021 into actuarial involvement in general insurance pricing for UK home and motor insurance.

126 https://www.actuaries.org.uk/system/files/field/document/TGRT_Campaign_Recommendations_FINAL.pdf
127 https://www.fca.org.uk/publication/thematic-reviews/tr19-03.pdf
128 https://www.fca.org.uk/publication/corporate/ep19-1.pdf
129 https://www.fca.org.uk/publication/market-studies/ms18-1-3.pdf
130 https://www.fca.org.uk/publication/policy/ps21-5.pdf
131 https://www.fca.org.uk/publication/research/research-note-discounts-cashback-soft-toys-promotion-consumer-decision-general-insurance-markets.pdf
132 https://www.actuaries.org.uk/system/files/field/document/GI_Thematic_Review_FINAL_0.pdf

This topic is discussed further in Impact of Undue Commercial Pressure (Section 4.7, Page 45), sub-section 'Pricing' (Page 45).

Access and exclusion in insurance

Certain groups can struggle with access to insurance if they are perceived as less profitable risks to the insurer. Big Data offers insurers more opportunities to analyse insurance risk in smaller and more-homogenous groups for pricing purposes, and if taken too far could lead to a breakdown of the risk-pooling principle.[133]

In July 2019 the FCA launched a consultation proposing new rules to help customers with pre-existing medical conditions (PEMCs) access suitable travel insurance[134] (CP19/23). The available evidence suggested that most customers with PEMCs could get cover if they were able to find the right provider. So the challenge was less about access but rather about how to assist customers in navigating a sometimes complex market. The consultation sought views on introducing a new 'signposting' rule, to provide customers with details of a directory of travel insurance firms that have the appetite and capability to cover customers with more serious pre-existing medical conditions. The FCA issued a Policy Statement in February 2020: Signposting to travel insurance for consumers with medical conditions[135] (PS20/3) which made explicit amendments to the Insurance: Conduct of Business sourcebook (ICOBS) to effect these changes.

In 2020 the IFoA launched their Inclusive Insurance[136] Bulletin Series to explore how the insurance industry innovates and evolves to address the changing needs of society in a way that is fair and includes those needing protection the most.

Part VII Insurance Transfers

Part VII insurance transfers involve the transfer of a book of business between insurers. There are signs of increased activity in this area. A key area of focus is that policyholders should not be adversely impacted by the transfer and that each policyholder is given adequate information on the impact of the transfer.

This topic is discussed further in Geopolitical, Legislative, and Regulatory Risk (Section 4.5, Page 34), sub-section 'Part VII Insurance Transfers' (Page 38).

Equity Release Mortgages

Equity Release Mortgages are increasing in popularity,[137] but borrowers may not appreciate the potential impact of compound interest. If monthly repayments of interest are not made regularly the loan outstanding can quickly increase dramatically.[138] Many products do not involve periodic payments and so a common feature is for the lump sum to roll up with interest and impact future inheritance outcomes. There is a risk that actuaries developing these products may not do enough to ensure that customer communications bring this risk to the fore. The IFoA plans to do a Thematic Review[139] in 2021 to ascertain areas of involvement for actuaries.

In June 2020 the FCA published the key findings[140] from its exploratory work on equity release mortgages. They found three significant areas of concern about the suitability of advice provided, which were considered to increase the risk of harm to consumers in this market:

- insufficient personalisation of advice;
- insufficient challenging of customer assumptions; and
- lack of evidence to support the suitability of advice.

[133] According to a 2019 thematic study by EIOPA there "is no evidence as yet that an increasing granularity of risk assessments is causing exclusion issues for high-risk consumers, although firms expect the impact of BDA [Big Data Analytics] to increase in the years to come."
[134] https://www.fca.org.uk/news/press-releases/fca-proposes-new-rules-help-consumers-pre-existing-medical-conditions-access-suitable-travel
[135] https://www.fca.org.uk/publication/policy/ps20-03.pdf
[136] https://www.actuaries.org.uk/news-and-insights/public-affairs-and-policy/inclusive-insurance
[137] https://www.equityreleasecouncil.com/
[138] https://www.moneysavingexpert.com/mortgages/equity-release/
[139] https://www.actuaries.org.uk/upholding-standards/actuarial-monitoring-scheme/current-and-planned-reviews
[140] https://www.fca.org.uk/publications/multi-firm-reviews/equity-release-sales-and-advice-process-key-findings

The FCA set out actions for firms and advisers active in this area. They also found anecdotal evidence of increased interest in equity release mortgages because of new pressures on peoples' finances from the COVID-19 pandemic, thus reinforcing the importance of advice reflecting the needs and circumstances of the individual. The FCA will be undertaking further work to review the suitability of advice in this market.

This topic is discussed further in Geopolitical, Legislative, and Regulatory Risk (Section 4.5, Page 34), sub-section 'Equity Release Mortgages' (Page 39).

DB to DC transfers

Transfers from defined benefit (DB) pension schemes to defined contribution (DC) pension schemes are considered generally unlikely to be in the best interests of most pension scheme members, although there are certain circumstances where they may be appropriate. TPR has been working closely with the FCA and other relevant industry bodies to address their primary concern that DB pension scheme members and their advisers have all the information they need to make an informed decision about what is in the pension scheme members' best interests. Useful references are:

- Guide for employers and trustees on providing support with financial matters without needing to be subject to FCA regulation,[141] published jointly by TPR and the FCA in March 2021, covering the type of support sponsoring employers and pension schemes' trustees can provide without undertaking FCA regulated activities such as advice or arranging investments.
- Advising on pension transfers[142] (FG21/3), published by the FCA in March 2021, to help advisers give suitable advice consistently. Among other things, it includes a standardised data list (at Annex 1) developed and agreed by the Pensions Administration Standards Association[143] (PASA), TPR and the FCA setting out the information which pension schemes should provide and financial advisers should request in order to advise on DB transfers.
- DB transfer consumers guides from the FCA, with recent updates in 2020/21, for pension schemes' trustees to use alongside the cash equivalent transfer value (CETV) letter and other communications with the pension scheme's members:
  - Considering a pension transfer: defined benefit[144]
  - Pension transfer advice: what to expect[145]
  - Advice checker: defined benefit pension transfers[146]
- PASA (DRAFT) Code of Good Practice[147] guide for DB transfers.

This topic is discussed further in Impact of Undue Commercial Pressure (Section 4.7, Page 45), sub-section 'Pension transfers' (Page 46).

DB scheme commutation rates

The actuarial factors used to calculate DB scheme benefits are one of the ways in which the work of the actuary affects the benefits received by pension scheme members. A Thematic Review[148] carried out by the IFoA was published in December 2020 and identified that the overall standard of advice given by actuaries in such situations is very high. However, the review found that commutation rates are often well below transfer values, which may be seen as poor value for pension scheme

[141] https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/tpr-fca-employers-trustees-financial-matters-guide.ashx
[142] https://www.fca.org.uk/publication/finalised-guidance/fg21-3.pdf
[143] https://www.pasa-uk.com/
[144] https://www.fca.org.uk/consumers/pension-transfer-defined-benefit
[145] https://www.fca.org.uk/consumers/pension-transfer/advice-what-expect
[146] https://www.fca.org.uk/consumers/defined-benefit-pension-transfers/advice-checker
[147] https://www.pasa-uk.com/wp-content/uploads/2020/02/PASA-DB-Transfers-CODE-P1-10202020-FINAL.pdf
[148] https://www.actuaries.org.uk/system/files/field/document/Pensions-Thematic-Review...PDF

members. In some pension schemes this may be a function of the pension scheme rules but there is a variety of other reasons for these differences, including the role of the pension scheme's trustees and sponsoring employer and the impact on funding.

DB superfunds

Superfunds provide new risks and opportunities as vehicles for delivering pension promises to pension scheme members. Pension scheme members need the confidence that these new superfunds are well-governed, run by fit and proper people, and are backed by adequate capital. TPR has issued clear guidance[149] setting out its expectations for both superfunds and pension schemes' trustees as well as sponsoring employers considering transferring to a superfund. However, in the absence of any specific legislation on superfunds there is a risk that potential providers may promote consolidation propositions which create new and untested risks for actuaries.

Unfair pension scheme member outcomes due to poor governance

Good governance[150] is key to pension schemes achieving good outcomes for their pension scheme members. It requires motivated, knowledgeable, and skilled pension schemes' trustees operating policies and procedures that enable effective and timely decisions and support strong risk management. While many pension schemes are meeting expected governance standards, there are others that are not performing as they should. Through a lack of awareness or capability these pension schemes could be putting pension scheme member benefits in jeopardy. TPR consulted[151] on proposals to clarify and enhance expectations in relation to scheme governance in 2019, and in February 2020 TPR delivered their response on the Future of trusteeship and governance.[152]

Value for pension scheme members in DC pension schemes

Assessment of value for money (VFM) for pension schemes' members consists of several criteria such as cost and charges, investment returns, and quality of services. This is at the heart of TPR's and the FCA's approach to DC governance. TPR works closely with the FCA and the Department for Work and Pensions (DWP) in this area.

On VFM, TPR sets out its regulatory expectations of trustees of DC occupational schemes when carrying out a VFM assessment (as required under pensions legislation) in its DC code. In June 2020 the FCA published their consultation on driving value for money in pensions (CP20/9),[153] to clarify the FCA's expectations and promote a consistent approach to VFM assessment by Independent Governance Committees (IGCs). The publication of the final rules was delayed due to COVID-19, and is now planned for Q4 2021.

In October 2018 TPR and the FCA published their joint regulatory strategy which set out how they would work together to tackle the key risks and issues facing the pensions and retirement income sector in the next five to ten years. One of the objectives set out in the strategy is that pension schemes are well-governed, well-run, and deliver value for money. The strategy acknowledged the complexity of assessing value for money and the need for stakeholders to be given more support with this. Consequently, both organisations have been working on a joint discussion paper which is planned for publication later this year. This paper will set out how TPR and the FCA intend to drive value for money for pension scheme members of DC pension schemes, including the introduction of a common framework for the assessment of value for money across the pension schemes regulated by TPR and the FCA.

[149] https://www.thepensionsregulator.gov.uk/en/trustees/managing-db-benefits/db-superfunds/superfund-guidance-for-prospective-ceding-trustees-and-employers
[150] https://www.thepensionsregulator.gov.uk/en/trustees/21st-century-trusteeship/1,-d-,-good-governance
[151] https://www.thepensionsregulator.gov.uk/en/document-library/consultations/future-of-trusteeship-and-governance-consultation
[152] https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/future-trusteeship-governance-consultation-response-february-2020.ashx
[153] https://www.fca.org.uk/publications/consultation-papers/cp20-9-driving-value-money-pensions

In September 2020 the DWP published its consultation Improving outcomes for members of defined contribution schemes.[154] The consultation recognised that many smaller DC pension schemes are poorly governed, and that the DWP wanted to ensure that trustees of the pension schemes concerned act in the best interests of their pension scheme members. Therefore the DWP are proposing that all pension schemes that provide DC benefits and have total assets of less than £100 million undertake a more holistic value for pension scheme members' assessment, which will involve comparing their costs and charges and investment returns against at least three other larger pension schemes, or personal pension schemes, as well as assessing their governance and administration against seven key metrics. If these pension schemes are unable to prove that they offer good value the pension schemes' trustees will be expected to take immediate action to wind up and move pension scheme members into another scheme or take immediate steps to ensure that the scheme does provide value. TPR is working closely with the DWP on these matters.

Helping customers make better choices

In Effective competition in non-workplace pensions[155] (FS19/5) the FCA found that in the non-workplace pension schemes market the complexity of products and charges exacerbates the lack of customer engagement. The feedback statement asked for views on a range of possible initiatives from the introduction of one or more investment pathways, to reducing the complexity of charges disclosure, to further analysis and remedies in relation to the level of charges.

A further example of complexity and lack of clarity can be seen in the FCA's MiFID II costs and charges disclosures review findings[156] published in February 2019. The FCA looked at the costs and charges disclosures of a sample of 50 firms authorised as MiFID investment firms in the retail investments sector.

The FCA found that these firms knew about their obligations for disclosing costs and charges but interpreted the rules in a variety of ways. They were better at disclosing the costs of their own services than at disclosing relevant third-party costs and charges. The FCA found evidence that firms were not sharing their costs and charges with each other to meet their obligations to provide aggregated figures to clients.

In another example of the weakness of competition in certain areas, the FCA published Unit-linked funds' governance review (follow up to PS18/8): findings and next steps[157] in September 2019. The findings demonstrated that firms check their competitors' prices but not apparently with the aim of competing on price. Firms also complied on regulatory interventions but tended not to go further.

Further Reading

- Paper presented to the JFAR (December 2019): The role of actuaries in DB to DC transfers (Section 5, Page 53)

[154] https://www.gov.uk/government/consultations/improving-outcomes-for-members-of-defined-contribution-pension-schemes
[155] https://www.fca.org.uk/publication/feedback/fs19-05.pdf
[156] https://www.fca.org.uk/publications/multi-firm-reviews/mifid-ii-costs-and-charges-disclosures-review-findings
[157] https://www.fca.org.uk/publications/multi-firm-reviews/unit-linked-funds-governance-review-follow-ps18-8-findings-next-steps