

Issues affecting unit-linked insurance business

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This paper provides an update to our [2019 publication 'Issues affecting unit-linked insurance business'](#),¹ which covered material developments relevant to unit-linked business during 2018 that, at the time of writing, remained areas of ongoing focus.

In 2019 and the first quarter of 2020, we have seen a range of new issues and trends across the unit-linked market. Most notably, the recent COVID-19 crisis has had huge financial, operational and social impacts. Additionally, the UK regulators and the European Insurance and Occupational Pensions Authority (EIOPA) have further developed their rules, guidance and expectations in a number of areas pertinent to unit-linked business. Finally, we have noted that customer behaviours, demands and needs have continued to evolve since our last paper.

Rather than an exhaustive list, the topics below represent some recent key developments that Milliman has helped its unit-linked clients to navigate through. They include:

- Challenges presented by COVID-19
- UK regulatory themes relating to investment strategies for unit-linked providers, liquidity of assets held in unit-linked funds, policyholder redemption terms and liquidity risk management more widely
- Consumer trends and value for money initiatives for unit-linked business
- Aspects of the Solvency II 2020 review specific to unit-linked business

The impacts of COVID-19

The current COVID-19 pandemic presents many challenges for insurers, not least those writing unit-linked business.

POLICYHOLDER PERSPECTIVE

From a policyholder perspective, the resulting market turmoil has had a significant direct impact on unit-linked benefits in a number of ways.

As equities continue to fall and credit spreads widen, likely to be only marginally offset by falling yields on government bonds, the diminishing value of unit-linked life and pension savings and the uncertainty regarding the timeframe for safe

disinvestment are major causes for concern. This is the case for all unit-linked policyholders but particularly for those who are close to maturity who might have been considering an annuity purchase.

Certain policyholders might panic and try to reinvest their unit-linked funds into cash; however, conventional wisdom would tell you that immediately after a crash is the very worst time to be doing this. For the same reason, now is probably not the best time to be drawing down on a unit-linked fund for retirement income but policyholders may not have alternative sources of income to make do with in the meantime.

Particularly in this environment, insurers face the challenge of providing information to protect policyholders without straying into providing financial advice. The Financial Conduct Authority (FCA) has published helpful guidance² on this subject, which explains what firms are already required to do by its 'Retirement Risk Warning' rules and how this may empower firms to have the right kind of discussions with investors.

Unfortunately, there is currently no clear road to recovery in sight. Continued market volatility for a sustained period will make financial planning harder and is likely to deflate policyholder confidence.

A large number of property fund managers have suspended dealing as a means to protect investors. Liquidating these funds at a stressed time would crystallise significant loss in value but, unfortunately, investors do not always read the small print and understand the full implications of their investment choices. This would also be the second time in four years when property funds have been suspended (the first being immediately after the Brexit referendum in 2016). Although these suspensions were put in place for the right reasons, notably to protect the interests of savers and pensioners at a time when fund managers might have struggled to sell the underlying properties at fair prices, they could have a lasting effect on the relative attractiveness of property funds for investors.

¹ Booth, C. et al. (11 February 2019). Issues affecting unit-linked insurance business. Milliman Briefing Note. <https://uk.milliman.com/en-GB/insight/issues-affecting-unit-linked-insurance-business>.

² FCA (30 April 2020). Pensions and Retirement income: our guidance for firms. <https://www.fca.org.uk/firms/pensions-and-retirement-income-our-guidance-firms>.

INSURER PERSPECTIVE

Unit-linked insurers themselves are affected in a number of ways as described below.

Balance sheet and profit impacts

Reduced value of future unit charges and, for those providing investment and risk-benefit guarantees, higher sums at risk and lower interest rates will have an immediate hit on own funds and solvency; however, this is only temporary if markets recover in say a year's time. Yes, firms will have incurred lower charges and higher costs if guarantees bite on maturing and surrendering policies over the year but solvency will hopefully eventually recover and the temporary reduction in profits (and short-term liquidity impacts, as discussed below), when assessed against the lifetime of the product, will potentially be not that great. In short, the real financial impact will depend on the speed of recovery.

Liquidity pressure

Accessing liquidity to meet expenses and pay policyholder benefits when due may involve digging deep into liquidity buffers; however, it is difficult to predict the impact with certainty. For unit-linked insurers, it will depend on the level of surrender, switch and restructure requests from unit-linked policyholders and pension schemes, the extent of any settlement mismatches on trading, and the liquidity of the underlying unit-linked assets and shareholder assets. Insurers that are part of a larger group may also benefit from additional liquidity support from other group entities. In any case, now is a time to stress test the liquidity position and take any necessary precautionary actions.

Operational challenges

Firms will need to implement effective contingency plans and agile decision making to maintain business operations in the light of changing working arrangements, strains on human resources (HR), customer services and information technology (IT) functions, and the virility and potency of the virus itself. The crisis highlights the importance of, and continues to test, business continuity plans and operational resilience.

For unit-linked insurers, operational risk is relatively significant, embedded in products, services and activities, and the focus it receives should be proportionate. As resources are squeezed, the volume of customer questions and concerns regarding the security and value of their investments and whether or not they should surrender their policies is likely to increase. Technology infrastructure may be stressed or show weak spots as more employees work remotely and more customers avail of online services such as investment portals, which in turn could have a material impact on customer service standards and security.

Firms that outsource critical operational activities to third parties will need to review service-level agreements (SLAs) and obtain details of how these parties are affected and of the steps they have taken to prepare, mitigate and manage their responses.

As for liquidity risk, the results from operational risk workshops and stress and scenario testing should be reviewed and refreshed to reflect not only current circumstances but also a range of possible COVID-19 outcomes that necessitate different management actions.

Fund performance

Another interesting consideration from an insurer's perspective is the relative performance of different types of funds. During the recent sustained bull market, multi-strategy funds such as the Standard Life Global Asset Return Strategies fund have suffered significant withdrawals. The performance of these type of funds has typically failed to match their own long-term investment targets and have generally been viewed as relatively poor in comparison to other, more 'vanilla' funds, for example pure equity funds.

However, the hedging strategies of these funds may now prove their worth, as recent turnarounds in relative performance suggest, and perhaps previously sceptical investors will be encouraged to reconsider the longer-term benefits of investing in such funds.

Milliman has published blogs to help our life insurance clients stay ahead of the risks associated with COVID-19^{3,4} along with a paper summarising recent recommendations from EIOPA on supervisory flexibility regarding the deadline of supervisory reporting and public disclosure of insurance and reinsurance undertakings.⁵

FCA themes

THE FCA ASSET MANAGEMENT MARKET STUDY (AMMS) AND UNIT-LINKED FUNDS' GOVERNANCE REVIEW

Our 2019 paper discussed the outcomes of the FCA AMMS. In particular, it mentioned that the FCA had published policy statements with rules and guidance for the first two sets of remedies ([PS18/8](#) and [PS19/4](#)), which focussed on:

- The duties fund managers have as the agents of investors in their funds.
- Fund objectives and the presentation of benchmarks.

Since 1 October 2019, these rules and guidance have come into effect and the FCA stated in its '[Business Plan 2019/20](#)' that it will continue to focus on their implementation. We note that, unsurprisingly, the latest FCA '[Business Plan 2020/21](#)', published on 7 April 2020, predominantly focusses on the

³ Vosvenieks, F. (16 March 2020). Coronavirus: Staying ahead of the risks. The Business of Risk. <https://www.thebusinessofrisk.com/?p=4615>.

⁴ Vosvenieks, F. (19 March 2020). Coronavirus: Staying ahead of the risks (part 2). The Business of Risk. <https://www.thebusinessofrisk.com/?p=4619>.

⁵ Stansfield, I. et al. (7 April 2020). Regulatory reporting updates in light of COVID-19: Latest from EIOPA and the PRA, April 2020. Milliman Briefing Note. <http://www.milliman.com/en/insight/Regulatory-Reporting-Updates-in-light-of-COVID-19>.

impact of COVID-19; however, the FCA does state that it will continue to assess the impact of the AMMS remedies and it is reasonable to assume that this work will continue to be a focus once the COVID-19 crisis subsides.

Our 2019 paper also mentioned that the FCA was undertaking diagnostic work to assess whether some of the AMMS requirements relating to governance should be extended to unit-linked and with-profits products. For unit-linked products specifically, this work is ongoing and includes the review of non-workplace pensions, the governance of unit-linked mirror funds, and the effectiveness of Independent Governance Committees (IGCs).

On 24 September 2019, the FCA released the publication '[Unit-linked funds' governance review \(follow up to PS18/8\): findings and next steps](#)'. The FCA highlighted that, although firms are subject to firm and product level governance requirements, there are no rules on unit-linked governance practices at the level of individual funds at this time.

The FCA reviewed the governance practices of unit-linked insurers with respect to the value provided by funds, in the context of the fees and charges paid by investors. In performing its appraisal, the FCA reviewed documents provided by firms, carried out interviews with firms' senior management in order to appreciate the workings of unit-linked fund governance and spoke with members of firms' independent governance bodies. Another area of focus was how firms had taken action to improve the value of unit-linked products where the firm's evaluation concluded better value was needed.

The FCA's key findings were that:

- Firms' thinking around value was sometimes too limited. For example, some firms only considered performance net of fees and charges, with limited assessment of how active the manager of a unit-linked fund had been in achieving this net performance.
- Firms did not usually compare their fund fees and charges to similar funds, and were mostly unable to explain large differences in fees and charges among otherwise similar funds.
- Firms did not usually share economies of scale with customers. For example, internal fund managers did not typically negotiate savings as the size of a fund increased, nor did they address fund underperformance with timely and meaningful measures.
- Firms did little more than comply with regulatory initiatives. For example, firms applied fund fee caps to default fund workplace pension funds, but did not consider whether similar funds should be charged the same rates in order to provide better value to customers.
- Firms were unable to demonstrate how product features (other than asset management) were good value, for example in cases where asset management charges accounted for a small fraction of the total product charges.

- Firms typically checked competitors' pricing with the aim of ensuring their prices were within normal market ranges and competitive on price.
- Institutional investors drove demand-side pressure and therefore may have had less need for investor protection through fund governance.
- The influence of independent governance bodies had been positive but limited. For example, governance bodies had been positive in helping firms reduce fees on the most expensive funds but had not challenged fees on other funds as long as they complied with the relevant charge caps.

The FCA has said that it will review its findings alongside its wider work on governance and will decide whether further remedies are needed.

The FCA's findings suggest that further work and remedies are required by firms to ensure that governance results in good value and outcomes for customers. We expect that the FCA will introduce further requirements in this area in the near future. In the meantime, firms should review their governance procedures in relation to providing value at the level of individual unit-linked funds, and consider whether adjustments can or should be made.

At a minimum, we would expect firms to have robust processes to regularly assess performance across the value chain, with consideration given to factors such as fees and charges, benchmarks, customer security and customer experience, as well as the value provided by the asset management itself. Naturally, the focus should be on any funds or products that either underperform over the long term or significantly underperform in the short term. Those undertaking value for money assessments should have the necessary skills, experience, support and information to undertake their roles effectively, and a forum for challenge where improvements are needed. Firms should also regularly evaluate the effectiveness of the assessment processes themselves. Where value for money assessments come up with suggested amendments to funds, consideration should also be given to whether the same changes should be made to similar funds.

Applying reductions or caps to fees and charges is one way of ensuring good value for customers. However, there might in fact be acceptable reasons for higher charges versus competitor funds, or for other inconsistencies between funds, and often the problem is that firms are not doing enough to explain and justify these differences. For example, funds investing in different markets or with different investment strategies are not always directly comparable, while certain unit-linked products may provide a relatively enhanced customer service experience that justifies higher costs. Furthermore, where firms do conclude that the right thing to do is to lower fees and charges, it can prove financially challenging, particularly if third parties provide certain fund services under fixed terms and so the insurer has to absorb the full cost itself.

PERMITTED LINKS

On 4 March 2020, the FCA published the policy statement ‘Amendment of COBS 21.3 permitted link rules’ (PS20/4), setting out its response to the feedback received to its earlier consultation paper, ‘Consultation on proposed amendment of COBS 21.3 permitted links rules’ (CP18/40), alongside final rules and guidance. According to the FCA, the new rules seek to address any unjustified barriers to retail investors investing in broader ranges of long-term assets in unit-linked funds, while maintaining appropriate degrees of investor protection.

The changes proposed in CP18/40 were summarised in our 2019 paper. The FCA received 29 responses to the consultation that, although broadly supportive of the proposals, have prompted changes in certain areas. Namely:

- **The rules relating to investment in permitted land and property:** Respondents suggested that permitted land and property should be excluded from any overall limit on illiquid assets in a unit-linked fund. They argued that management of liquidity risks in unit-linked funds invested solely in property, and investors’ familiarity with the concept of property investments being less liquid, meant it was not proportionate to restrict investment in land and property to the same extent as other categories of illiquid assets. Accordingly, the FCA has now excluded permitted land and property from the overall limit. The only limit relating to investment in land and property remains the 10% gearing limit on permitted land and property under existing COBS 21.3 permitted links rules.
- **The level of the overall threshold limit on illiquid assets held as permitted links:** In CP18/40, the FCA proposed introducing an overall limit of 50% on illiquid assets held as permitted links or conditional permitted links for firms meeting the investor protection conditions. Several respondents disagreed with this limit for varying reasons. They ranged from questioning the need for any limit to suggesting that 50% was too high, particularly if permitted land and property were not included. The final measures set an overall limit of 35% on the proportion of the fund that may be invested in these assets, which the FCA is satisfied should facilitate a broader range of illiquid investments in a way that will mitigate the risks.

The new rules and guidance are of particular relevance to defined contribution (DC) pension schemes and complement the UK government’s 2019 consultation setting out proposals to encourage larger DC schemes to increase investment in illiquid assets.⁶ This incentive could benefit long-term investors, from both diversification and returns perspectives, as well as the wider economy, from the increased investment in important sectors such as infrastructure, real estate and private equity and debt.

However, investment in illiquid assets presents associated risks and so requires further governance. Indeed, insurers will only be able to take advantage of the FCA’s new rules where they can ensure that the investments are appropriate for their policyholders’ circumstances on an ongoing basis, namely where the policyholders’ priority is longer-term return rather than maintaining short-term liquidity. Insurers must continue to pay policyholders’ benefits as they fall due, although they may be able to defer policyholder requests to exercise other rights where it is considered necessary for the prudent management of the fund and in policyholders’ best interests. Insurers must also clearly and prominently inform policyholders of the additional risks and consequences associated with the use of these extended permissions.

This work should be viewed in the context of the FCA’s wider activity on patient capital⁷ and liquidity in investment funds, notably its continuing work on illiquid assets in open-ended funds (discussed below), which aims to address how best to align fund redemption terms with the liquidity of their assets in order to minimise financial stability risks.

OPEN-ENDED FUNDS INVESTING IN LESS LIQUID ASSETS

On 30 September 2019, the FCA published the policy statement ‘Illiquid assets and open-ended funds and feedback to Consultation Paper CP18/27’ (PS19/24). The new rules and guidance, which will come into force on 30 September 2020, focus on non-Undertaking for Collective Investment in Transferable Securities (UCITS) retail schemes, known as NURSSs, and seek to reduce the potential for harm to investors in funds that hold inherently illiquid assets, particularly under stressed market conditions.

The FCA is changing its Handbook in three broad areas:

- **Suspension of dealing in units:** The new rules introduce a requirement for NURSSs holding property and other immovables to suspend dealing when there is ‘material uncertainty’ about the valuation of at least 20% of the scheme property, unless a fund manager agrees with the fund’s depository that suspension would not be in the best interests of investors.
- **Improving the quality of liquidity risk management:** The FCA is requiring managers of funds investing mainly in illiquid assets to produce contingency plans for dealing with liquidity risks. It is also giving depositaries a specific duty to oversee the processes used to manage the liquidity of the fund. Further guidance is provided, which is intended to clarify both the circumstances in which it may be appropriate to suspend dealing and the process for arriving at a fair and reasonable value for an immovable asset, where it needs to be sold quickly to ensure that the fund can continue to meet redemption requests as they fall due.

⁶ Gov.UK (5 February 2019). Closed Consultation: Defined Contribution Pensions: Investments and Consolidation. <https://www.gov.uk/government/consultations/defined-contribution-pensions-investments-and-consolidation>.

⁷ FCA (28 February 2020). FS20/2: Patient Capital and Authorised Funds. Feedback Statement. <https://www.fca.org.uk/publications/feedback-statements/fs20-2-patient-capital-and-authorised-funds>.

- **Increased disclosure:** Additional disclosure is required in a fund's prospectus of the details of its liquidity risk management strategies. A standard risk warning is to be given in financial promotions to retail clients for such funds (this will apply to all firms communicating a financial promotion, not just the fund manager).

Insurers with unit-linked funds investing in property or other inherently illiquid assets should consider:

- The liquidity risk management measures they currently have in place, including their contingency plans
- Their policies and processes to ensure fairness between exiting and remaining customers
- The level of transparency for customers on these matters and on the potential consequences of investing in funds with illiquid assets

With this in mind, we then suggest conducting a gap analysis relative to the new rules and guidance set out in PS19/24.

Since the consultation closed, two high-profile UCITS funds, the LF Woodford Equity Income Fund and the M&G Property Portfolio, saw suspended dealing in 2019, which raised questions regarding the need for wider reforms to all open-ended funds (both NURS and UCITS) to ensure redemption terms are better aligned with liquidity of assets.

As indicated in PS19/24, the FCA and the Bank of England Financial Policy Committee (FPC) are currently considering such wider reforms. On 16 December 2019, in its Financial Stability Report, the FPC published the initial findings of a joint review on open-ended investment funds and the risks posed by their liquidity mismatches.⁸ The FPC established the following principles of fund design that would deliver greater consistency between redemption terms and funds' liquidity:

1. Liquidity of funds' assets should be assessed either as the price discount needed for a quick sale of a representative sample (or vertical slice) of those assets or the time period needed for a sale to avoid a material price discount.
2. Redeeming investors should receive a price for their units in a fund that reflects the discount needed to sell the required portion of the fund's assets in the specified redemption notice period.
3. Redemption notice periods should reflect the time needed to sell the required portion of a fund's assets without discounts beyond those captured in the price received by redeeming investors.

The joint review is now considering how these principles could be implemented in a proportionate and effective manner and the conclusions of the review will be used to inform the FCA's development of further rules for all open-ended funds. However, progress has been delayed due to the spreading coronavirus crisis, with a planned survey covering circa 300 funds postponed until further notice.

THE LF WOODFORD EQUITY INCOME FUND SUSPENSION

The LF Woodford Equity Income Fund was originally suspended for 28 days in June 2019 after being unable to meet daily redemptions from investors. Over the 12 months leading up to the suspension, a growing number of investors withdrew their money, which proved challenging for the fund manager because the portfolio contained a number of unquoted and illiquid investments that are hard to sell at short notice.

The suspension was subsequently extended and had been expected to end in December 2019. However, due to uncertainty as to whether this timeline would be achievable, in October 2019 the fund's authorised corporate director (Link Fund Solutions) decided to wind up the fund by selling the assets and returning the proceeds to investors. Following this decision, Neil Woodford is no longer managing the fund and the fund has been renamed as the LF Equity Income Fund.

The wind-up process began on 18 January 2020 and two capital distributions have since been paid to investors from the proceeds of the sale of the assets of the fund.

THE M&G PROPERTY PORTFOLIO SUSPENSION

In December 2019, dealing was suspended in the M&G Property Portfolio following unusually high outflows prompted by continued Brexit-related uncertainty and ongoing structural shifts in the UK retail sector. These circumstances and deteriorating market conditions significantly affected M&G's ability to sell the underlying commercial property assets at fair prices.

This temporary suspension has continued to date, with monthly formal reviews. There is currently no certainty as to when the fund will reopen as markets continue to feel the impact of the coronavirus pandemic.

It will be interesting to see what the FCA and FPC implementation recommendations will be. We suspect it might be difficult for firms to undertake these assessments in an objective manner in practice, without exercising significant expert judgement, and this could give rise to material inconsistencies in approach across the market. Furthermore, where the results from this exercise are unacceptable or unattractive, there is the question as to how easy, or indeed sensible when viewed against other objectives, it would be to unwind some of the existing fund investments.

⁸ Bank of England (16 December 2019). Financial Conduct Authority and Bank of England statement on joint review of open-ended funds. Press release. <https://www.bankofengland.co.uk/news/2019/december/open-ended-funds>.

The FPC does state in its Financial Stability Report⁹ that some similar measures are being used elsewhere. For example, the US Securities and Exchange Commission (SEC) recently adopted liquidity measures based on the time period of sale and settlement needed to avoid a material price discount, and swing pricing is already used by some funds across different jurisdictions to remove any incentive to redeem from a fund ahead of other investors. Thus, for these areas, perhaps we can learn from those who have gone before. However, the FPC also acknowledges potential challenges, specifically that some calibrations may be difficult in practice due to changing market conditions and data limitations, and that carefully designed mechanisms would be needed to ensure the fair treatment of all investors.

When one draws this together with the FCA's new permitted links rules, it is interesting to note the potentially competing objectives at play: encouraging greater investment in and access to illiquid long-term investments versus stricter requirements on funds that do hold these instruments.

PRA themes

THE PRUDENT PERSON PRINCIPLE (PPP)

On 18 September 2019, the Prudent Regulation Authority (PRA) published the consultation paper 'Solvency II: The Prudent Person Principle' (CP22/19), setting out its draft expectations for how firms should manage their investment risks in accordance with the PPP.¹⁰ Many of the proposals do not apply for assets backing unit-linked contracts (with the exception of assets backing embedded guarantees). However, those of relevance include expectations relating to the following.

Firms' investment strategies

The PRA proposes setting expectations for firms to:

- Develop and document an investment strategy that is subject to minimum information and governance requirements, such as board oversight of the continuing appropriateness of, or material changes to, the strategy
- Clearly document their compliance with the Investments section of the PRA Rulebook

Different investment strategies that pertain specifically to unit-linked business include:

- Implementing Solvency II unit matching, which is the process of only holding unit-linked assets to cover the unit-linked part of the technical provisions. Alternatively, firms may choose to hold unit-linked assets to cover the full value or surrender value of policyholders' unit-linked funds.
- Holding derivatives outside of unit-linked funds to mitigate the firm's exposure to falls in unit prices, which reduce the value of future management charges (income) more than that of future outgo (expenses that are, in part, fixed).

- Backing non-linked liabilities with cash, liquidity funds and fixed interest investments, which are more appropriate to the nature and duration of these liabilities.

Alignment of investments with firm's risk management framework

The PRA proposes setting the expectation for alignment of investments with the firm's risk appetite, risk management policies, risk tolerance limits and investment strategy, alongside the firm's overall business model.

We believe these expectations are relevant to both the unit-linked and non-linked assets backing unit-linked contracts.

The value of in-force¹¹ (VIF) associated with unit-linked contracts is often hedged to reduce market risks, specifically the risk of changes in VIF due to movements in unit prices, with the optimal level of hedging typically determined with reference to the firm's risk profile and appetite. VIF securitisations can be used for the same de-risking and capital relief purposes, with the added benefit of providing liquidity, for example to help fund a firm's new business and acquisition plans. For similar reasons, as alluded to above, unit-linked insurers might choose to implement a unit matching strategy.

When launching new funds, unit-linked providers will often invest a level of own funds as 'seed capital' to get the business started. In this case, there will be no offsetting unit-linked liability and so additional risk capital and balance sheet volatility is generated. To manage this, firms holding seed capital assets can stress-test the market risk exposure at different levels of seed capital investment in order to assess the associated risks relative to risk appetite and inform limit setting.

With respect to assets held to cover the non-linked part of the technical provisions, unit-linked firms typically hold assets such as cash, liquidity funds or bonds. Such assets should generally be appropriate to the nature and duration of non-linked liabilities, for example fixed expenses. Further, cash and liquidity funds are highly liquid and so help firms to manage the risk of failing to meet planned or unforeseen payments as they fall due.

It should be noted that further expectations apply for unit-linked firms where assets covering technical provisions are held to cover investment guarantees or other guaranteed benefits. These expectations are set out in section 3.4 to 3.23 of the PRA's draft supervisory statement in the appendix of the consultation paper. They include:

- Quantifying the impact on solvency of investment risks under a range of scenarios
- Risk monitoring (including, amongst others, monitoring of changes in asset characteristics, changes in asset value and volatility and concentrations of risks within a portfolio)
- Providing regular management information to the board on investments risks

⁹ Bank of England (December 2019). Financial Stability Report. <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf>.

¹⁰ The PPP is currently set out in the Investments section of the PRA Rulebook for Solvency II firms.

¹¹ The present value of future profits associated with the in-force business.

- Monitoring the effectiveness of any risk-mitigating hedge
- Developing an investment risk management policy, which includes setting internal quantitative investment limits for assets and exposures
- Avoiding risk concentration, accumulation and lack of diversification

Outsourcing of investment activities

The PRA proposes setting expectations for firms to:

- Undertake appropriate due diligence and be confident that external parties have sufficient risk management expertise to meet the PRA's expectations
- Explain their reasoning if they determine that investment functions are not 'critical or important'

Unit-linked firms often outsource investment management to a third party and, as such, the initial and ongoing due diligence are key to managing associated risks. Due diligence on external investment managers should include regular validations of information provided, review of the adequacy of outsourcer systems and controls, audit of the outsourcer and use of contractual agreements that ensure the outsourcer complies with relevant regulation and best practice as well as additional governance arrangements such as board oversight. Preparation of exit plans and transitional arrangements are also key to ensuring operational resilience in the context of outsourced investment arrangements.

Some unit-linked firms also offer externally managed funds to their customers. We would expect firms to perform sufficient due diligence and review to ensure that the external funds remain secure and appropriate for policyholders to invest in on an ongoing basis. For example, this might include setting and monitoring minimum credit rating limits and SLAs, keeping abreast of any organisational or structural issues that could affect performance and checking that the external funds are being run in line with stated objectives. Indeed, some firms state within their online unit-linked fund literature that they ensure that the service provided by any external fund manager is in line with their agreed expectations and requirements, and that access to external funds may be closed where these arrangements are no longer considered in the best interests of policyholders.

Valuation uncertainty

The PRA proposes setting the expectation that, where firms invest in non-traded assets, they take account of and appropriately manage the associated valuation uncertainty risk. This includes:

- Complying with relevant sections and articles of the PRA Rulebook and Delegated Regulation
- Ensuring the skills and expertise of the persons involved in the valuation of these assets are proportionate to the materiality of the firm's exposure
- Quantifying bounds on any valuation uncertainty at a granular level and ensuring the level of valuation

uncertainty is consistent with the firm's risk appetite and investment strategy

These requirements are likely to be relevant where unit-linked funds are invested in property or non-traded assets, which are difficult to value. Best practice suggests use of a range of valuation sources where possible, creating a hierarchy of these valuation sources based on historical accuracy, investigating reasons for a wide spread of valuation results, avoiding use of so-called 'stale prices' where more up-to-date information is available and ensuring the independence of valuations. For example, for funds holding property, an external and independent chartered surveyor who holds the relevant professional accreditations typically performs regular valuations. Valuation procedures for non-traded assets should be documented, along with contingency plans to address unexpected delays in information becoming available.

The deadline for responses to the consultation was 18 December 2019.

LIQUIDITY RISK MANAGEMENT

In September 2019, the PRA published the policy statement 'Liquidity risk management for insurers' (PS18/19). This provided feedback to its earlier consultation paper on the subject (CP4/19) and included a supervisory statement (SS5/19). Milliman published a white paper¹² in July 2019 in response to CP4/19.

Generally, the updates made in PS18/19 were points of clarification rather than substance. The most significant amendments clarify the PRA's expectations on:

- The definition of risk limits within an insurer's liquidity risk appetite framework: the PRA has added flexibility where this is justified.
- The role of the board in managing liquidity risk: The PRA has clarified that appropriate oversight for liquidity risk management may generally be conducted by any risk committee of the board. However, as the insurer's liquidity risk appetite is owned by the board, the PRA expects that any breach (or near breach) of liquidity risk appetite will be escalated to the board and that the PRA will be informed.
- The function and characteristics of the liquidity buffer have been clarified: The PRA expects that an insurer should be able to monetise the assets in its liquidity buffer to meet its excess cash flow needs in the chosen time horizon without directly conflicting with any existing business or risk management strategies. Hence, an insurer is expected to avoid counting funds committed for future payments or investments used for regular income generation as part of its liquidity buffer. The PRA has also clarified the definitions of assets of primary and secondary liquidity to assist insurers in understanding the rationale behind the distinction. It highlights the need to be careful with money-market funds that may themselves have procedures to manage their own liquidity risks, which limit their realisability.

¹² Booth, C. et al. (3 July 2019). Liquidity risk management: An area of increased focus for insurers. Milliman White Paper. <https://uk.milliman.com/en-GB/insight/liquidity-risk-management-an-area-of-increased-focus-for-insurers>.

In our initial July 2019 white paper, we covered some of the specific measures that unit-linked insurers could take to manage liquidity risk.

In the short term, they include deferring claims by suspending redemptions on certain unit-linked funds when asset markets are under stress. Where unit-linked products have contractual terms and conditions giving the insurer the option to do this, it can help greatly by allowing a suitable period in which to liquidate the underlying unit-linked assets. However, for many products, deferring the payment of claims may come with adverse commercial implications. This ties in closely with our earlier discussions on the FCA's work on permitted links and open-ended funds investing in less liquid assets.

Other potential longer-term actions for unit-linked insurers include:

- Boosting liquidity by monetising the VIF through securitisations or unit matching implementation, which we mentioned in the context of the PRA's recent PPP consultation.
- Establishing and monitoring early warning indicators to identify an emerging real-life stress situation. Such indicators might include unit-linked funds moving to a bid-offer spread, or a rise in bid-offer spreads, and the level of policyholder settlement mismatches.
- Regular monitoring and reporting of cash and liquidity fund balances, liquidity surpluses and planned liquidity requirements.
- Entity-specific liquidity stress testing to both set and monitor the risk appetite position.

EIOPA themes

In December 2019 EIOPA released its '[Consumer Trends Report 2019](#)', which highlighted a number of issues typically found with unit-linked products. The issues related to the complexity of some unit-linked contracts, including lack of transparency, lack of consumer understanding of products, conflicts of interest, product complexity and inadequate returns.

Evidence from consumer interviews highlighted that customers often do not understand their unit-linked products, whilst sales of unit-linked policies to vulnerable customer groups is another one of the issues which has been reported.

Although increased sales to vulnerable customers is not in itself a negative trend if the products sold meet the needs of the customer and are adequately explained, attention should be paid by firms to ensure that this is the case.

The primary cause of unit-linked product conduct risks was found to be commission-related complaints. EIOPA found that 208 undertakings (of 501 firms studied) had commission rates above 6% and that commission rates grew between 2017 and 2018 in 21 EU Member States. Of the Member States where commission rates grew, two grew by more than 2%, with 25

Member States having commission rates above the European Economic Area (EEA) average. EIOPA states that there are some concerns related to potential conflicts of interest and aggressive sales tactics where the data shows both high growth in gross written premiums and high commissions.

Low returns are an area of concern, particularly as there could be a mismatch between the returns a consumer expects and the actual returns achieved. Another concern centres on the fact that the unit-linked products are often bought for their tax advantages and therefore costs are often disregarded. On the other hand, the report does point to recent regulation driving improvements in disclosures on costs and returns. For example, the packaged retail and insurance-based investment products (PRIIPs) Key Information Documents (KIDs) have helped consumers in this respect.

These findings echo the FCA themes arising in the AMMS and unit-linked governance review. Conduct issues and value for money are key areas which have come to the regulators' attention and where there appears to be room for improvement and retrospection by unit-linked providers.

Climate change and environmental, social and governance (ESG) risks

CLIMATE CHANGE RISKS

The insurance industry has recently faced increasing attention from regulators in managing the financial risks from climate change. The PRA, the FCA and EIOPA have published papers and statements to engage the industry on various topics within climate change. These topics are discussed further in the Milliman papers '[Financial risks arising from climate change](#)' and '[Emerging risks in insurance: Climate change](#)'.¹³

Additionally some notable FCA publications include:

- On 16 October 2019, the FCA published a feedback statement, '[Climate Change and green finance: Summary of responses and next steps](#)', which discusses the responses it received to its earlier discussion paper (DP18/8) and sets out proposals to improve climate change disclosures by issuers and information to consumers on green financial products and services. In this paper, the FCA states that its new permitted links rules have a strong relevance to climate change. In particular, they enable greater innovation and access to a wide range of investment opportunities, which is likely to be important in funding the cost of the transition to a greener economy.
- On 17 December 2019, the FCA published the policy statement '[Independent Governance Committees: Extension of remit](#)' (PS/30). It includes a new duty for IGCs to consider and report on their firms' policies on ESG issues, member concerns and stewardship for the products that IGCs oversee. The report suggests that these rules may encourage competition among firms to incorporate ESG factors into investment strategies and decision making. Unit-linked firms

¹³ Milliman also distributed an email summarising EIOPA's 'Opinion on Sustainability within Solvency II' of 30 September 2019. Please contact us if you would like to receive a copy of this summary.

may therefore see pressure from IGCs to adjust their fund and product offerings to ensure that ESG factors are being taken into account both within investment management and within wider decision making.

ESG RISKS

For unit-linked funds, a key focus is in managing ESG risks. With investors progressively demanding ESG fund options and information regarding the carbon footprint and social responsibility of their investments, unit-linked providers increasingly face pressure to provide environmentally and socially ethical investment options. The size of the ESG market has grown significantly recently. For example, Morningstar data showed that inflows of on average £124 million per week went into UK ESG funds in the first three quarters of 2019.¹⁴ As an extension of this trend, unit-linked providers are likely to see an increase in interest in ESG funds over time.

Unit-linked firms are beginning to publicise their ESG investment approaches; for example, Utmost Life and Pensions describes the integration of ESG factors within its funds on its website¹⁵ and Standard Life Assurance Limited has published a policy on how it incorporates ESG factors into its unit-linked investments.¹⁶

Amendments¹⁷ to the Occupational Pension Schemes (Investment) Regulations 2005,¹⁸ which came into force on 1 October 2019, mean that for private pension schemes with over 100 members trustees are required to demonstrate ESG considerations in a statement of investment principles (SIP). This regulation is likely to drive further attention from pension scheme trustees in ensuring that pension portfolios take into account ESG principles. The Pensions and Lifetime Savings Association (PLSA) issued a guide titled 'ESG & Stewardship: A Practical Guide to Trustee Duties'. The guidance suggests a number of questions trustees should consider asking asset managers. For example, questions include:

- How is your approach to ESG and stewardship evolving in response to the surge of interest in this issue? What might this mean for our current investments?
- How are you managing climate change risk and opportunities on our behalf?
- In what ways are you influencing companies on our behalf?

Although these regulations do not specifically cover unit-linked insurance firms, the drive for trustees to consider and assess the ESG characteristics of pension investments is likely to instigate pressure being applied to unit-linked firms to explain how ESG factors are taken into account within their funds, or encourage them to offer ESG funds.

A key problem for firms providing information on the ESG features of products is the lack of consensus regarding what represents an ESG investment, or how ESG properties can be measured. With different firms providing different ESG characteristics within their fund options, there is a risk that reputational and conduct issues could arise further down the line if firms are not clear on exactly how they have classified products as being environmentally and socially friendly. ESG compliance criteria may be set by individual investors or a company, and therefore there is potential for a mismatch between the ESG principles of those investing their money and the company administering the investments.

Clear disclosures on ESG characteristics and classification methodology are key to mitigating this risk. The insurance industry, spurred by regulatory scrutiny and developments, is gradually integrating the guidance of the Task Force on Climate-Related Financial Disclosures (TCFD) within their disclosures on climate change and sustainability risks. The TCFD's 2017 report¹⁹ describes recommended disclosures covering governance, strategy, risk management and metrics and targets.

Solvency II 2020 Review

On 11 February 2019, the European Commission (EC) issued a formal 'Call for Advice' to EIOPA on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 as required by the Solvency II Directive.

Prior to this, on 19 December 2018, EIOPA issued a 'Call for Input' to provide the opportunity for the industry and other stakeholders to give input on areas of Solvency II that could be further improved. Taking into consideration the responses and feedback from stakeholders, EIOPA published a series of consultation papers²⁰ on its proposals for the 2020 Review.

Some of the changes proposed by EIOPA are likely to have a particular impact on firms with unit-linked business.

¹⁴ Tew, I. (30 October 2019). ESG funds see £124m inflows per week. Financial Times Adviser. <https://www.ftadviser.com/investments/2019/10/30/esg-funds-see-124m-inflows-per-week/>.

¹⁵ Utmost Life and Pensions. How we manage our unit-linked funds. <https://www.utmost.co.uk/investment-funds/how-we-manage-our-unit-linked-funds/>.

¹⁶ Standard Life Assurance Limited. Integrating a responsible approach to your pension investments. <https://www.standardlifeworkplace.co.uk/employer/assets/invcp53.pdf>.

¹⁷ Department for Work and Pensions (September 2018). Clarifying and strengthening trustees' investment duties. Government response. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/739331/response-clarifying-and-strengthening-trustees-investment-duties.pdf.

¹⁸ See the full text at <http://www.legislation.gov.uk/uksi/2005/3378/data.pdf>.

¹⁹ TCFD (June 2017). Recommendations of the Task Force on Climate-Related Financial Disclosures. Final Report. <https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf>.

²⁰ EIOPA. 2020 review of Solvency II. https://www.eiopa.europa.eu/browse/solvency-ii/2020-review-solvency-ii_en.

SOLVENCY AND FINANCIAL CONDITION REPORTS

In the consultation paper focussing on Solvency and Financial Condition Reports (SFCRs),²¹ EIOPA has proposed that all SFCRs should be published on the company website and be in a format that is machine-readable. The area of the website containing the SFCR should also provide links to other available policyholder information.

For unit-linked firms, there could be a significant amount of additional information that needs to be provided within the area of the website containing the SFCR. This will cover the products on offer and also the different funds available.

QUANTITATIVE REPORTING TEMPLATES

In the consultation paper focussing on Quantitative Reporting Templates (QRTs),²² EIOPA has proposed a number of amendments to existing QRTs as well as the introduction of new QRTs to capture additional information.

The proposed changes to the QRTs that we think will have a significant impact on unit-linked firms are:

- Additional information required on QRT S.05.01 ('Premiums, claims and expenses by line of business'), including the number of contracts, the number of insured lives and the total amount of surrenders.
- Additional information required on QRT S.06.02 ('List of assets'), including information on ESG-compliant or sustainable investments.
- New QRT S.06.04 ('Collective undertakings – look-through approach'), which will capture much more detailed information than what is currently required for collectives, such as the name, sector, group and country of the issuer as well as the currency. We expect that this increased requirement will present a particular challenge to unit-linked firms where existing look-through requirements can prove challenging.
- New QRT S.29.05 ('Variation of the best estimate in life insurance'), which will supersede S.29.03 and S.29.04 for unit-linked life insurers. This new QRT is intended to better capture the characteristics of life insurance than the previous QRTs. An equivalent non-life insurance template has also been proposed.

Milliman consultants have produced more detailed summaries²³ of the EIOPA consultations on SFCRs and QRTs as well as all the other EIOPA consultations produced as part of the 2020 Review.

How Milliman can help

Milliman has a wide range of experience of working with unit-linked business. Our consultants and principals hold a number of Chief Actuary roles and have worked on a range of transactions and optimisation and restructuring projects across the sector. In particular, we have supported such firms in the following areas:

- Calculation of the Solvency II Pillar 1 balance sheet, including ad hoc queries covering regulatory interpretations
- Production of forward-looking projections
- Development of stress and scenario testing, and risk appetite and limits frameworks
- Completion of the Solvency II QRTs
- Contribution to and review of the SFCR and Regular Supervisory Report (RSR)
- Independent Expert assignments for Part VII transfers
- Capital optimisation projects, including implementations of unit matching and derivative hedging strategies
- Production of fund illustrations for fund fact sheets
- Independent assessments of clients' compliance against various aspects of UK regulations

If you have any questions or comments on this paper, or on any other issues affecting unit-linked insurance business, please contact any of the consultants below or your usual Milliman consultant.

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²¹ EIOPA (25 June 2019). Consultation Paper on proposals for Solvency II 2020 Review: 4. Solvency and Financial Condition Report. https://www.eiopa.europa.eu/sites/default/files/publications/consultations/eiopa-bos-19-309_sfc_r_disclosure.pdf.

²² EIOPA (25 June 2019). Consultation Paper on proposals for Solvency II 2020 Review: 2. EIOPA proposals template by template. https://www.eiopa.europa.eu/sites/default/files/publications/consultations/eiopa-bos-19-305_qrt_review.pdf.

²³ Crowson, J. et al. (24 January 2020). Solvency II 2020 review. <https://uk.milliman.com/en-GB/insight/solvency-ii-2020-review>.