



Guernsey Financial
Services Commission

**REPORT ON THE THEMATIC REVIEW OF
INVESTMENT AND LONG-TERM INSURANCE
SALES PRACTICE**

June 2014

Executive Summary

Between October and December 2013 the Commission undertook a series of 12 on-site visits to intermediaries providing advice to retail customers on investments and long-term insurance products (“the Review”). The Review formed part of the Commission’s ongoing work to ensure retail customers receive an appropriate level of protection.

The series of visits were a follow up to the 8 visits of a similar nature that the Commission undertook in July 2012 and to the Commission’s letter of January 2013 (the “Commission’s Letter”) which summarised the findings from these visits.

Through its 2013 visits, the Commission found that the majority of licensees visited had made improvements and rectified a number of the issues identified in the Commission’s Letter. However a number of licensees had not made sufficient efforts to implement the improvements required by the Commission’s Letter. Of these, several licensees were referred to the Enforcement Division for further investigation.

While a number of the issues identified by the 2012 visits have been addressed, the Commission’s findings indicate that further work is required across the sector, by every licensee.

This report will summarise the Commission’s findings and explain our expectations going forward.

Methodology

As with the 2012 visits, the Commission engaged RWA Compliance Services Limited to conduct the visits alongside Commission staff.

Three of the licensees visited were also visited as part of the 2012 Visits. When combined with the 2012 visits, the Commission has now visited the majority of those licensees offering advice on investment and long-term insurance products. Those licensees that were not visited were either newly licensed, did very little business or only sold protection products. These licensees were selected on a risk based approach with due regard being given to those licensees with greatest market share and potential risk to consumers.

The Review was mainly concerned with how licensees gathered sufficient information to give suitable advice and how they communicated that advice to their clients. The Commission also looked to see what improvements licensees had made in response to the Commission’s Letter.

In advance of the visits, licensees were asked to provide various information, including a completed pre-visit questionnaire, a schedule containing details of all new business placed, surrendered or transferred in the 12 months prior to the request and copies of the standard documents used to record client information and assess their attitude to investment risk.

The visits were conducted by interviewing key personnel followed by reviewing client files selected from the schedule referred to above. The findings summarised below are based on the documents reviewed and the responses given in advance of the visit and during the interviews.

Findings

The most significant findings of the Review are summarised below. This includes areas of both good and poor practice. Where there have been common areas of poor practice the Commission has set out what it expects from licensees going forward.

Areas of good practice have been highlighted by way of example. These examples should not be taken as guidance and are in no way prescriptive. These practices may not be appropriate for every licensee, based on the internal organisation and range of products offered.

1. Client Information

Principle 4 of the Principles of Conduct of Finance Business¹ (the “Principles”): Information about Customers, requires a licensee to seek from customers it advises or for whom it exercises discretion any information about their circumstances and investment objectives which might reasonably be expected to be relevant in enabling it to fulfil its responsibilities to them.

In order to give objective, suitable financial advice, an adviser needs to collect sufficient information regarding their client’s objectives, circumstances, both financial and personal and their willingness and ability to take risks.

1.1. Fact Finds

The majority of licensees used a fact find questionnaire to obtain information regarding their client’s personal and financial circumstances. In most cases these were completed to a good standard, with the reasons for blank sections noted. However there were still a number of instances where licensees left sections blank without explanation or updated a previously used fact find.

Of particular note, while there were almost always specific fields for recording detailed information regarding client’s mortgage liabilities, the sections for recording client’s other liabilities usually consisted of a simple text field, when they were present at all. The Commission is concerned that this will lead to advisers paying insufficient attention to client’s non-mortgage liabilities. When considering making a lump sum investment it may often be in a client’s best interests to pay off a debt instead.

Where clients do not wish to disclose information regarding their personal circumstances, the adviser should consider whether he has sufficient information to give advice. Several examples were identified where shortly after entering into a long term investment, the client

¹Link: The Principles of Conduct of Finance Business

required to withdraw funds and was penalised for so doing. However the fact find did not indicate that access to the investment had been discussed or considered.

1.2. Objectives

The majority of fact finds reviewed by the Commission contained a section for clients to record their objectives. In most cases this consisted of a list of general areas clients might require advice about, such as pension planning, mortgage protection or lump sum investments. Clients would indicate, often by numbering in order of priority, which areas they required advice regarding.

The Commission is concerned that this may not allow licensees to record their clients' individual, specific needs such as, the case of pension planning, the client's income needs and expectations or in the case of lump sum investments and saving plans, the purpose for which the funds are being saved or invested. A number of licensees did make use of file notes to record additional information about their clients which in some cases did include information regarding the client's objectives but this was usually along the lines of 'to invest further funds'. File notes were also not used in a consistent and organised manner.

At one licensee, the objectives recorded in the fact finds were completely uniform, consisting of the same three phrases in every case.

1.3. Client's willingness and ability to take risk

Most licensees visited assessed their client's attitude to risk using a scoring system based on a questionnaire. This score would then be translated into a particular category, such as high, medium or low. These categories were generally accompanied by a description of what that level of risk would entail. The Commission often found that these descriptions used were vague, qualitative terms such as 'some', 'more', and 'greater' to describe the level of risk and did not enable the client to understand the consequences, both in terms of potential gains and potential losses, of investing with a particular level of risk.

While the Commission recognises that past performance is not a guarantee of future performance, providing quantitative information regarding the historic volatility of portfolios at a particular risk rating may help clients, as long as the licensee takes care to explain what it means for the client. Providing information regarding the potential losses as well as the potential gains will also help manage client expectations and consider overall affordability.

In a number of cases the descriptions and categories of risk used by licensees varied between the documents they used, creating potential confusion for the client.

Some licensees attempted to provide further information to their clients by setting out what classes of assets, often in percentage terms, a portfolio constructed at a particular level of risk would typically hold. The Commission is concerned that, by itself, this may not be particularly useful to a client that does not already understand the kinds of risk attached to a particular asset class.

A small number of licensees assessed their clients' attitude to risk by providing them with a sheet containing a description of each level of risk, often along with a list of the types of

investments that typically fall within that level. Clients are then expected to select an appropriate level of risk for themselves. The Commission does not consider that this is sufficient by itself. We would expect licensees to assist their clients in deciding on an appropriate level of risk and evidence the process and the rationale behind the final decision.

In most cases the Commission did not find that the clients' ability to take risk, their capacity to bear loss, was sufficiently addressed. While some of the questionnaires included questions that alluded to the effects of loss upon the client, the issue was rarely explicitly addressed. The Commission also found little evidence of the adviser's consideration of the client's concentration risk.

2. Client Advice

Principle 5 of the Principles: Information for Customers, requires a licensee to take reasonable steps to give a customer it advises, in a comprehensible and timely way, any information needed to enable them to make a balanced and informed decision. A licensee is also required to be ready to provide a customer with a full and fair account of the fulfilment of its responsibilities to them.

The Commission expects licensees to provide their clients with written advice clearly explaining what they are recommending and how it will help the client meet their objectives. The purpose of this written advice is to provide the client with sufficient information, in a format they will understand, to enable them to make a balanced and informed decision regarding the licensee's recommendations. The Commission also expects licensees to take reasonable steps to satisfy themselves that their clients do in fact understand the advice.

2.1. Objectives

In order to be suitable, a licensee's advice must address the client's objectives. In order to demonstrate the suitability of their advice and ensure the client understands the reasoning behind it, it is important to express the client's objectives clearly.

The Commission found that the written advice prepared by many of the licensees did not express the client's objectives in a clear manner. In some cases product information was included in the section dealing with objectives, often expressed in technical terms a retail client is unlikely to use or understand. In general, the objectives recorded within the written advice were vague and generic, such as 'to invest further funds' or 'get a better return than available at the bank'. The purpose of the investment, the use the funds invested were likely to be put to, or the client's income needs in retirement, was rarely addressed.

2.2. Risk

The Commission expects a licensee to explain the particular risks of any product they recommend and demonstrate how it relates to their client's risk profile.

While the majority of licensees attempted to do this, the link between the client's risk profile and the risk of the product was not always clear, in part due to the vague manner in which the client's risk profile was described. In many cases it consisted of the licensee stating that

the client had a low risk profile and that the recommended product was low risk. It was unclear what criteria the licensee had used to determine that the product was in fact low risk.

In an example of good practice, the output of the client risk profiling tool used by a licensee produced a model portfolio that matched the client's risk profile. The licensee then constructed a portfolio similar to the model portfolio and explained the connection to the client.

The Commission found that many licensees did not give the same prominence to the negative aspects of the products they recommended as they did to the positive. In one case a licensee routinely recommended structured products to clients with low and medium risk profiles without sufficiently emphasising the capital-at-risk nature of the products.

2.3. Explaining the Product

The Commission found that a number of licensees were still relying on product provider information and fact sheets to explain the product they were recommending. As stated in the Commission's Letter, the Commission does not consider this sufficient, particularly when advising retail clients.

In particular, the Commission found very little reference within licensee's written advice to any 'cooling off' periods in which the client may cancel their investment without penalty.

The Commission also found that some licensees include what appeared to be information copied and pasted from the product provider's documentation. This has the potential to mislead clients into believing that it is the licensee's own opinion. In one case this included what appeared to be sections of fund fact sheets, which were technical and potentially incomprehensible to a retail client.

2.4. Costs

The Commission found that the majority of licensees disclosed the fees or commissions that they would receive to their clients in a reasonable, clear and transparent fashion. However some licensees were not disclosing the costs of the product themselves. In some cases the licensee's fees or commissions and the costs of the product were set out in different sections of the written advice or as part of the illustrations provided to the client.

The Commission considers that clients will find it useful to have the total costs that they will incur, both annual and initial, set out and itemised in one place, in both cash and percentage terms, with these costs identifying both the adviser and product provider charges.

A number of licensees made reference to receiving retrocession payments from fund managers which would, in some cases, be re-invested into the client's portfolio. There was generally little information as to the extent this would occur and its value to the client.

2.5. Peer Review

The Commission found that at every licensee visited there was evidence that some form of peer review occurred. This generally took the form of a signed peer review checklist or

email correspondence within the file indicating that the reviewer was satisfied with the advice being given.

However, the Commission was often unable to determine the effectiveness of the peer review process as many of the licensees did not maintain records within the client file of any changes the peer reviewer made. In one case a licensee maintained copies of the draft reports, including the reviewer's notes and suggested changes, within the client file. In this case the Commission was able to determine that the adviser's work was being peer reviewed in an effective manner.

For the avoidance of doubt, the purpose of a peer review is to ensure the advice being given is both suitable and communicated clearly, in writing, to the client.

2.6. Research

In files where a licensee provided advice on a long-term protection insurance product, the Commission generally found evidence of research within the client file and a reasonable attempt within the written advice to explain to the client why a particular product from a particular provider was being recommended over similar products from other providers. This was usually based on the cost or, when a more expensive product was recommended, on the superior service or level of protection offered.

This was less evident when advice was given on investment products. In many cases licensees would include a general list of other products that they had considered within their written advice before stating that the one they were recommending was the most suitable. The Commission did not find this particularly useful or informative. There was also little evidence within the client file to support the claim that the other products had been considered. However, in an example of good practice, one licensee set out a number of products they had considered and explained, briefly, why they had not recommended them.

2.7. Investment Platforms

The majority of licensees in the Review used an investment platform to manage their client's investments. While most licensees provided some information regarding the purpose of the platform, the benefits of, and rationale for, using it were not always clear. In addition each licensee made exclusive use of a single platform and, based on the files reviewed, did not consider whether that platform was suitable given the particular circumstances of each client. As the use of an investment platform involves a cost, the Commission expects licensees to justify its use to their clients.

In one case the only information regarding the use of an investment platform within a licensee's written advice was in the section dealing with costs.

2.8. Central Investment Process

The Commission found that a number of licensees had adopted, or were in the process of adopting, some form of central investment process. This generally involved some form of investment committee reviewing and researching the market and selecting various products, with various risk profiles, that they believed to be suitable for their clients and likely to

perform well. This would lead to the creation of a panel of products, sometimes referred to as a 'white list', which the licensee's advisers would make recommendations from.

The Commission has, in principle, no objection to such a process. However, we would expect licensees to be able to demonstrate and evidence its operation. This would include formal policies and procedures setting out the terms of reference of any investment committee, the methods used to review the market and research products, the regularity of said reviews, the criteria used in selecting products for the panel and the criteria for removing products together with retained documentary evidence of the above processes being carried out.

2.9. In-house Solutions

The Commission found that a number of licensees, particularly in relation to RATS, were offering some form of in-house solution or service. This either took the form of products and services offered by a related or group company or products and services provided by a third party with the licensee's branding. When the licensee was offering its 'own brand' RATS it would have an agreement with the trust company that administered the Scheme and the investment firm who managed the holdings within the RATS, usually including a set of risk rated portfolios. The investment firm often offered discretionary management services, for which they charged a higher level of commission or fees. The Commission is concerned that licensees are recommending discretionary management services, when other more cost effective products may be more suitable, given the individual circumstances and risk profiles of their clients.

When advising on the formation of a RATS a licensee with such an 'in-house' solution would always recommend their own product as the default solution. It could be argued that this is acceptable as long as the licensee made it clear to their clients and explained the relationship between them and the other companies providing services, on the basis that a client could simply go elsewhere if they did not feel the product they were being offered was good value.

However, the Commission is concerned that retail clients are unlikely to have sufficient knowledge of the market to make an informed judgement, particularly regarding the costs attached to a product. Clients have a reasonable expectation that their adviser has acted in their best interests and recommended a product that is not unreasonably expensive.

There is a clear conflict of interest when a licensee advises on its own products, whether they be provided by group companies or through a partnership with third party providers. This is particularly the case when the nature of the relationship and/or the terms of the agreement are unclear or unknown to the client. The scale of many local licensees, where directors and shareholders are often providing advice to clients, can only exacerbate this issue.

Principle 3 of the Principles: Conflicts of Interest states that a licensee should either avoid any conflicts of interest arising or, where a conflict arises, should ensure fair treatment to all its customers by disclosure, internal rules of confidentiality, declining to act, or otherwise. A licensee should not unfairly place its interests above those of its customers and, when a properly informed customer would reasonably expect that the financial institution would place their interests above its own, the licensee should live up to that expectation.

The Commission expects, at a minimum, that licensees make their clients aware of any conflicts of interest that may exist.

3. Pension Transfers

The Commission found that the majority of licensees offered their clients advice on the transfer of existing pension plans into RATS.

In some cases licensees included phrases such as ‘To transfer your existing pension benefit into a RATS’ within the client’s objectives. This unduly shifts the responsibility onto the client and presents what should be the end-result of the advisory process as a foregone conclusion.

The Commission found that the benefits of, and reasons for creating, a RATS, as stated within licensees’ written advice, were qualitative and emotive. They focused on flexibility regarding investments, retirement age and method of draw-down, the ability to take a loan from the trust and the passing of any residual funds to the client’s estate. There was not an assessment of how valuable the above might be to a client. In particular the fact that there may not be any residual funds was rarely sufficiently emphasised.

When recommending that an existing pension be transferred into a RATS, most of licensees included information regarding the costs of the existing scheme, usually in percentage terms. While this is information that should be communicated to the client, it was not always presented in such a manner as to allow the client to easily compare the costs of their existing scheme to the scheme recommended by the licensee, either due to the two figures being presented in different formats or the figures being presented in different parts of the written advice. In addition the Commission found little information about the performance of the existing scheme.

When providing advice on transferring out of a defined benefit pension scheme, licensees are required to produce an actuarial report if the transfer value is £30,000 or above. This would set out, amongst other things, the percentage return on investment that would be required in order to match the retirement benefits provided by the defined benefit pension scheme. Most licensees summarised the salient points of the actuarial report within their written advice as well as providing the client with a copy of the report. However the required return was always presented gross of charges.

The Commission is concerned that clients may be unaware of the impact the various charges will have on the required return. This could turn what appeared to be a reasonable required return into one that may be unachievable, given a client’s particular attitude to risk.

4. Training and Competency

While the Review did not focus on issues around licensee’s training and competency schemes, the Commission noted that some licensees did not have a formal training and competency scheme in place. Other licensees were in the process of enhancing their

schemes. Guidance on the Commission's expectations on training and supervision schemes is being issued by the Commission as part of the implementation of the Guernsey Financial Advice Standards.

Conclusions

The Commission is encouraged by the engagement most licensees have shown with this Review.

However the findings of this review show that while some firms have made improvements since the Commission's Letter, there is still further work to be done by all licensees. In general terms, the industry still needs to become more customer focused and less product focused.

The Commission is grateful for the cooperation received from the licensees that took part in this Review.