

CASE STUDY: Standard Life – ticking boxes cause trouble...

A number of the compliance points made in this case study are very basic, but are based on recently recorded basic failures at a very large financial services organisation.

Event

On 20th January FSA fined Standard Life Assurance Limited (“SLAL”) £2.45 million under Principles 3 and 7 for failing to organise its affairs responsibly, and communicating with clients in a way that was misleading. This was related to the payment of £102 million by Standard Life into its Pension Sterling Fund in February 2009.

There are some breathtaking failures described by FSA, and one or two issues which aren’t explored in the Final Notice, which – considering the history of this issue – is interesting for what it doesn’t address as much as what it does.

Background

Standard Life launched the Pension Sterling Fund (“PSF”) in 1996, to provide enhanced returns but low volatility. The fund was marketed as the ideal temporary home for imminent retirees who were uncomfortable about the volatility and instability of bond and equity markets. For at least the period between July 2006 and February 2009, most Standard Life marketing materials described the fund, both in graphic and text forms, as “..invested wholly in cash – the most stable investment.”

At the peak point in July 2007, 80.7% of the fund’s assets were invested in FRNs (which was technically permissible within the ABI classification of money market funds). Whilst a simple man would understand typical FRNs as medium-term bank-issued unsecured notes paying interest linked to, say, LIBOR, the salient point is that these FRNs were almost entirely Asset-Backed Securities including, for example, significant exposure to commercial mortgages, and to Northern Rock retail mortgages through the Granite Master Trust vehicle. As of January 2009, that proportion was down to 48.3%.

On 23rd December Standard Life apparently became aware of valuation problems with some of the fund’s holdings. On 14th January 2009 the eruption came when Standard Life revalued the PSF, marking down net asset value by approximately 5% – about £100mn – overnight.

Naturally, 97,000 investors were unable to understand how a conservatively-invested, unexciting money market fund could lose 5% of its £2 billion value (and of their invested money) overnight. The issue swept the bulletin boards like wildfire with, unusually, a number of IFAs joining the chorus of analysis and complaint, which quickly reached FSA, the mainstream press and the BBC’s Moneybox programme.

Having initially dismissed out of hand the concept of remediation for any of the fund’s investors, on 28th January 2009 Standard Life said publicly that certain investors’ cases for remediation would be considered, and that any eventual cost for this would be less than £10 million.

On 12th February 2009, in a very public U-turn, Standard Life injected £102 million into the fund to cover the write-down and restore all investors.

Standard Life’s April 2009 new business results release mentions that product sales significantly reduced

following the PSF revaluation, but then recovered quickly following the cash injection, so it appears that Standard Life was influenced to do the right thing for sound commercial, rather than purely philanthropic reasons.

Now, a year after the events, FSA has levied a very significant fine on Standard Life and published a detailed Final Notice containing a number of uncomplicated lessons for the industry.

Issues and Lesson — Valuations

Standard Life appears to have been unable to value certain of the fund's asset backed securities accurately over a long period. Eventually the valuation became an issue, and an alternative valuation method was applied in December 2008, resulting in the writedown.

The practical lessons from this are:

- that where assets haven't traded for a period, firms need regularly to review external information in the market relating to the security and issuer to establish whether the last-traded price remains materially valid (particularly where there is a ratings downgrade or other media turbulence). Certainly, mortgage-backed securities were known to be in trouble rather earlier than December 2008. Given that Standard Life had decided to cease investing in such securities for this fund and to start to divest as far back as the summer of 2007, a much higher degree of care should have been applied to valuation of the fund from then on;
- that whilst depending on an independent fund administrator for valuations is a safe, industry-standard practice, responsibility remains with the fund manager to review and challenge those valuations.

Issues and Lesson — Outsourcing

PSF marketing materials were partly outsourced to a mysterious "data provider", unnamed throughout the Final Notice. The materials - both those produced by the data provider and those produced by Standard Life - referred to the fund as entirely invested in cash (and included graphics representing this).

This element of misleading communication is what cost Standard Life £102 million, as investors could point very clearly to the huge disparity between the description of the fund and its actual investments.

When alerted to the problem by Standard Life, the data provider was unable to fix it immediately without impacting its entire client base, so did nothing. No alternative actions were taken or controls imposed by Standard Life, and progress towards a fix was not monitored or chased.

- As a very basic check, all fund marketing materials need to be validated against the actual underlying portfolio composition on a routine basis;
- If there is a material problem with an outsourced service that the service provider is unable to fix, the firm must promptly devise a workaround to cure it until a proper solution can be implemented;
- Firms remain wholly accountable for outsourced services, and must routinely check the quality of such services.

Issues and Lesson — Compliance Monitoring

Standard Life carried out informal, ad hoc internal checks on materials produced by the data producer, but focused on whether the data was complete, not whether it was accurate – even where it was extracted for use in other marketing materials. Where inaccurate information was identified there was no system in place to correct it.

- It's absolutely pointless to follow a checklist to confirm that all required statements and disclosures have been made if there is no accompanying check on their accuracy;
- It's also obviously pointless – and indeed actually dangerous – to undertake internal monitoring and

review unless there is a process in place to resolve exceptions.

Issues and Lesson — Internal Audit Findings

Standard Life marketing compliance processes were subject to both internal audit review and compliance monitoring checks. As early as January 2007 internal audit highlighted that controls around the approval of marketing materials were “not robust” and required improvement. Plans to improve the control environment were subsequently postponed and adequate systems were not introduced.

- Once agreed, compliance-related audit points have to be resolved within the agreed timeframe: any kind of postponement needs to be exceptional, agreed and temporary. Regulators always ask for audit reports during investigations and unaddressed material audit points are inevitably viewed as smoking guns.

Issues and Lesson — Escalation and Follow-up

Between September 2007 and October 2008, concerns were raised with or by Marketing on a number of occasions, either through alerts from the investment manager or complaints by consumers, or as a result of internal reviews of the materials, but were neither escalated nor adequately followed up. Given that the concerns were quite specific in terms of the content of the marketing materials against the fund’s actual investments, and that mis-selling is not exactly a new issue, this appears to be reckless behaviour.

- Compliance escalation and management information processes must be comprehensive, documented, and must cross silos where necessary.

Issues and Lesson — Thinking Outside the Tick-box

Compliance reviewed the data producer factsheets and other marketing materials and concluded that investors had not been deliberately misled: FSA say that this did not even consider whether investors had been inadvertently misled, with all the implications such a finding would have had. A further review of the marketing materials concluded that the then-current literature should be ‘tightened’, but failed to consider the impact of the previous materials on investors in the fund, and so did not contact those investors to clarify the types of instruments in which the fund was invested.

- Compliance functions must obviously always consider the potential past impacts of current problems.

Issues and Lesson — Governance

“The business operated in distinct silos, with the result that the marketing material issues relating to the Fund were passed from area to area without any one business area or committee having overall responsibility for ensuring that the marketing material correctly reflected the investments held by the Fund.”

- This is basic governance. The organisation must know who’s accountable for what, and who has authority to fix things when they go wrong. Basic.

Issues and Lesson — PR during a Reputational Event

Standard Life’s initial PR handling of the problem was disastrous, with brash statements made that there was no need for remediation, and subsequently that there would be some remediation but the exposure was not large. These statements contained references to the documentation having made the mix of fund investments clear. The market already knew it hadn’t. Whilst insurers usually require authorised firms not to admit any material liability until it is proven, this went some distance beyond that.

- In the event of a regulatory problem, senior managers should not talk to the media when they don’t know all the salient facts. During a material investigation, management and compliance should be planning, talking and reviewing progress on a frequent basis, and in the early days the only sensible external response is (a) we’re looking into it in detail, (b) it’s too early to give a definitive answer on what, if anything, has gone wrong, and (c) we take our responsibilities seriously and will do the right thing.

What the Final Notice doesn't address

Eight weeks ago a pensioner successfully sued Standard Life in the County Court, based on the marketing literature, for losses on his previous investment in PSF resulting from the fund valuation dropping by 0.5% in November 2008, which could open the door to further claims. This had followed a previous material downward revaluation made in September 2008 in response to the bankruptcy of Lehman Brothers.

It seems surprising that there is no stated systems and controls breach around Standard Life's valuation processes prior to December 2008. A footnote in the Notice merely states that, "The temporary reduction of liquidity of certain assets held by the Fund, which led to their revaluation, was a result of the difficult market conditions in 2008."

If you wish to discuss these issues and how they may impact on your own business and compliance activities, please contact Nick Gibson at Chase Cooper Compliance Solutions on (020) 7826 9013, or by e-mail at nick.gibson@chasecooper.com