Kathryn Morgan
Prudential Insurance Department
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

9 October 2012

Dear Kathryn,

AFM Response to CP12/13- Transposition of Solvency II

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

   - Highlight concern about the extent to which the proposed changes go beyond the requirements of Solvency II; and

   - Explain where those changes have material consequences for the mutual insurance sector.

2. The Association of Financial Mutuals (AFM) was established on 1 January 2010, as a result of a merger between the Association of Mutual Insurers and the Association of Friendly Societies. Financial Mutuals are member-owned organisations, and the nature of their ownership, and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers.

3. AFM currently has 55 members and represents mutual insurers and friendly societies in the UK. Between them, these organisations manage the savings, protection and healthcare needs of 20 million people, and have total funds under management of over £90 billion.

4. We recognise the need for FSA to make changes to its rulebooks to accommodate the requirements of Solvency II, and we responded positively and constructively to the previous consultation on this. We appreciate the recognition by FSA in this consultation to our support for some recent firm surveys.

5. We recognise that where FSA makes changes to the rulebook that are the result of the Directive it is the clear that FSA does not have to produce a detailed cost-benefit case. However, in our view some of the rule changes on with-profits products proposed in this consultation:

    a. go significantly beyond that required for transposition of Solvency II;

    b. go well beyond the stated ambition of tidying up the rulebook;

    c. are not properly co-ordinated with the policy work being undertaken by other parts of the FSA; and

    d. lack the cost-benefit analysis to which the FSA is properly bound by legislation to undertake.

6. To illustrate, we are concerned that the changes proposed to a number of the definitions distort some of the current definitions significantly, and go significantly beyond the changes required for Solvency II. The definitions, combined with some of the rule changes elsewhere have potentially significant implications for the way with-profits funds are run within mutual organisations.

7. Some of the proposals not required by Solvency II would result in potential capital problems under the Directive for mutuals. The approach to ring-fenced funds would mean that capital, if greater than the SCR, would be set to be equal to the SCR at all times, which could lead to the mistaken perception that some mutuals are poorly capitalised. This might further have the effect of preventing the Tier 1 Capital of a mutual's common (with-profits) fund being available for covering the risks outside the ring-fenced fund, which may include the operational risk component of the SCR as well as other elements.

8. Combined with some of the other proposals, these changes are likely to place mutuals at a significant competitive disadvantage and undermine the work elsewhere in the FSA on identifying mutual capital and other solutions to the long-running Project Chrysalis. Where the government is committed to promoting mutuals and where the draft Financial Services Bill requires the new regulators to consider the differential impact of new rules on mutuals, there is a greater expectation on the regulator to recognise the implications of its work, and the indication that the changes are not material is not consistent with that.

9. We have prepared this response on the assumption that the current timetable, i.e. that firms comply with Solvency II from 1 January 2014, remains intact. Clearly there is greater uncertainty that this will be the case. The result of any further delay, in relation to this consultation, is that any new rules made final will have been introduced:

a. *with regard to those rules relating to Solvency II:* to an unnecessarily early timetable; and

b. *where FSA has gone beyond the rule changes needed for Solvency II:* with harmful consequences, both to the UK mutual insurance sector, but also to other parts of the FSA who have consulted exhaustively with the sector to develop a proportionate approach.

10. This is a lengthy and complex consultation. We were surprised that FSA failed to engage with the mutual insurance sector, particularly on its proposals for with-profits, in-between the consultation on CP11/22 and the release of this paper. We think this would have helped FSA to provide context that would have enabled more constructive engagement from the sector. Equally we are surprised that the changes to with-profits were not covered under the product review work, as we consider this might have allowed a fuller understanding of the material consequences in the consultation, which were not fully developed in the commentary within the paper.

11. This is a disappointing conclusion, and we urge FSA to recognise that those proposals that are not prerequisites for Solvency II should be more fully sensitivity-tested against the work underway within the FSA on with-profits more broadly, and a more thorough impact assessment undertaken. We would be very happy to engage on this process.

12. Detailed responses to individual questions raised in the consultation are attached- we have limited our review though to Chapter 7 which has the most serious consequences for our members.

13. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Responses to selected questions

Q3: Do you agree with the changes that we have described above to the conduct rules for distributions?

We support the stated intention of this chapter, that changes to the with-profits rules are being driven by Solvency II, as well as consequential changes to ensure consistency with the Directive. However whilst paragraph 7.1 confirms that "We are not making material changes to our underlying policy on conduct regulation for with-profits funds", as we explain below, some of the proposed changes DO have a material impact on the with-profits regime, and this is particularly the case for mutual insurers.

We highlighted these concerns to FSA soon after publication of the consultation, and were assured that the intention remained to avoid making material changes. We would be keen therefore to engage with the policy team to explain the consequences of some of the changes that appear not to have been anticipated when the consultation was produced.

Similarly, where the with-profits policy team was charged in March with producing a paper in September/ October on the subject of mutual capital, we would have expected that the transposition paper would avoid making changes now which could undermine that work- in the same way that FSA has accepted that it needs to produce a further consultation on transposition because other policy areas are still emerging. However it is not apparent from the commentary that changes to the definitions and rules for with-profits will have a different impact on mutuals now- and particularly after FSA has consulted on proposals for recognising mutual capital.

AFM is very happy to work with the various FSA policy areas to ensure there is a consistent approach. Certainly where Solvency II will have gone live after legal cut-over, we would urge FSA to adopt now the requirements drafted into the Financial Services Bill for the regulators to do a separate analysis of the implications for diverse business models of proposed rules. We think this analyse would have helped identify some of the areas that we highlight below (see response to Q.17 in particular).

More generally, whilst we see the attraction of moving elements of the current regime into a broader COBS 20 in order to affect a wider set of changes, we note that some of the changes transfer current guidance into rules, and that this might imply a higher regulatory hurdle, though the cost-benefit analysis indicates there is no intended change.

Equally, moving some aspects of INSPRU and GENPRU into COBS 20 will have the effect of transferring them from PRA to FCA responsibility under the new regime. The Financial Services Bill clearly implies that PRA will have lead responsibility on with-profits, so this approach appears to be at odds with the government's intent. This is not explored within the consultation so we would appreciate clarity on how this will impact on the respective responsibilities of the new regulators.

We would also point out that Holloway friendly societies are exempted from COBS 20, and would therefore welcome the reduction in rules relating to the management of their organisation. There is no reference to Holloway in the consultation so we suggest FSA reassures itself that this is consistent with its policy intent, particular in relation to the items covered in paragraph 7.3.

We note a number of points that require further clarity in the table on page 38 onwards:

- refers to changes to INSPRU 1.1.137R(2)- this does not exist;
- proposed COBS 20.2.26AR requires that firms must not charge to a with-profits fund any financial penalty imposed by FSA, but where the effect of the FSA rulebook definition of a with-profits fund is that it applies to the whole of a mutual's common fund, this is not possible for a mutual- we suggest this is amended to adopt a similar style to draft rule COBS 20.1A.15 G (2), by inserting the phrase 'other than a mutual';
- COBS 20.2.25R proposes firms pay compensation or redress from assets attributable to shareholders, whether or not they are held in a long-term insurance fund or with profits fund- but we understand the definition of long-term insurance fund only exists for non-directive firms since the first transposition paper. The definition of course also applies to shareholders- mutuals do not have shareholders.

Q4: Do you agree with our proposal to amend the definition of excess surplus for the purposes of the rule and evidential provision relating to the distribution of excess surplus?

We agree that Solvency II firms should retain the concept of excess surplus, and appreciate the separate treatment of non-Solvency II firms, who will see no change to the rules on excess surplus.

As we comment in response to question 17 though, we have some concerns about the definition of excess surplus introduced.

Q5: Do you agree that for Solvency II firms we should disapply COBS 20.2.32R in relation to loans and produce new guidance as proposed?

Q6: Do you agree that we should retain this guidance as proposed, and introduce a new rule on support assets?

It is not clear from the commentary that these changes are required for Solvency II purposes.

Amendments to existing guidance in COBS 20.2.33 appear to limit its application to assets that are actually transferred into the with-profits fund, although the commentary suggests that this change merely clarifies the current position.

COBS 20.2.34 covers assets providing support from outside the with-profits fund. The reason for limiting the application of this guidance to arrangements approved by the court (or, in the case of a friendly society, the FSA) has not been explained. Given that it would have the effect of prohibiting reliance on support arrangements established by other means (including, for example, pre-FSMA section 68 Orders, Board resolutions

and PPFM), we think that this change should be properly justified.

New rule COBS 20.2.34AR will operate in addition to existing requirements, but it is not clear what it add, given that it requires firms to meet obligations that they are already under, and the terms on which assets provide support for the with-profits business will be described in a scheme, regulatory waiver or Board resolution. However, even if a firm considers those terms to be well-documented, they are likely to require amendment to reflect the introduction of Solvency II. In some cases, this will mean asking the court to approve the amendment of a scheme[1]. In this context, it would be helpful if the FSA could explain how it expects firms to meet the test of "adequacy" under new COBS 20.2.34AR.

Q7: Do you agree to our retaining guidance on reviewing non-profit business, reinsurance and disclosure of decisions on strategic investments for all firms, but that for Solvency II firms that we disapply the rules and guidance referred to above which overlap the Prudent Person Principle?

Q8: Do you agree that we should introduce guidance to Solvency II firms writing with-profits business that the provisions implementing the Prudent Person Principle should be applied to the investment of with profits assets by reference to the particular circumstances within the with profits fund including in relation to strategic investments?

We think the changes on strategic investments are likely to be helpful for mutuals, which often need to make strategic investments through their single common fund. However the transitional relief on COBS 20.2.36, introduced in PS12/3 comes to an end on 1 October, so some mutuals may be expected to have planned for the disposal of strategic investments before the new rule is introduced.

The position could become more confusing: mutuals will have been able to make strategic investments under the pre-April 2012 COBS 20.2.36, had that flexibility taken away from 1 Oct 2012 under the PS12/4 version of the rule, only to get it back again under the new COBS 20.2.35A, which contemplates the possibility of strategic investments again. However the new flexibility may be illusory because of the double jeopardy in the final sentence of COBS 20.2.35A which says, in effect, that COBS 20.2.36 still applies.

Q9: Do you agree that the changes to the provisions on ceasing to effect new business should be restricted to those required to align the rules with Solvency II terminology?

We recognise the intention is to remain consistent with existing rules for firms in run-off, whilst incorporating terminology required for Solvency II.

[1] In the case of a friendly society transfer, it would be the FSA that had to amend the terms of an Instrument of Transfer it had previously approved and registered – there is no clear mechanism whereby this could be done, although individual instruments of transfer, if well drafted, may provide for subsequent amendments.

Q10: Do you agree with our proposals to amend the changes in surplus distribution notification requirements currently addressed by IPRU (INS) Chapter 3.3?

Q11: Do you agree that IPRU (INS) section 3.5 should be transcribed into COBS 20?

We highlight above some concerns and consequences of moving prudential rules into the conduct sourcebook. We consider this has significant implications for the nature of regulation. The payment of distributions to owners of a business is first and foremost an issue of prudential management- in recognising that a surplus has arisen that should be distributed- the conduct consequences should be limited to the basis of how the distribution is paid, and what is communicated to policyholders. We would appreciate clarity on why FSA now believes this is a conduct issue.

On the substance of the changes, we accept that a change in the percentage of surplus allocated to policyholders of more than two per cent should require prior notice to FSA and policyholders. However, pre-existing rules requiring distribution to policyholders of at least the "required percentage" of the total amount distributed (COBS 20.2.17 R(2)), the prior notice requirement is unlikely ever to be relevant for most firms.

These rules were originally designed to provide some controls on the use of surplus between policyholders and shareholders. They were not originally designed to create artificial barriers in the use of surplus between various classes of policyholder.

Q12: Do you agree that we should amend COBS 20.3 to require Solvency II firms who wish to use support assets to document and describe them in their PPFMs?

We agree.

Q13: Do you agree that we should amend COBS 20.4.4 and that with-profits committees should also consider the existence and scope of sub-funds within COBS 20.5?

We agree.

Q14: Do you agree that the proposed new provisions in COBS 20 relating to GENPRU 2.2.271R(1)-(3) are appropriate?

On the assumption (as it is not stated in the commentary) that the new COBS provisions are limited to COBS 20.1A.14R- 20.1A.15G, we agree.

Q15: Do you agree that the governance and management provisions from INSPRU 1.5 should be converted into new rules in COBS 20 for Solvency II firms in order that policyholder interests continue to have adequate protection?

COBS 20.1A.3 considers firms with multiple with-profits funds. We understand this indicates that each with-profits fund must comply with COBS 20 on an individual basis, and thereby hold assets of a value sufficient to cover the technical provisions and other liabilities of all business allocated to that sub-fund.

Combined with the definition of with-profits fund in COBS 20.1A.2, this appears to suggest that all sub-funds will be regarded as separate with-profits funds for regulatory purposes. We would appreciate clarification of this point, as for mutual organisations the with-profits fund, as defined by FSA, represents the single fund for most mutuals, and the test applied for sub-funds as we describe above may create new burdens for mutuals.

Q16: Do you agree that we should include a new rule in COBS 20 to require Solvency II firms to manage their with-profits fund to ensure that assets meet liabilities?

This change does not appear to stem from the requirements of Solvency II. Where COBS 20.1A.5R refers to the assets held within the with-profits fund(s), this would appear to refer to the prudential management of the firm, and FSA has not clarified why it now sees this as a conduct management issue.

Q17: Do you agree with our proposals to amend definitions, as above, and to introduce a transitional provision (para 7.51)?

In general terms, we are concerned that the changes proposed here distort some of the current definitions significantly, and go significantly beyond the changes required for Solvency II. There is a risk that the treatment of some of the definitions reinforces some of the complex issues relating to with-profits mutuals that are subject to continuing review under Project Chrysalis, and as such undermine the potential for the policy work currently underway in that area.

The definitions, combined with some of the rule changes elsewhere have potentially significant implications for the way with-profits funds are run within mutual organisations, particularly in relation to the definition of the fund, allocation of profits from non-profit business, and ring-fencing of funds.

We have detailed comments about a number of the proposed definition changes and some of the terms used:

<u>"With-profits policy"</u>

Currently, a long-term insurance contract is treated as "with-profits" if it is "eligible to participate in any part of any established surplus". The proposed new definition reflects in part the Solvency II position where the term surplus has a different sense[2].

[2] "*a long-term insurance contract which provides benefits through, at least in part, eligibility to participate materially in periodic discretionary distributions based on profits*

However, the requirement that the extent of participation in discretionary benefits is both "material" and determined "periodically" is a material change that is not driven by Solvency II. Firms that are currently looking towards replacing diminishing volumes of traditional with-profits business with new forms of participating products, will find this new onerous, as well as inconsistent with discussions under way with policy colleagues.

The new rules should also make this clear that the test of materiality is applied at a policy level, rather than aggregate. We would also suggest that the definition is clear that policies with a zero reversionary bonus rate are not disqualified as with-profits policies.

Additionally there is the risk that the approach to defined with-profits policy will potentially bring Holloway contracts into the scope of COBS 20 where they are currently exempted.

"With-profits fund"

Companies are likely to need to make an adjustment to their own funds to reflect the fact that assets held within the ring-fenced fund (i.e. within the with-profits fund) are not available to meet liabilities of the firm falling outside the fund.

We have explored the implications of the new definition, and have a number of comments:

- The new definition will require firms to assign assets described in their PPFM (or other literature) as being available to cover with-profits liabilities to the with-profits fund, irrespective of how they are accounted for by the firm. Any other assets identified by the firm as being available for that purpose should also be included.

  In both cases, however, the implication is that those assets are only available on the occurrence of a contingent event and where they have not been identified by the firm as restricted to covering liabilities arising from its with-profits business, they will remain outside the with-profits fund under the new definition.

- Paragraph 7.48 states that FSA has explicitly included in their proposed definition of a with-profits fund *"income and assets intended to cover liabilities in connection with non-profit business".* The definitions adopted refer to non-profit business held in a with-profits fund as an investment of the with-profits business (in other words, assets into which premiums and other receivables in respect of with-profits policies have been converted).

  This may be helpful to the creation of mutual capital, in that it implicitly acknowledges that there may be non-profit business in a with-profits fund which is not an investment of the with-profits business. It should also be evident that profits from such non-profit business would not accrue to with-profits policyholders.

---

arising from the firm's business or a particular part".

The reference to "assets identified as available to cover insurance liabilities arising from the business of effecting and carrying out with-profits policies" however may create issues because of uncertainty in relation to its scope. Potentially, this might cover any assets allocated to a with-profits fund, on the basis that any assets allocated to a with-profits fund are available to cover liabilities arising from a with-profits business.

- Paragraph 7.50 states that firms will need to ensure that policy terms, established practice of the firm and communications from the firm (including the PPFM) are consistent with the identity and scope of with-profits funds and sub-funds that they have in place. Paragraph 7.50 also states that a sub-fund can only be created if that is consistent with what all affected policyholders have been told and, in the case of conflict, if it is fair between all such policyholders. Whilst that might be focused on separate with-profits sub-funds, it might reasonably be expected that similar principles will be applied to the identification of the component parts of a Common Fund.

  New guidance, to be included in COBS 20.1A.3, indicates that the fact that policyholders have not been told that a with-profits fund actually operates as a Common Fund would not necessarily be fatal to the Common Fund argument in circumstances where a firm has not explained the existence of the Common Fund to its policyholders – this does not appear to be putting the burden of proof on firms to demonstrate that they have told policyholders about the existence of a Common Fund.

Ring-fenced fund

Further to above, we question the need to treat the with-profits fund as a ring-fenced fund for the purposes of Solvency II in the proposed rule 20.1A3 (6). Ring-fenced funds have certain meanings within the provisions of Solvency II and the main with-profits fund of a mutual insurer is normally expected to provide the operating capital of the insurer generally. By making the with-profits fund a ring-fenced fund and by defining the with-profits fund in the way that the FSA has, there is a significant risk that the work undertaken by FSA and the sector on Project Chrysalis will be undermined.

The consultation contends that a sub-fund established from the transfer in of other businesses is ring-fenced and that this also extends to the 'main fund'; as a result the SCR calculation does not take account of any diversification between main fund and sub-fund, and the surplus or 'own funds' in excess of the SCR are not transferable. This would mean that capital, if greater than the SCR would be set to be equal to the SCR at all times, which could lead to the mistaken perception that some mutuals are poorly capitalised. Moreover it is possible that the form of ‘white knight’ support that FSA has relied on to enable one mutual to transfer in another, will be unable to proceed in future if this change is enacted.

Further this might have the effect of preventing the Tier 1 Capital of a mutual fund being available for covering the risks outside the ring-fenced fund, which may include the operational risk component of the SCR as well as other elements. This is particularly important to mutual insurers who may decide not to split their non-profit business into a separate fund and may, therefore, have no assets other than within the ring-fenced fund.

The creation of the ring-fenced fund will also reduce the ability of the insurer to support lines of business *inside* the ring-fenced fund with capital from *outside* the ring-fenced fund. Therefore, if mutual capital is created in the way that is being discussed to resolve Project Chrysalis, this mutual capital cannot be used to support the with-profit business. Neither can surplus generated on any support from the mutual capital be repaid to the mutual capital.

We believe that the ring-fenced fund section of the Solvency II rules was never intended to be used to restrict with-profits business in this way. Therefore, we would strongly suggest that the ring-fenced fund definition is removed or refined.

Excess surplus

The definition of "excess surplus" is potentially very wide. In determining whether there is excess surplus there is a requirement to include any other financial resources applied to, or expected to be applied to, the with-profits fund, whether or not they are held within the with-profit fund. Such financial resources do not appear to be restricted to those resources which fall within the definition of with-profits fund and may therefore include assets outside the fund which are available only on the occurrence of a contingent event and are not identified as only being able to cover with-profits liabilities.

On the basis of such a broad definition an excess surplus may arise (even after taking account of the amount needed to meet the capital requirements of the with-profits fund and the amount required to support the new business plans of the with-profits fund), due to the surplus funds outside the with-profits fund which might be used to support the fund in certain stressed scenarios. We believe that it would be more appropriate to include in the definition of excess surplus only those assets which would fall within the definition of with-profits fund and with-profits assets. We would expect for example the creation of mutual capital to result in those funds falling outside COBS 20.

Inherited estate

The definition of “inherited estate” is the value of the “with-profits assets” less the value of technical provisions and other liabilities of the with-profits fund. Those liabilities must include the liabilities for the non-profit business in that fund. However the definition of “with-profits assets” is assets which meet technical provisions in respect of with profits insurance business and “the excess of assets in the with-profits fund over the technical provisions in respect of insurance business. This definition therefore excludes assets actually backing non-profit business, while the inherited estate definition requires those assets to be included in the definition of with-profits assets, otherwise the liabilities will be double-counted.

This guidance may create problems, as it is limited to business "written into" the with-profits fund, arguably overlooking transfers of business into the fund. To address this, the reference should perhaps be to business allocated to, rather than "written into" the with-profits fund.

Transitional provision

This transitional provision referred to in paragraph 7.51 deems assets within a with-profits fund on 31 December 2013 to be the with-profits fund from the effective date of the new rules. Understandably, this is intended to prevent firms improperly taking assets out of a with-profits fund before then.

TP 2.23 refers to the removal of assets only in accordance with INSPRU 1.5.21R and 1.5.27R. We think those provisions are likely to be too restrictive to allow a mutual to separate its common fund into a with-profits fund and a mutual capital fund as is being discussed in the context of Project Chrysalis. Given that the position on mutual capital is not yet finalised it would be helpful to qualify this transitional provision, to ensure that it does not obstruct a solution to the work on Project Chrysalis.

Q18: Do you agree that firms should be required to ask the court to review the appropriateness of their continued reliance on the transitional provision with the FSA when bringing a scheme back to court?

New COBS TP 2.9B- with an implementation date of 31 March 2013 and therefore some way in advance of Solvency II- provides that where any court application is made in the future in relation to a with-profits fund to which exemptions under the current COBS TP 2.9 applies, the court should be asked to review the continuing appropriateness of the firm's reliance on COBS TP 2.9. The court may as a result order that the operation of the relevant fund should become fully compliant with the current rules.

We think the following points might require further clarity:

- The draft text of TP 2.9B provides that a firm's continued reliance on TP 2.9 in relation to a with-profits fund must be considered by the court whenever a firm "makes an application to court in relation to a with-profits fund". It is not clear when exactly the requirement would be triggered. For example, applications are often made to the court to amend a scheme in accordance with its terms (perhaps to reflect administrative, operational or actuarial advances which have become available to the firm and policyholders since the scheme was first sanctioned). We would not expect applications made to the court to transfer business to funds established by a firm which are not with- profits funds relying on TP2.9 to trigger the requirement in TP2.9B.

- Further, it presumably is not the case that an application made to court which has nothing to do with the arrangement in question should be caught (an application to recover a debt, for example). There is no guidance provided on this point.

- The role of the court when sanctioning an insurance business transfer scheme is well established. Following the decisions in Re London Life Association Ltd (1989) (unreported) and Re AXA Equity & Law Life Assurance Society plc (2001) All ER 1010 (amongst others), it is clear that the court is required to determine whether a particular transfer as a whole is fair as between the interests of the different classes of person affected. It is not the court's role to produce what, in its view, would be the best possible scheme. However, the amendments to TP 2.9 require the court to determine whether it will be "more appropriate" for a pre-2005 arrangement to be amended and brought in line with COBS than for an

existing non-COBS compliant arrangement to be maintained. This is potentially a materially different role for the court.

Q19: Do you agree with the proposed rules which specify the determination of assets shares, or equivalent calculations, in order to calculate approved surplus funds?

Q20: Do you agree with our revised definition of approved surplus funds and the proposed guidance on classification?

SOLPRU 2.4.7 allows firms to exclude any "approved surplus funds" from their technical provisions. The effect of this is that such surplus funds should qualify as Tier 1 capital (see SOLPRU 3.2.12), consistent with the FSA having exercised its Member State option under Article 91(2) of the Directive.

We welcome this proposal, though we suspect its impact is reduced by the rules on ring-fenced funds.