association of financial mutuals

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18 March 2013

Dear Matthew,

AFM Response to CP12/38, Mutuality and with-profits: a way forward

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:

    - Signify our positive support for the change of approach adopted by FSA in this consultation; and
    - Offer considered views on the practicability of the proposed approach.

2. The Association of Financial Mutuals (AFM) represents 54 member companies, most of which are owned by their customers. Between them, AFM members manage the savings, protection and healthcare needs of 20 million people, and have total funds under management of approaching £100 billion. 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, and have been recognised by Parliament as worthy of additional consideration by the new regulators.

3. We applaud the new approach that FSA has developed. AFM responded in detail to CP11/05 and other consultations relating to with-profits, and Project Chrysalis remains a key priority for the AFM Board (and was not, as suggested in Annex 4 to the paper, closed down in 2010). The with-profits concept remains a vital offering for many AFM members, is key to the financial viability of the sector, and is highly regarded by the policyholders and members of mutual insurers. And as the Government has become more convinced that diversity in financial services is vital to restoring trust and ensuring that competition works in the best interest of consumers, so politicians and other stakeholders have offered support for an effective solution to Project Chrysalis.

4. Previous engagements between the sector and the regulator on the issues covered in this paper has been characterised by contradictory legal positions and fundamental differences of opinion about how to secure the best interests of all policyholders and members in mutual societies. The approach taken in this

paper is therefore refreshing and constructive, and we have no hesitation in supporting the broad objectives of the consultation.

5. The alternative, as the paper acknowledges, and has been our continuing position, would be the forced closure of healthy, viable mutuals, which would have “a detrimental effect on wider financial markets as mutuals are likely to provide stronger competition in financial markets as mutuals rather than as proprietary firms, and therefore provide better outcomes for all market participants.”

6. The solutions proposed in the paper are therefore likely to provide a vital lifeline to some mutuals, whose with-profits income may be faltering, as well as facilitating more effective competition in financial markets. There are of course a number of mutuals writing substantial levels of new with-profits business: they may choose to continue with their current business model for as long as the product remains relevant. Equally, whilst some organisations will seek to embrace the mutual members’ fund as a solution to Chrysalis, the last six years of engagement has clearly demonstrated that a single solution will never be appropriate for all, and other AFM members are actively exploring ideas such as new forms of participating products.

7. For our part, the mutual insurance sector is committed to working with its members, in order to maintain high standards of integrity, and to treat all customers fairly. Whilst regulation has provided strong incentives for firms to pursue these areas, the sector continues to challenge itself to deliver high standards of governance, transparency and fairness, and has developed significant experience, which we are happy to share with the FCA, and which we believe will enable the new regulators to be more balanced in their commentary about with-profits.

8. We would be pleased to discuss further any of the issues raised by our response, and hope to engage constructively with FCA on the outcomes of this consultation, as well as other work on with-profits.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Responses to specific questions

***Q1:** Do you agree with this analysis and do you think its conclusions are fair to with-profits policyholders and sustainable for mutual organisations?*

We welcome the fresh approach being adopted by FSA, and recognise much of the justification as being consistent with the views the mutual sector put forward in response to the two Dear CEO letters, as well as CP11/05. As FSA now accepts, it may not be in the best interests of policyholders for otherwise vibrant mutuals to be forced into run-off.

Hence we fully agree with the primary objective, as well as the challenge in achieving this, as described in paragraph 2.2:

> "Our primary objective in our proposals is to ensure that with-profits policyholders and other policyholders within the mutual sector are treated fairly and, in particular, that they are no worse off in terms of policy benefits than their counterparts in proprietary firms. The challenge is to achieve fairness to with-profits policyholders whilst at the same time allowing with-profits mutuals that have a viable business plan to continue to provide other financial products after the run-off of their with-profits business."

We would comment thought that whilst the paper is focused on actions relating to mutuals with a with-profits funds in run-off, this is not true of all mutuals- a number of whom continue to write material volumes of new business. Equally, the consequences of a with-profits fund in run-off will be significantly different, depending on whether other aspects of the business remain open and vibrant.

***Q2:** Do you agree with our approach to a proposed process for recognising mutual members' funds?*

We agree with the proposal in general, however we question why the proposed approach is centred around with-profits funds that are in run-off. We make a series of comments on the detail.

Most mutuals with a with-profits fund have been trading for over 100 years- some for more than 200. With-profits was devised to share the profits of the organisation with the policyholders, and the product was most popular for a 60-year period from the 1930s. The concept of with-profits is therefore very important to the evolution of the sector, but it is not its sole determinator. The new approach outlined in **paragraph 2.30** helpfully accepts that it is not been easy or practical in most cases to retro-fit today's regulatory expectations to a business approach that has not remained static, and where the established practices have grown up according to different standards. As a sector though we aspire to emulate good practice wherever it is recognised, and accept that for many this includes the need to enhance the level of communication and engagement with our members.

Paragraph 2.10 indicates that the effect of *COBS 20.2.1 G (2)* is that a mutual with a single with-profits common fund is caught entirely and "may be unable to continue in business beyond the end of the with-profits run-off". We agreed with this implication, and that where the organisation is otherwise viable, this is likely to be detrimental to the majority or all policyholders and all members. As FSA accepts, the implied “one-size-fits-all” approach did not adequately reflect the way mutuals operate, or the best interests of all stakeholders.

Attributing the interests of the range of stakeholders is therefore not possible currently without a court ruling, and this is not always possible. The approach outlined in **paragraph 2.16** does therefore provide a practical and sensible alternative where a court ruling cannot reasonably be applied. The FSA suggests that firms should be able to put forward proposals for achieving a separation of the common fund where other legal processes are "not available or viable in the circumstances". It is not clear what the word "viable" is intended to mean, and we would value clarity on whether cost or complexity alone would be regarded as sufficient.

We think the proposal of a **notional separation of funds** within the common fund, with the provisions of COBS20 applying only to that part of the fund which contains the assets backing the with-profits business, is a good one and can potentially be applied to some mutuals. Clearly a lot will depend on what basis the fund is split: this will be a key part of the interaction between the mutual and the independent reviewer. We would expect that post-split, the with-profits fund(s) of a mutual should be based largely on asset share, with the additional of any further amounts proposed by the mutual and agreed with the reviewer, taking account of the specific interests of policyholders and members of that particular mutual; the balance thereby becoming the mutual members’ fund(s). Further guidance from FCA/ PRA on this would be welcome.

<u>Pursuing a modification (waiver)</u>

The process as outlined in **paragraph 2.16** proposed that firms apply for a **modification** to, rather than FSA apply a universal change of, the current rules. This is not ideal, but it is a pragmatic solution that ensures each firm and their supervisors can interpret the optimal route to maintaining the interests of with- and non-profit policyholders. However we think the approach may be problematic, and would welcome some clarity around a number of areas:

i. For a modification to be granted, the firm needs to demonstrate that the rule is unduly burdensome or would not achieve its purpose- this may prevent a mutual opting to split the common fund unless they can also demonstrate their with-profits is in decline:

> **Statutory conditions for modification of rules**
>
> The FCA cannot waive or modify its rules under section 138A FSMA unless it is satisfied that:
>
> - compliance:
>   - would be unduly burdensome; or
>   - would not achieve the purpose for which the rules were made; and
> - the waiver/ modification would not adversely affect the advancement of its operational objectives.

This would suggest that to satisfy the statutory test some sort of “trigger” might be required before a firm can contemplate making an application. The trigger should not simply be that the with-profits fund is in run-off: our position throughout Project Chrysalis is that the rules in COBS 20 were created with proprietary insurers in mind. As a result any mutual writing with-profits business faces unduly burdensome rules, as the text in CP12/38 accepts to some extent. Hence, the usual trigger is not relevant: we believe that mutuals should be allowed to apply for a modification even if they are currently managing to work with the present regime.

In any event, mutuals are experiencing a range of UK and European regulation, which could affect future with-profits business. These include the emerging impact of the RDR and UK tax law changes, as well as IMD 2 and Solvency II, which may make the product more difficult to manage in the future, in addition to the general trend away from with-profits which the FSA notes in its consultation paper.

ii. Splitting the common fund is likely only ever to be a one-way street; it is difficult to see how this might be reversed once undertaken (as covered in paragraph 2.35), and manufacturing the modification in such a way as to make the split temporary will risk destabilising the mutual.

iii. Modifications are expected to be time limited. However, for a mutual to be able to confidently take advantage of the modification they would need long-term certainty on the process: any time limit would probably have to align to the demise of the with-profits fund, due to ii) above and/ or the need to align to the lifespan of non-profit products developed.

iv. Where the FCA concludes that a modification-led route is preferable to the creation of new rules for mutuals, we believe it should give further consideration to whether the nature of a modification is different if the mutual is open to new business elsewhere, as opposed to being in run-off. For example, some mutuals that seek a solution based on the alternative approaches we describe below, might also seek a waiver to create a mutual members' fund- though the nature of that modification will be different.

Solvency II

As stated in **paragraph 2.21**, under **Solvency II** a firm needs to ensure it has sufficient own funds to meet its SCR, "having regard to the effect of the Solvency II ring-fenced funds regime on the with-profits fund and on the solvency calculations for the firm as a whole". Our understanding is that this is addressed via the sense of a 'semi-permeable membrane' between the with-profits fund(s) and the mutual members' fund(s). This implies that the solvency position for the firm post-split will be unchanged from that pre-split, and that the ring-fencing should not require each with-profits fund to meet solvency requirements, as this might result in their being insufficient capital in the mutual members' fund.

The proposed Solvency II requirements on **ring-fencing** are likely to mean that the time horizon for taking advantage of the modification could be very limited. Paragraph 2.21 implies that the FSA will wish to treat any with-profits fund as a ring-fenced fund under Solvency II. While the full implications of this are still not clear we are concerned that the requirement that any such fund must be entirely self-supporting could negate the potential benefits of these proposals, or force firms into a more restrictive investment policy for the assets backing their with-profits business.

In the process of preparing this response we have engaged with representatives of the PRA who have provided some reassurance regarding the nature of the semi-permeable membrane, but who have also stressed that conduct issues would need to be considered by FCA first. We look forward to clarity on what conduct issued need to be addressed, and what effect this might have on the flow of capital between funds post-split. In the meantime, we are seeking further input from our members on a range of solutions to facilitate the semi-permeable membrane.

The changes proposed in **CP12/13** are not reflected in the Handbook text proposed in CP12/38, which will, therefore, need to be looked at again for Solvency II purposes. This is likely to include looking at abolition of the distinction between the long-term fund and the shareholder fund and the implications of new rules concerning ring-fenced funds.

Some of the restrictions that currently attach to the long-term fund will, under current Solvency II proposals, transfer into COBS 20. For example, *IPRU (INS) 3.3*, which relates to the distribution of established surplus between shareholders and policyholders, will attach to distributions from the "with-profits fund" post Solvency II (see proposed COBS 20.2.19A). The transfer of provisions from prudential sourcebooks into COBS 20 may (absent further modification of the CP12/13 proposals to reflect the CP12/38 proposals) have the unintended consequence of changing the effect of a pre-Solvency II modification of the definition of "with-profits fund" that is grandfathered across to the new regime without adjustment.

Principles and Practices for Financial Management

Depending on the nature of rights that are granted to policyholders in their capacity as members, and absent a separate waiver/ modification on this point, the members' mutual fund may also qualify in its own right as a separate "with-profits fund" as defined in the Glossary. Equally, some mutuals are distributing surplus to policies that do not specifically share in profits in the traditional way, through mutuality dividends or premium reductions. The definition of *with-profits fund* could be interpreted to define a fund that contained only non-profit policies (annuities or term assurance, for example) as a with-profits fund, merely because there is a potential entitlement to surplus on wind-up or because the directors are able to declare a mutuality dividend, even if they do not do so. We are sure that this is not the intention of FSA's Rules and Guidance, and therefore clarity in the definition would be helpful.

Consequences of this would include a requirement for firms to establish **PPFM** separately for the mutual members' fund(s) and non-profit fund(s), in addition to any required in respect of the original with-profits business. Also in this scenario the members' mutual fund would remain part of the long-term fund, and therefore Handbook provisions applying to the long-term fund (e.g. INSPRU 1.5 restrictions on the use of long-term fund assets) would have to continue to be met in full unless the application of those requirements had been modified to reflect the agreed split in the common fund.

In addition, other legal and regulatory consequences may follow from the modification of COBS 20. For example, PPFM are likely to require amendment and procedures for making such changes and their communication to policyholders need to be followed carefully. Depending on the content of each firm's principles (as opposed to its practices), formal modification by the FCA of rules restricting the ability to amend principles in the PPFM may also be required.

The definition of *with-profits fund* in INSPRU does not fit easily with the proposal that a mutual can split its common fund into a fund that contains with-profits policies and a fund that contains non-profit business. The Articles of Association of a mutual must provide for a distribution of surplus to someone in the event of wind-up when there are no with-profits policies remaining.

<u>Alternative approaches</u>

Whilst FSA's preferred route is to agree modifications that recognise the potential- for mutuals that face declining with-profits books- to undertake a separation of the common fund to create a discrete with-profits fund(s) and a mutual members' fund (that sits outside the scope of COBS20), AFM and FSA explored a range of alternatives during 2012 which, whilst not explicitly covered in the document, remain available based on our interpretation of paragraph 2.40 ("We will encourage further development in this area"). We believe that where a mutual can demonstrate that an alternative approach provides a strong foundation for fairness to all policyholder and members, they should be encouraged to explore them with their supervisors. These alternatives include that a firm should be able to recognise its existing position (**established practice**) provided that there is some independent validation of the exercise.

In addition it is also consistent with the suggestions put forward in the first Dear CEO letter for a mutual to develop new forms of **participating product** via an appropriate impact assessment. This might involve the creation of a 'member account' alongside a protection product, which thereby meets the definition of with-profits at present, and which would thereby enable the mutual to demonstrate that material volumes of new business are being written into the with-profits fund. However, we believe FCA may have some concerns about seeing new products caught by COBS 20. We are not aware of the legal justification for this concern, which we do not as a result share, and are keen to discuss this further. Our initial view is that this might also be resolved via a long-term waiver, albeit of a different nature to that proposed in paragraph 2.16.

Hence, some AFM members are already exploring how they might expand the degree to which members of a mutual share in the profits of the fund "through member dividends and premium reductions". The prospect that protection customers might share in the success of the mutual proffers a new period of pro-consumer product innovation.

<u>Other comments</u>

We make the following points about specific wording:

- It has become usual to refer to a mutual's common fund as the "**<u>single</u> common fund**" (as in paragraph 2.10). However, although most mutuals writing both with-profits and non-profit business do have a common fund, it is not necessarily the <u>single</u> fund of the mutual as many also have other funds which they might, for example, have acquired through mergers, portfolio transfers or transfers of engagements. The first line of COBS 20.2.1(2A)(a) is therefore inaccurate where it refers to a mutual's "single common fund" and we suggest the word "single" should be deleted.

- **Reattributions**: there is an inconsistency between what the FSA appear to be saying in paragraph 2.16 of the paper and its proposed Handbook amendment (which also is not reflected in their high-level principles in paragraph 2.36). The requirement to demonstrate that firms' proposals do not amount to a reattribution in COBS 20.2.1(2A)(c)(i) is an obstacle to firms which wish to recognise mutual capital and is not logically coherent with the text of the consultation paper. It would therefore be better if it could be established as part of the definition of the process of recognising mutual capital that the process does not amount to a reattribution (as suggested in para 2.16), rather than it being part of the minimum requirements for applicant firms to demonstrate that it is not. This same exemption should also be granted to any mutual firm that chooses to use an available alternative legal mechanism (such as a scheme of arrangement) to restructure its common fund.

- **Holloway societies**- this sub-set of friendly societies and their contracts are not required to comply with COBS 20 at present, though they have been engaged on Project Chrysalis and are listed as affected by these proposals. We consider that the current arrangements provide an important safeguard to Holloway business, and it is vital that these are maintained to make the product viable. Where FSA did not explicitly address Holloway societies in the consultation paper, we believe it is important that they should do so in the subsequent policy statement, to ensure that the exemption remains valid and robust. By contrast, a number of Holloways have reported practical difficulties in writing business post-implementation of the Retail Distribution Review, due to the limited effect of the exemption provided there.

- **Resolution regime for insurance**- a recent speech by the CEO-designate of the PRA infers that work to explore the need for a resolution regime for insurance is underway, and that the nature of with-profits presents potential risks to policyholders where a firm is in run-off. Whilst such thinking is in its early stages, it may well affect the approach prudential supervisors take in future, as well as the complexity for a firm exploring whether to take advantage of these proposals.

***Q3:** Do you agree with the support elements we are proposing for the process and the principles outlined?*

The paper does not make it clear where **non-profit business** would sit in the new structure. It may be that the FSA is leaving this for firms to decide for themselves, but some more clarity would be helpful. We might expect that new non-profit business would generally be written in the mutual members' fund using the capital in that part of the fund; however, firms may have a different view concerning existing business, particularly for with-profits business that has been made paid up.

Each firm will need to carefully weigh up whether in their view the costs and opportunities presented in CP12/38 will result in greater certainty for their business model, compared to maintaining the current situation.

The FSA also comments that the process of agreeing a split in the common fund with firms will not be dependent on any particular legal view of the respective rights and interests of with-profits policyholders and members. Mutuals that seek to agree a split with the FSA without having regard to legal rights and interests must leave themselves exposed to challenge as to the legitimacy of what has been agreed.

The **high-level principles** therefore present a largely coherent basis for a mutual to adopt as part of the process of applying for a modification. We would expect a mutual to have carefully considered how it might meet each of these principles well in advance of any application to the FCA, or indeed ahead of discussions leading up to an application.

High-level principles applying to applications

1) The firm has a convincing and robust business case
2) The firm can demonstrate that its proposals are compatible with its obligations to treat policyholders fairly
3) An independent assessment of the proposals and how they affect policyholders is carried out
4) With-profits policyholders under the firm's proposals will be no worse off than equivalent with-profits policyholders in a proprietary with-profits fund
5) The firm has a strategy to ensure that with-profits policyholders and the wider membership of the mutual are appropriately engaged and informed
6) Safety and soundness issues are identified and addressed appropriately
7) The rule variation applied for meets the appropriate statutory tests

This exercise may be difficult, though, given the lack of clarity surrounding the meaning of the high-level principles. There is, for example, no guidance on what constitutes "a convincing and robust business case" and firms may wish to seek clarification from the FSA in the form of additional guidance.

The FSA might also be asked to confirm that its comparison of the position of mutual policyholders with that of "equivalent with-profits policyholders" in a proprietary with-profits fund will be done on the basis of a proprietary with-profits fund that contains the same assets and liabilities and that benefits from the same formal and informal support from the rest of the company as the proposed mutual with-profits fund. Otherwise, it is not clear how a meaningful comparison can be made.

Also, high-level principle 5 requires a firm to ensure that its "with-profits policyholders and the wider membership" are engaged and informed about the proposal to split the common fund. There is a mismatch between this statement and the text of the proposed guidance in COBS 20.2.1(2A)(iv), which refers to engagement with the mutual's "with-profits policyholders and other policyholders". Clearly, a mutual's membership does not necessarily align completely with its policyholders and this should, therefore, be corrected by replacing the words "other policyholders" in COBS 20.2.1(2A)(iv) to read "other members". The same point applies to proposed COBS 20.2.1(2A)(vii). It would be helpful to understand what nature of engagement the regulator will consider appropriate, where this does not amount to policyholder consent.

We generally agree with the proposal of an **independent expert's report** to back the proposed sub-division. The cost of this approach is likely to be much lower than pursuing a court-based, or member-vote, solution. This is particularly the case where the proposal is to use the FCA's s166 procurement list, rather than the larger and more appropriate pool of experts available for Part VII transfers.

As such, our experience of incurring advice on this issue to date leads us to believe the costs will be higher than the indicative figures provided in the cost-benefit analysis. To illustrate, the **cost-benefit case** estimates the cost of an independent expert to be around £32,000: this seems very unrealistic. A more realistic cost may be £100,000, which raises the question of proportionality for smaller mutuals- particularly as they will not have internal actuarial resource to undertake the initial analysis.

We support the removal of the requirement to seek **with-profits policyholders' approval** for carrying on non-profits business. But firms would need to give careful thought as to how they can demonstrate that with-profits policyholders and other policyholders are appropriately engaged in the exercise. The regulators' views on what is ultimately deemed 'appropriate' could significantly influence costs, and a proportionate approach, for smaller mutuals in particular, will be vital.

It would therefore be helpful for FCA to provide some clarity on their approval process for granting modifications and how long they would expect the process to take, so that mutuals can build this into their plans.

Subject to the comments above, we consider the **draft guidance** in the Appendix works in the way that is intended.

Q4: *We are not proposing new rules in this area, but we would welcome comment from members and other policyholders in mutuals about governance and accountability and how they see their involvement in how the business is managed.*

We support the initiative by the FSA to **engage with members** and policyholders of mutuals, concerning the governance of their mutual and the accountability of the Board/ management. These are vital issues and ones that continue to be central to the thinking of mutual companies. We therefore offer a few observations.

The sector recognises the importance of making further efforts to **engage with members** and to present to them the benefits- both as a customer and as a member- of their mutual status. Last year, to inform this work, AFM commissioned research from Kellogg College, Oxford on 'Measuring Mutuality- indicators for financial mutuals'. The AFM Board is actively encouraging its members to develop a 'mutuality scorecard' as a basis for identifying the range of measures that are most important for each company, along the axis of customer value; member value; financial diversity; and social responsibility. We also launched a new website last year: www.ownedbyyou.org, to provide information to members of mutual organisations about the benefits of mutuality as well as their rights as members.

One of the perceived limitations of mutuals is their **lack of permanence**. Notwithstanding that the average AFM member has operated for 130 years, the current decline in with-profits does put some organisations at risk of forced closure, or demutualisation, or merger. One of the recommendations of the independent Ownership Commission, whose report was issued in March 2012, was that*: "mutuals should have the opportunity to choose a legally binding corporate form that enshrines the principle of "disinterested distribution", as is common in other EU states, so there can never be a benefit from cashing out because the assets must be transferred to another mutual."*

We would very much welcome the opportunity to share with FCA our findings on these issues, and to work together in light of feedback from policyholders and members, to explore how best to meet expectations for governance and accountability.