Orla Fitzpatrick
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

29 December 2014

Dear Orla,

AFM Response to PRA consultation CP21/14, Policyholder Protection

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:

   - Respond to the consultation proposals and highlight any specific implications for our members.

2. The Association of Financial Mutuals (AFM) represents 52 member companies, most of which are owned by their customers. Between them, AFM members manage the savings, pensions, protection and healthcare needs of over 20 million people in the UK and Ireland, and have total funds under management of over £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 continued support and promotion.

3. We consider that the existence of a formal compensation scheme in the UK is a vital part of consumer protection, and therefore represents a core value of the market. The extent of compensation arrangements in insurance has historically been different to that provided for deposit-takers. This owes much to the different regulatory regimes in place pre-FSA. We therefore welcome the opportunity for a debate on the nature and scale of protection in insurance, which is long overdue. Over that period, just as regulation has changed significantly, so has the nature of the insurance sector.

4. It is surprising therefore that the consultation paper takes for granted that the starting point for a compensation scheme, or policyholder protection arrangements, should always be to "pay compensation to eligible claimants" (Statement of policy, paragraph 16a). Whilst the statement subsequently recognises the need for insurance contracts to provide continuity of cover (paragraph 18), we think it is disappointing that the opportunity to consider the nature of protection required for insurance policyholders has been

missed. For example in a recent report, the Social Markets Foundation comments "*the UK's generous deposit insurance scheme… has removed the impetus for consumers to worry about the safety of their savings*", and advocates a reduction in the amount of compensation provided, to encourage consumers to undertake their own due-diligence, as well as a basis for enhancing competition[1]. Whilst not supporting this conclusion, we think it illustrates the imperative of not assuming that maximising compensation is the only, or indeed best, form of (policyholder) protection in every case.

5. Indeed, regulators and insurers continue to work collaboratively to resolve problem firms in the insurance sector, and to thereby ensure continuity of cover. This white-knight approach has proven very valuable in avoiding potential problems. But it also means that, given the low incidence of insurer failures in the UK, particularly amongst life insurers, FSCS has very limited experience of handling technical recoveries in the mainstream insurance sector.

6. Hence it is worth reiterating some of the critical differences between deposit-taking and insurance when it comes to consumer protection and compensation. First, insurers tend to hold long-term assets that broadly match their liabilities: losses may still occur but not on as significant scale as in banking, as insurers are not exposed to the same high levels of leverage. Secondly insurers do not suffer the same balance sheet mismatch: whereas banks' deposits tend to be short-term and their liabilities illiquid and long-term, by comparison insurance liabilities are generally tradable, with a predictable volume of both inflows and payments. Third, where insurers use derivatives it tends to be for hedging and risk management purposes, and has not been on the industrial scale employed by banks. For all these reasons, a failure by an insurer in most cases will generally be better covered by capital, and be relatively containable.

7. The nature of protection that an insurance policyholder requires may depend on the nature of the product, and their expectation is generally quite different from the expectations of depositor protection. For example, a policyholder with a life contract would not benefit from the refund of their premiums in the event that their insurer failed. Equally the policyholder would not be entitled to payment of the sum assured, and would not have an expectation of that payment, in the event of the failure of the insurer. What matters crucially is that they can readily achieve continuity of cover on similar terms: if necessary with an alternative provider.

8. A specific challenge in insurance is if an insurer (whether providing long-term or short-term contracts), which provides a niche product or serves a specific market, fails and no alternative provider is able or willing to offer to take on a contract on the same terms. The same would be true of a contract where the circumstances of the policyholder have changed over time: for example that they are now in poor health. The role of the FSCS might therefore be initially to work with regulators to seek the most appropriate alternative provider, and

[1] http://www.smf.co.uk/wp-content/uploads/2014/11/Social-Market-FoundationPublication-Good-Culture-in-Financial-Services-Does-the-model-matter.pdf

then to assess how 100% of cover can be maintained; if an additional cost is incurred FSCS might then be expected to determine how that is raised and how and to whom the payment is made. The alternative is to transfer the policy to another provider on new terms, and to consider a claim for compensation at the time when (and if) a policy claim is made: with life cover for example, if the policyholder dies within the term of the policy any shortfall in payout by the new provider might be facilitated by FSCS.

9. As regards the specific proposals in the consultation:

   a. We are generally comfortable with the concept of raising the amount of compensation potentially available: we believe this is an important safeguard for consumers and supports confidence in the sector, and properly reflects the nature of risks that consumers are exposed to, particularly in long-term contracts;

   b. We believe that intermediaries and staff in providers will better understand the nature of compensation available on specific products, where there is greater consistency;

   c. We agree, given some of the points we make above concerning self-reliance, that the compensation costs of the proposed changes are likely to be relatively low;

   d. We agree that capping large claims could be problematic for certain types of insurance claim, so it is preferable to avoid this. However, altering the amount of cover, depending on the product, might be confusing for consumers, and indeed there is some evidence that firms sometimes misinterpret the amount of cover provided. For large losses, where the claim is limited to 90% of value where the provider fails, it may prove to be a hollow reassurance that, as you state, they can find cover elsewhere.

   e. We dispute the conclusion that changing compensation arrangements results in no *compliance* costs to firms. In fact, firms may need to alter literature, amend their website, re-train staff and communicate with intermediaries. The extent of these costs will depend on lead-time: for example, many firms work on a specific cycle for replenishing literature, though for small mutuals where the volume of sales may be low, the replacement cycle might usually be longer than the norm, so the cost of complying will be proportionately greater. We have assumed that changes will be made to all products and not just new sales, so firms may also need to amend information provided to existing policyholders.

   f. Paragraphs 3.4 and 3.5 appear to offer contradictory views on whether any claims might be covered by FSCS where the event triggering the claim occurs after a transfer to a successor firm. We would appreciate clarity on this.

g. Paragraph 5.4 suggests an alternative funding option based on “the number of eligible claimants”. We think this should be the value of those policies, as the current approach is based on value (of net premiums), and basing a levy on the number of contracts will significantly favour insurers with small numbers of high-value policies compared to those, such as mutuals, with large numbers of low-value contracts.

10. The consultation cross-references PRA paper CP20/14 ‘Depositor protection’. This was not published on the insurance part of the PRA website, but as CP21/14 indicated the depositors consultations also makes changes to the levy set for insurers we have reviewed the paper. However, as the commentary does not make clear any specific changes for insurers we have not been able to identify any specific changes or their consequences for mutual insurers. We would suggest PRA in future takes greater care to ensure that communications targeted at insurers are not concealed within the depths of a consultation that purports to be targeted only at deposit-takers, and which is not highlighted in the relevant part of the Bank website.

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

Yours sincerely,

Chief Executive
Association of Financial Mutuals