Jack Middleton
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

7 November 2014

Dear Jack,

AFM Response to PRA consultation CP16/14, Transposition of Solvency 2, part 3

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 welcome this consultation which, including the various appendices and the promise of further consultations to come, provides significant clarity from the PRA on preparations for transposition of Solvency 2, and an indication of how the final rulebook might look. As PRA acknowledges though, the provisions in the consultation are not yet complete, and the lack of final clarity remains a concern for our members, given the scale of work they have undertaken so far and that which remains. We accept though that in many cases the rate of progress is not within wholly within the control of the UK regulators.

4. Our response is relatively brief as we have largely restricted our review of this consultation to particular aspects most relevant to our members:

    a. the particular impact on mutuals;
    b. with-profits, where we have been engaging with the regulators on the Solvency 2 impact for some time;
    c. the treatment of proportionality, where our members are generally at the smaller end of the spectrum;
    d. the chapters on surplus funds and National Specific Templates, which we understand PRA would be most interested in hearing our views on, based on discussions in a recent meeting with Giles Fairhead;
    e. we have also avoided duplicating the proposals on the volatility adjustment, which we explored in responding to HM Treasury's own Solvency 2 consultation, and attach that response for reference.

5. With regards to the first of these, the paper confirms in a number of places that the PRA has considered whether the **impact on mutuals** will be significantly different from other firms. In each case though the conclusion appears to be that there is no significant difference (as stated in chapters 1, 9, 11 and 12). Instead, PRA refers the reader to FSA's consultation on transposition, CP11/22. However FSA did not have the same statutory responsibility as the PRA (and FCA), and the analysis- stating that implementation costs for mutuals would be £27 million and that the predicted reduction in free surplus would be 11%- are not at all consistent with the position we see today.

6. As we note below, the treatment of surplus funds has a different impact on mutuals, and in relation to implementation, we are beginning to see evidence that the costs will be many multiples of the figure posted in CP11/22. We therefore conclude it is not appropriate for PRA to contend that there are no specific consequences for mutuals, and that therefore they have failed to investigate the differences properly, or have not engaged staff with a knowledge of the sector to review its proposals.

7. PRA indicates that **with-profits** will be covered in a separate consultation, excepting the treatment of surplus funds covered in chapter 10, as will the proportionality of transitional measures. We will of course respond to these in due course, and remain particularly concerned that the approach to ring-fenced puts mutuals at a significant competitive disadvantage.

8. It is though a concern that with regards to **proportionality**, whilst in paragraph 1.38 PRA states that within the consultation it has, where

relevant, “set out how its approach is consistent with the principle of proportionality”, there remains very little concrete discussion beyond a principle level of what specific actions PRA will be taking to help deliver a proportionate approach. The absence of guidance means that firms tend to take an overcautious approach, spending more money than they might need to- which may not be in their members’ best interests.

9. We do not think responsibility for exercising proportionality rests entirely with supervisors, and would like to see PRA spell out in more detail, in further consultations and supervisory statements, what specific measures it has taken to support the principle. This might range from simplification, to alternative approaches, to reduced expectations, to disqualifying certain criteria.

10. When Solvency 2 rules are transposed in January 2016, certain elements of the current rulebook are removed for Solvency 2 firms. For non-Directive firms, generally those below the Solvency 2 threshold, there will be a requirement to maintain a specific PRA rulebook. We note that PRA plans to consult on this shortly, and given the short timescales and very limited resources of non-Directives, we believe proportionality can now be best achieved by maintaining the rulebook as close as possible to the current rules.

11. Chapter 10 covers **surplus funds**, which we wrote on at length within our responses to FSA consultations CP11/22 and CP12/13 (see: http://www.financialmutuals.org/files/files/AFM%20response%20to%20CP12,13.pdf). We had previously highlighted how the original rules put UK mutuals at a significant competitive disadvantage, so we were surprised that the PRA has not considered the specific impact of rule changes in this chapter on mutuals.

12. The inclusion in a typical with-profits mutual of policyholder funds, non-profit business and surplus funds within a single common fund will undoubtedly mean that the impact of rules relating to each of those elements is different to a proprietary firm. The supervisory statement in Appendix 2.11 goes some way to addressing some of our previous concerns, such as through clarifying the intent and meaning of terms in CP12/13 that were problematic for smaller mutuals, including asset share methodology and planned enhancements. However, until the outstanding requirements for with-profits firms are consulted on, it is not possible to say with confidence that the material differences we saw in CP12/13 have been addressed. For examples, FSA’s approach on ring-fencing, if left unchanged, would severely reduce the benefit of treating surplus funds as Tier 1 capital in a mutual. We have considered below the amended definitions in Appendix 1.19 in more detail.

13. With regards to **national specific templates** (NSTs), we are pleased with the progress PRA has made with this, but also concerned that as yet it is not possible to regard the proposals as final. We recognise this is largely outside PRA's control, but given the high amount of resource that is required in this area, we encourage PRA to avoid making further changes to NSTs this side of the implementation date. We have made comments on some of the templates below.

14. More generally with regards to reporting, we urge PRA only to collect data where it has a reasonable expectation of using it, and of it being useful. This includes:

    a. Assessing under proportionality, whether the cost of collecting data are valid for small firms; and
    b. The regularity of data reporting: if supervisors only expect to review data from small firms annual or bi-annually, they should resist asking for quarterly data. There is an unhelpful inconsistency in the consultation between paragraph 12.4, which states NSTs will only be collected annually, and Appendix 1.15 paragraph 2.8 which suggests quarterly data collection.

15. We have noted in previous consultation responses and by writing directly to PRA that we consider the readability of their documents is poor. It is disappointing that the regulator has not taken steps to improve their approach. The navigability online of a paper with several hundreds of pages, thirty-three appendices on unnumbered pages, eleven reporting templates, a number of antecedent papers, all with no hyperlinks, and with no explanations of replaced or added contents in rules, would fail to meet the expectations of PRA for firms' materials, and we consider they should modernise their approach and set a good example more generally. We would also like to point out an error in chapter 10, where the text refers the reader to appendix 1.9, rather than the appropriate content which is in appendix 1.19.

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

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Additional comments on Appendix 1.19

We consider that the definition of *with-profits assets* should allow for the exclusion of the capital requirements relating to non-profit liabilities as well as the liabilities themselves.

We are pleased that the revised definitions of *with-profits policy* took account of concerns we raised in response to the proposed definition in CP12/13, and are content that the amendments bring the definition back into line with Solvency 2.

We believe that the definition of *surplus funds* should exclude the capital requirements associated with the firm's non-profit business in a with-profits fund.

We raised a concern in response to CP12/14 that FSA was taking a very prescriptive approach to the calculation of *with-profits liabilities.* In our assessment this was not required by the Directive. We see much of this repeated in this consultation, and repeat our view that the Directive requirements appear to be sufficient.

We therefore suggest that the text should simply align with the requirements of the Directive. We note that the proposed text prescribing the asset share approach will create a conflict for firms because the Directive requires separate calculation of the value of guaranteed benefits and the value of discretionary additions for the purpose of the SCR. We therefore do not consider that the proposed text in Appendix 1.19, paragraphs 3.2 and 3.3 should be implemented and that firms should be given the freedom to value with-profits benefits in line with the requirements of the Directive.

Additional comments on National Specific Templates

NS.01 – *With-profits Value of Bonus*

The information requested in this template is noted as being largely consistent with Form 58 of the PRA Return for each ring-fenced fund. However, the template includes an additional requirement to report the distribution of profits which are subject to special apportionment rules. The rationale for requesting this information annually is not clear: in the majority of cases insurers do not frequently apply special apportionments. It would make more sense for firms to report on an ad-hoc basis in the year the event that triggers the reporting requirements occurs.

NS.05 – *Revenue Account*

A life business is required to produce a revenue account in accordance with UK GAAP within this NST. As many insurers now report under IFRS rules, they will no longer produce data in the UK GAAP format. Any requirement for firms to produce two sets of accounting data would result in significant additional costs, and with further changes to accounting rules in development, PRA should ask firms to specify the basis by which they prepare a revenue account in their report and accounts, and report on that basis.

NS.06 – *Business model analysis (Life)*

The vast majority of the information requested by this template will be produced as part of a firm's ORSA, so the data is of limited value. Additionally, fitting a review of the firm's future business model into the timetable for regulatory reporting is not consistent with the way that strategy is developed currently, so data produced may not be reliable in every case.

NS.09 – *Best estimate assumptions for life insurance risks*

Currently smaller firms might review their experience less frequently than annually, particularly where the class of business in small, which would make completing this form difficult. In any event, firms would generally avoid altering assumptions on the basis of a single year. We would suggest there is scope for a more proportionate approach here.

Annex:

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Solvency II Consultation
c/o Insurance and Savings Team
Financial Services Group
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

15 September 2014

AFM Response to HMT consultation on Solvency 2

17. 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 for a basis by which UK insurers might apply for a Volatility Adjustment.

18. 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, 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.

19. We agree with the overall proposals in the consultation, and note that the paper has been issued in conjunction with a separate PRA consultation. We accept that there needs to be an orderly basis by which UK insurers might adopt the Volatility Adjustment (VA), and that use of the VA should be made transparent, in order to support policyholder protection. At a European level, we consider that this has been a carefully thought through part of the solution to the challenges in the long-term guarantees package, and it is essential that UK insurers are not put at a competitive disadvantage, by not being able to take timely advantage of it.

20. We have responded to the specific questions in the consultation below, and would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Answers to specific questions

Question 1
Do you agree with the government's proposal to implement the option provided in the Directive which would make use of the volatility adjustment subject to supervisory approval in the UK?

We agree that there needs to be a safeguard in place, to avoid insurers using a volatility adjustment (VA) in a way that exacerbates the procyclical nature of long-term products at a time of market stress, and which thereby risks policyholder protection.

Treasury explores the need for the approval process to be "transparent, proportionate and timely". It is vital that the process adopted does not:

- Place too high a hurdle in the way of firms, to the extent that it renders the solution unworkable;
- Does not create undue delays;
- Is compatible with other requirements under the Solvency 2 regime; and
- Avoids making the application of the volatility adjustment impractical for smaller firms.

We would also want to see a proactive and positive approach from the PRA to identifying circumstances in which small firms in particular might benefit from applying the VA. This might be due to specifics in their business model, or as a result of market-wide conditions. Allied to this, PRA should be very specific about the nature and amount of information required to approve an application.

This should include consideration of the reason why a firm might need to apply for a VA. In most cases this is likely to be to achieve a temporary waiver of some of the Solvency 2 rules: hence it is entirely unhelpful to expect firms to have to incur significant external costs in support of an application, and to be tied to an approval process that could take up to six months. We would challenge PRA to commit to no more than ten working days to respond to a waiver application.

We consider that PRA should publish details of firms that have had an application for a VA approved, and that the notice should explain the basis for this. We do not think it would be helpful to publish this information at the time of application, or if an application is rejected, as this could be misconstrued by the market. Equally we do not think that the information disclosed should be extensive. In any event, if analysts are seeking to draw comparisons between the level of liabilities and capital before and after a waiver application, there is a risk that they will not appreciate why the numbers are different. This can be avoided by a clear and positive message from the PRA.

We would expect that on the whole a firm would seek first to apply for the Matching Adjustment (MA). On that basis it would be logically to ensure that the MA approval process is designed in such a way that the PRA can opine on whether it would be preferable, for the purposes of capital safeguarding and policyholder protection, to grant a VA rather than a MA.

Hence we consider that a single process should be developed to cover both, and that this would reduce firm costs, and turnaround time.

Question 2
Do you believe there any circumstances where automatic use of the volatility adjustment may be preferable to prior supervisory approval?

Yes: specific market conditions would warrant universal application of the VA; for example where this avoids insurers acting in a way that amplifies market volatility at a time of stress, or where corporate bond spreads are enormous and do not seem justified by risk when at a specific time most insurers are in corporate bonds rather than gilts.

The PRA should be able to judge extreme market conditions and authorise use of the volatility adjustment for all firms, with the capacity to review impact after the event.

Question 3
Do you agree that supervisory approval for use of the VA, as proposed in this consultation document, would be consistent with government's guiding principles on EU legislation?

As currently set out, it is not clear to us that this is achieved. The key will be the clarity of the PRA process, and the timescales it works to. A fully defined process and a commitment to turnaround approval in days, rather than months, would resolve this.

Section 3.5 of the paper talks about the value of a process for granting a VA in relation to market confidence. Whilst the general point about a robust approach providing confidence in the UK insurance sector is fair, the commentary largely assumes the position of listed companies. These circumstances will not apply equally for mutuals, who it could therefore be argued face a more gold-plated process, in order to satisfy the short-term priorities of the listed market, which are not likely to be as relevant to them.

Question 4
Do you agree with the government's proposed approach to the de-authorisation of insurance and reinsurance undertakings? Alternatively, what would be the consequences, particularly to policyholders, if such undertakings were not permitted to manage and pay claims on their existing insurance contracts?

We agree. It is unlikely that winding up is likely to produce a good result for policyholders. The government might also consider the duties, motives and value of an appointed administrator. The administrator may act to keep the firm going in order to maintain its income stream, regardless of coverage of the regulatory capital.