Robin Swain
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

12 December 2014

Dear Robin,

AFM Response to PRA consultation CP22/14, PRA approach to with-profits

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 the specific and significant implications for our members of the changed definition of a with-profits fund.

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. PRA has a statutory obligation to consider the specific consequences for mutuals of any new regulation.

3. We consider that the approach taken to PRA in this consultation will be helpful to firms, both in providing a sensible split of rules on with-profits with the FCA, and in providing rules and definitions that are relevant to PRA's objectives as well as in supporting the implementation of Solvency 2. With-profits remains vital for many mutual insurers- both as a core product, and also within the construct of the with-profits fund- and a surge in demand for some with-profits products during the financial crisis emphasised that they remain an attractive option for some consumers.

4. We met with FCA in November to discuss the consequences of their feedback statement on mutuals, which in a number of areas were problematic. We have made some progress with FCA, and whilst we do not

have the same range of concerns with this consultation, we do make some specific points regarding your proposals.

5. Paragraph 2.10 proposes With-Profits rule 2.1 for firms to ensure they hold sufficient assets in each with-profits fund to meet the with-profits liabilities of that fund. There is no consideration here of non-profits business that is held in the same fund: in a PLC any shortfall in assets might be expected to be made good from the shareholders funds; in a mutual with a separate mutual members' fund this would also apply; however in a mutual with a single common fund (with-profits fund), non-profits liabilities can only be backed by assets within the with-profits fund. The Solvency 2 rules on ring-fencing, as defined in FS14/1, treat multiple with-profits funds in the same firm as sister funds, and therefore non-profit liabilities arising in each fund would need to be covered by assets in that same fund only.

6. The consultation paper stresses in paragraph 2.20 that PRA and FCA share an ambition to produce "with-profits related definitions which use the same language for common terms", but also goes on to suggest that the FCA definition for with-profits fund in FS14/1 is wrong because it seeks to align to PRA's definition of surplus funds in CP16/14, rather than the specific definition of with-profits fund subsequently provided in CP22/14. We think it is regrettable that as the two documents were issued simultaneously, there was not greater effort by PRA to brief FCA on changes. This is particularly so because AFM and its members have raised a series of concerns with FCA about the definition they have used: which appears potentially to undermine much of the work done in resolution of Project Chrysalis. As you go on to state in paragraph 2.21 "neither regulator intends for divergence on substantive parts of the definition (of with-profits fund)" and we urge PRA to liaise with FCA on the issues that our members are raising on FCA's working definition, to ensure that the final definition is fit for purpose and does not represent a significantly different burden for mutuals. In this regard, whilst the PRA definition has evolved further, we see a number of abiding concerns:

    a. The definition fails to explicitly include reference to the inherited estate, working capital, discretionary member benefits, risk margin or capital requirements;
    b. The definition used by PRA also implies that assets within the with-profits fund, other than 'excluded assets' (which cannot be considered to be part of the with-profits fund, and which must be clearly documented- and which presumably included the items listed in a.) are exclusively for the use of with-profits policyholders, except for those needed to meet non-profit policy liabilities, and other liabilities properly payable out of the fund;
    c. This implies that for a mutual organisation, the presumption is that working capital must sit outside the with-profits fund, if it is to be used for purposes other than relating to with-profits policyholders: this appears to remove the option for many mutuals to retain a single common fund even where this is in the best interests of with-profits policyholders, non-profits policyholders and non-policyholder

members (albeit issues such as established practice and the rules of the mutual will also need to be taken into account);

d. Given the long history of discussion of these issues under Project Chrysalis this appears to actively encourage mutuals to undertake a modification under the terms of FCA paper PS14/5 and PRA SS1/14, which means that the statements in paragraphs 1.21 and 1.22 are misleading: whilst PRA can satisfy itself that the rules apply equally to PLCs and mutuals it cannot reasonably suggest that the impact will not be significantly different;
e. For some mutuals, it might be difficult to substantiate the rules are sufficiently burdensome to warrant a modification, and in any event, based on the definitions now provided by PRA and FCA, adopting such a route might not produce significant mutual capital.

7. Paragraph 2.2 of the proposed Supervisory Statement states that: *"A Solvency II firm will therefore be required to reflect the lack of availability of assets and own funds within the with-profits fund to cover the risks of the rest of the firm".* As section 3 states, this is less a '*lack of availability'* as a need to properly justify and document the support arrangements in place. We consider the Statement might remove the apparent contradiction[1].

8. Section 6 of the Supervisory Statement indicates with-profits firms will need to keep separate accounting records for each with-profits fund. This is likely to be onerous for some smaller mutuals, depending on the extent of separation that is expected. For branch or lodge-based friendly societies, where each branch affectively controls its own with-profits policies this will require every branch to account separately.

9. As the consultation states, these rules apply to all with-profits firms from 1 January 2016. For Solvency 2 firms, additional rules relating to the prudential regulation of the with-profits fund are covered in the Directive, whilst for non-Directive firms, PRA will retain specific rules where necessary. Given the short timescale and the size of non-Directives, we believe it is imperative that rules are copied across from the current rulebook with minimal change.

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

Yours sincerely,

Chief Executive
Association of Financial Mutuals

[1] This appears to mirror FCA's draft rule COBS 20.1A.10, in FS14/1, where FCA stress that they consider that the assets in a with-profits fund should be used for the purposes of each fund - as such any cross-subsidy could be for the purposes of each with-profits fund but that will be a matter for the fund, the WPA, and their governance arrangements- all of which need to demonstrate the ability for cross-subsidy. We raised this in discussion with FCA, who stressed there was no intention to stop cross-subsidy or intra-fund arrangements where that can be shown to be for the purposes of each of the funds concerned.