Ellie Goodsall
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1 August 2016

Dear Ellie,

AFM Response to Consultation Paper CP23/16, *Solvency 2: external audit of the public disclosure requirement*

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:

   - Consider the PRA's response to our earlier feedback.

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £16.4 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2].

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[1] ICMIF, http://www.icmif.org/global-mutual-market-share-2013
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted

4. In addition, the Bank of England and Financial Services Act 2016 now provides an additional Diversity clause for FiSMA, to require the PRA and FCA to take account of corporate diversity and the mutual business model in all aspects of their work, via an amendment to the regulatory principles[3]. This is an additional requirement for regulators that came into place after the original consultation, and might have warranted more thorough consideration in this consultation.

5. Solvency 2 is the bedrock of insurance regulation in the UK and Europe, and our members remain committed to supporting PRA's work to implementing the Directive effectively and in the best interests of customers and markets.

6. In our previous response we highlighted the lack of evidence that PRA had taken account of, in assessing the impact its proposals would have on different business models and different scales of business (copy attached). The follow-up consultation considers some of these concerns.

7. Indeed, there appears to be acceptance that the case for imposing new audit requirements was not properly made for mutuals in the original consultation, with a revised assessment of the benefits of audit in paragraph 1.9. We are disappointed though that no evidence is presented to support the suppositions made (that policyholders and IFAs will benefit from external audit, to the same extent as external investors in a listed company will benefit from greater market discipline). The statement on mutuals also forgets that the data will be available publicly to policyholders and IFAs, regardless of whether it is audited: it is the extra assurance that an audit provides that is the issue here.

8. We regret therefore that the costs of complying with this consultation will fall disproportionately on smaller directive mutuals/ insurers. This is partly a result of their size, but also the limited benefit that may derive from audit: members of mutuals already receive the organisation's report and accounts, which are thoroughly audited, and which give assurance on the financial position and prospects of the organisation. We have not undertaken research on whether a member of a mutual would value a further 100-odd pages of financial analysis, nor that in doing so they will be able to assess whether the differences in data between the accounts and the SFCR are reconcilable, now whether it will affect their behaviour either as a member or as a policyholder.

[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

9. In our first consultation response, we encouraged PRA to consider more proportionate options, such as simplified assurance routes for mutuals, given the limited relevance of the benefits suggested. We also questioned the absolute costs inferred by PRA's analysis. This showed that organisations might face bills of between five times and twenty times the cost of auditing the annual report and accounts. As much of the work is similar regardless of scale, inevitably smaller organisations, a larger proportion of which are mutual, will incur higher costs proportionately. These multiples suggest that the amount of audit time needed will seriously affect the availability of competent audit support in the short period firms have to produce and publish their report, and therefore jeopardises firms' ability to report on time.

10. It is disappointing that PRA dismissed this concern, and instead redirected concerns over its application of the proportionality principle to the fact that not all elements of the report need to be audited, and that larger, internal model firms, can avoid the cost.

11. The new consultation makes some changes to the role of the auditor and does not therefore have an immediate impact on our members, and we have duly not considered those proposals.

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

Yours sincerely,

Chief Executive
Association of Financial Mutuals

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January 2016

Dear Ellie,

AFM Response to Consultation Paper CP43/15, *Solvency 2: external audit of the public disclosure requirement*

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 our concerns regarding PRA's proposals; and*
- *Explore the degree to which PRA's analysis fails to give proper consideration to its responsibilities for competition and corporate diversity.*

The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £16.4 billion, and employ nearly 30,000 staff.

The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses.

AFM supports Solvency 2, and the actions taken by PRA in general to ensuring the Directive is implemented practically and proportionately in the UK. We have worked with our members to encourage the adoption of high governance standards, both in response to the Directive, and in our own Annotated Corporate Governance Code. Through the latter in particular, we firmly believe that transparency is key to ensuring good behaviour in financial services, and that companies and senior managers in particular should satisfy themselves that information produced for public consumption is appropriate for the intended users.

It is not clear in this consultation what the intended objective of the proposed new rules are: paragraph 2.1 indicates that "it is the PRA's view that external audit can underpin confidence", but this is not a full objective or justification for the new rules. As a consequence, the general tone is of a fait accompli, rather than an attempt to provide a thoughtful and persuasive rationale for an approach which goes beyond that expected by EIOPA. We explore below areas of more specific concern by reference to the headings in the PRA consultation.

PRA's statutory obligations

Paragraphs 1.5 to 1.9 provide PRA's response to its statutory obligations. We have considered PRA's views with regards to competition and for mutuals, and do not consider these areas to have been fully or properly addressed:

- *With regard to competition, PRA's focus is on market discipline and the information needs of investors. However these are not valid issues for mutuals, who do not generally have external investors, whilst the term 'market discipline' is generally used, both by the PRA and more broadly, to explore the capacity of the market to act appropriately in response to information intended to inform on the prospects and riskiness of a business: on the assumption that the market rewards good behaviour via market price. In the case of mutuals such market discipline does not apply as they have no market price.*

  The same paragraph presumes the cost of external audit is low for insurers: though as later described, in paragraph 3.4, for smaller insurers the cost can be 20 times more expensive in relative terms, so there is no sense of proportionality in this statement.

  We also consider barriers to entry as another issue which should always be considered on any exploration of the effect of competition. This is not considered in the consultation, but in our view the application of a further external cost to a new business, or for an insurer seeking to move from non-directive to directive status, would be unwelcome and disproportionate, and have an impact of their ability to compete.

- *Paragraph 1.8 indicates the costs involved would not vary materially for mutuals. However, as we stated in response to PRA's recent consultation on the structure of audit committees (CP34/15), our assessment of FSMA s138K is that the regulator should consider both the implementing cost and the ongoing costs of new requirements, as well as those relative to scale and the derived value to the business.*

  Most mutuals will not audit this kind of data, because it presents no value to the organisation or its owners, unlike the approach PRA describes in the listed world where there is potential for a market reward. Hence, the starting point for mutuals will be different to an equivalent PLC, so in our view the impact <u>is</u> materially different.

  As we discuss in the previous section, the market disciplines for mutuals are not the same as for PLCs. Hence the additional costs imposed on mutuals do not produce the presumed benefit of improved intelligence by the financial markets. This of course means that the analysis under the first regulatory principle provided in paragraph 1.7 is incomplete.

  Equally, as mutuals tend to be smaller organisations, they see a disproportionately higher cost of implementation. This may be particularly the case when all aspects of audit are outsourced: as the cost benefit case accepts, the relative costs of audit for mutuals may be twenty times higher. As the owners of a mutual are its customers, there is no option but to pass on higher costs to policyholders.

  Concerns about the way in which both PRA and FCA have failed to properly embrace the expectations under FSMA s138k led to a recent discussion in the House of Lords, and amendment to the Bank of England Bill, to place a sterner test on the regulators in assessing the impact on mutuality, both in setting new requirements and in way *they undertaking their general responsibilities. We look forward to further engaging with PRA on how this can be achieved.*

PRA Proposal

Section A of chapter 2 sets out what PRA's proposal is, without providing a clear rationale. Paragraph 2.6 puts this into some context against potential developments in accounting elsewhere. Such uncertainty might offer an opportunity for the regulator to avoid making further changes now which might be negated in the future.

The narrative refers to IFRS 4 phase 2 developments, but these are not expected to be finalised for a number of years. In the short term, most mutuals continue to use UK GAAP reporting, so a better time to implement these changes- from our sector's perspective- is when there is clarity on future accounting requirements.

Background to the PRA's proposals

In section B of chapter 2, PRA highlights the expectation that public disclosure will enhance the quality and comparability of data across Europe. That being the case it would be reasonable to expect PRA to take an approach to audit that is common with other countries. However, analysis provided to us by AMICE suggests nations such as France and Germany will not be insisting on external audit of pillar 3 data, and most others have not yet decided. PRA's position will therefore inevitably lead to questions about gold-plating.

As we state above, most mutual insurers and friendly societies retain UK GAAP accounting. But many large insurers will prefer to use Solvency 1 data to inform their accounting rather than Solvency 2, to give historic consistency. We held a discussion on this issue with our members recently, and with the FRC, to explore whether mutuals may wish to start using Solvency 2 derived data for their accounting now[4]. Given the assumption that Solvency 2 data will be more meaningful, we have encouraged our members to explore this issue on an individual basis, but the need to double audit the same data would remove some of the advantages of adopting this approach now.

PRA's approach to its proposal

This section highlights the information needs of investors and regulators. As we explain above, customer-owned mutuals do not have external investors. Whilst it is true to say that members of a mutual, as its owners, should expect clear and transparent information about the mutual, in most cases their ownership interest is not material or financial, and this data does not tend to influence their decision on whether or not to become a member/ policyholder.

This is not though to suggest that the customers of mutuals should expect lower levels of transparency simply because the provider is not listed. Customers of mutuals rely on much of the financial information that is published, and look for reassurance that the organisation is financially secure, is well-managed and can honour its commitments. This is of course no different to the customers of PLC insurers- but nowhere in the consultation paper does PRA suggest Solvency 2 public disclosure is intended for the end consumer.

[4] A presentation on this issue is available via our website: http://www.financialmutuals.org/files/files/AFM%20Seminar%20SII%20and%20GAAP%20in%20UK.pdf

The key external users of public disclosure data from mutual organisations are therefore the regulators themselves. The primary safeguard for PRA of requiring external audit of published data for a mutual organisation appears to be to mitigate the potential risk that its own assessment is incomplete, and this does not seem to be an appropriate justification. Insurer regulatory returns are already extensive, and increase significantly under Solvency 2; some of these are already subject to audit. PRA accepts that where further external assurance is required on regulatory returns it can be obtained through the use of skilled person under Section 166 of FMSA. In fact, by excluding internal model firms from the need to audit, PRA is indicating that its assurance processes are more meaningful than those of an external auditor.

We suggest that the same approach is adopted for public disclosure, for insurers that PRA has assessed do not represent a significant risk to its priorities, and who are not directly supervised. PRA's desk based analysis will help it identify any outliers and to consider whether further external assurance is required.

Cost Benefit Analysis

As we state earlier, the cost benefit analysis of these proposals indicated very clearly that the costs of implementation will be disproportionately greater for smaller insurers: in relative terms the cost can be up to 20 times higher according to PRA's own analysis. It is surprising therefore that PRA has not considered whether a more proportionate approach might have been taken: for example:

- *by imposing the requirement only on the largest organisations and retaining the option of additional external assurance in smaller firms only where it is considered necessary; or*
- *by excluding those for whom the perceived benefits are weaker, such as for mutuals; or*
- *by simply allowing the market to settle post-Solvency 2 implementation, once there is stronger agreement across Europe, and once IFRS 4 phase 2 rules are finalised, considering then any new requirements in light of this.*

In summary, the PRA consultation appears to gold-plate the proposals in the Directive. Whilst this might be an understandable reaction to the need for increased scrutiny of large organisations, the consultation has not justified why the same approach is necessary for small mutuals, nor has it thoroughly explored the impact on proportionality.

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

Yours sincerely,

Chief Executive
Association of Financial Mutuals