



Marta Frankiewicz  
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Bank of England  
London  
EC2R 8AH

1 December 2015

Dear Marta,

**AFM Response to Consultation Paper CP34/15, *Implementing audit committee requirements under the revised Statutory Audit Directive***

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:
  - Comment on the proposals by PRA to extend the requirements for audit committees beyond those of the relevant Directive; and
  - Highlight the consequences for mutual insurers, particularly where PRA has opted not to adopt many of the concessions open to it.
2. The Association of Financial Mutuals (AFM) represents 47 member companies, and in most of our member companies, customers present and future are the owners of the business. 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<sup>1</sup>.
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<sup>2</sup>.

<sup>1</sup> ICMIF, <http://www.icmif.org/global-mutual-market-share-2013>

<sup>2</sup> Financial Services Act 2012, section 138 K: <http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted>

4. AFM agrees with PRA on its assessment of the value of a properly functioning and independent audit committee, that serves the best interests of the owners of the business and other key stakeholders. As a trade body we invest a significant proportion of our resources, above and beyond our members' attention to regulatory expectations (from FRC and FCA as well as PRA), to maintaining high standards of governance in the sector, and of course audit and transparency are key elements of that.
5. In particular, it is a condition of AFM membership that firms comply with the Annotated Corporate Governance Code<sup>3</sup>, which makes significant demands on the audit process in mutuals, in the same way as FRC's UK Corporate Governance Code does on listed companies. It is a testament to the long-running commitment of our members to high standards that section of the Code relating to audit are amongst those with the highest compliance rates<sup>4</sup>. AFM regularly provides guidance to members in addition to the standards in the Code, to keep our approach on track with other governance developments, such as those set by BIS or FRC<sup>5</sup>: whilst most AFM members are not governed under the companies act, we seek to adopt consistent standards wherever underlying legislation permits.
6. As a result, many of the requirements in the Statutory Audit Directive are already reflected in the approach taken by mutual insurers in the UK. That said there are some new requirements which will cause extra costs and complexity for small mutuals (covered later in this note); these are exacerbated by those areas where PRA has gone beyond the base requirements of the Directive and/ or disregarded the proportionality options open to it.
7. In paragraph 1.15, PRA makes the remark that its proposals "*would introduce additional costs for smaller Solvency II insurers which may subsequently introduce added difficulty in entering or maintaining position in the marketplace*". The same paragraph goes on to suggest that this will be to the benefit of competition. This is a very unwelcome statement, as it implies (whether this was the intention or not) that the Bank of England has an active policy of placing obstacles in the way of the survival of small insurers, in the belief that less choice of provider increases competition.
8. We consider the admission from PRA that its proposals will create difficulty for smaller insurers should therefore recognise a potentially disproportionately higher burden on mutuals, given the greater population of mutual insurers and friendly societies in the smaller insurers' categories.
9. PRA considers the effect on mutuals in paragraph 1.16. The paragraph correctly quotes the requirement under FSMA for the regulators to give an

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[http://www.financialmutuals.org/files/files/7ii\)%20Annotated%20Combined%20Governance%20Code,%20v%20April%202015\(1\).pdf](http://www.financialmutuals.org/files/files/7ii)%20Annotated%20Combined%20Governance%20Code,%20v%20April%202015(1).pdf)

<sup>4</sup> In 2014, Solvency 2 members reported 97% compliance with section 3 of the Code on Accountability

<sup>5</sup> for example, see: [http://afmgovernance.co.uk/news/corporate\\_governance\\_guidance\\_note](http://afmgovernance.co.uk/news/corporate_governance_guidance_note)

opinion on whether a proposed rule has a significantly different impact on mutuals. However, we disagree with the way PRA interprets that responsibility in this consultation, as it seeks only to measure the arrival destination, which in this case is the same for all (non-significant) Solvency 2 firms, rather than the costs of moving from current arrangements to the arrival point, which is not the same.

10. We consider that in relative terms small mutuals in particular will have greater implementation activity and costs, as PRA appears to accept, and therefore this should be taken into account in the application by PRA of its obligation under FSMA 138K. We have raised similar points in previous consultation responses, and note the PRA's apparent reluctance to explore properly its legislative requirements. We understand government is considering whether to adopt draft amendments to the Bank of England and Financial Services Bill which might encourage a more serious treatment of this responsibility<sup>6</sup>. We would be happy to work with PRA to explore this further.
11. To illustrate the range of concerns for mutual insurers specific to the proposals in this consultation:
  - a. The UK Corporate Governance Code Annotated for Mutual Insurers, adopts a 'comply or explain' basis, which allows organisations to provide explanations where they deviate from practice in the listed world, and where it is generally in their members' and customers' best interests not to adopt standards expected of large listed companies. The formal rules in this consultation remove the option of providing explanations in relevant aspects of the Code, and some of our members would therefore need to make significant changes, possibly requiring changes to their rules via the Annual General Meeting, as well as new recruitment or authorisations.
  - b. The UK Corporate Governance Code permits firms to treat NEDs as independent, even where they have served more than nine years on the Board, as long as they submit to annual election and set out why they are considered still to be independent. The PRA rules impose a different approach, in other words that directors that have served more than nine years cannot be considered independent for the purposes of retaining a majority of independent NEDs on the audit committee. Again this may lead to the need to recruit new NEDs in some cases, as well as to creating confusion on the different circumstances in which a director may or may not be deemed independent.
  - c. The PRA rules and the underlying directive highlight the need for NEDs serving on the audit committee to have competence relevant to the sector, and for at least one to have competence in accounting or audit. It is not clear how PRA expects to interpret this: for example, for an affinity-based friendly society with directors employed within the industry represented (such as policemen, vets, dentists, bus drivers), will service on the board of the friendly society in itself be deemed to

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<sup>6</sup> <http://www.publications.parliament.uk/pa/bills/lbill/2015-2016/0065/amend/am065-a.htm>

provide sufficient competence of the sector? If not, only externally recruited NEDs will be able to serve on the audit committee, rendering the lower benchmark for smaller entities superfluous, because all those serving on the audit committee may become independent NEDs. This will result in extra costs for affinity-based and delegate-based friendly societies, where member directors are often not remunerated;

- d. Much of the dialogue used by PRA in this consultation, and in the more recently issued CP43/15 (Solvency II: external audit of the public disclosure requirement) relates to improving market and investor confidence through audit and transparency. The narrative makes a broad assumption that the target audience is informed/institutional investors, but that is not the case in customer-owned mutuals. Similarly, there is no heterogeneous market for financial services, and the cost benefit case does little to demonstrate effort has been made to apply a proportionate approach, as the focus appears to be on addressing concerns in large PLC organisations.

12. AFM data, provided via member accounts<sup>7</sup>, on the make-up of the audit committee of firms above the Solvency 2 threshold, shows:

- a. An average of 3.7 members on the audit committee;
- b. One organisation has no audit committee, as it is an unincorporated friendly society and this is not required under relevant friendly society legislation;
- c. Five organisations with executive directors on the audit committee (nine individuals in total);
- d. Six organisations with NEDs that are not regarded as independent on the audit committee (ten individuals); however, this is likely to be a significant understatement, based on the PRA interpretation of the 'nine-year rule' which will mean many NEDs considered independent in every other sense will not meet PRA's criteria;
- e. We do not have data on the number of audit committee members with sector experience and with accounting/ audit experience. However, a review of some of the smaller mutuals indicated most would need to change at least one member of the audit committee, and for some over half of the current incumbents did not meet the PRA expectation.

13. We expect some of the personnel issues above to be addressed as firms respond to the requirements of the Senior Insurance Managers Regime- and have engaged extensively with PRA on the transition process. However, the brief implementation period for these rules means that in the short term some organisations may not have recruited suitable individuals in time for the new regime.

14. Many smaller AFM members combine their audit committee with other functions such as finance, risk and compliance. We note that paragraph 3.26 indicates this will remain permissible, and we agree this is a proportionate

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<sup>7</sup> for more, see the 'company and financial data' file on our website:

<http://www.financialmutuals.org/resources/key-statistics>

response. However, whilst this could be a practical option for smaller mutuals, it would only work if the rules allow flexibility in relation to the structure and membership requirements of the risk committee carrying out the audit committee functions. For example, allowing executive members of the risk committee to 'step out' during audit committee business.

15. Regarding the functions of the audit committee, we consider these are broadly consistent with the requirements of the UK Corporate Governance Code and would anticipate mutuals will be capable of fulfilling them.
16. Another related development will be the impact on smaller mutuals of FRC's consultation on 'enhancing confidence in audit'. We anticipate this will reduce choice and further increase costs for small insurers, as we expect that the availability of auditors will fall as a result. We are responding separately to FRC on this point.
17. We note that the PRA has indicated it is willing to consider providing a transitional period for some or all of the proposals that exceed the minimum harmonisation elements of the Directive, and we urge PRA to adopt this, to enable smaller mutuals to programme and sequence activity, where they might have to bolster the skills and independence of parts of their board, to meet new requirements, as set out above.
18. In short, 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 suggest that PRA adopts more of a two-tier approach, so that where it chooses not to adopt options available to it under the Directive, it restricts these more onerous conditions to more targeted audiences.
19. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'AB' followed by a long horizontal stroke.

Chief Executive  
Association of Financial Mutuals