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15 April 2015

Dear Emily,

**AFM Response to Consultation Paper CP07/15 (PRA) and CP15/05 (FCA) -
Approach to non-executive directors in banking and Solvency II firms**

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 specific implications for our members, where we consider the consultation has not taken proper account of differences in business model.
2. The Association of Financial Mutuals (AFM) represents 50 member companies, and in most of our member companies, customers present and future are the owners of the business. Between them, AFM members manage the savings, pensions, protection and healthcare needs of over 20 million people in the UK and Ireland. 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 accept the general principle that individuals with senior responsibilities within financial services firms must be fit and proper, including of course the non-executive directors of the organisation. Their integrity, collectively and individually, is vital to maintaining the right culture in the organisation.
4. The consultation paper seeks to justify aligning the regime for NEDs in insurers with that in banking in helping to “mitigate any potential impact

on competition between banking and insurance firms stemming from the SMR”. Unfortunately the paper does not spell out what adverse competitive risks might arise from differences in the regime- given that the SMR was the result of the PCBS review of the risk of systemic failure in banking, linked to the failings of the sector in recent years. The original ‘July 2014’ consultation on NED responsibilities is stated in the consultation as forming the basis for the NED regime for insurers; yet that original papers was only directed at banking, and the current consultation relies on feedback to the earlier consultation to justify its approach for a very different audience.

5. A key facet of a mutual organisation- which distinguishes it from other financial companies- is that the board, or committee of management, works in the best interests of the members, who as well as owners, are also of course customers of the organisation. In many AFM members this is achieved by appointing member directors, drawn from the population of eligible members, with individuals delegated to represent the interests of a wider group of members. For affinity-based organisations, where the mutual works closely with the wider trade or profession (such as teachers, police officers, train drivers or farmers), it is therefore natural to appoint lay people into NED positions. In relation to the new regime, we expect that on the whole such member directors fulfil the role of ‘standard NED’.
6. It is therefore welcome that the regulators have made a clear differentiation between those NEDs subject to the SIMR regime, and standard NEDs. However, in some mutuals, particularly smaller affinity mutuals and delegate friendly societies, there are currently member directors fulfilling ‘senior manager’ roles; in light of the new regime, the organisation may need to consider whether to replace these NEDs with an individual with the relevant experience. This will inevitably increase costs for these organisations, and may alter the overall balance of the board significantly- exacerbated by the possibility that low/ unpaid member directors may be more reluctant to stand in the future.
7. The PRA and FCA both have a responsibility to assess whether new rules have a different impact on mutuals: it is not clear that the authors of this consultation have properly explored the consequences of the business model of some mutuals and how therefore the impact is different. We consider this at length later in this note.
8. It is proposed that parts of the revised Approved Persons Regime for insurers come into force on 1 January 2016, alongside the implementation of Solvency 2 (this is covered separately in FCA (CP15/16) and PRA (CP13/15)). This is ahead of the full implementation of SMR and SIMR, due 7 March 2016. With final rules

not due until the summer, we encourage PRA and FCA to ensure that grandfathering procedures are as streamlined as possible, and that regulators commit to granting approvals in plenty of time.

9. Our comments on specific questions are attached. 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 the initials 'AB' followed by a stylized flourish.

Chief Executive
Association of Financial Mutuals

Answers to specific questions

- Q1 [PRA]: Do you agree with the content of Part 1 of the PRA's draft Supervisory Statement (in Appendix 2) regarding the responsibilities and accountability of NEDs in scope of the Senior Managers Regime?**

We have not responded to this question as it is outside our scope as a trade association representing mutual insurers.

- Q2 [FCA]: Do you agree with the guidance in Appendix 3 concerning the role and responsibilities of NEDs within the FCA SMR?**

We have not responded to this question as it is outside our scope as a trade association representing mutual insurers.

- Q3 [PRA]: Do you agree with the PRA's proposed scope for the SIMR as far as NEDs are concerned?**

As per our comments in the attached cover letter, the case for aligning the SIMR with the SMR has only been presented superficially. Notwithstanding this, we agree with the general objectives of the SMR, of promoting a clear allocation of responsibilities, and on strengthening individual accountability, and are comfortable that these objectives should translate into insurers.

The restricted nature of the responsibilities and accountability of NED's is welcome, given the FCA view that "NEDs individually do not manage a firm's business in the same way as executive directors" (paragraph 2.15).

We are concerned though that the proposals will be a disproportionate burden for smaller mutual insurers and friendly societies. As we set out in our covering letter, the proposals will have a disproportionate impact on some mutuals, given the nature and structure of their boards at present. The consultation appears not to have considered this and the consequences for some mutuals.

Given the absence of systemic risk in smaller insurers more generally, We suggest a practical solution to this would be to require only the Chairman and the Chair of the Audit Committee (from the point where it becomes mandatory under the Audit Directive for all insurers to have an Audit Committee) of a category 4 or 5 insurer should be treated as a senior manager, with all other NEDs being treated as standard NEDs.

Q4 [PRA]: Do you agree with the PRA's proposals for the:

- **allocation of core responsibilities to NEDs within the SIMR**
- **application of the Conduct Standards to NEDs within the SIMR**
- **requirement for firms to ensure that NEDs outside the scope of the SIMR observe the Conduct Standards 1-3, 7 and 8?**

We agree that these proposals are sensible and proportionate.

The proposal to streamline requirements for standard NEDs is welcome, and they are also a pragmatic solution to the resource constraints within the PRA and FCA. We are concerned therefore that the issue of grandfathering for existing senior manager NEDs has not been finalised, and this will increase workloads and uncertainty for firms, as well as imposing potentially unrealistic timescales for supervisors to approve roles. Paragraph 3.18 alludes to a further consultation on this and other issues.

Q5 [FCA]: Do you agree with the FCA's proposed approach to NEDs under the APR for Solvency II firms?

FCA had earlier concluded in a joint consultation with PRA (CP14/13) that it would require firms within the scope of the PCBS report to include additional roles within the APR beyond those required of PRA's SIMR. This includes the chair of the Nominations Committee. FCA gave some superficial justification for a two-tier approval system in CP14/13, but in this consultation has presumed that this should apply, without justification, to Solvency 2 firms. It is, we believe, regrettably that the case for applying additional requirements was based on feedback received to a different consultation targeted at a different audience. It would have been helpful for FCA to set out the reasons for including, given that insurers were not the subject of the PCBS review. Even better, it would have been helpful to maintain a single approach between the two regulators.

Many smaller mutuals do not have a specific Nominations Committee; this role is fulfilled by the Board. Hence we would expect FCA to clarify that these responsibilities are directed to the Chairman in such cases, as is consistent with our response to Q3.

FCA suggests that 'many of the elements linked to the SMR... will not apply to Solvency 2 firms' (paragraph 3.13). The examples given relate to sanctions on individuals that misbehave, so the reality is that for the vast majority of firms and NEDs, who are conscientious who does not misbehave, this statement is not appropriate.

Q6 [FCA]: Do you agree with the FCA's approach to NEDs in incoming EEA Solvency II branches?

Q7 [FCA]: Do you agree with the FCA's approach to NEDs in incoming non-EEA Solvency II branches?

These questions are beyond the scope of AFM.

Q8 [PRA]: Do you agree with the proposed notification requirement for Standard NEDs in relevant authorised persons, including the draft form set out in Appendix 5?

We have not responded to this question as it is outside our scope as a trade association representing mutual insurers.

Q9 [PRA]: Do you agree with the clarifications and expectations set out in Part 2 of the Supervisory Statement in Appendix 2 regarding the PRA's proposed application of the presumption of responsibility?

We have not responded to this question as it is outside our scope as a trade association representing mutual insurers.

Cost benefit analyses

There are no questions linked to the cost benefit analysis. We have therefore highlighted a concern in our cover letter the cost benefit work in relation to what we perceive to be a manifestly different impact on some mutuals.

As we state, the proposals have largely disregarded the differences in starting point, particularly for mutual insurers with either a delegate structure, or where the organisation was created to serve a particular trade. In such cases, the organisation has continued to rely on strong input from member directors. Whilst the potential shortcoming of an approach which relies entirely on lay directors was put into sharp focus by the failings of the Cooperative, there has been in mutual insurance an evolution towards a board with a wide skillset, including the appointment of non-members with the appropriate skills to help lead the organisation for the future.

Governance standards have generally assessed the suitability of the board as a whole to fulfil its functions, and in such cases, member directors continue to play an important role in representing the interests of policyholders as a whole.

The impact of the senior manager regime on large insurers is, as the cost benefit cases assesses, unlikely to be significant. But we do not consider this to be the situation in smaller mutuals:

- there will be higher recruitment costs for key roles;
- fees paid to NEDs that fulfil senior manager roles will be higher, particularly in circumstances where these roles were previously filled by a member director;
- the supply of candidates for member director (standard NED) roles may reduce, both as a result of the greater responsibilities inherent in the role, and as a result of the disparity in pay with NEDs in a senior manager role. Scarcity of supply will again produce upward pressure on costs;
- the extent to which individuals can hold a number of CFs in a small mutual will potentially be compromised by the potential risk of conflict between those

- functions, as presented in the governance maps. This again will be likely to increase costs as more individuals may be required to take on CF roles;
- the balance of the board might change, and there is a greater risk of conflict within the board due to the differences in background and expectations of NEDs;
 - ultimately mutuals will be forced either to coalesce towards the PLC business model for which the rules are principally set, or to accept that the costs and complexity of business are too great to remain independent: in either case there would be a reduction in competition in the market.

It is disappointing that the cost benefit assessment was relatively superficial and did not consider the wider implications. AFM, along with the Building Societies Association, highlighted this as a wider concern in our "[Manifesto for Financial Mutuals](#)". The approach taken in this consultation has been to take the recommendations of the PCBS and apply those to banks, then translate them into insurers and presume a single approach produces no different consequences for other business models. Accordingly the policy team starts with a presumption of there being no difference.

Our assessment of the requirement in FSMA is that the regulators should take a quite different approach: to recognise the policy outcomes they seek to achieve via new rules, and then to develop requirements, taking proper account of the different business models that it might refer to. We would be happy to discuss this bottom-up approach with PRA and FCA.