



Financial Conduct Authority
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Canary Wharf
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23 January 2017

AFM Response to consultation on FCA Mission

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 in the Mission document;
 - provide views on the consequences on the FCA approach from the mutual and not-for-profit sector.
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 staff¹.
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 businesses².
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 work³.
5. AFM firmly supports the continued need for effective consumer protection in the UK, and on regulation that adopts proper principles to ensure firms

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>

³ <http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted>

understand their responsibilities and are challenged to always behave well. We welcome the revised Mission document as a valuable way of calibrating how FCA fulfils its role and its statutory objectives, as well as how it adapts to the changing marketplace for retail financial services.

6. FCA's role is wide-ranging, in respect not just of the number and range of firms within its jurisdiction, but also with regard to the powers it has as a financial and competition regulator. Whilst the document rightly does not dwell on the implications of Brexit, there is a strong possibility that the process of leaving the EU means the FCA Mission will have to evolve further: FCA will move from being largely a supervisor and enforcer of rules written elsewhere, to having more direct control of its rulebook.
7. We do not, for example, consider that it is appropriate for FCA to simply copy across rules into its handbook, as we would expect careful scrutiny of the impact those rules have on the specifics of the UK marketplace, the relative maturity of our financial system, the particular needs of UK citizens, and the nature of the society and competitive economy that the UK government wishes to build post-Brexit.
8. We were surprised, in exploring FCA's role and responsibilities, that no mention is made in the Mission document to the duties imposed on FCA to take account of corporate diversity, and the impact of its work on mutuals. This is a more intensive exercise than merely presuming new rules have no significant difference: we have regularly invited FCA to explore the consequences of the Bank of England and Financial Services Act, and await that conversation.
9. Our answers to the questions raised in the consultation are attached. We would welcome the opportunity to discuss further 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

Responses to specific questions raised in the paper

Chapter 4

1. *Do you think our definition of a well-functioning market is complete? What other characteristics do you think we should consider?*
2. *Do you think our approach to consumer loss in well-functioning markets is appropriate?*
3. *Do you think we have got the balance right between individual due diligence and the regulator's role in enforcing market discipline?*
4. *Do you think the distinction we make between wholesale and retail markets is right? If not, can you tell us why and what other factors you believe we should consider?*
5. *Do you think the way we measure performance is meaningful? What other criteria do you think are central to measuring our effectiveness?*

AFM and its members recognise there would be significant limitations to the functionality of financial services markets in the absence of regulation. A well-functioning market is one where consumers are treated fairly, but also where suppliers of services act ethically and can be relied upon to deliver their contractual obligations.

The current FCA consultation on reforms to FSCS funding highlights the problems inherent in the FCA approach to the intermediary sector (and more generally to the proper functioning of markets): the regulator is responsible for vetting new licenses and permissions, to avoid unsuitable applications or ones from previously failed intermediaries; scarce regulatory resources mean that conduct supervision of small intermediaries is light-touch, leading to a greater risk of mis-selling and failure; capital requirements are low/ inadequate to reflect the losses to consumers incurred in a failure; the indemnity markets is not working properly; the volumes of failures referred to the Compensation Scheme is higher than it should be due to upstream problems in the system; the rectification costs to the intermediary market area very high and unsustainable. Where regulators have constantly raised the levels of capital and prudential scrutiny of providers, it is the absence of this for some aspects of the market that contributes to the high costs of failure.

We accept the challenges, as stated in the NAO report on performance management by regulators, that there is no single way of measuring performance for FCA. As NAO also states, it is important to translate high level objectives and the Mission “into more specific and measurable lower-level objectives”⁴.

When making new rules, or amending the existing Handbook, FCA is required under FISMA to produce a cost-benefit analysis. In an era where regulatory

⁴ <https://www.nao.org.uk/report/performance-measurement-by-regulators/>

costs are very high and regulation is regularly categorised as the top risk firms face⁵, we think this analysis provides a valuable safeguard in measuring the cost and proportionality of regulatory change.

We do however consider that the effectiveness of the CBA approach most often provides unreliable evidence of a full assessment of the costs and benefits: this very often appears to be an afterthought, and benefits in particular are too vague to be useful. This is compounded by the absence of post-implementation review- which would itself provide a more accurate assessment of the actual costs and benefits that have accrued.

Reference in the document to an 'individual's due diligence' suggests a higher level of scrutiny than the phrase 'consumer responsibility': the latter may imply that the consumer understands the product they are purchasing, or the limits of their knowledge, and the responsibility to act in accordance with the contract. Due diligence imposes an expectation on consumers that they have effectively researched the provider and seller of the product or service. Unless there is a zero tolerance of failure, it is now enough to verify that the firm is regulated, to have completed due diligence. FCA refers to this issue, and it would be helpful to see what they consider what more is expected of an 'individual's due diligence'. The more limited this is, the greater the regulators role for enforcing market discipline, and ultimately the more the regulator is at risk of having failed in this where consumers suffer detriment from a failure.

Chapter 5

6. *Do you think the way we interpret our objective to protect and enhance the integrity of the UK financial system is appropriate? Are there other aspects you think we should include?*
7. *Do you think our intervention framework is the correct one?*

There are some useful and positive assessments of how FCA intervention has yielded better results for consumers (on the GAP market, LIBOR, payday lenders etc). We are surprised and disappointed though that this chapter- and indeed the entire publication- makes no reference to corporate diversity. As we make clear in our opening remarks, FCA has a responsibility, both under FiSMA and under the Bank of England and Financial Services Act 2016, to take account of the mutual business model and to assess whether the consequences of its proposals vary.

In the past we have too often seen analysis in FCA papers that suggests that, because FCA does not take account of business model, it is not imposing different expectations on different corporate forms. This is wrong, partly because

⁵ See for example: http://www.pwc.com/gx/en/insurance/banana-skins/assets/pwc_insurance_banana_skins_2015.pdf

most rules are created through the lens of the PLC corporate form, but also because FCA's objectives explicitly require it to consider how to facilitate competition, and the nurturing of different business forms would in no way be incompatible with that. Regulatory analysis of the recent and severe financial crisis demonstrates that some parts of the financial marketplace would have failed to function had not mutuals and not-for-profit providers, such as building societies and friendly societies, stepped up to offer continuity of supply- for example in the supply of first time mortgages or in the Child Trust Fund market. Subsequent actions by regulators that constrain corporate diversity mean that capability may not be so apparent in a future downcycle: disproportionate capital requirements, governance arrangements imported from the PLC world, and a misunderstanding of ownership rights in mutuals are examples of these constraints.

In our assessment, an approach to policy making that places issues like competition and corporate diversity as part of the process, rather than as part of the post-production justification, will avoid this failure.

With regard to the intervention framework, we agree this gives a broad and appropriate structure for the majority of FCA's response to areas of concern. In the vast majority of cases, consumer protection is best served by a rigorous and thorough process- to properly diagnose the problems and identify the optimal resolution. By necessity, the FCA framework is extensive, and in some situations- where consumer risks are immediate or realised, such as via an investment scam- there needs to be flexibility to ensure intervention is timely, and even if the solution is temporary and sub-optimal, it removes or reduces the immediate risk of loss to consumers.

Chapter 6

- 8. Where do you believe the boundary between broader policy and the FCA's regulatory responsibility lies?*
- 9. Is our understanding of the benefits and risk of price discrimination and cross subsidy correct? Is our approach to intervention the right one?*
- 10. Does increased individual responsibility increase the need and scope for a greater and more innovative regulatory response?*
- 11. Would a Duty of Care help ensure that financial markets function well?*

The mutual and not-for-profit insurance, and friendly society, sectors have a proud heritage in bringing affordable products to market, and in widening access to financial services. Long before the welfare state was established, working people would pay money into their local society, to provide cover for their old age or illness. Many of today's societies continue to work with parts of society that are not well-served by mainstream providers.

We were interested in the way the FCA Chief Executive approached the issue of the boundary between regulation and public policy in a speech to the ABI conference in late 2016. We took from this the possibility that whilst wider developments, such as Big Data, might be a valuable tool in helping to improve risk management and pricing, for insurers in particular, it also increases the possibility that certain consumers might be excluded from the financial system.

Mr Bailey offered Flood Re as an example of where public policy had intervened to restrict the free movement of the market: by levering higher costs on all consumers to avoid the problem that some high-risk consumers would be priced out of home insurance altogether. The suggestion was that policymakers and regulators might be forced to intervene more often in future where the pure market solution does not work to the common good.

We do see a two-way element to this: whilst FCA is not able to change public policy directly, it should have a responsibility for engaging with government on how public policy solutions can resolve wider societal issues. Equally, FCA has a responsibility for acting on public policy initiatives: there are good examples of this, such as with basis bank accounts and vulnerable customers, but there are also examples, such as recent legislation on corporate diversity, that it has chosen to disregard.

There are elements of the way more effective interaction between public policy and regulation might interact, with the way mutual and not-for-profits insurers operate; for example: long before the Gender Directive, many mutuals did not differentiate the price or features of some general insurance or protection products; with-profits products include features like smoothing and guarantees to ensure a fairer and more consistent distribution of returns over time; mutuals dominated the Child Trust Fund market, which required access by all new-born citizens to a low value product; health cash plans provide free optical and dental cover for people who might otherwise find those costs too high. Unfortunately, in the past and until legislation or public policy have changed perceptions, conduct regulators have tended to dismiss these approaches as either creating cross-subsidy or lack of transparency, or high cost, and have as a result marginalised the mutual sector.

We are not convinced that a Duty of Care will produce measurably better functioning markets. The current 'treating customers fairly' principle is a powerful focus for firms, and it is generally the case that where a firm fails in this area it is also negligent in others, thereby providing the wider justification for intervention that FCA panels seeks. As mutual and not-for-profit organisations, AFM and its members sympathise with the Consumer Panel's desire to 'oblige providers of financial services to avoid conflicts of interest and act in the best interests of their customers'⁶: this after all is consistent with the rules and constitution of our

⁶ https://fs-cp.org.uk/sites/default/files/duty_of_care_briefing_-_jan_2017.pdf

members. And in our assessment, a consumer has recourse to the complaints system if he/ she is unhappy with their treatment.

Chapter 7

- 12. Is our approach to offering consumers greater protection for more complex products the right one?*
- 13. Is our regulatory distinction between consumers with greater and lesser capability appropriate?*
- 14. Is our approach to redress schemes for issues outside our regulatory perimeter the right one? Would more specific criteria help firms and consumers?*
- 15. What more can we do to ensure consumers using redress schemes feel they are receiving the appropriate level of personal attention?*

The approach to complex products is evolving. In insurance, the implications of European legislation such as PRIIPs and the IDD are changing the regulatory approach to complexity. Whilst FCA has limited discretion on how to limit these Directives, it does have more ability to consider to what extent products meet the definition of complex.

For example, during the implementation of the Retail Distribution Review, we undertook a great deal of work with FSA on Holloway income protection products, which are only available from friendly societies. FSA accepted that contracts with a low investment content (known as 'Holloway lite') would not be classified as investments, and therefore would be governed under ICOBS rather than COBS rules.

FCA has taken a different approach to the IDD and PRIIPS, assuming all Holloway contracts are investment products, and all are with-profits. This will have severe repercussions for some Holloway providers, as it will prevent them from distributing products on a non-advised basis; it is also inconsistent with the current approach which means that Holloway-lite products are not classed as investments or complex. FCA has persistently resisted proper engagement on this and has not taken the issue into account in its CBA, where it is clear the consequences are different for mutuals as the product is unique to the sector.

Chapter 8

- 16. Is our approach to giving vulnerable consumers greater levels of protection the right one?*

We agree, and value the work FCA is undertaking to protect vulnerable consumers.

Chapter 9

17. *Is our approach to the effectiveness of disclosure based on the right assumption?*
18. *Given the evidence, is it appropriate for us to take a more 'interventionist' approach where conventional disclosure steps prove ineffective?*

FCA's work in behavioural economics is helping to inform the regulator and industry on how to frame disclosure more effectively. It is important that FCA acts on its own learnings. A good example is the tendency for consumers to select general insurance products on price alone, only to find that at the point of claim they were inadequately covered. Comparison websites reinforce human nature to focus on price and do not help properly assess value for money or whether key features are included.

FCA's recent decisions on disclosure at renewal on general insurance products makes the same mistake of factoring price over all other product features. We are concerned that this leaves customers more exposed to buying unsuitable products in future.

Chapter 10

19. *Do you think our approach to deciding when to intervene will help make FCA decisions more predictable?*
20. *Are there any other factors we ought to consider when deciding whether to intervene?*
21. *What more do you think we could do to improve our communication about our interventions?*

We broadly agree with the approach to intervention.

As a trade association that represents smaller organisations that are largely not represented elsewhere, it is of concern to us that FCA has markedly reduced the level of engagement with trade bodies. The role of the FCA Panels is different, and individuals involved are expected to offer a personal perspective, not a sector one. Thus, it is often the case that it only becomes apparent that new rules are ill-designed or disproportionate after a consultation paper has been issued, and when the proposed policy is set.

FCA has a challenge in getting the best out of its fixed vs flexible portfolio approach to supervision. At present, we see that the vast majority of resources are given to fixed portfolio firms, and for flexible portfolio firms, interaction is limited largely to data collection and thematic reviews. This may be an area where more and better engagement with representatives can improve outcomes.

Chapter 11

22. Is there anything else in addition to the points set out above that it would be helpful for us to communicate when consulting on new proposals?

We agree with the approach, though we often do not see clear evidence that the policy approach has fully considered how changes will be assessed or how the benefits assumed of a new approach are borne out post-implementation.

Chapter 12

23. Do you think it is our role to encourage innovation?

24. Do you think our approach to firm failure is appropriate?

We would like to see greater commitment from FCA to exploring how it can encourage new entrants into markets. For example: in the last 30 years only one new retail mutual insurer has been created (The Military Mutual) and this was only possible after very extensive and costly regulatory engagement over a number of years, and by a focus on products which are mainly discretionary and therefore not regulated; equally amongst credit institutions the policy response to improving the authorisation process for new banking licenses has tended to hasten the launch of new challenger banks- based on the same model as organisations for which the original intent was to become an antidote to- rather than to nurture corporate diversity that might avoid the herd instinct that exacerbated the financial crisis.

Chapter 13

25. Do you think more formal discussions with firms about lessons learned will help improve regulatory outcomes?

26. Do you think that private warnings are consistent with our desire to be more transparent?

We consider formal discussions of this nature will help broader understanding of regulatory aims and contribute to better consumer outcomes.

Additional questions from FCA website

27. How can we better communicate the choices we make?

The trade associations meeting on 18 January was a helpful way of exploring the approach to the FCA Mission. In the recent past, FCA has been less inclined to engage with trade bodies on a coordinated basis. We consider this will help ensure communications with member companies is better informed and more constructive.

In the past, FSA and FCA published a details risk outlook. This was useful in understanding the specific risks the regulator was addressing, what emerging risks they were monitoring, and how this translated into specific themes in the business plan. There is now less focus on the risk outlook, and in particular less correlation between the risk outlook and the business plan.

28. Who should be included in our definition of a vulnerable consumer? What should more protection look like? Are there vulnerable consumers in the wholesale space? If so, who?

The definition of vulnerable people is not likely to be constant, just as the people defined as vulnerable will change regularly. FCA has undertaken valuable work in identifying different consumer cohorts and the varying needs for protection, and this is a useful approach for the future.

FCA's recent thematic review into vulnerable customers is a good example of where the understanding of vulnerability, and the mitigating actions that can be taken, is still developing. To illustrate, a google search of the term 'vulnerable customers' yields responses mainly from the FCA, and from firms responding to FCA's thematic work. Examples from other industries are limited, and there is a role for FCA to work with regulators in other sectors to better understand the constituent elements of vulnerability, and the ways of addressing the needs of vulnerable customers.

29. In which circumstances are prescriptive rules or higher level principles more appropriate?

Prescriptive rules are often particularly helpful for smaller organisations, as they help make regulatory intentions clearer for organisations who lack the resources to test the boundaries of regulation. The use of guidance can be problematic for firms, particularly with the implication that because guidance is not rules it is not binding; albeit the guidance in conjunction with principles is often used as a threat which has the same effect as rules.

30. How can we best engage with 56,000 firms taking into account their different requirements and needs?

The skills and knowledge of the contact centre are key in ensuring the majority of firms, who are supervised on a flexible portfolio approach, have reliable support.