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Financial Conduct Authority

31 August 2021

AFM Response to FCA guidance consultation GC21/3, proposed changes to the guidance on Part VII transfers

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 proposed changes to the guidance, and their consequences for insurers in scope.

About AFM and its members

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 £19.6 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 and to take account of corporate diversity³.

¹ ICMIF, <https://www.icmif.org/publications/market-insights/market-insights-uk-2016>

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>

AFM comments on the proposals

4. We agree with the need to review the guidance, both to address changes as a result of the UK exit from the EU, as well as to clarify general expectations. Our experience of transfers is that much of the time, and of the costs involved, occurs due to regulatory requests during the transfer process. Often these arise late in the day and cause significant stress to the time plan.
5. By enhancing the guidance, we can expect that firms can better understand earlier what is expected from the FCA, and that this will reduce last-minute queries. We wrote to PRA in April 2019 on the subject of transfers, and await a response on other aspects of the regulatory expectations which we consider would benefit from review (copy attached).
6. We also note a deliberate intent to provide the guidance in more everyday language, and we expect that this will help firms to understand and adopt the guidance more regularly.
7. We note that the compatibility statement does not reference the obligation (as set out in paragraph 3 above) on FCA to explore the potentially different consequences for mutuals. We think that was an unhelpful omission, because it would have served to remind firms that Part VII rules apply to mutual insurers, but not to friendly societies. The consultation has also been issued against the backdrop of a contentious transfer of a mutual society that is currently underway.
8. For example, in paragraph 4.10 (and 4.16), the guidance indicates a firm should satisfy themselves the proposals will not have a material adverse impact on policyholders. In our experience, transfers that take effect within a demutualisation do invariably have a material adverse impact: through a reduction in the quality of service provided, a more combative approach to claims-handling, and via reductions in investment returns. We agree that it is a legitimate expectation to expect this to be addressed by senior management, but it is important also that FCA assesses the transfer in this light, particularly where it also corresponds with a change of status.
9. The revised guidance seeks to place extra expectations on the Independent Expert. We anticipate that this will raise further the costs of the IE, without necessarily delivering the absolute endorsement FCA seeks. For example, in its recent [Inquiry into the planned demutualisation of LV=](#), the All-Party Parliamentary Group for Mutuals, indicates the IE is not perceived as being independent enough, and that “it’s very rare for such an expert to oppose... they are appointed by the

leadership of the business [seeking to demutualise] and are paid for by that organisation". We plan to raise this further with PRA, as per our own 2019 letter, as we also consider there are alternative solutions to increasing independence, and to making the costs more proportionate.

10. We note that the changes proposed to the text, to reflect the UK exit from the EU are relatively straightforward, and we agree with all changes made in this respect.
11. We would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,



Martin Shaw
Chief Executive
Association of Financial Mutuals

Annex: AFM letter to PRA on transfers, April 2019

Association of Financial Mutuals, April 2019

Addressing obstacles to transfers in the sector

Introduction

1. At a recent meeting with PRA, we had a discussion on what barriers there were to mutuals working more closely together to achieve scale, including through mergers and transfers, as per the following extract from AFM's notes from the meeting:
 - *"This also led to a discussion on scale and the possible need for consolidation: with the likely high costs of managing the CTF book and expected outflow of funds from 2020, PRA speculated this might lead to a transfer of funds and/ or consolidation. We explained that as well as the usual barriers to entry, the sheer costs in transactions meant that they were increasingly unproductive. We suggested a cost of £0.3 million to £0.5 million on each side was typical, though £1 million each was not uncommon, and that this use of members' money was difficult to justify.*
 - *AFM agreed to investigate the current actuarial and other costs with a view to exploring what costs could be reduced in the current framework, and whether PRA might explore a 'fast-track' process similar to that recently developed for new approvals."*
2. This note explores the current situation, and with input from a range of relevant professional services providers, explores options to streamline work or reduce costs in transfers.

The current situation

3. The level of transfers in the sector now is low compared to those in previous years. To illustrate, ten years ago the Association of Friendly Societies had 46 members, and a third have ceased to trade since, though there have been no transfers since Teachers Provident into LV= in 2016, and only a limited volume of partial transfers in recent years.
4. Amongst some of the factors that have contributed to that reduction in activity may be:
 - a. The least sustainable organisations have now exited the market;
 - b. The sector has doubled market share since 2008 (from 5% to 10%) indicating strategies are working and most businesses are largely stable;
 - c. The professionalism of boards has increased and is combined with relatively high turnover of Executive, leading to new appetite to invest in businesses;

- d. However, there is a reluctance by some Boards to accept that their business model may not survive, and a reticence to explore strategic options: AFM's note on Duties of Directors covers this in part;
 - e. The legislation for friendly societies dates back to 1992 and does not permit the Part VII approach available to Companies Act Mutuals;
 - f. Some of the traditional 'white knights' have grown more wary of taking on new books of business, which only offer a marginal economic benefit (at best); and
 - g. Regulatory demands have increased the complexity and cost of transfer disproportionately.
5. In relation to the final point:
- a. Actuarial costs for the simplest form of transfer (within the same group and just moving policies from one fund to another in the same overall firm), are typically in the order of £60,000 to £70,000. More complex transfers, and those involving larger actuarial firms will be many multiples of this.
 - b. Legal costs start at a similar level, though where a firm does much of the preparation work itself, it can see these costs reduce dramatically.
 - c. There is only limited economy of scale accorded to the size of the transfer, often because there are a wide range of parties involved.
 - d. In our members' experience, it is quite common for the core work to represent only around 50% of the final actuarial or legal cost, with the rest made up of addressing queries from the regulators, which often arise late in the process. Whilst a certain amount of project management and planning- as well as early engagement with PRA and FCA- will foresee these, for smaller organisations queries may be less standardised, due both to the uncommon nature of the business and less familiarity within the regulators.
6. The consequence of the high costs involved are that a firm receiving a transfer has to be able to demonstrate an increase in policy sales, or a reduction in cost base to justify the decision, and that may nowadays be a high hurdle for a mutual to accept.

Proposals to streamline the process and reduce costs

7. Some of the practical suggestions from professional advisers, to help reduce the costs of transfers are set out below. They support the view that the costs and timescales can be significantly reduced by a bespoke and simplified regulatory process for small insurers/mutuals. The suggestions include:
- a. A separate and more streamlined regulatory approach for smaller firms (with funds under a defined limit), such that the PRA could delegate approval, based on actuarial advice from a single party that both sides agree to. This is similar to Court Experts appointed on a Single Joint Expert basis where one expert advises the Court on a dispute or issue between two parties. Regulators might look to the process for 'change in control' as well, as an approach that might be adapted to low value transfers. This approach would still need all the parties to prepare relevant reports and papers to demonstrate the transaction makes sense, but

excluding PRA/FCA (on a delegated basis) might help expedite the smaller and more straightforward cases.

- b. Another legislative option, in cases where a friendly society sought to transfer its entire business, would be to update the Friendly Societies Act 1992 to provide for an amended transfer process for smaller transfers by HM Treasury order under the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 (albeit the Act is not designed for this purpose and requires transfer to a subsidiary).
- c. Given the likely unavailability in the short term of solutions relying on primary legislation (like a and b above), in the meantime it should be possible whenever feasible to permit a single legal advisor to the transaction rather than advisers to each side. This may not be possible on larger or contentious transactions but should be on smaller transactions, as long as the commercial terms are decided in advance: this will help avoid legal point scoring and streamline regulatory requests.
- d. The requirement for mutual companies to seek court approval (under part VII) might similarly be disposed of for small scale transactions, or made more proportionate, for example with regard to the appointment of the Independent Expert. This would reduce time and legal costs significantly.
- e. Legal and actuarial complexity could also be streamlined by the adoption of a 'model form' set of documents by PRA and FCA. This might for example include a skeleton member communications pack that covers the main areas expected from the regulators and helps firms assimilate information, and to devote sufficient time to the early stages of preparation to reduce later queries. This might draw on a simplified version of previous regulatory papers on Part VII transfers and/ or Friendly Societies Act transfers.
- f. The regulatory rules also need to be reviewed to provide fair value to members of the receiving scheme. Currently, it is difficult to envisage why a firm would want to take on the liabilities of a business with limited solvency and/ or a faltering business plan, given the potential disruption to the business, the risks and potential complexity of the transfer, the costs of the transaction and the absence of a reward for the economy of scales. (Specifically, regulated rules for with-profits fund transfer mean the maximum that can be charged to the transferring fund is the actual expenses incurred.)
- g. PRA has recently invited one of AFM's Associates, with a legal and regulatory background and plenty of experience of transactions, to do a training session on friendly societies for the in-house legal teams from both the PRA and the FCA. This is a sensible step forward that might be extended to other areas of the regulators, given that these transactions are not all that frequent.

8. We would be happy to explore these issues further.

Association of Financial Mutuals, April 2019