Future Regulatory Framework Review
Financial Services Strategy
HM Treasury
1 Horse Guards Road
SW1A 2HQ

AFM Response to HM Treasury consultation on Future Regulatory Framework Review

19 February 2021

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:

- Provide our views on the proposals set out in the consultation; and
- Highlight a particular concern on proposals for the regulation of capital management in very small insurers.

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 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] and to take account of corporate diversity[3].

[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

Introductory comments

4. We support the objectives of the review, and believe that as the UK now sits outside the EU, it is appropriate to explore how the regulatory framework should evolve. In our assessment, the UK benefits from effective, and largely successful, regulation, and we consider that this is because of- not in spite of- the EU standards to which we have been previously committed.

5. Brexit offers a vital opportunity to reassert the structure of regulation in the UK, but we consider that should build on- and not dismantle- all the structures we have in place today, which offer consumers a high level of protection.

6. The review also provides scope to re-explore the role of insurance in supporting wider societal aims: as per paragraph 2.38 of the consultation, that has to include a role for insurance in 'building back better' during the forthcoming recovery, and in adapting the economy to climate change. Competitive forces can only go so far in supporting the needs of underserved parts of the population, and ensure that there is a level playing field between large and small, old and new, listed and mutual, UK and overseas, is vital in facilitating sustainable growth.

7. Just as important as making the UK an attractive place for overseas firms to do business, is the need to ensure UK consumers who buy products from overseas firms, are afforded equal protection, compared to purchases from UK firms. In recent years, we have seen a number of defaults to the Financial Services Compensation Scheme from overseas insurers, typically passporting into the UK from a jurisdiction where supervisory overview was insufficient and capital requirements lax. The cost of these failures is borne by UK consumers. The same is true of cybercrime and fraud, so the regulatory framework needs to be better at protecting the perimeter.

8. The UK/ EU trade deal does not currently extend to financial services. We consider this is a vital requirement to enabling the market to work effectively. Whilst AFM members generally only sell products to UK citizens, over time we have seen a significant level of migration, and currently there is no consistent view on how UK insurance providers continue to serve customers who have moved overseas. This means for example that if someone retires to Spain, there is a risk that their UK-earned pension may not be paid out, their UK-funded healthcare will be cancelled, and their UK bank account cancelled. We expect the current situation will create significant problems over time.

9. We have commented at length on the Treasury's Call for Evidence as part of its Review of Solvency 2, and we also welcome the confirmation that Government is committed to reviewing the PRIIPs regime. As a result, we have only selectively commented on issues put forward in this consultation.

<u>Post-EU framework approach</u>

10. We support the broad framework set out in Chapter 2, and the five main elements proposed in paragraph 2.33. In particular, the purpose of the regime, as set out in relation to insurance, sets out relevant general functions for the PRA. We also agree that FSMA remains a relevant way to take forward reforms.

11. However, we are very concerned by the inference under 'scope of the regime' in paragraph 2.36 that Treasury is minded to move from two regimes for prudential regulation of insurers, to one (i.e. for regulation of Solvency 2 firms and non-Directives). Whilst we agree there is scope for the regime to be more linear, so that high level principles are recognised across all insurers, we do not consider that a single coherent regime is an appropriate aspiration.

12. Most UK insurers that sit outside the Solvency 2 regime continue to operate a system of prudential regulation based on the Solvency 1 regime. Many non-Directive insurers are very small companies, and any practical advantage from a supervisory perspective of moving them towards a Solvency 2-type regime would be overshadowed by the cost and complexity this would introduce.

13. Across AFM's 43 members, we have 29 in the Solvency 2 regime, 10 subject to Solvency 1, and 4 that are not regulated by PRA as they are not insurance providers. When Solvency 2 was first introduced, PRA considered whether there was merit in developing a simplified regime for non-Directives, based on Solvency 2 pillars, but soon recognised the idea lacked proportionality.

14. In our assessment, almost all AFM members that sit outside Solvency 2 would be unlikely to be able to introduce even a highly simplified approach. This would lead to wholesale closures or transfers, with a consequent loss of choice for consumers. As many of these businesses serve customers who are underserved by traditional insurance providers, this would materially affect the financial prospects of some of our more vulnerable consumers.

15. Historically, Treasury has a responsibility for assessing the adequacy of corporate governance standards for the mutual insurance sector (in the aftermath of the Equitable Life collapse in 2000/01). This led to the development of the AFM Corporate Governance Code, to help assure high standards in the sector. As an example of self-regulation, we consider there may be more scope for trade associations to help maintain standards, in areas where the regulators assess there is a potentially low risk overall, and where regulatory resources are limited. In the case of non-directive insurers for example, a self-regulatory approach would be likely to produce better consumer outcomes than a heavy-handed Solvency 2-led regime.

Accountability and regulatory structure

16. We agree with the sentiments in paragraph 3.53, which considers that one aspect of the UK regulatory framework that needs strengthening now is on accountability, and in holding regulators to account. A valuable role performed by the European Supervisory Agencies, as well as by peer scrutiny across 27 EU states, is the capacity to scrutinise decision-making. We consider that more effective scrutiny is needed in the UK, both of the role of Treasury and the regulators; as well as on the effectiveness and cost efficiency of the regulatory framework.

17. We consider that this will properly incentivise the appropriate degree of coordination between Treasury and the regulators. We also consider that an effective Memorandum of Understanding between Treasury and the regulators must include a clearer oversight function, to ensure the PRA and FCA's activities are clearly delivered against the objectives laid out in FSMA. This includes the capacity for Treasury to assess how effectively the regulatory framework has been in facilitating a competitive market for financial services, in which consumers are effectively protected, but also in which firms of all size, shape and form can compete effectively.

18. To illustrate, government extended the regulatory principles for PRA and FCA in 2016, to account for corporate diversity[4]. However, since that time we have seen no recognisable increase in focus of the PRA and FCA to exploring how the policywork and supervisory actions affect the mutual sector, and the regulators' annual reports and business plan have not commented on how they are discharging this priority.

19. There is a longer standing obligation on the PRA and FCA, via FSMA, for the regulators to consider as part of any new consultation, whether there are different consequences from new rules on mutuals[5]. We would

[4] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted
[5] http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted

like to see this obligation extended to Treasury, as part of their impact assessments. We would also like to see the regulators undertake this obligation more thoroughly: all too often consultations include a standard phrasing, which suggests only passing consideration. These statements do not set out what form of investigation has been taken, or what factors were taken into account to assess the impact.

20. We also consider greater energy should be devoted to post-implementation review, to consider whether the factors used in the cost-benefit analysis, which were used to justify a course of action, are borne out in reality. Very often speculative assumptions are made to set out the benefit case for a rule change, with a lack of thorough research, but which results in significant costs for industry.

21. To illustrate, FCA's analysis on general insurance pricing and values had been made entirely by reference to the research it has undertaken on the markets for motor and home insurance: as quasi-compulsory products, the consequences of increased costs are quite different to products which see more price elasticity of demand. Were regulators habitually committed to undertake post-implementation reviews, for rule changes with significant consequence, we consider they would be more rigorous in their original CBA, and as a result focus resources on the areas of greatest potential harm.

22. Any review of the regulatory structure should also take account of the satellite regulators, including the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS). In our assessment, there is significant scope for improvement: FCA has acknowledged that the costs of FSCS- over £1 billion for 2021/22- are unsustainable, and more effort needs to be made on problem firms before they become failures. The EIOPA review of Solvency 2 considered insurance guarantee schemes, and recovery and resolution, and we consider the UK Government should consider whether the FSCS continues to fulfill an effective role in insurance. Equally, FOS continues to perform inefficiently, and reviews high numbers of cases on an individual basis, which should be better considered in aggregate by FCA. We consider the accountability mechanisms, as set out in paragraph 3.25, should be extended to consider regulatory performance in the round.

23. We also consider that this framework should extend to the Financial Reporting Council (FRC, soon to be replaced by the Audit, Reporting and Governance Authority). The totality of reporting requirements, from PRA, FCA and FRC is very cumbersome and expensive for small mutuals, and a further layer of climate change report is only welcomed if it is introduced in a coherent and proportionate manner. In addition,

we have recently reported to FRC (and BEIS) how raised standards for external audit have produced a significant distortion to the supply and cost of audit to small mutuals. We think these are unintended consequences of regulatory intervention that did not take full account of the market changes it would produce.

24. The Treasury consultation also explores how the range of stakeholder panels and groups contribute to the regulators' policy-making functions. We make the following observations:

    a. The structure of statutory panels established by FCA, as set out in paragraph 3.43 ensures there is effective engagement with a range of key stakeholders: we particularly value the role of the smaller business practitioner panel in extending engagement to smaller firms.
    b. The single PRA industry panel has not in our assessment brought the same degree of scrutiny to the work of the PRA. The panel does not report publicly in any substance on its operations, and did not produce a report at all for 2019/20: where its remit seeks to cover all aspects of PRA regulation, AFM has never been extended an invitation to participate. The insurance sub-committee only meets occasionally and with a limited agenda.
    c. Where the FCA and PRA established a working group of practitioners to support its work on climate change, the group is entirely constituted of very large, listed organisations, and its outputs therefore offer very little value to smaller, mutually-owned organisations.

25. We would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Martin Shaw
Chief Executive
Association of Financial Mutuals