By email to: CP2_24@bankofengland.co.uk

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Prudential Regulation Authority
20 Moorgate, London, EC2R 6DA

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Dear Krish,

AFM Response to PRA CP27/23, Solvent exit planning for insurers

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, and
- Raise concerns about the apparent misunderstanding of the mutual sector and the impact of these proposals on them.

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). As a whole, the mutual insurance sector manage the savings, pensions, protection and healthcare needs of over 26 million people in the UK and Ireland, collect annual premium income of over £23 billion, and employ nearly 23,000 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 and AFM, 2023: https://financialmutuals.org/wp-content/uploads/2023/10/UK-Market-Insights-2023.pdf
[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 welcome the opportunity to respond to this consultation paper. We recognise that orderly exits by insurers are more likely to lead to better protection for policyholders, as well as lower costs, and that they help maintain market confidence.

5. The rationale set out for the consultation is *'to increase confidence that firms can exit the market with minimal disruption, in an orderly way, and without having to rely on the backstop of an insolvency or resolution process*'. We recognise the value of this, and note the action already being taken forward with deposit-takers. However, we think that in insurance there is more scope to remove barriers to exit (and transfer) and that, combined with a simpler set of requirements for exit planning, this may yield better results than imposing significant extra costs for the entire sector, especially for small firms.

Implementation

6. We note PRA intends to issue final rules and its supervisory statement in the second half of 2024, with implementation set for Q4 2025. We note that the proposed deadline broadly coincides with that for deposit-takers (1 October 2025), for whom the implementation date was set some time ago, and that therefore insurers will have much less time to execute all requirements. For the largest insurers, including bancassurers, PRA appears to have discounted the likelihood of the government's Insurance Resolution Regime going forward, as if it did, this would cause significant overlap and disruption. For mutuals, as we explain below, pre-existing work on removing barriers is also moving forward but to a different timescale, and for smaller insurers and non-Directive firms more generally the extra work will represent a significant burden.

7. Hence we consider the timeline PRA is working to is unnecessarily short, and would benefit from an extended implementation date.

A solvent exit or transfer

8. Paragraph 2.1 of the consultation sets out the process for achieving a solvent run-off, and recognises that an alternative to this might be to complete a sale or transfer of the business. The commentary refers to Part VII of FSMA and a scheme of arrangement under the companies act; however these options are not open to a friendly society, which operates with different legislative requirements. We are working with PRA on streamlining the M&A process for mutuals, and on removing

barriers to transfer. The government has also appointed the Law Commission to undertake a review of the Friendly Societies Act 1992, and we would anticipate this could level the playing field for mutual transfers.

9. Until then however, the text in paragraph 2.1 offers only a partial view on the alternatives to a solvent exit. This is particularly relevant because, as stated in paragraph 2.2, life firms (including all friendly societies) have historically exited the market by transfer rather than a solvent run-off of their liabilities. The situation is more mixed for general insurance, where the liabilities run-off much sooner, and where it is more straightforward to allow liabilities to run their course.

10. We would value more clarity around the point, as stated in paragraph 2.1, that: *"During a solvent exit, firms would still be required to comply with the PRA's statutory Threshold Conditions".* Footnote 1 of the consultation, and footnote 3 of the SS affirm that 'solvent' refers to a firm meeting its liabilities when they fall due. A firm could do this but fail to meet its regulatory capital requirement: so, does a solvent exit mean having just enough to meet liabilities, or just enough to meet regulatory capital requirements during the exit? If the latter, consider a Solvency 2 firm that is required to maintain a minimum capital requirement (MCR) of €4m; the implication is that this needs to be maintained until the firm is no longer a regulated insurer, ie that point when it demonstrates that it has no further insurance liabilities and applies for its permissions to be cancelled. The firm therefore either has to breach its capital requirements (and use up this capital to support the exit), or it exits with a significant amount of assets remaining. For a shareholder-owned company any residual value could be distributed, but for a with-profits company or mutual it is necessary to distribute this capital to members *as they exit*. If the liabilities are being transferred, this can be factored into the transfer terms: but in a run-off scenario this implicit requirement to meet ongoing capital requirements could result in issues around the equitable distribution of surplus funds. For a small mutual with a declining membership, this can represent significant value, and there is therefore a material difference in a plan to exit whilst remaining solvent, and one that seeks to maintain regulatory capital requirements.

11. We agree that solvent exit indicators, as set out in paragraph 2.9 on the draft supervisory statement, provide critical information to the board of an insurer on its future prospects. Insurers, particularly those in scope of Solvency 2, will monitor these regularly, and will recognise that a deterioration in one or more indicators will trigger a range of management actions, as per the 'ladder of intervention' established for Solvency 2 firms.

12. We consider more support is needed for non-Directive firms to monitor and recognise triggers to intervention. The consultation infers that these exist, though with imminent changes to Solvency 2 thresholds, we think it would be helpful for PRA to set out more clearly what indicators non-Directive firms should be utilising.

13. Where we consider the proposals for, and costs of, producing a solvent exit analysis are over-engineered and costly (for small firms at least), we do agree with the form of 'solvent exit execution plan' set out in chapter 3 of the SS. We consider early actions in response to materialised risks, or a reasonable prospect that a firm may need to execute a solvent exit, or vital, and the actions set out are wholly appropriate.

Cost-benefit case

14. The benefit case set out broadly assumes the best solution to a potential failure is solvent run-off; but as we state above, in most cases, a transfer of engagements is likely to yield a better outcome, particularly for policyholders, by maintaining policy cover. This is particularly for cases that involve investments, as well as long-term cover for life, health or income protection, where any change in customer circumstances may mean new cover is not obtainable, or not on the same terms.

15. PRA infers that the costs of implementing these proposals might be offset against savings in compensation costs paid by the FSCS. We agree that action is necessary to address FSCS costs, though as almost all of these costs in the last ten years relate to failings in passported-in general insurers, as well as intermediaries, we consider that the majority of actions are needed elsewhere and that the ambition of reducing insurer-related compensation by 10% is not likely to be achieved through the production of solvency exit analysis.

16. The cost case bundles over 80% of all insurers regulated by PRA as small. We think this is misleading as there is a very broad range of firms within this category. This includes non-directive firms with fewer than 5 employees and premiums of less than £1 million, through to quite sizeable businesses with a million or more policies under management.

17. The typical costs assumed by PRA range from £12,300 to £68,300 initially, as well as £3,200 to £18,700 every year. For very small firms we consider those costs are significant, and may represent a sizeable element of their total costs. The PRA estimate is that the work required on average 'would be equivalent to two full-time employed staff', but in very small insurers that is not a credible solution. Furthermore, the costs might be understated for small firms, for whom there is no internal resource to undertake the work, and who will therefore rely on external

consultants to undertake the work at much higher cost. For small mutuals, these extra costs may only be recovered from policyholder funds, since there are no shareholders to call on, and annual profits may be close to zero.

18. In assessing the position for deposit-takers in PS5/25[4], PRA provides much higher costs: for small deposit-takers the estimate is £25,000 initially and £10,000 annually. It is unclear whether the work involved is substantially less for an insurer: indeed, the draft SS attached to this consultation appears to copy across most of the approach required for banks and building societies. Further, as PRA indicates that the cost of producing a SEA for a deposit-taker is reduced because of the pre-existing recovery regime, it is very possible that the amount of work involved will be greater for an insurer. We do not share PRA's view, as expressed in paragraph 2.58, that for small insurers it is necessarily the case that '*a firm's preparations for solvent exit are based on the firm's own circumstances, business model and strategy, of which the firm itself is more likely to have the fullest understanding rather than external specialists'*. This is because for insurers there may be a degree of actuarial and legal assessment needed of aged books of business.

19. We consider that for small firms, a more practical approach to solvent exit planning would be for the board of a firm to maintain a simplified set of solvent exit indicators, and to review them annually, and to record their responses to a set of qualitative questions, which may include:

   a. Has there been a deterioration in any of the solvent exit indicators?
   b. Is there any other information available to the Board, to cause them to re-consider their future prospects?
   c. If either of the above indicates there is a greater risk of the business plan failing, what action is needed to modify the plan to ensure the current trend in indicators is corrected?
   d. How will the business measure these actions and assess the risks of them failing?
   e. If this action does not succeed, what action is necessary to protect the interests of policyholders and other stakeholders?
   f. If a transfer of engagements might present the best solution to a potential failure, how would management progress this?
   g. If a transfer of engagements would not lead to the optimal outcome, what further steps would be required to commence an orderly run-off?
   h. What review timescale is necessary for any actions needed?
   i. Is it necessary to inform the PRA of these actions?

[4] https://www.bankofengland.co.uk/prudential-regulation/publication/2024/march/solvent-exit-planning-for-non-systemic-banks-and-building-societies-policy-statement

Mutual specific considerations

20. PRA refers to the 'complex governance structures' of mutual insurers and friendly societies (paragraph 1.10). In the context of this paper that implies that it might be more difficult to achieve an orderly exit or an unambiguous outcome, or that the governance structure adds greater costs to consumers. We don't recognise that a member-owned business has any more complex a governance structure, or that this structure risks sub-optimal outcomes; and indeed PRA suggests in paragraph 2.36 that the impact of these proposals on mutuals is not different to that for other insurers. There is surely therefore either a contradiction in the PRA's views, or else that its analysis of the impact on mutuals was no more than superficial.

21. In general we do not recognise this 'complexity' in governance structure, and suggest that differences in business model and governance structure are a healthy factor within the market environment that PRA regulates. Indeed, FSMA recognises the value of corporate diversity, and our supervisory contacts in PRA regularly demonstrate that they recognise the need for an even-handed approach, and that they carefully consider proportionality in their actions.

22. Where we do see potential differences in business model, which PRA must take account of in their approach, and where the current statement on the 'impact on mutuals' is misleading, are in:

    a. Ownership: member-owned businesses have a simple and transparent membership structure; there are no complex or overseas shareholding or debt structures; and much less risk of a conflict of interests in pursuing the best outcomes for policyholders.
    b. Scale and simplicity: most mutuals and friendly societies are significantly smaller than the average insurer; most offer a limited line of products; and products may be simpler.
    c. Heritage: the mutual sector has a positive history in avoiding disorderly failures: policyholder protection has been maintained by a focus on transfers; during the financial crisis where some building societies failed, they were readily able to find a partner to take on their liabilities; governance lessons learned from the failure of Equitable Life nearly 25 years ago have strengthened processes today, particularly since the introduction of Solvency 2.
    d. Legislation: the Friendly Societies Act provides separate and distinctive arrangements for insolvent friendly societies and for

those going through a transfer of engagements. For example, the regulators have, under s90 of the Friendly Societies Act 1992, the power to compel a society to transfer: we consider this draconian and have called for it to be removed from the current Law Commission review of the Act, though in the meantime it might negate the need for an extensive exit plan by a friendly society. In addition, the solvency regime for friendly societies is set out in ss19-26 of the 1992 Act, and these businesses are therefore excluded from Part XXIV of FSMA. We note that in PS 5/24, the minimum voting required under the Building Societies Act was flagged as a potential barrier to the solvent exit of a building society[5]. PRA's solution for building societies was that they should raise the issue as a potential obstacle; given a similar issue in a friendly society, we would find it helpful if PRA could provide a more informed response to this issue, and whether it invalidates the benefit for a friendly society of a Solvent Exit Analysis.

e. Stakeholders: within the draft SEA, in paragraphs SS2.20 and SS3.14, PRA lists a set of stakeholders that may be impacted by a (solvent) exit. The list includes shareholders, which do not apply to mutuals, and does not include members- who are the owners of a mutual. We don't consider that setting shareholders as the default reflects the proper approach to corporate diversity that PRA is required by law to assume.

23. We would welcome the opportunity to discuss further the issues raised by our response. We are happy to be included in the published list of respondents.

Yours sincerely,

Martin Shaw
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Association of Financial Mutuals

[5] https://www.bankofengland.co.uk/prudential-regulation/publication/2024/march/solvent-exit-planning-for-non-systemic-banks-and-building-societies-policy-statement, paragraph 2.54