

With-Profits, Memorandum of Understanding

Purpose and scope

1. In the new regulatory framework, both the PRA and the FCA are responsible for regulating and supervising insurance companies. They will co-ordinate these activities under the framework set out in the main PRA/FCA MoU. In the case of with-profits policies, additional coordination arrangements are needed: this is because the returns on with-profits policies are not well defined, and are affected by certain actions taken at the discretion of the insurance companies in managing the with-profit fund, (“Relevant Actions”) which give rise to issues of both fairness to policyholders and the safety and soundness of insurers, and so engage the objectives of both regulators.
2. This Memorandum of Understanding (MoU) has been prepared in accordance with section 3F of the Financial Services and Markets Act 2000, as amended by the Financial Services Act 2012, (the “Act”) to set out the roles that the PRA and the FCA will have in relation to the regulation and supervision of with-profits policies.
3. Under with-profits policies, premiums are invested on a pooled basis and the returns to policyholders generally take the form of a guaranteed amount augmented by discretionary annual and terminal bonuses. These bonuses are intended to represent a participation in the fund’s profits, but the distributions of profits are from year to year to a large extent determined at the discretion of the insurer.
4. This exercise of discretion gives rise to questions of fairness – as between policyholders and shareholders of the insurer, for example, and also between different groups of policyholders – and that is a matter for the FCA. The PRA on the other hand has responsibility under the Act for measures designed to contribute to the securing of an appropriate degree of protection for current and future policyholders. The PRA will therefore be concerned about the impact on the safety and soundness of insurers, and in particular their solvency, of any Relevant Actions taken or proposed by the insurer. It will be the FCA’s responsibility to satisfy itself that firms are behaving fairly in relation to those Relevant Actions: the PRA’s concern will be to ensure that discretionary increases in liabilities do not adversely affect the insurer’s ability to meet, and continue to meet, the PRA’s standards for safety and soundness (and in particular its ability to meet the Threshold Conditions). In so doing, the PRA will contribute to the securing of an appropriate degree of protection for current and future with-profits policyholders.

Respective roles and responsibilities of the PRA and the FCA

(1) FCA

5. Subject to any contractual commitments such as guarantees, and to regulatory requirements, insurers have considerable discretion in respect of the Relevant Actions they may decide to take. In determining policyholders’ benefits, there may be a conflict between, on the one hand, the interests of policyholders whose policies are maturing or being surrendered, and on the other hand, the interests of policyholders whose policies are remaining in the fund. Many with-profits funds also write other types of insurance business, which can give rise to a further conflict since the capital and reserves

required to support the risks of this business reduce the profits available for distribution. The framework for the distribution of any returns must be set out in the policy documents and other policyholder communications including, for most with-profits funds, the Principles and Practices of Financial Management (PPFM).

6. It is an insurer's responsibility to treat policyholders fairly in managing its with-profits fund, and to exercise its discretion to take Relevant Actions so as to ensure any proposed changes which might affect benefits or payments are consistent with its previous communications to policyholders, the FCA's conduct rules and the insurer's overriding obligation to treat customers fairly. It will be the FCA's responsibility under the Act to regulate and supervise insurers to ensure that they do so.
7. If an insurer persistently fails to deliver a return to policyholders that the FCA would consider to be fair (either for affordability reasons or otherwise), or otherwise takes Relevant Actions that are not fair to one or more groups of policyholders, it should expect supervisory intervention by the FCA.
8. The FCA will also be concerned with other conduct-related matters such as the regular activities performed by insurers in operating with-profits funds. These may involve conflicts of interest between with-profits policyholders as a class and others, or between different groups of with-profits policyholders.

(2) PRA

9. The PRA has responsibility under the Act for promoting the safety and soundness of firms and contributing to the securing of an appropriate degree of protection for current and future policyholders (including those holding with-profits policies of insurance). As part of its on-going assessment of whether an insurer has appropriate financial resources to meet the Threshold Conditions, the PRA will consider whether Relevant Actions that the insurer has proposed, and which the FCA considers to be fair, are also affordable. In particular, the PRA will expect an insurer to establish and maintain adequate financial resources in respect of both guaranteed and discretionary payments to with-profits policyholders.
10. Where any Relevant Actions proposed or taken by an insurer raise concerns as to their affordability or otherwise affect the PRA's objectives, the PRA will consider (together with the FCA and the firm) different approaches that both the PRA and FCA would consider to be compatible with their respective objectives. This may ultimately result in the reduction or cancellation of some or all of any discretionary benefits or payments that the insurer had otherwise proposed to make.
11. Where the two regulators are unable to reconcile their concerns, the PRA may exercise the power of direction bestowed on it by section 3J of the Act so as to require the FCA not to exercise its regulatory powers or not to exercise them in a specified manner.
12. Section 3K of the Act provides that publication of the power of direction is not required where the PRA decides that publication would be against the public interest. In making this decision, the PRA will consult both HM Treasury (as required by the Act) and the FCA.

How this will work in practice

13. The role of each regulator in relation to some Relevant Actions is set out below.

Investment strategy

14. It is for insurers to set their own investment strategies within the confines of applicable law and regulatory/supervisory constraints. In respect of with-profits funds, these will be articulated primarily (though not exclusively) through each insurer's Principles and Practices of Financial Management (PPFM).
15. The PRA will consider the effect of those proposed investment strategies on an insurer's overall solvency and liquidity position.
16. The FCA will review the insurer's strategy for consistency with its statements to policyholders and check that the insurer has appropriate governance around the purchase, retention and sale of investments to support that strategy.

Amounts payable to with-profits policyholders

17. It will be for the FCA to operate rules to ensure that proposed payments or other benefits for with-profits policyholders are fair, having regard to the insurer's PPFM and its communications with policyholders, as well as the need for fairness between different classes and groups of policyholders.
18. The PRA will be concerned with the implications of proposed benefits on an insurer's ability to meet its prudential requirements and so whether the insurer would continue to meet the Threshold Conditions. The PRA will have regard to the need for insurers to maintain adequate reserves to meet expected bonus or other discretionary payments, as well as any declared bonuses or other contractual payments.
19. Where an insurer's proposed approach to the allocation of benefits is within the range of approaches regarded as fair by the FCA, but PRA considers that such an approach might adversely affect the safety and soundness of the insurer, the PRA may decide not to agree to that approach. As noted above, this may ultimately require the exercise by the PRA of its power of direction under section 3J of the Act, in appropriate circumstances.

Provisioning

20. The FCA will be responsible for judgements as to whether provisions in respect of future benefits to policyholders are consistent with a fair exercise of the insurer's discretion, having regard to its PPFM, its previous communications to policyholders and the FCA's conduct rules. In making this determination, the FCA will rely on the assumptions put forward by the insurer and will not be required to test the validity of those assumptions. That will be for the PRA in the context of its judgements about whether an insurer's proposed actions are compatible with its objectives. As the

provisioning will involve withholding surpluses potentially available for distribution now in anticipation of future liabilities, the FCA will be responsible for determining whether the distribution policy adopted is fair, including as between different classes and groups of policyholders, given the experience of the fund.

21. The PRA will be responsible for judgements as to whether the expected level of future discretionary payments included in the provisioning policy proposed is affordable, given wider considerations of safety and soundness. In making that assessment, the PRA will rely on any determination made by the FCA as to the fairness of the proposed distribution.

Charges & Expenses

22. The FCA will operate rules on the fairness of charges or expenses that may be levied on with-profits policies or with-profits funds, including compensation and redress payments. Particular issues arise in respect of shareholder-owned with-profits funds in terms of whether some expenses should properly lie with the shareholder or whether it is fair to charge them to the with-profits fund. Within the fund there is also the issue of whether charges should reduce asset shares or whether the costs associated with those charges should be borne by another part of the fund, reducing the likelihood of future distributions of excess surplus but leaving current asset shares untouched.
23. If the allocation or amount of charges or expenses is such that to meet them would compromise the firm's ability to meet its liabilities to policyholders, the PRA may consider (together with the FCA and the firm) alternative ways to approach the issue and, if necessary, may exercise its power of direction under section 3J of the Act. Where the insurer's ability to meet its liabilities to policyholders will not be materially affected, the PRA will not seek to intervene.

The governance of with-profits funds and communications with policyholders

24. The FCA will operate rules concerning the governance of with-profits funds with a view to ensuring that insurers identify and manage conflicts of interest and ensuring fair outcomes for policyholders.
25. The PRA's rules and policies will include those designed to ensure that insurers have appropriate financial resources to meet their liabilities and, more generally, satisfy Threshold Conditions.

Financial transactions

26. The FCA will operate rules to ensure that the terms of a financial transaction (such as a form of risk transfer, a contingent loan or other forms of support to the fund) are fair to policyholders.
27. It is the PRA's responsibility to assess the effect on the financial soundness of a with-profits fund of a financial transaction that is significant in the context of the particular insurer concerned.

Reattribution of inherited estate

28. A reattribution of inherited estate will need to be considered by each regulator to assess its implications for their own objectives and, if appropriate, sanctioned by the Court.
29. In particular, the FCA will consider, and (as appropriate) offer its view to the Court on, whether any payments or adjustments to benefits offered to with-profits policyholders as part of the reattribution are within the range of fair outcomes.
30. The PRA will consider, and (as appropriate) offer its view to the Court on, the effect of the scheme and any payments or adjustments to benefits associated with it on the insurer's financial soundness.

Part VII transfers

31. There will be separate arrangements between the PRA and the FCA in relation to their respective roles on transfers of insurance business under Part VII of the Act. To the extent that a proposed transfer relates to with-profits policies, the roles and responsibilities set out in this MoU will also apply.

Supervision and resolution of issues of common interest

32. In cases where the PRA has no affordability or other concerns arising from its objectives in relation to with-profits policies, firms can expect to deal primarily with the FCA, as considerations of fairness are likely to determine the outcome.
33. In circumstances where the regulatory requirements of the PRA and the FCA could produce an inconsistent outcome in relation to the discretionary benefits afforded by with-profits policies, section 3J of the Act makes clear that the PRA is empowered to resolve this situation in favour of its objectives.
34. For conduct of business matters that do not trigger affordability concerns or other issues arising from its objectives, the PRA will have no role or responsibility.
35. Each regulator will notify the other in advance of any proposed legal or regulatory action or supervisory intervention that appears likely to be materially relevant to the other regulator's objective(s).

Information sharing

36. Timely and focused exchange of relevant information is essential to delivering effective supervision of with-profits insurers. The same principles as set out in the standard PRA-FCA MoU will apply to the PRA's and FCA's functions in this area. In addition, each regulator agrees to share any concerns that it may have in relation to any firms writing or having written with-profits policies which are relevant to the other's objectives.

Rule-making

37. Both the PRA and the FCA will have rule-making powers in their respective areas of competence. The PRA will have responsibility for prudential rules that affect with-profits insurers, while the FCA will have responsibility for rules which relate to conduct of business. Where the rules have the potential to trigger affordability and fairness concerns, the regulators will seek to identify the possible read across to each other's areas of competence. The same principles as set out in the main PRA-FCA MoU will apply to the PRA's and FCA's functions in this area. Each regulator will consult the other in advance of proposing any changes to its rules in relation to with-profits business as part of any pre-consultation process. Any amendments to existing rules will also be subject to any required consultation process.

Maintaining and amending the MoU

38. Each regulator will appoint a senior executive responsible for the co-ordination set out in this MoU. For the first year following the introduction of the new regulatory framework, the regulators will meet quarterly to review the effectiveness and efficiency of co-ordination and co-operation and at least annually thereafter.
39. The Boards of each regulator will review each year how the MoU is working, taking into account any feedback received from with-profits insurers, their policyholders and other interested parties. The regulators' annual reports will include a summary of the key points from these reviews.
40. As a result of these reviews, each regulator will decide whether there is a need to update its existing rules or guidance, or its policies, relating to with-profits insurers or the arrangements set out in this MoU. Any amendments to the MoU are subject to approval by the Boards of both regulators.