



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP22/14

The Prudential Regulation Authority's approach to with-profits insurance business

October 2014

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Responses to CP22/14
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1 Overview

1.1 This consultation paper (CP) sets out proposed changes to the Prudential Regulation Authority's (PRA's) regulation of UK with-profits insurance business. This CP:

- clarifies the PRA's role and objectives in relation to with-profits in light of the framework of co-ordinated supervision of with-profits business as set out in the with-profits Memorandum of Understanding⁽¹⁾ (WP MoU);
- explains how the new PRA Rulebook will affect the current designation of with-profits provisions within the existing shared Handbook; and
- proposes changes in anticipation of prudential regulations associated with Solvency II.

1.2 This CP is of interest to all insurance firms that write⁽²⁾ with-profits insurance business within the United Kingdom, whether or not they are within the scope of Solvency II. It proposes rules which are intended to apply to both Solvency II firms and non-Directive firms.

1.3 The Financial Conduct Authority (FCA) is simultaneously publishing feedback statement FS14/1⁽³⁾ to set out its conduct approach to the regulation of with-profits insurance business.

Background

1.4 In CP12/13⁽⁴⁾ the Financial Services Authority (FSA) consulted on proposed amendments to with-profits rules and guidance in the Conduct of Business Sourcebook chapter 20 (COBS 20) which it felt were required to achieve its aims under Solvency II. This included incorporation of some rules and guidance relating to the governance of with-profits business contained in a number of other sourcebooks.⁽⁵⁾

1.5 Subsequent to the publication of CP12/13, the Financial Services Act 2012 split the FSA's functions between the FCA and the PRA, each of which was given its own new statutory objectives.⁽⁶⁾ At legal cutover, each regulator designated those rules and guidance within the existing FSA Handbook that it wished to retain within its own regulatory framework. For the PRA, this included some with-profits provisions within COBS 20. A designation in respect of the amendments to COBS 20 proposed in CP12/13 was not completed at that time, as those rules had not been made.

1.6 Since then, the PRA has been considering the rules in respect of with-profits insurance business that it needs in order to advance its objectives, taking into account the:

- PRA's approach to insurance supervision;⁽⁷⁾
- PRA's responsibilities under the WP MoU; and
- Solvency II Directive.

Objective of this consultation

1.7 This CP sets out the PRA's proposed approach to regulation of with-profits insurance business and how this will interact with the FCA's proposed amendments of COBS 20 set out in its feedback statement FS14/1.

1.8 As part of the creation of the PRA Rulebook, the PRA proposes to delete all existing PRA-designated COBS 20 provisions and replace them with three new prudential rules applicable to firms with UK with-profits insurance business, which are consistent with the considerations set out in paragraph 1.6. The proposed rules address the following areas relevant to the prudential regulation of with-profits insurance business:

- assets in the with-profits fund;
- distribution strategies; and
- support arrangements.

1.9 Rules addressing these topics are needed to enable the PRA to advance its general and insurance objectives. For firms that will be subject to the Solvency II Directive, these rules are also intended to ensure that the Solvency II and UK with-profits regimes operate together in a coherent and

(1) The with-profits MoU between the FCA and PRA is available at: www.bankofengland.co.uk/about/Documents/mous/mouwithprofits.pdf. The FCA and PRA also have a general MoU which is available at: www.bankofengland.co.uk/about/Documents/mous/moufcapra.pdf.

(2) By referring to firms that write with-profits business, the PRA intends for this to capture not only firms which actively write new with-profits business, but also firms with closed with-profits funds.

(3) www.fca.org.uk/news/feedback-statements/fs14-1-solvency-ii-cobs-rule-changes.

(4) *FSA Consultation Paper CP12/13*, 'Transposition of Solvency II: Part 2'; www.fsa.gov.uk/static/pubs/cp/cp12-13.pdf.

(5) Prudential Sourcebook for Insurers (INSPRU); General Prudential Sourcebook (GENPRU); Interim Prudential Sourcebook for Insurers (IPRU(INS)); and Supervision (SUP).

(6) More information on changes in the regulatory landscape is available at www.bankofengland.co.uk/pru/Pages/default.aspx.

(7) More information on the PRA's approach to insurance supervision is available at: www.bankofengland.co.uk/publications/Documents/prapproach/insuranceappr1406.pdf.

consistent way. The content of these rules and underlying rationale is addressed in Chapter 2 of this CP, which also contains the PRA's proposals for relevant glossary terms. In addition, Chapter 2 proposes a supervisory statement which sets out the PRA's expectations of firms in respect of with-profits business.

1.10 Although the PRA and FCA are required under the WP MoU to co-ordinate their activities in relation to with-profits insurance business, each regulator has different objectives and responsibilities. The two regulators have therefore issued separate publications to explain their proposals for the regulation of with-profits business subsequent to CP12/13. The advantages of this approach are that it:

- provides clarity for industry regarding the split of responsibilities pertaining to the regulation of firms that write with-profits insurance business; and
- allows each regulator to address its areas of responsibility with reference to its specific objectives.

1.11 The FCA has set out in FS14/1 its approach to conduct regulation of UK with-profits insurance business, including proposals for rules and guidance together with feedback on responses to the proposed amendments of COBS 20 published in CP12/13. As the PRA now proposes to delete COBS 20 from its Handbook, feedback on responses to CP12/13 will be addressed solely by the FCA in its publication (save in relation to the rules on surplus funds for which the PRA published feedback in CP16/14⁽¹⁾ — see paragraph 1.13).

1.12 The proposals set out in this CP will result in fewer PRA rules applicable to UK with-profits business than at present, but this does not mean that the PRA is no longer interested in the regulation of with-profits business. On the contrary, the PRA continues to view the regulation of with-profits business as an important element of its approach to insurance supervision. The PRA's intention is to provide a sharper focus to its regulatory regime, so that firms are clear on the respective roles and requirements of the PRA and the FCA in this area. The PRA and FCA will continue to liaise on the regulation and supervision of with-profits business according to the framework set out in the WP MoU, and the PRA's main responsibilities under the MoU are addressed in the proposed rules and draft supervisory statement.

1.13 The PRA included within CP16/14 its proposed rules on the calculation of surplus funds, which are relevant to UK Solvency II firms writing with-profits insurance business. As those rules constitute the relevant national law for the purposes of Article 91 of the Solvency II Directive, they were included within CP16/14 as part of the transposition of Solvency II.

Statutory Obligations

1.14 The PRA must, in discharging its general functions of making rules and determining the general policy and principles by reference to which it performs particular functions, so far as reasonably possible, act in a way that advances its general objective to promote the safety and soundness of PRA-authorized firms and its insurance objective to contribute to the securing of an appropriate degree of protection for policyholders. Considerations in respect of the PRA's secondary competition objective are addressed in paragraphs 1.23 and 1.24.

1.15 In developing the rules covered in this CP, and establishing its practices and procedures, the PRA has adhered to the eight regulatory principles which apply to the PRA. For example, one of the regulatory principles is that regulators should exercise their functions as transparently as possible. The PRA has followed this principle in trying to make clear, where relevant, how the proposed new rules outlined in this paper are consistent with the other rules and regulations that apply to firms with UK with-profits insurance business. In addition, the PRA has followed the regulatory principle of proportionality when developing the rules outlined in this CP, so that the costs imposed by those rules are expected to be proportionate to the benefits which they are expected to generate.

Cost benefit analysis

1.16 This section provides an economic analysis of the impact that the PRA's approach to with-profits, including proposed new rules within the PRA Rulebook and setting out PRA expectations within a supervisory statement, will have on firms that write with-profits insurance business.

1.17 The baseline for the cost benefit analysis is the set of with-profits provisions designated by the PRA at legal cutover, including those in prudential sourcebooks and in COBS 20.

1.18 The proposed new rules outlined in this CP would replace the PRA-designated rules in COBS 20. The PRA intends for these new rules to come into force at the same time as the commencement of Solvency II. From 1 January 2016, non-Directive firms would have to comply with these rules in conjunction with all PRA-designated rules in relevant prudential sourcebooks, while UK Solvency II firms would have to comply with these rules and the rules proposed by the PRA in CP16/14. All firms would also have to comply with any conduct regulations issued by the FCA in its Handbook.

1.19 The benefits of re-structuring the PRA's approach to with-profits as set out in this CP include:

(1) *PRA Consultation Paper CP16/14, 'Transposition of Solvency II: Part 3'*; www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1614.pdf.

- providing clarity for firms as to how the PRA's rules are consistent with the PRA's approach and objectives;
- reflecting the changes in the UK regulatory landscape by producing PRA rules and supervisory expectations, which complement those of the FCA, and recognise the different objectives and responsibilities of the two regulators, as set out in the WP MoU; and
- setting out a PRA UK with-profits regulatory framework that will align with Solvency II, when the Directive comes into effect.

1.20 The PRA expects that the proposals within this CP will lead to few additional costs for firms. Deletion of COBS 20 and the introduction of three new rules will reduce the number of prudential rules with which with-profits firms will need to comply. The new rules codify and clarify practices that the PRA already expects firms to adhere to in complying with the current UK with-profits regulatory regime. In addition, they build on the current with-profits regime and address changes in the UK regulatory landscape and the introduction of Solvency II.

Impact on mutuals

1.21 The PRA has a statutory requirement to state whether the impact on mutuals will be significantly different from the impact on other firms. The with-profits provisions proposed within this CP will affect mutual firms that write with-profits insurance business. The proposed rules and supervisory statement would apply equally to all firms that write with-profits business, both mutuals and proprietary companies.

1.22 As the incremental costs to firms are expected to be minimal, the incremental impact on mutuals is also expected to be minimal. Hence, the PRA does not expect that the proposals within this CP will have a disproportionate impact on mutuals.

Impact on competition

1.23 The PRA has a secondary objective to facilitate effective competition. This means that in taking action which advances its general and/or insurance objective it will be expected to act in a way which advances its secondary objective. The proposed PRA approach to with-profits insurance business involves issuing three new prudential rules, and supplementing those rules with a supervisory statement which sets out the PRA's expectations of with-profits insurers.

1.24 The PRA does not expect that the proposed rules and supervisory statement within this CP will have a significant impact on UK with-profits firms. Rather, the PRA considers that these proposals are required to ensure that the UK with-profits prudential regulatory regime is consistent with

the considerations set out in paragraph 1.19. As such, the PRA does not expect that these proposals will have a significant impact on competition within the UK with-profits insurance market.

Equality and diversity

1.25 The PRA may not act in an unlawfully discriminatory manner. It is also required under the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions. As part of this, the PRA assesses the equality and diversity implications of any new policy proposals considered.

1.26 The PRA considers that the clarification of the scope and objectives of its approach to with-profits insurance business in this CP will not have any direct or indirect discriminatory impact under existing UK law.

Responses and next steps

1.27 This consultation closes on 14 January 2015. Views are welcomed on the issues raised in the CP. In particular, respondents may wish to comment on the way in which the PRA has tailored the with-profits rules and supervisory statement to take into account the:

- PRA's objectives and approach to insurance supervision;
- framework of co-ordinated supervision of with-profits insurers with the FCA as set out in the WP MoU; and
- introduction of Solvency II.

1.28 The PRA will publish a policy statement with feedback, finalised rules and final supervisory statement in early 2015. The changes to the rules will come into force from 1 January 2016.

2 Proposed rules and supervisory statement

2.1 This chapter outlines the PRA's proposals for rules relating to the operation of with-profits insurance business. It also covers changes to relevant glossary definitions, and the PRA's considerations for a supervisory statement on with-profits business.

2.2 The proposed rules are set out in the draft 'With-profits' instrument in Appendix 1. For UK Solvency II firms, these rules would apply in conjunction with the rules proposed by the PRA in CP16/14, and the conduct rules in COBS 20 in the FCA's Handbook. For non-Directive firms, these rules would apply in conjunction with PRA rules in relevant prudential sourcebooks and the conduct rules in COBS 20 in the FCA's Handbook.

Prudential issues arising from with-profits business

2.3 The key feature of a with-profits policy is the opportunity it affords the policyholder to participate in the profits arising from an identifiable pool of assets, in addition to whatever minimum level of benefit is guaranteed at outset. The discretion exercisable by firms in determining the extent of policyholder participation in those profits, typically through the declaration of annual or other bonuses, which are added to guaranteed benefits, is circumscribed by, among other things, the FCA's conduct rules. This is consistent with the WP MoU, which makes clear that the FCA is responsible for making rules to ensure that proposed bonus payments or other benefits for with-profits policyholders are fair.

2.4 The PRA has a role to play in relation to with-profits insurance business through seeking to ensure that:

- firms maintain adequate financial resources to provide security of benefits for both guaranteed and discretionary policyholder benefits;⁽¹⁾ and
- discretionary increases in policy benefits do not adversely affect the firm's ability to meet the PRA's requirements for safety and soundness.⁽²⁾

2.5 In discharging its role, the PRA will need to consider a variety of factors, but, in particular:

- the resources that the firm has available in order to meet liabilities to with-profits policyholders, what these consist of and whether there are any restrictions that apply to them; and

- whether discretionary benefits, which the firm proposes to pay to its with-profits policyholders, are affordable and sustainable.

Assets in the with-profits fund

2.6 The policyholder liabilities of a with-profits fund contain both guaranteed and discretionary elements. Discretionary bonuses become guaranteed liabilities over time as they are declared but, prior to that, they are dependent upon the continued existence of the pool of assets from which profits are derived and on both the management and performance of those assets.

2.7 The FCA's current rules relating to the governance of with-profits funds recognise this feature of with-profits policies and operate to constrain the discretion that firms might otherwise exercise in relation to the management of their with-profits funds, and the assets within it, in order to secure fair treatment of policyholders.

2.8 It is for the FCA to set rules requiring firms to manage their with-profits funds in order to achieve fair outcomes for with-profits policyholders. The nature of UK with-profits policies, combined with the effect of FCA rules, mean that a firm's ability to meet its with-profits liabilities will therefore depend upon the assets maintained within each of its with-profits funds. This has clear prudential implications which the PRA needs to address.

2.9 One important aspect of the PRA's regulation of with-profits business is the requirement for firms to include expected future discretionary bonus payments when calculating their liabilities in respect of with-profits policies.⁽³⁾ However, this requirement would not, on its own, promote the degree of benefit security that the PRA considers necessary for current and future with-profits policyholders, given that it is the assets in the with-profits fund that will generate the profits required to fund such benefits.

2.10 Recognising that prudential implications may arise, the PRA is, therefore, proposing to make a rule requiring firms to

(1) Paragraph 9 of the WP MoU, available at: www.bankofengland.co.uk/about/Documents/mous/mouwithprofits.pdf.

(2) Paragraph 4 of the WP MoU, available at: www.bankofengland.co.uk/about/Documents/mous/mouwithprofits.pdf.

(3) Except to the extent that these constitute surplus funds — see CP16/14.

hold, within each of its with-profits funds, assets that are sufficient to meet the with-profits liabilities of those funds.

2.11 The rationale for this rule is consistent with the Solvency II Directive, which recognises that supervisors also need to take into account the prudential implications for firms of national conduct regulations to which they are subject, along with other factors. Through the Solvency II ring-fenced fund (RFF) regime, the Directive explicitly acknowledges that some assets held by a Solvency II firm are effectively restricted and that one class of policyholder may have greater rights to those assets than others.⁽¹⁾ The PRA articulated its view in supervisory statement 1/14⁽²⁾ that the restrictions on assets resulting from the nature and regulatory context of with-profits business in the United Kingdom will generally mean that each with-profits fund gives rise to a RFF. The existence of a RFF has clear prudential implications for a firm, including through the determination of a firm's Solvency Capital Requirement (SCR) and the amount of own funds available to meet the firm's SCR.

Distribution strategies which are affordable and sustainable

2.12 Although the FCA is responsible for making any rules it deems necessary to ensure that a firm's distribution practices are fair to with-profits policyholders, the PRA is responsible for making judgements about whether the level of future discretionary payments that a firm proposes to make is affordable, sustainable and does not adversely affect the insurer's ability to meet (and continue to meet) the PRA's standards for safety and soundness. From a prudential perspective, there could be a significant negative impact on the security of both the current and future benefits payable to with-profits policyholders if a firm adopts an imprudent strategy on discretionary distributions.

2.13 Such a strategy could ultimately endanger the safety and soundness of the entire firm, since the firm might need to call upon assets outside the with-profits fund in order to meet liabilities in respect of declared bonuses — and any other guaranteed liabilities — to with-profits policyholders, to the detriment of its other, non-profit, policyholders.

2.14 Under the Solvency II Regulations,⁽³⁾ the present value of expected future transfers to shareholders that are associated with the distribution of profits to with-profits policyholders will be treated as unrestricted own fund items. The PRA is concerned to ensure that with-profits firms do not adopt an accelerated or imprudent distribution strategy in order to accelerate actual transfers or to maximise the value of future transfers to shareholders and thereby boost the level of their unrestricted own funds. These considerations are clearly relevant to proprietary firms but may also be relevant to a mutual which has separated its common fund into a with-profits fund and a members' fund.⁽⁴⁾

2.15 For these reasons, the PRA is proposing to make a rule which requires with-profits firms to ensure that their distribution strategies are affordable, sustainable and are not expected to have a significant negative impact on the safety and soundness of the firm as a whole or on the benefit security of all policyholders of the firm.

Clarity on support arrangements

2.16 A number of firms have set up arrangements to provide support to their with-profits funds to enable the firm to provide some degree of benefit security for policyholders of the with-profits fund where it would not be able to do so from the resources of the with-profits fund alone.

2.17 The terms and conditions outlining the use of support arrangements vary between firms and funds depending on the terms of the court scheme, reattribution scheme or Board resolution relevant to the specific case. Some arrangements are intended for the exclusive use of a with-profits fund, while others are equally available to cover losses in other parts of the business.

2.18 The PRA is proposing to make a rule requiring firms to clarify the structure, terms and conditions of with-profits support arrangements, including the extent of any restrictions on a firm's use of those arrangements. In complying with this rule, firms should have regard to terms of the arrangement as set out in the governing documentation, and to any supporting documentation (eg a report by an independent actuary for a court-approved scheme or circular issued to policyholders in respect of a transfer of with-profits business). This will aid the PRA when taking a view on the safety and soundness of relevant firms, and the potential availability of support in stressed conditions.

Definitions relevant to with-profits business

2.19 The PRA has been working with the FCA to develop appropriate definitions for terms relevant to with-profits business. The proposed definitions are included in Appendix 1.

2.20 In the interest of clarity, both regulators recognise the importance of using, wherever possible, with-profits related definitions which use the same language for common terms. The proposed PRA definitions for 'with-profits policy' and 'with-profits assets' have recently been published within the draft 'Surplus Funds' instrument included within CP16/14. The FCA proposes to include identical definitions for these terms

(1) See, for example, recital 49 to the Solvency II Directive.

(2) *PRA Supervisory Statement SS1/14*, 'Mutuality and with-profits funds: a way forward'; www.bankofengland.co.uk/pradocuments/publications/policy/2014/mutuality114.pdf.

(3) In CP16/14 the PRA proposed the following definition for 'Solvency II Regulations': the directly applicable EU Regulations adopted in accordance with the Solvency II Directive.

(4) The separation may have been achieved in a number of ways, including those set out in *PRA Supervisory Statement SS1/14*, 'Mutuality and with-profits funds: a way forward'; www.bankofengland.co.uk/pradocuments/publications/policy/2014/mutuality114.pdf.

within the FCA Handbook, as set out in the FCA's publication FS14/1.

2.21 The definition of 'with-profits fund' was not included in CP16/14, as the definition was still under discussion in respect of the proposals in this CP. The definition proposed by the PRA in this CP differs slightly from that proposed by the FCA in FS14/1 because the PRA is seeking to align it with the content of PRA rules on surplus funds proposed in CP16/14, but neither regulator intends for divergence on substantive parts of the definition.

Supervisory statement

2.22 The proposed PRA supervisory statement on with-profits business is included in Appendix 2. The statement sets out the PRA's expectations in respect of insurance firms that write with-profits insurance business.

2.23 The material within the statement is intended to supplement the proposed with-profits rules. The statement covers some areas which featured as either rules or guidance within the FSA's Handbook, but which the PRA considers more appropriate for supervisory statement material than for rules.

Appendices

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- 1 PRA Rulebook — With-profits
 - 2 Supervisory statement — With-profits
-

**PRA RULEBOOK SOLVENCY II FIRMS: NON-SOLVENCY II FIRMS: WITH PROFITS
INSTRUMENT [YEAR]**

Powers exercised

- A. The Prudential Regulation Authority (“PRA”) makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137G (the PRA’s general rules); and
 - (2) section 137T (general supplementary powers).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

Pre-conditions to making

- C. In accordance with section 138J of the Act (consultation with the Financial Conduct Authority), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

PRA Rulebook Solvency II Firms: Non-Solvency II Firms: With Profits Instrument [Year]

- D. The PRA makes the rules in Annex A and Annex B to this instrument.

Commencement

- E. This instrument comes into force on [DATE].

Deletions

- F. The following Parts of the PRA Handbook are deleted:

COBS 20.1: Application
COBS 20.2: Treating with-profits policyholders fairly

Citation

- G. This instrument may be cited as the Solvency II Firms: Non-Solvency II Firms: With Profits Instrument [Year].

By order of the Board of the Prudential Regulation Authority

[DATE]

Annex A

Insert the following new definitions (in the appropriate alphabetical position) into the Glossary Part of the PRA Rulebook:

excluded assets

means, in relation to a *with-profits fund*, those assets which the *firm* has clearly identified in its policy documentation, *PPFM*, other *policyholder* communication or otherwise in accordance with any relevant provision of the *FCA Handbook* as:

- (1) available to cover the *firm's* liabilities arising from *with-profits policies* only in particular circumstances; and
- (2) not forming part of that *with-profits fund*.

friendly society

means an *incorporated friendly society* or a *registered friendly society*.

future policy-related liabilities

means, in relation to a *with-profits fund*, the aggregate of the following amounts (to the extent each constitutes a liability) less the aggregate of such amounts (to the extent each constitutes an asset):

- (1) planned deductions for the costs of guarantees, options, smoothing and provision of life cover and other benefits from the amount calculated in accordance with Surplus Funds 3.3¹ or, where a *firm* is required under Surplus Funds 3.2 to use the calculation method in Surplus Funds 3.4, in accordance with Surplus Funds 3.4;
- (2) planned deductions for other costs deemed chargeable to the amount calculated in accordance with Surplus Funds 3.3 or, where a *firm* is required under Surplus Funds 3.2 to use the calculation method in Surplus Funds 3.4, in accordance with Surplus Funds 3.4;
- (3) future costs of contractual guarantees (other than financial options);
- (4) future costs of financial options, including guaranteed annuity and cash options;
- (5) future costs or proceeds of smoothing;
- (6) future liabilities to repay financing costs of a *with-profits fund* where the *firm* expects to have to meet such liabilities; and
- (7) other future costs related to the provision of the benefits referred to in Surplus Funds 3.4(4) (regardless of whether the *firm* is required to effect the calculation in Surplus Funds 3.4);

but only to the extent that they are not already included in the amount calculated in accordance with Surplus Funds 3.3 or, if applicable, Surplus Funds 3.4.

¹ The Solvency II Firms – Surplus Funds Part of the PRA Rulebook can be found in CP16/14 Transposition of Solvency II: Part 3 (August 2014)

Holloway sickness policies

means a *contract of long-term insurance* offered or effected by a *friendly society* under the Holloway system, providing *permanent health* benefits and, in addition, investment benefits, where the investment benefits:

- (1) are derived from surpluses accrued by the *friendly society* and apportioned to *policyholders*; and
- (2) are payable to *policyholders* at maturity, on retirement, on death, or as otherwise specified by contractual provisions or individual society rules.

incorporated friendly society

means a society incorporated under the Friendly Societies Act 1992.

non-profit insurance business

means the business of *effecting contracts of insurance* or *carrying out contracts of insurance* that are *non-profit policies*.

non-profit policy

means a *contract of long-term insurance* which is not a *with-profits policy*.

registered friendly society

means a friendly society registered under section 7(1)(a) of the Friendly Societies Act 1974 or any enactment which it replaced, including any registered branches.

permanent health

means the class of contract of insurance, specified in paragraph 4 of Part 2 of Schedule 1 to the Regulated Activities Order.

support arrangements

means arrangements under which the financial resources available to a *with-profits fund* include (or are intended in particular circumstances to include) financial resources from outside that *with-profits fund*.

with-profits fund

means the business of the *firm*, or a particular part of the business of the *firm*, in the profits of which certain *with-profits policies* are eligible to participate through discretionary distributions under such policies and the assets of which comprise the items set out in (1) – (6) less the outgoings in (7) and (8) (including the items and outgoings relating to both current and past business):

- (1) *premiums* and other receivables in respect of *with-profits policies*;
- (2) other receipts of the *firm's with-profits insurance business*, including tax receipts;
- (3) amounts which have been provided by the *firm* to facilitate the carrying on of its *with-profits insurance business* (other than *excluded assets*);
- (4) all income and capital receipts in respect of the items in (1) to (3);

- (5) assets into which the items in (1) to (4) have been converted, including assets representing investment in *non-profit insurance business*; and
- (6) premiums, receivables, other receipts, income and capital receipts from *non-profit insurance business* falling within (5) or otherwise written for the benefit, in whole or in part, of the *firm's with-profits insurance business*;

outgoings:

- (7) outgoings in respect of the *firm's with-profits insurance business* permitted in accordance with any relevant provision of the *FCA Handbook* or any other applicable regulatory requirement and, to the extent that incoming items have been included in (6), *non-profit insurance business*; and
- (8) transfers to shareholders which have been permitted in accordance with any relevant provision of the *FCA Handbook* or any other applicable regulatory requirement;

and, where so required by *FCA rule COBS 20.1A.2R*, each sub-fund identified in accordance with that *rule* shall constitute a separate *with-profits fund*.

with-profits insurance business

means the business of *effecting contracts of insurance* or *carrying out contracts of insurance* that are *with-profits policies*.

with-profits policy

means a contract of *long-term insurance* which provides benefits through eligibility to participate in discretionary distributions based on profits arising from the *firm's* business or from a particular part of the *firm's* business.

with-profits policy liabilities

means, in relation to a *with-profits fund*, the value of liabilities attributable to *with-profits policies* (excluding any liabilities relating to non-profit insurance associated with such policies) set out in, and calculated on the basis prescribed by Surplus Funds 3.3 or, if applicable, Surplus Funds 3.4 and (in either case) having also made adequate provisions for amounts representing *future policy-related liabilities*.

Annex B

In this Annex, the text is all new and is not underlined.

Part

WITH PROFITS

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1 APPLICATION AND DEFINITIONS

- 1.1 Subject to 1.2, this Part applies to a *firm* carrying on *with-profits insurance business*.
- 1.2 This Part does not apply to *with-profits insurance business* that consists of *effecting contracts of insurance* or *carrying out contracts of insurance* that are *Holloway sickness policies*.

2 ASSETS IN THE WITH-PROFITS FUND

- 2.1 A *firm* must ensure that it holds assets in each of its *with-profits funds* of a value sufficient to cover the *with-profits policy liabilities* in respect of all of the business written in, or transferred into, that *with-profits fund*.

3 DISTRIBUTION STRATEGIES

- 3.1 A *firm* must ensure at all times that its strategy for distribution of discretionary benefits in respect of each of its *with-profits funds*:
- (1) is affordable and sustainable; and
 - (2) cannot reasonably be expected to have an adverse effect on the safety and soundness of the firm as a whole, or on the benefit security of all *policyholders* of the *firm*.

4 SUPPORT ARRANGEMENTS

- 4.1 If a *firm* is using, or intends to use, *support arrangements* to contribute to benefit security for the *policyholders* of a *with-profits fund*, it must ensure that:
- (1) all the terms and conditions governing those *support arrangements*, including the circumstances in which they take effect and the terms on which they are or may be repayable, are adequately documented in the *firm's* records; and
 - (2) the extent of any restrictions on the *firm's* use of those *support arrangements* is clearly identified.

Appendix 2 Supervisory statement — With profits

1 Introduction

1.1 This draft supervisory statement is directed to all UK firms that write⁽¹⁾ with-profits insurance business. By setting out the Prudential Regulation Authority's (PRA's) expectations of firms that write such business, this statement promotes the safety and soundness of those firms and the benefit security of policyholders.

1.2 Both conduct and prudential matters are relevant to the regulation of with-profits insurance business. The PRA expects that firms will need to have regard to the following rules and regulations when writing and administering with-profits insurance business:

- (a) for Solvency II firms, the Solvency II Regulations including ring-fenced fund provisions, and for non-Directive firms any PRA-designated rules in prudential sourcebooks;⁽²⁾
- (b) the PRA Rulebook and any relevant supervisory statements; and
- (c) the Financial Conduct Authority's (FCA's) Handbook.

2 Solvency II ring-fenced fund (RFF) regime

2.1 The Solvency II Regulations contain provisions which affect both the determination of own funds and the Solvency Capital Requirement (SCR), where RFFs arise. The assessment of whether an arrangement gives rise to a RFF is based on the restrictions which apply to the use of certain assets or own funds. These restrictions may arise from the particular characteristics of the arrangement, contract or product.⁽³⁾

2.2 Restrictions on assets and own funds result from the nature of, and regulatory regime for, with-profits insurance business in the United Kingdom. As communicated in supervisory statement 1/14,⁽⁴⁾ the PRA expects that such restrictions will generally mean that each with-profits fund displays the characteristics of a RFF. A Solvency II firm will therefore be required to reflect the lack of availability of assets and own funds within the with-profits fund to cover the risks of the rest of the firm.

2.3 Where a firm operates sub-funds within a with-profits fund, it will need to determine whether any or all of those sub-funds should be treated as separate with-profits funds as provided for in the FCA's Conduct of Business Sourcebook chapter 20 (COBS 20). If the arrangements governing a sub-fund mean that the fund needs to be treated as a separate with-profits fund then the PRA expects that each such fund would be treated as a RFF under Solvency II.

3 Support arrangements

3.1 Firms sometimes seek to provide support to a with-profits fund from financial resources outside that fund. These support arrangements can take a variety of forms and are intended for use in a wide range of different circumstances. Where such support arrangements are intended to provide benefit security for policyholders, the PRA will need to consider, in the light of the terms governing their use and other relevant factors, whether they achieve their purpose. In particular, the PRA will expect firms to be able to justify their use of these arrangements, where the financial resources to which they relate may also be intended to support other areas of the firm's business.

3.2 The PRA expects Solvency II firms to consider whether any support arrangements that exist in relation to a with-profits fund also fall within the Solvency II RFF requirements, having regard to the terms and conditions of those arrangements. In particular, firms should take into account the extent of any restrictions on a firm's use of assets associated with support arrangements, and the expected availability of such assets in stressed conditions.

3.3 Where the terms and conditions of a support arrangement state clearly that the support is for the exclusive use of a with-profits fund, the PRA expects that one or more of the ring-fencing criteria set out in the Solvency II Regulations will be met, and that any assets associated with such a support arrangement will form part of the RFF constituted by the with-profits fund receiving support. The PRA considers support for a with-profits fund to be 'exclusive' if under the terms of the arrangement it cannot be used to meet losses arising in other areas of the business.

3.4 Where support is not for the exclusive use of a with-profits fund, the PRA expects that assets associated with support arrangements should not generally form part of the Solvency II RFF constituted by the with-profits fund receiving support. In this case, the expectations of the PRA in respect of those arrangements are as follows:

- (a) The extent to which the PRA will permit a Solvency II firm to recognise and use such support assets as part of the financial resources available to meet the liabilities of the with-profits fund will depend on the PRA's view of the financial strength of the overall firm, including the parts of

(1) By referring to firms that write with-profits business, the PRA intends for this to capture not only firms which actively write new with-profits business, but also firms with closed with-profits funds.

(2) Prudential Sourcebook for Insurers (INSPRU); General Prudential Sourcebook (GENPRU); Interim Prudential Sourcebook for Insurers (IPRU(INS)); Supervision (SUP); and Interim Prudential Sourcebook for Friendly Societies (IPRU(FSOC)).

(3) More information on RFF restrictions is available in EIOPA's draft guidelines paper on RFFs: eiopa.europa.eu/en/consultations/consultation-papers/index.html.

(4) PRA Supervisory Statement SS1/14, 'Mutuality and with-profits funds: a way forward'; www.bankofengland.co.uk/pradocuments/publications/policy/2014/mutuality114.pdf.

the firm which are subject to the RFF regime and those which are not. The PRA's view will be based on an assessment of the risks involved, the degree of reliance placed on such support, and may include consideration of factors outside a with-profits fund which could have a negative or detrimental impact on the financial strength of the firm, including the ability of the arrangement to support the with-profits fund in periods of stress.

- (b) In certain circumstances the PRA might expect a Solvency II firm to recognise a with-profits support arrangement as providing exclusive support to a with-profits fund. In those cases, the PRA might expect a firm to identify specific support assets and to include them within the RFF constituted by the with-profits fund receiving support, in advance of it drawing upon a support arrangement, and any transfer of assets from outside to inside the with-profits fund associated with such an action.

4 Affordability and sustainability of distribution strategies

4.1 When assessing the affordability and sustainability of distribution strategies of with-profits firms, the PRA will consider whether those strategies are consistent with its objectives. The PRA expects firms not to make distributions from with-profits funds which could endanger the safety and soundness of the overall firm, or which could have a detrimental impact on the benefit security of any group of policyholders.

4.2 Firms should not set with-profits distribution strategies which accelerate the transfer of profits outside the with-profits fund. This includes the approach firms might take when making or considering special/one-off distributions.

4.3 When taking a view on the affordability of distributions from a with-profits fund, firms should give due consideration to the PRA rule requiring firms to hold assets sufficient to meet liabilities within the with-profits fund.

5 Investment strategy of with-profits funds

5.1 When setting an investment strategy for a with-profits fund, the PRA expects firms to take into account any regulatory requirements, including:

- (a) for Solvency II firms, the prudent person principle set out in Article 132 of the Solvency II Directive and RFF requirements in the Solvency II Regulations, and for non-Directive firms any PRA-designated rules in prudential sourcebooks;

- (b) financial resources requirements and the availability of capital resources;
- (c) any applicable conduct rules and guidance issued by the FCA; and
- (d) any communication to policyholders in compliance with the relevant FCA conduct rules.

6 Separation of different with-profits business

6.1 The PRA expects firms to maintain, in respect of each with-profits fund, separate accounting records so as to enable the firm to satisfy all relevant requirements in relation to that fund and in particular, having regard to:

- (a) the relevant FCA conduct rules in COBS 20;
- (b) the PRA rules in respect of with-profits and surplus funds; and
- (c) for Solvency II firms, the prudent person principle and the ring-fenced fund requirements of Solvency II, and for non-Directive firms any PRA-designated rules in relevant prudential sourcebooks.

7 Significant changes in with-profits funds

7.1 Consistent with the Fundamental Rules, the PRA expects firms to inform their supervisors of any plans to make significant changes to the operation, management or business strategy of a with-profits fund, so that the PRA can take a view on the impact of those changes on the safety and soundness of the firm. This would include providing the PRA with appropriate advance notification of the following actions:

- (a) ceasing to effect new contracts of insurance in a with-profits fund;
- (b) proposing changes to run-off plans for a closed with-profits fund;
- (c) proposing a reattribution of inherited estates;
- (d) proposing a demutualisation; and
- (e) planning a Part VII transfer.

The above list is not intended to be exhaustive, and the PRA expects firms to engage in early dialogue with it, in addition to complying with any FCA requirements, in advance of any significant changes to the business or structure of a with-profits fund.

8 Reducing new business sales, closing to new business and submission of run-off plan

8.1 A firm should notify the PRA on a timely basis if it plans to reduce sales of new with-profits policies to a minimal level and to explain the expected impact of such plans on its with-profits fund.

8.2 A firm proposing to close a with-profits fund to new business should notify the PRA on a timely basis. The PRA expects such a firm to submit a run-off plan as soon as reasonably practicable.

8.3 The PRA expects that a firm operating a closed with-profits fund would periodically review and update its run-off plan in light of experience, to ensure that the run-off plan remains appropriate. Any revisions to the run-off plan for a closed with-profits fund should be submitted to the PRA.

9 Reattributions of inherited estate

9.1 A reattribution of inherited estate will need to be considered by the PRA to assess its implications on the PRA's objectives. It must also comply with any FCA requirements.

9.2 When assessing a proposed reattribution, the PRA will consider the impact of the scheme and any payments or adjustments to benefits associated with it on the:

- firm's safety and soundness; and
- degree of protection for the firm's with-profits policyholders.

9.3 A firm that is seeking to make a reattribution of the inherited estate associated with a with-profits fund should first submit to the PRA:

- (a) projections for capital required to support existing business and financial resources available to meet those requirements;
- (b) an assessment of the firm's future risk appetite for the with-profits fund and other relevant business;
- (c) projections for capital required to support future new business, including an assessment of new business volumes, product terms and pricing margins; and
- (d) any restrictions on the transferability or availability of assets likely to result from the reattribution and their impact on the solvency position and financial strength of the firm.

10 Demutualisations

10.1 A mutual firm that is seeking to demutualise should first discuss with the PRA the expected impact on the firm's financial position, structure, business model, and strategy, so that the PRA can take a view on the potential impact of the transaction and assess if, in the context of the firm, the transaction is consistent with the PRA's objectives.

11 With-profits mutual waivers

11.1 As set out in SS1/14,⁽¹⁾ a mutual firm seeking to apply for a with-profits mutual waiver should apply to the FCA in the first instance. The FCA and PRA will then co-ordinate activities during their review of the waiver application.

11.2 The PRA expects a firm applying for a with-profits mutual waiver to submit appropriate supporting evidence to enable it to assess the application and to determine whether the proposed actions are likely to meet the statutory tests, and are consistent with the PRA's objectives.

12 Part VII transfers

12.1 Firms considering a transfer of with-profits insurance business should first discuss with the PRA the expected impact of the transfer on the financial position, structures, business models, and strategies of both the transferring and receiving firm, so that the PRA can take a view on the potential impact of the transaction and assess if, in the context of those firms, the transaction is consistent with the PRA's objectives.

(1) *PRA Supervisory Statement SS1/14*, 'Mutuality and with-profits funds: a way forward'; www.bankofengland.co.uk/pradocuments/publications/policy/2014/mutuality114.pdf.