

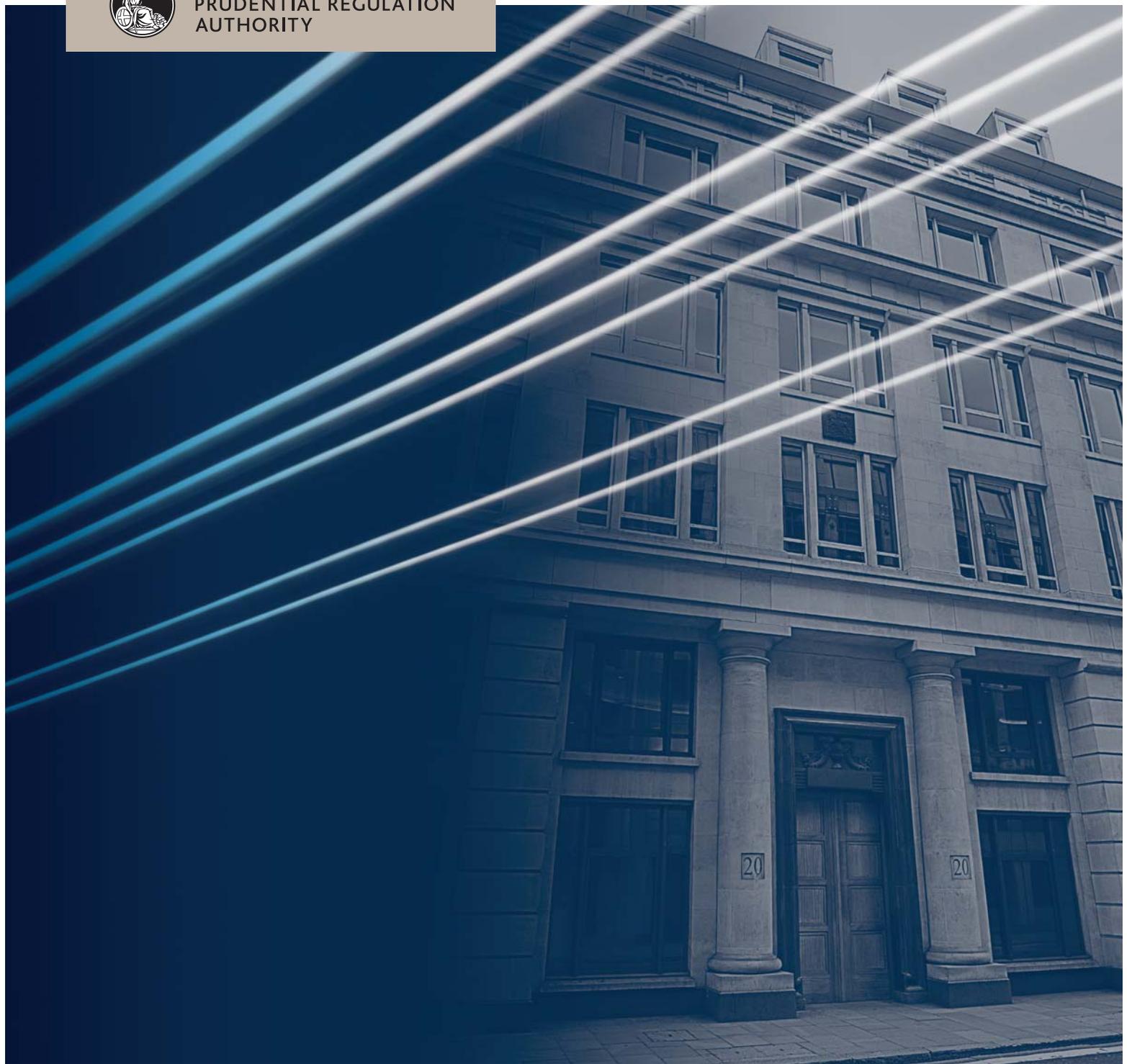
Supervisory Statement | SS1/14

Mutuality and with-profits funds: a way forward

March 2014



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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1 Introduction

1.1 This supervisory statement sets out Prudential Regulation Authority (PRA) policy in relation to a consultation originally published in December 2012 by the Financial Services Authority (FSA): *CP12/38 Mutuality and with-profits funds: a way forward*.⁽¹⁾ It is relevant for all mutual insurance firms and friendly societies writing new with-profits business or with existing books of with-profits business and provides a response to comments received pertaining to the PRA's areas of interest in this consultation.

1.2 The statement covers the:

- background and substance of the proposals in CP12/38;
- change in the regulatory landscape since December 2012 when CP12/38 was issued; and
- PRA's expectations regarding the with-profits mutual waiver process.

2 Background

2.1 Since the introduction of the detailed rules on with-profits business in the Conduct of Business Sourcebook (COBS) 20 of the FSA Handbook in 2005, with-profit mutuals have been concerned that some of the FSA's rules and guidance were too prescriptive and prevented mutuals moving beyond their with-profits business into new non-profit business, even where firms considered that this would be demonstrably fair to all their policyholders and in the interests of their members. With-profits mutuals said that, for mutuals which wrote their with-profits business out of a common fund (in which the interests of with-profits policyholders and the interests of members were co-mingled) these rules (in particular, COBS 20.2.55R and 56R) raised the risk of these firms having to close to new business altogether and go into run-off.

2.2 With-profits mutuals approached the FSA with these concerns, and the FSA along with representatives of the sector undertook work from April 2007 to seek to resolve this issue. This work was known as Project Chrysalis. Further representations were made in 2011 following publication of CP11/5,⁽²⁾ and in December 2012 the FSA published CP12/38. This proposed that COBS 20 should explicitly recognise the potential for with-profits mutuals with a common fund to seek to identify within that fund a mutual members' fund to which COBS 20 would not apply directly. The mutual members' fund could then, for example, be used to write new business without being restricted directly by the limitations contained in COBS 20. The FSA proposed that firms could achieve this split for regulatory purposes by applying for a waiver under section 148 of the Financial Services and Markets Act 2000 (FSMA) in order to modify the application of relevant parts of COBS 20 to the mutual members' fund.

3 Change in regulatory landscape since CP12/38 was issued

3.1 Following changes in the structure of regulation in the United Kingdom which took effect on 1 April 2013, the FSA ceased to exist and was replaced by two new regulatory bodies, the Financial Conduct Authority (FCA) and the PRA, each of which was given its own statutory objectives.⁽³⁾

3.2 The rules and guidance contained in COBS 20 of the FSA's Handbook were primarily aimed at ensuring the fair treatment of with-profits policyholders and the majority of these (including COBS 20.2.55R and 56R) therefore now appear solely in the FCA's Handbook. A limited number (including the definition of a 'with-profits fund') appear in both regulators' Handbooks, since they embody prudential matters relevant to the PRA's objectives.

3.3 In view of the different objectives and responsibilities of the FCA and PRA, the two regulators will publish separate statements in response to the CP12/38 consultation. The advantages of this approach are that it:

- provides clarity for industry regarding the split of responsibilities pertaining to the provisions arising out of CP12/38; and
- allows each regulator to answer questions addressed to its areas of responsibility, referencing its specific objectives.

3.4 CP12/38 proposed some changes to COBS 20 guidance which is now in the FCA Handbook, but not in the PRA Handbook. This is being addressed in the FCA's Policy Statement on CP12/38, which is being published concurrently with this supervisory statement. The FCA's Policy Statement also contains information about the responses received to CP12/38 and to which readers are referred for further information.⁽⁴⁾

4 Scope of supervisory statement

4.1 The purpose of this statement is to explain:

- how the PRA's process for with-profits mutual waivers will work, including how it will co-ordinate with that of the FCA; and
- how the PRA expects the forthcoming Solvency II ring-fenced fund provisions to interact with the UK with-profits regime.

(1) www.fca.org.uk/your-fca/documents/consultation-papers/fsa-cp1238.

(2) *FSA CP11/5: Protecting with-profits policyholders*, available at www.fsa.gov.uk/library/policy/cp/2011/11_05.shtml.

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

(4) www.fca.org.uk/news/firms/ps14-05-response-to-cp12-38.

4.2 This statement therefore expands on the PRA's general approach, as set out in the insurance approach document.⁽¹⁾ By articulating in this statement the approach it will take to applications for these waivers (referred to in this statement as 'mutual with-profits waivers'), the PRA is seeking to advance both its general objective of promoting the safety and soundness of the firms it regulates and its insurance objective of contributing to the securing of an appropriate degree of protection for policyholders.

4.3 With effect from 1 March 2014, the PRA was also given a new secondary competition objective, which applies when the PRA discharges its general functions in a way that advances its objectives. This new objective is to act in a way which (as far as reasonably possible) facilitates effective competition in the markets for services provided by PRA-authorized persons in carrying on regulated activities. In issuing this statement, the PRA is setting out the basis upon which with-profits mutuals may apply for a waiver as a means of continuing to write new business, thereby increasing or maintaining the range of products on offer from mutual providers in the markets in which these firms operate. The PRA considers this to be compatible with its secondary competition objective.

4.4 The PRA has also considered other matters to which it is required to have regard, and believes that this statement is compatible with the Regulatory Principles,⁽²⁾ in particular the principle that a burden or restriction placed on firms should be proportionate to the benefits expected to result and the desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons regulated under FSMA.

5 The PRA and the mutual with-profits waiver process

5.1 Any mutual with-profits waiver application will list the rules which the with-profits mutual wishes to be disapplied to its members' fund. This may include both COBS 20 and any connected provisions, such as those in the Prudential Sourcebook for Insurers (INSPRU), which rely on the definition and scope of a with-profits fund.

Application process

5.2 Both the PRA and FCA will need to approve any application to modify the definition of 'with-profits fund' by a dual-regulated mutual. When considering such an application each regulator will therefore consider whether it meets the statutory tests in s138(4) FSMA, which includes consideration of whether the waiver would adversely affect the advancement of each regulators' statutory objectives.

5.3 The PRA and the FCA have a statutory duty to ensure a co-ordinated exercise of powers when reviewing waiver

applications;⁽³⁾ the PRA recognises the importance of co-ordination between both organisations, as highlighted by respondents to CP12/38.

5.4 For the purposes of its regulatory decision-making, the FCA expects to agree, with the firm applying for the waiver, the selection of an independent expert, and the drafting of the expert's terms of reference (in consultation with the PRA). Since the appointment of such an expert is likely to occur early in the consideration of whether to apply for a mutual with-profits waiver, firms should send the application, and all supporting documentation, to the FCA in the first instance. The FCA will then forward the relevant information to the PRA. Where the PRA and FCA are each satisfied that the requirements of section s138A of FSMA are met, each regulator will approve a mutual with-profits waiver and issue a waiver direction, usually as a joint PRA/FCA waiver direction.

Supporting evidence for a waiver

5.5 Before the PRA grants a mutual with-profits waiver it will consider whether the statutory tests are met; that compliance with the unmodified rule would be unduly burdensome or would not achieve the purpose for which it was made.

5.6 As set out above, it will also consider whether granting a mutual with-profit waiver will affect the advancement of both its general and insurance objectives.

5.7 Supporting material that the PRA expects the firm to supply includes, but is not limited to:

- A medium-term business plan, based on credible estimates of new business volumes and profitability.
- How the new business written in the members' fund will provide for the risks of that business, taking particular account of the fact that the with-profits rules in COBS 20 will limit the extent to which funds within the with-profits fund will be available to support those risks.
- How new product offerings will be sustainable. The PRA will expect the business plan, at least for the early years, to be based around products which the firm already provides or for which it can demonstrate relevant knowledge and expertise.
- Projected capital requirements for the firm as a whole and how it will meet those with capital of an appropriate quality.

(1) The PRA's approach to insurance supervision is available at www.bankofengland.co.uk/pr/Pages/supervision/approach/default.aspx.

(2) Section 3B of FSMA 2000.

(3) Section 3D of FSMA 2000.

- Evidence to demonstrate how any distributions, dividends or other payments in respect of members' rights will affect the financial and capital position of the firm.

5.8 The PRA recognises that the provision of such evidence, and thus the ability to show that the grant of a mutual with-profits waiver will meet the statutory tests, may not be possible for all with-profits mutuals. In such cases, the best outcome for the firm, from the point of view of safety and soundness and benefit security for policyholders, might well be for that firm to go into run-off.

5.9 While the PRA aims to consider mutual with-profits waiver applications as promptly as possible, the time which it will need in order to reach a decision on an application will in practice depend on the quality of the original submission and the complexity and circumstances of the specific case.

Duration of mutual with-profits waiver

5.10 The PRA expects that the granting of a with-profit mutual waiver will allow with-profit mutuals to restructure and change their business model. Such actions necessarily have long-term implications; it is unclear how such a decision could subsequently be reversed. The PRA therefore understands the importance of permanence, as raised by respondents to CP12/38, or at least certainty over the longer term, when a waiver is granted. The PRA agrees with respondents to CP12/38 that a waiver with duration similar to that of a firm's remaining with-profits business is desirable, and expects that a waiver of such length may be granted. However, this must be balanced by the fact that it is not appropriate for the PRA to fetter its discretion in relation to its statutory power to revoke a waiver, nor to cease to monitor the continued appropriateness of the waiver in the context of the PRA's objectives. Therefore the PRA retains the right to agree a shorter waiver if more appropriate to the circumstances of the application.

Eligibility of with-profits mutuals not in run-off

5.11 Several respondents to CP12/38 suggested that any solution to allow with-profits mutuals to recognise a mutual members' fund should be available regardless of whether the with-profits business is in run-off.

5.12 The PRA will consider whether an application meets the PRA statutory tests for a with-profits mutual waiver regardless of whether the firm is in run-off or not, subject to the application process described from paragraph 5.2 above.

Type of business entered into by the mutual members' fund

5.13 The PRA will consider the impact of a firm's proposals on its objectives and firms should be able to demonstrate, in particular, that policyholder benefits will be sustainable immediately and for a period after the waiver. Therefore, when

considering a waiver application, the PRA will be mindful of the risks that current and future policyholders in both parts of the firm might face.

5.14 Firms will be expected to demonstrate in a waiver application that the business plan shows that the proposition can deliver capital commensurate with the business and its risks. The higher the risk attached to the new business, the higher the related capital requirement will be. If that part of the common fund which would be identified as the with-profits fund gives rise to a ring-fenced fund under Solvency II (see paragraph 6.2) this would mean that the elements of capital requirements relating to the separate members' fund will have to be met from that members' fund; they cannot be met from within the with-profits fund.

5.15 In addition to this, firms are prohibited from undertaking business unless they have been granted the appropriate permissions. Any request to vary permissions will be considered according to the PRA's existing procedures for variation of permissions in the context of the firm's capabilities and governance arrangements.

Implications of failure to meet new business plan

5.16 Firms should expect supervisors to review continued appropriateness, including progress against business plans, in line with the PRA's supervisory approach. The PRA has the power to revoke a direction giving a rule waiver at any time if the firm no longer meets the statutory tests for the grant of a direction, or the direction is no longer appropriate for other reasons.

5.17 The PRA expects firms to meet the new business plan targets. If a firm fails to meet these and the PRA considers that this failure did, or could, adversely affect the safety and soundness of the firm or the benefit security for policyholders, then revocation of the waiver would be one of a range of supervisory responses available to the PRA (recognising that once the mutual had restructured it is unclear how any separation between the with-profits fund and a separate members' fund might be reversed).

5.18 Should a waiver revocation be the appropriate supervisory response to such a situation, then the PRA will follow its published procedures for the revocation of waivers.

6 Interaction with Solvency II

6.1 Solvency II is a largely maximum-harmonising directive applicable to all EU Member States. Notwithstanding the suggestions made by some respondents to CP12/38, it is not within the power of national jurisdictions to exempt individual firms within its scope from the application of Solvency II.

The expected Solvency II ring-fenced funds regime

6.2 The PRA expects that under Solvency II a ring-fenced fund (RFF) will arise when own-fund items have a reduced capacity to fully absorb losses on a going concern basis due to lack of transferability within an insurance or reinsurance undertaking because this restricted capital can only be used to cover losses:

- on a defined portion of contracts;
- in respect of certain policyholders or beneficiaries; or
- arising from particular risks.

6.3 The assessment of whether an arrangement gives rise to a RFF is based on the restrictions on assets which arise from the particular characteristics of the arrangement, contract or product. Restrictions on assets result from the nature and regulatory context of with-profits business in the United Kingdom. The PRA expects that these restrictions will generally mean that each with-profit fund gives rise to a RFF.

6.4 Where a with-profits fund is regarded as a RFF for the purposes of Solvency II, the effect of the RFF requirements is to reflect the lack of availability of assets and capital within the with-profits fund to support the risks of the rest of the firm.

Adjustments for restricted capital

6.5 The PRA expects that the RFF regime will require a firm to calculate a notional solvency capital requirement and then make a capital adjustment to the extent that the capital held within the RFF exceeds this notional requirement. In the case of a with-profits fund this adjustment will reflect reality, that capital within the with-profits fund will not be available to support risks elsewhere, ie risks of the business of the members' fund.

Members' funds and RFF requirements

6.6 The identification of a RFF for the purposes of Solvency II will depend on the extent to which the members' fund is restricted and therefore have a reduced capacity to fully absorb losses on a going concern basis due to lack of transferability within a firm. Provided that the assets and capital resources held in the mutual members' fund are not restricted in this way, the fund should not meet the criteria for identification as a RFF.