The Actuarial Profession
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Consultation Response
Financial Services Authority

CP12/13 Transposition of Solvency II – Part 2

15 October 2012

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Kathryn Morgan
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15 October 2012

Dear Kathryn,

CP12/13 Transposition of Solvency II part 2

The Institute and Faculty of Actuaries welcomes the opportunity to respond to this consultation. Our response has been prepared by the Solvency II steering group supported by other actuaries including the Life Practice and the General Insurance Practice Executive Committees. These groups are comprised of Fellows of the Institute and Faculty of Actuaries who have significant experience working on issues relevant to this topic.

A number of with-profits Actuaries took the unusual step of contacting us directly because of their concerns about the proposals contained within Chapter 7. In general our members felt that other organisations, such as the London Market Actuaries Club or the ABI would be better placed to support the FSA regarding Chapter 5, Chapter 6 and Chapter 8. For this reason we have restricted our comments to Chapter 7.

In preparing this response it has been clear that the nature of with-profits business makes the transposition of Solvency II to this class of business problematic. The rules governing each with-profits fund have been built up over time and differ from firm to firm based on the differing experiences the funds have gone through. For example some will, as a result of a demutualisation, be covered by a legally constructed “court scheme”; others might not have such a court scheme and rely on historic practice as set out in their Principles and Practices of Financial Management. In addition, funds will be in different stages of their life. Some will have been closed to new business for some time and be rapidly running off; others may still be taking on new business and thinking about how they develop the concept of with-profits investing for future products and future customers.

We believe that suspension of further political trilogues till after completion and analysis of the long term guarantees impact assessment will inevitably delay the introduction of Solvency II beyond 2014. This potentially gives the FSA a little more breathing space to consider more widely some of the issues that we will identify later in this response before pressing ahead with the transposition of this particular aspect of Solvency II. We hope that by taking this opportunity the FSA can avoid some of the potential unintended consequences of the current proposals.

We would welcome the opportunity to work with the FSA and its successor organisations to find a practical way forward. We are pleased that on a recent call the FSA agreed to our proposal to set up a working group combining their officials and some of the actuaries who are working daily on with-profits issues. Executive staff here at the Institute and Faculty of Actuaries are available to play a part in helping you facilitate such a group and in recruiting our members to the group.

Concerns have been raised that the proposals would put in place prudential requirements that are stronger than those required by Solvency II. If this is not the FSA’s policy objective (and it does seem at odds with the FSA’s

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stated objective of making “consequential and largely technical changes to the current rules so that they are consistent with the requirements of the Directive.”), we would be happy to highlight the areas where an inadvertent strengthening of the regime may have taken place.

The key points we would like to draw to your attention are as follows:-

- A number of prudential requirements are now contained in the COBS rules rather than elsewhere. We haven’t cross-referenced this consultation with CP12/24 but it would seem, in the post FSA environment, to bring the Financial Conduct Authority (who owns the COBS rules) into the territory that should properly be owned by the Prudential Regulation Authority. We are concerned that this split of responsibilities will result in confusion, and potentially additional costs for firms that will ultimately be passed on to with-profits policyholders.
- The proposed amendment to COBS 20.2.34 means that the managers of a with-profits fund can only recognise the unambiguous support given to that fund from other resources of the firm and then only if the arrangements have been formally approved by a court – or, in relation to a friendly society, by the FSA. This modification effectively reverses the meaning of this section and would potentially operate against policyholders’ interests if it, for example, limits the ability of the fund to invest freely.
- The definition of “with-profits policy” the FSA is now proposing to use appears to restrict the potential scope of the category of with-profits policy considerably. This may run counter to the public interest if with-profits type policies end up being part of the thinking under plans for defined contribution pensions, for example. Firms that are looking to react to declining levels of traditional business by developing new participating products may also find this unhelpful.

We anticipate that the FSA will receive a large number of responses from individual firms which will detail the specific issues that each fund has identified. Our members have been involved in preparing these responses. Rather than repeat again the technical points made in our response we felt it would be more helpful just to highlight some of the high level issues that have been raised and why we think resolving them is important to the public interest.

Turning now to each of the questions that have been asked:

Q3: Do you agree with the changes that we have described above to the conduct rules for distributions?

Members have identified that the definition of ‘with-profits fund surplus’ may not achieve the desired objectives for funds in run-off.

The two issues raised are whether these proposals work when a firm is in the process of distributing an estate and whether transfers of assets can only take place within three months of an actuarial investigation.

Q4: Do you agree with our proposal to amend the definition of excess surplus for the purposes of the rule and evidential provision relating to the distribution of excess surplus?

Our comments in answer to Q3 relating to the way distributions work are intrinsically related to the definition of ‘with-profits fund surplus’.

Q5: Do you agree that for Solvency II firms we should disapply COBS 20.2.32R in relation to loans and produce new guidance as proposed?

These rules indicate that a firm’s management must reasonably consider the loan of assets of a with-profits fund to be in the “best interest” of with-profits policyholders of the fund. Whilst this sounds intrinsically sensible, there is no real guidance on how “best interest” should be defined. Therefore, economically attractive opportunities to loan assets might be declined as managers cannot be sure that the regulator will define “best interest” in the same way that they have.

Q6: Do you agree that we should retain this guidance as proposed, and introduce a new rule on support assets?

Where assets from outside a with-profits fund are made available to support that fund (and there is no ambiguity in the criteria governing any repayment obligations to the support provider), a firm should manage the fund ~~disregarding the liability to repay those assets, at least in so far as that is necessary for its policyholders to be treated fairly taking those assets into account~~ solely to the extent the arrangements have been formally approved by a court or, in relation to a friendly society, the FSA.

The modification makes the effect more or less opposite to that of the original, and potentially acts against policyholders' interests. The original requires support to be taken into account (for example in deciding what EBR the fund can afford to run) while the proposed new guidance seeks to limit the extent to which support is taken into account, which reflects the prudential objective of controlling risk.

Q7: Do you agree to our retaining guidance on reviewing non-profit business, reinsurance and disclosure of decisions on strategic investments for all firms, but that for Solvency II firms that we disapply the rules and guidance referred to above which overlap the Prudent Person Principle?

We believe the proposals are reasonable.

Q8: Do you agree that we should introduce guidance to Solvency II firms writing with-profits business that the provisions implementing the Prudent Person Principle should be applied to the investment of with-profits assets by reference to the particular circumstances within the with-profits fund including in relation to strategic investments?

We believe the proposals are reasonable.

Q9: Do you agree that the changes to the provisions on ceasing to effect new business should be restricted to those required to align the rules with Solvency II terminology?

We believe the proposals appear reasonable although some members have questioned whether the run-off plan should also consider the impact of closure on the ORSA.

Q10: Do you agree with our proposals to amend the changes in surplus distribution notification requirements currently addressed by IPRU (INS) Chapter 3.3?

The issues raised in answer to Q3 will be relevant here.

Q11: Do you agree that IPRU (INS) section 3.5 should be transcribed into COBS 20?

See our response to Q3 above.

Q12: Do you agree that we should amend COBS 20.3 to require Solvency II firms who wish to use support assets to document and describe them in their PPFMs?

There is a risk that specific mention of the proposals will force companies to disclose trivial support mechanisms in their CFPPFM, which could confuse policyholders.

Q13: Do you agree that we should amend COBS 20.4.4 and that with-profits Committees should also consider the existence and scope of sub-funds within COBS 20.5?

Yes. We believe the proposal appears reasonable.

Q14: Do you agree that the proposed new provisions in COBS 20 relating to GENPRU 2.2.271R(1)-(3) are appropriate?

Yes. We believe the proposals appear reasonable.

Q15: Do you agree that the governance and management provisions from INSPRU 1.5 should be converted into new rules in COBS 20 for Solvency II firms in order that policyholder interests continue to have adequate protection?

We are concerned that these proposals could result in more sub-divided with-profits funds than is currently the case. Separation of funds is a costly exercise and we are concerned that policyholders would suffer from what could be argued is an over-proportionate response where there is no material customer or supervisory benefit from splitting current with-profits funds into sub-with-profits funds.

Q16: Do you agree that we should include a new rule in COBS 20 to require Solvency II firms to manage their with-profits fund to ensure that assets meet liabilities?

We fully support the objective of ensuring that assets are available to meet all liabilities to policyholders and recognise the special considerations for with-profits business, in which the benefits due to policyholders depend on the performance of the fund. Some of our members have however raised concerns that the potential operation of the proposed rules in the wide range of possible circumstances needs to be very thoroughly explored to ensure that they do not have inappropriate outcomes. It will not be in policyholders' interests if there is unnecessary de-risking of with-profits funds that sit within well capitalised entities. We are also concerned that funds in run-off may never be able to meet the proposed requirements.

Q17: Do you agree with our proposals to amend definitions, as above, and to introduce a transitional provision (para 7.51)?

Members have identified issues with the detail of some of the definitions.

We think that the definition of a 'with-profits policy' needs to give more thought to a product that is part with-profits and part non-profit. As currently drafted such a product would appear to be treated as with-profits, which may not always be appropriate.

In addition to the above, we note that the 'with-profits policy' and 'with-profits fund' definitions may differ from those that apply under court schemes.   It would seem that the definition should refer to the relevant schemes where appropriate.

The definition of "with-profits policy" the FSA also appears to restrict the potential scope of the category of with-profits policy considerably. This may run counter to the public interest if with-profits type policies end up being part of the thinking under plans for defined contribution pensions, for example. Firms that are looking to react to declining levels of traditional business by developing new participating products may also find this unhelpful.

Q18: Do you agree that firms should be required to ask the court to review the appropriateness of their continued reliance on the transitional provision with the FSA when bringing a scheme back to court?

Members were surprised to be asked this question as part of the implementation of Solvency II and wondered whether it would be better addressed as part of the FSA's with-profits Regime Review.

There was a general feeling that the elements of past court-approved schemes that give rise to these transitional reliefs were part of the overall negotiation (e.g. between policyholders and the new shareholders in a demutualisation). If a court-approved scheme sanctioned a particular approach, then any financial compensation (e.g. special bonuses, injections to an estate or demutualisation compensation payments) may have reflected that. To change the approach now, without adjusting the other terms of the negotiation, does not seem right.

Q19: Do you agree with the proposed rules which specify the determination of assets shares, or equivalent calculations, in order to calculate approved surplus funds?

The principle appears reasonable, but we believe the detailed rules probably need to be reviewed.

Reference to “accepted actuarial practice” will need to be defined. This may not be appropriate if this is inconsistent with a scheme, PPFM or established practice.

Q20: Do you agree with our revised definition of approved surplus funds and the proposed guidance on classification?

The principle appears reasonable, but greater clarity is required regarding the amounts which constitute approved surplus funds.

Yours sincerely,

David Hare

D.J.P Hare
President-elect
Institute and Faculty of Actuaries