The Actuarial Profession
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Consultation Response
Financial Services Authority

CP12/38: Mutuality and With-Profits Funds: A Way Forward

19 March 2013

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.

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19 March 2013

Dear Matthew

FSA CP12/38: Mutuality and with-profits funds: a way forward

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to this consultation. As the professional body representing actuaries in the UK, many of our members who work as With-Profits Actuaries or in mutuals spoke of their interest in this topic. This response has been prepared by a group of experienced actuaries in this area.

Whilst we are broadly supportive of the proposals as set out in the consultation paper, we have a few concerns which we have illustrated below.

Q1. Do you agree with this analysis and do you think its conclusions are fair to with-profits policyholders and sustainable for mutual organisations?

We agree that this proposal provides a sensible framework. However, the detail of how to apply the rules is the primary issue and there are certain elements of uncertainty that need to be addressed to ensure, as far as is possible, fairness for with-profits policyholders and sustainability for mutuals. The key areas of uncertainty relate to:

a) <u>How the FSA envisages applying any withdrawal of approval</u>

Whilst CP 12/38 indicates that the FSA does not expect to withdraw approval of a particular firm before its with-profits business has run off *'provided the original justification for granting it continues to hold'*, this creates a level of uncertainty for future members and management due to the following:

- It is not clear how the regulator would react to a failure to meet new business plan targets (for other types of products); for example, if new business levels were to fall below a certain level. This could potentially lead to the setting of targets prior to seeking approval that the company is certain it can achieve. What level of realism is expected in these situations and how flexible does the regulator intend to be?

- Members and corporate management may be uncomfortable potentially providing the regulator with greater powers of veto than for other corporate structures. There is concern that a company's business model may need to be altered at the regulator's request and it is not clear how any withdrawal of authorisation might be applied.

b) Clarity on the time-limit applying

Whilst we understand the reasoning behind a time limit on the proposal, many firms have with-profits liabilities extending 10-20 years into the future and, as such, a short-term modification is unlikely to be of benefit to firms or policyholders. Any time limit needs to be of sufficient length so as to be commensurate with the liability profile of the insurer. Such clarity would allow steps to be taken to ensure the sustainability of mutuals working in this area.

Q2. Do you agree with our approach to a proposed process for recognising mutual members' funds?

We welcome the clarification that establishment of a Mutual Members Fund (MMF) is optional. Whilst we are assured that the proposed modifications are designed to help firms by removing the need to secure explicit policyholder approval, it is highly likely that firms will need to assess the specific legal rights and interests of members to avoid subsequent legal challenges from specific member or policyholder groups. It is not clear whether the FSA's revised approach is suggesting that firms take full ownership as to whether their own interpretation of the legal position facilitates the modification. A clarification on this matter would be welcome.

Some other observations we have regarding this process which the FSA may wish to consider are:

- We welcome the flexibility that this process allows for mutuals and concur that it would be difficult to demonstrate retrospectively clear and unambiguous communication of capital distribution to policyholders. Any overarching requirement in the identification of mutual capital for a 90:10 distribution for the policyholder and the company from a with-profits fund may conflict with the legal rights of policyholders. Under such circumstances, it would have been necessary for a mutual to assess its Memorandum and Articles of Association to ensure such distributions and/or changes could occur. We agree that a 'one-size-fits-all' approach should be avoided. Clarification of how a mutual can fulfil the new process and demonstrate retrospectively that they have a MMF without clear communication would be welcome.

- We believe a core part of any effective re-structure of a common fund would be to increase the clarity of, and establish a process for, any remaining interactions following separation.

  - For example, the MMF may need to be used in the event of burnthrough of the with-profits fund and could be considered within the management actions of the with-profits fund.

  - If a firm were allowed to follow the course of sub-dividing its common fund, the question of where capital sits becomes more of an issue. The FSA may consider that it should not allow the with-profits element to be declared a ring-fenced fund as doing so could negate much of the benefits of the proposed process.

- The proposals will be more feasible if the FSA is prepared to be flexible regarding the definition of the with-profits element. The FSA may consider including asset shares (or appropriate reserve) for with-profits business plus the capital requirements (with the balance representing the members' fund). However, this may become unworkable if the bulk of any free capital goes into the with-profits fund.

It would be helpful if the FSA could clarify whether it intends for new non-profit business to be written into the members' fund. Furthermore, clarification of the FSA's intention regarding existing non-profit business (some of which may be paid-up with-profits business) would be helpful to establish whether that element is to sit in the with-profits or the members' element of the fund or is to be left to the firm's discretion.

Q.3 Do you agree with the support elements we are proposing for the process and the principles outlined?

Yes, we are in broad agreement with the proposals. However we have minor comments relating to proposals 3 and 4 of paragraph 2.36, as stated below.

a) Principle 3: An independent assessment of the proposals and how they affect policyholders is carried out

We agree with the proposal to require an independent expert's report, but we have concerns that the cost of this has been underestimated. This is particularly the case for smaller firms where the work is often contracted-out and the expert will either have to commission additional verification work from the firm's actuarial service providers or from within their own firm. We feel this is likely to cost more than the £32,000 total quoted in the cost-benefit analysis (CBA). A potential solution to this issue may be for the FSA to consider waiving this requirement for very small funds (e.g. funds of less than £100m, or those which are under the current Directive premium limit).

One possible step could be for the definition of "Independent" to be widened so that it does not always need to be an external actuary. There may be some value in using the Actuarial Function Holder (AFH) where they are external to the mutual. In this instance, the AFH is equivalent to an adviser acting for multiple firms and paid a fee for their services. The AFH is not employed by the company and hence, not conflicted. The important point is for the FSA to recognise the issue of cost. This will be a barrier to take-up of the initiative, potentially in situations where it is most appropriate, and hence a practical solution needs to be developed.

We note that the FSA's own costs appear to amount to no more than £3,000 per firm (if 20 out of 35 apply), which may be an understatement.

b) Principle 4: With-profits policyholders under the firm's proposals will be no worse off than equivalent with-profits policyholders in a proprietary with-profits fund

We question the applicability of this criterion. It is unclear, in the first instance, whether this solely relates to the application of the proprietary-specific rules within COBS 20 or whether it requires some assessment against a 90:10 structure. This may be difficult to measure, or potentially be irrelevant, as mutual structures have no similarity with a 90:10 structure. We would appreciate more detail as to how the FSA envisages this being applied.

Q.4 We are not proposing new rules in this area, but we would welcome comment from members and other policyholders in mutuals about governance and accountability and how they see their involvement in how the business is managed.

We are supportive of the FSA in not requiring policyholder approval in advance of the event. We feel it is appropriate for the mutual to ensure members are provided with sufficient information so they can understand the impact of the event and to separately demonstrate to members the level of governance they have applied.

One further additional comment we would make regards the lack of current understanding as to how some of the proposals within the FSA's consultation CP 12/13, on the transposition of Solvency II regarding ring-fencing and potential sub-fund re-structuring, may interact with the CP 12/38 proposals. The publication of the revised rules arising from CP 12/13 has been deferred whilst uncertainty still exists on the overall Solvency II timescales, therefore care will be needed to try and ensure, as far as possible, that any separation of the common fund will not result in a disadvantageous position (from a Solvency II perspective) whereby it is effectively being locked-in.

Should you wish to discuss this or any points in our response further, please contact Helena Dumycz, Policy Manager at the IFoA (helena.dumycz@actuaries.org.uk or +44 (0)207 632 2118).

Yours sincerely,

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