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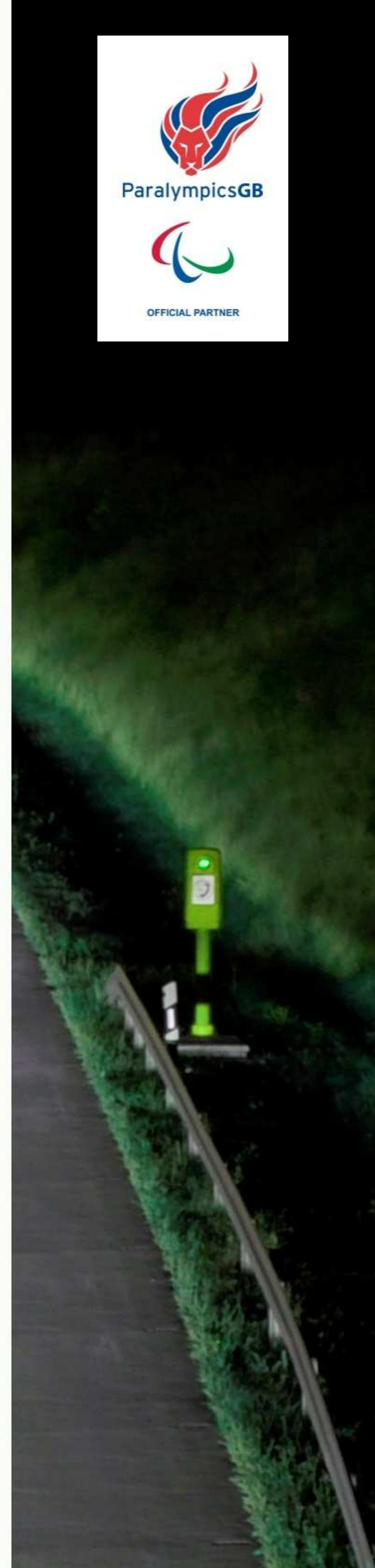
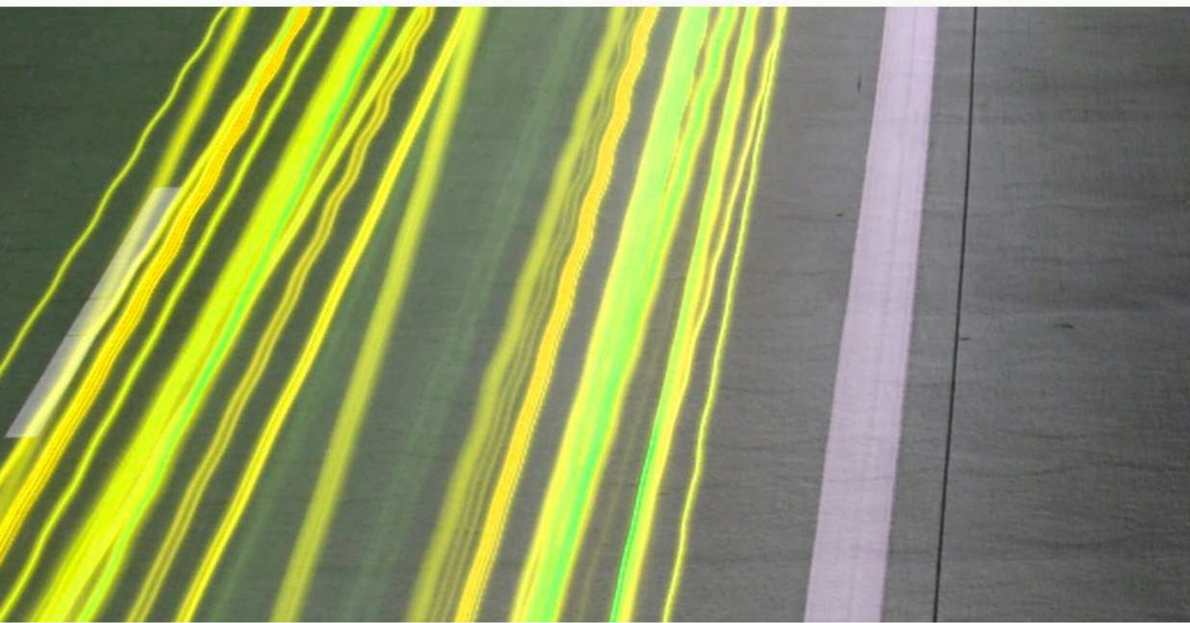


Mutuality and With-Profits Funds: A way forward

The Regulators' final response to Project Chrysalis



Introduction

The UK financial services regulators have published their long-awaited responses to the FSA's consultation, CP12/38 published in December 2012, on recognising mutual capital in mutual life insurers writing with-profits business in a common fund. Since this touches on both conduct and prudential supervision, the FCA and the PRA have each issued separate documents: a policy statement, PS 14/5, from the FCA and a supervisory statement, SS1/14, from the PRA.

The FCA's response is the longer and more detailed document and the FCA will, in effect, act as the lead regulator in considering applications to recognise mutual capital under the new regime. PS 14/5 also sets out amendments to Chapter 20 in the FCA's Conduct of Business Sourcebook which took effect immediately upon publication of the policy statement.

The FCA Response: PS 14/5

The FCA has not substantially altered its view of the legal position, which it sets out at length in an appendix to PS 14/5. Although the reasoning has changed, the conclusions are substantially similar to those set out in the summary of legal advice that accompanied the FSA's first Dear CEO Letter on Project Chrysalis in October 2009: that in a typical mutual with-profits policyholders have an almost exclusive interest in any surplus in the common fund and other members (in their capacity either as members or as holders of non-profit policies) have no significant interest.

Despite this, the FCA has managed to persuade itself that it is appropriate to implement the regime suggested by the FSA in CP 12/38 to recognise mutual capital for two reasons:

- The inevitable long term consequence of applying the FCA's legal analysis to mutual firms writing with-profits business will be that, as the volumes of with-profits business decline, mutuals will be forced into run-off and will disappear from the market. The FCA accepts that this result would be contrary to its competition objective, which is to "promote effective competition in the interests of consumers in the markets for regulated financial services".
- The FCA accepts that its legal analysis is not the only possible legal analysis of the situation. Although the explanation of alternative analyses in the appendix to PS 14/5 barely does them justice, the FCA does accept that at least one alternative view is tenable and that therefore uncertainty exists over whether with-profits policyholders are indeed entitled to effectively all the surplus in a mutual's common fund. The FCA therefore believes that it can be in the interests of with-profits policyholders to segregate mutual capital in order to remove the uncertainty that would otherwise exist.

Having thus established a rationale for recognising mutual capital, the FCA sets out a process under which firms can apply to do so. This is substantially unchanged from the FSA's proposals in CP 12/38. The mutual would apply to the regulators for a modification of COBS 20 in relation to that part of its common fund it wished to treat as mutual capital. The same high level principles as were enunciated in CP 12/38 would apply: ie:

- The firm has a convincing and robust business case.
- The firm can demonstrate that its proposals are compatible with its obligations to treat policyholders fairly.
- An independent assessment of the proposals and how they will affect policyholders is carried out.
- With-profits policyholders will be no worse off than equivalent with-profits policyholders in a proprietary with-profits fund.
- The firm has a strategy to ensure that with-profits policyholders and the wider membership of the mutual are appropriately engaged and informed.
- Balance sheet safety and soundness issues are identified and addressed appropriately.
- The rule modification meets the appropriate statutory tests.

Both regulators intend to deal with applications to recognise mutual capital by way of a modification or waiver of their rules. This is the same approach as was proposed in CP 12/38. The FCA has recognised that segregating a common fund into a with-profits fund which is subject to COBS 20 and a mutual capital fund which is not is likely to be irreversible and therefore expects any modification it grants to be for a substantial period equivalent to the run-off of the firm's with-profits business[1]. However, the FCA does reserve the right to withdraw the modification, even

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[1] Paragraph 2.27.

though it expects to do so rarely. Applications for rule modifications may only be granted if they meet the statutory criteria set out in s138A of the Financial Services and Markets Act 2000, ie:

- that complying with the unmodified rules would either be unduly burdensome or would not achieve the purpose of the rules; and
- the modification would not adversely affect the advancement of the regulators' objectives (in the case of the FCA, to secure an appropriate degree of protection for consumers, to protect and enhance the integrity of the UK financial system and to promote effective competition in the interests of consumers).

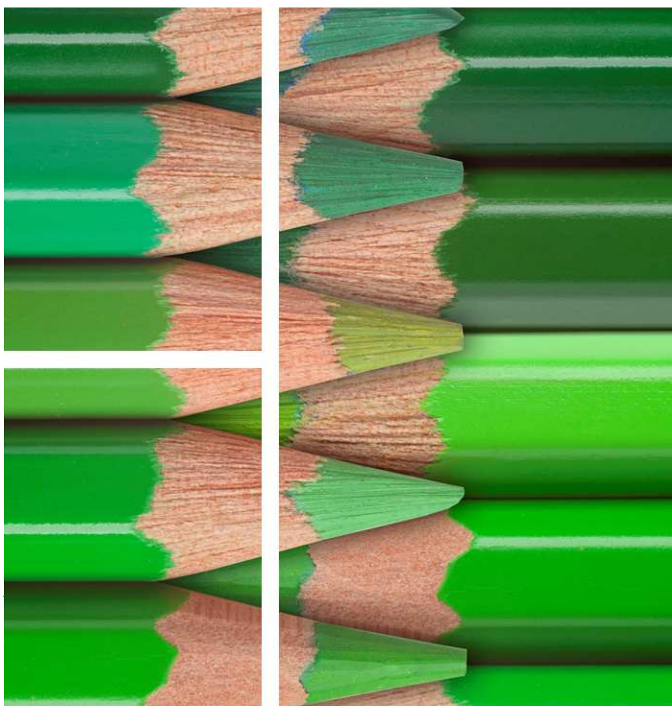
There remains therefore an undesirable degree of uncertainty, first as to the duration of the modification (the FCA does not explain how long a modification might be granted to a firm which is not in run-off) and, secondly, over the risk of a modification being withdrawn.

The high-level principles are reflected in the amendments to COBS 20 set out in the annex to PS 14/5. These have already come into force. In CP 12/38, draft guidance to implement the principles was placed at the beginning of COBS 20.2 under the heading "Introduction". In PS 14/5, the guidance, which is virtually unchanged, has been moved to the end of COBS 20.2 under the heading "Ceasing to effect new contracts of insurance in a with-profits fund", which is where the rules on closure to new business and run-off are to be found. Despite this, the FCA does confirm in PS 14/5 that applications to recognise mutual capital will be accepted from firms which are not in run-off or about to become so[2].

The guidance sets out the FCA's expectations of how an application to recognise mutual capital will be justified. These expand upon the high-level principles and the text of PS 14/5 also contains useful indications of how the FCA intends to apply these principles and the guidance.

The guidance (set out in COBS 20.2.61(3)) is as follows:

Demonstrate that the exercise does not amount to a reattribution: The first item in the guidance (COBS 20.2.61(3)(a)) requires applicants to demonstrate that the exercise does not amount to a reattribution. This is not referred to in the principles, although it was mentioned elsewhere in CP 12/38, which appeared to suggest that recognition of mutual capital did not amount to a reattribution[3] by definition. In PS 14/5, the FCA states that it requires the independent expert's report (please see below) to consider whether the proposal is a reattribution nor not. In view of the very wide definition of a "reattribution" in the handbook glossary, this may be difficult. We expect the nub of the issue to be whether the process "redefines" the rights of with-profits policyholders in the inherited estate or whether it merely clarifies existing rights, and hence what part of the common fund should properly be described as a "with-profits fund". There is likely to be a degree of uncertainty over this – it will be interesting to see how the FCA reacts to this.



Demonstrate that the proposals are fair to its with-profits policyholders and other policyholders having regard to the mutual's own particular structure, origins and other relevant circumstances: The guidance makes clear that this is an overriding obligation in addition to the more specific fairness tests listed. The legal analysis is relevant here. The FCA's legal analysis considers fairness exclusively from the point of view of with-profits policyholders. We have argued throughout Project Chrysalis that it is impossible to form a considered view of what is "fair" to with-profits

policyholders without giving full consideration to interests which might compete with theirs, including the rights of members in their capacity as members (as distinct from their capacity as policyholders).

Obtain the report of an Independent expert: PS 14/5 provides useful additional detail on what the FCA expects from the independent expert's report. It contemplates that the expert will normally be an actuary but that he or she will normally require independent legal advice, particularly in forming a view as to whether the FCA's legal analysis is correct in the particular case of the mutual under consideration. The FCA expects to be involved in setting the independent expert's terms of reference[4].

Demonstrate that the mutual's with-profits policyholders and other policyholders are appropriately engaged and informed about the proposals: The FCA has accepted that with-profits policyholders should not vote on proposals to recognise mutual capital and has amended COBS 20.2.60(2) which previously required that they should do so in cases where a mutual wished to continue to write non-profit business after its with-profits business had run off. The FCA does expect that with-profits policyholders should have an "appropriate degree" of protection in the absence of a vote and that this will include being notified of the proposals and having any objections they made taken into account. It is also part of the role of the independent expert to consider the interests of with-profits policyholders[5].

Demonstrate that it is compliant with the relevant requirements and the mutual's constitutional documents, for example that members are appropriately involved in agreeing to any proposals: This does not strike us as particularly onerous – compliance with the mutual's constitution should be a minimum requirement in any event.

Demonstrate that the mutual has a convincing and robust business case for continuing in business, as opposed to run-off: The FCA has clarified that the business case should consist of a medium term business plan based on credible estimates of new business volumes and profitability. The FCA indicates that it expects new business proposals to be incremental and complementary with a firm's existing business[6]. The PRA's statement SS 1/14 also discusses requirements for the business case[7].

Demonstrate how, and the extent to which, continuing membership rights will benefit with-profits policyholders and other policyholders: This requirement is not discussed in the text of PS 14/5 beyond a statement that continuing membership rights will have a bearing on the overall fairness of the modification and whether it meets the statutory tests[8]. It was also not explained in CP 12/38. It seems to us to be axiomatic that the policyholders will continue to have membership rights in a mutual and these should not be adversely affected by the recognition of membership capital.

Explain the nature in terms of any continuing support being provided to the with-profits fund from outside the with-profits fund: This relates more directly to the PRA's area of responsibility and is considered further in SS 1/14[9].

Demonstrate that with-profits policyholders under the mutual's proposals will not be at a disadvantage compared to equivalent with-profits policyholders in a proprietary with-profits fund: This was a key theme in CP 12/38 and has been carried over to PS 14/5. Helpfully, the FCA clarifies in PS 14/5[10] that it expects the comparison to be drawn with policyholders in a standard 90:10 with-profits fund in a proprietary company rather than assuming, on the basis of the FCA's legal analysis, that the comparison should be with a policyholders in a 100:0 fund. We believe this is correct: few policyholders, when taking out a policy, will enquire whether they are investing in a 90:10 fund or not; most will end up in a 90:10 fund and therefore it is realistic to use that as the comparator.

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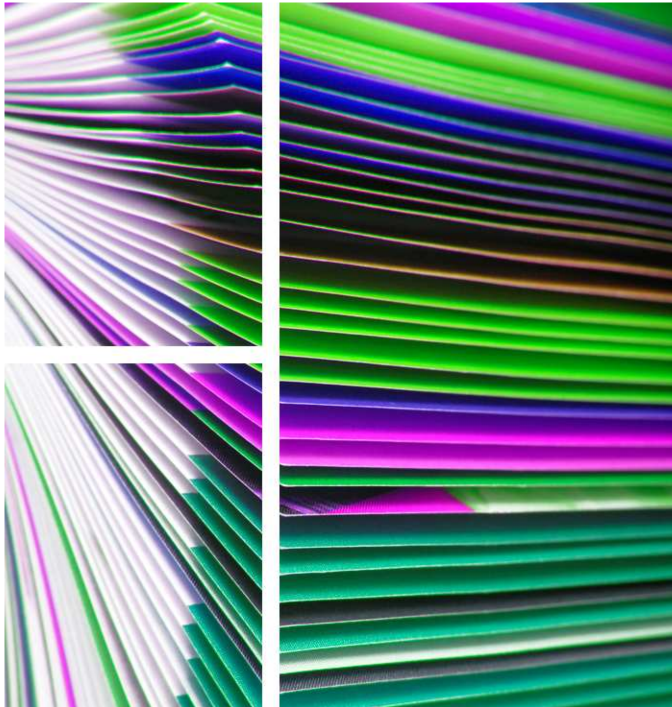
4 Paragraph 3.8 and COBS 20.2.61(3)(c).
5 Paragraph 3.8.
6 Paragraph 4.9.
7 SS 1/14, paragraph 5.7.
8 Paragraph 5.2.
9 SS 1/14, paragraphs 5.7, 5.8, 6.2-6.6.
10 Paragraph 4.9.



Explain how it proposes to pay any compensation or redress that is, or may become, due to a policyholder or former policyholder: Without saying so in so many words, the FCA's expectation is clearly that any redress or compensation will be payable from the mutual capital fund[11]. We believe this is just: a mutual in which mutual capital has been recognised will replicate the structure of a proprietary company which has a separate with-profits fund and shareholders' fund. COBS 20.2.24 requires that proprietary companies do not make redress or compensation payments out of their with-profits funds and it is only reasonable that the equivalent should apply in a mutual which has other funds available with which to make such payments.

CP 14/5 also makes it clear that the recognition of mutual capital is not necessarily the only solution for a mutual facing a decline in with-profits business in its common fund. Other solutions include writing new style with-profits policies and restructuring the mutual through a scheme of arrangement, which would remove any uncertainty and would have the further advantage of being legally binding upon all policyholders whether or not they voted in favour of the scheme[12]. PS14/5 appears to treat a scheme of arrangement as a separate process from the recognition of mutual capital under the new COBS 20.2.61 rather than as a supplementary part of the same process[13]. There is a danger of firms which can write new style with-profits products finding themselves in a Catch-22 situation, in that the statutory test for a modification, that the rule to be modified is unduly burdensome, may not apply to them. Although PS 14/5 refers to selling new products, it does not discuss this option at any length.

New products are also the subject of a separate section in the summary of the FCA's legal view but, again, this only reaches the generally unhelpful conclusion that each case would have to be decided on a case-by-case basis in conjunction with COBS 20.2.28[14]. The legal analysis does present the stark choice between writing the new style product and not doing so, in which case the firm might have to go into run-off. If it went into run-off, there would be likely to be a distribution of surplus to existing with-profits policyholders but whether this was of the whole surplus would depend on whether the FCA's legal analysis was applied. The FCA acknowledges that other views are possible. PS 14/5 therefore appears not to add much clarity to this already complex area.

Our view is that for a mutual contemplating writing new products the recognition of mutual capital should not be seen as an alternative strategy: writing new products still leaves open the issue of the extent of the "traditional" with-profits policyholders' interest in the common fund. The longer this remains unresolved, the more difficult it may become to address the issue in the future.

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11 Paragraph 4.9.

12 However, this option is only available to mutuals constituted as companies subject to the Companies Act 2006; it is not available to friendly societies.

13 Paragraphs 2.16 and 2.24.

14 Appendix 2 to PS 14/5, paragraphs 52-62.

The PRA's response: SS 1/14

The PRA's response to CP 12/38 is very much shorter than the FCA's (SS 1/14 has only 8 pages compared with the 61 pages of PS 14/5). It is nonetheless important: a firm will need a modification or waiver of COBS 20 from both regulators in all cases in order to recognise mutual capital. The same statutory criteria will apply to PRA waivers, although in the case of the PRA the statutory objectives which must not be adversely affected are the PRA's objective of ensuring the stability of the financial markets and its insurance objective of contributing to the securing of an appropriate degree of protection for those who are or may become policyholders. The PRA has also recently been given a new secondary objective, which is to act in a way which (as far as recently possible) facilitates effective competition in the markets for services provided by PRA-authorised persons. This is clearly relevant to the recognition of mutual capital in the same way as the FCA's competition objective.

There is considerable overlap between the two regulators' approaches to recognising mutual capital and a similar recognition by the PRA that any waiver it grants should have the same duration as the firm's with-profits business , subject to the PRA's right to revoke a waiver . Like the FCA, the PRA acknowledges that firms which are not in run-off may wish to recognise mutual capital as well as those which are . However, also like the FCA, there is no indication what the duration of the with-profits business means in the context of a firm that is not in run-off.

The PRA's main focus is on the business plan to be submitted under COBS 20.2.61(3)(f) where the PRA will be looking to see how any new business written in the mutual capital fund will be sustainable given that the extent to which the two funds able to receive support from each other will be limited.

The other key points identified by the PRA are :

- Sustainability of the new products; the PRA has expressed an expectation that any new products will be based around products which the firm already provides or for which it can demonstrate relevant knowledge and expertise.
- Capital requirements for the firm as a whole.
- Evidence that any distributions, dividends or other payments in respect of members rights will not harm the financial and capital position of the firm.

Finally, the PRA provides a brief commentary in SS1/14 on the ringfencing of the with-profits and mutual capital funds under Solvency II. The paper clarifies that capital within a ringfenced fund will not be available to support activities outside it but contemplates that the mutual capital fund may not be a ringfenced fund and therefore capital held within it may be available to support business carried on elsewhere within the firm.

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