

Response to CP12/38 – Mutuality and with-profits funds: a way forward

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In this Policy Statement we report on the main issues arising from Consultation Paper 12/38 (*Mutuality and with-profits funds: a way forward*) and publish the final rules.

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Abbreviations used in this paper

AFM	Association of Financial Mutuals
CBA	Cost benefit analysis
COBS 20	Conduct of Business sourcebook chapter 20 (with-profits rules and guidance)s
CP	Consultation paper
FCA	Financial Conduct Authority
FSA	Financial Services Authority
FSMA	Financial Service and Markets Act 2000
INSPRU	Prudential Sourcebook for Insurers
PRA	Prudential Regulation Authority
PS	Policy statement
PPFM	Principles and Practices of Financial Management – document

1. Overview

Introduction

- 1.1** In December 2012 the FSA consulted on CP12/38, *Mutuality and with-profits funds: a way forward*. This dealt with the issue of mutual with-profit life assurance providers (mutuals) which are facing declining levels of with-profits business (or which already have with-profits funds in run-off). The paper proposed an option of seeking a rule modification which would allow mutuals with a viable business plan to continue after their with-profits funds have run-off.
- 1.2** We have considered the comments received on CP12/38. This policy statement (PS) confirms that we will proceed with the proposal, modified to take the comments into account. It also provides a response to the comments. It recognises that the method outlined is one of a number of options with-profits mutuals could use to continue operating. It also sets out some principles for firms seeking an alternative.
- 1.3** The PRA is making a separate announcement on this subject. The PRA and FCA have been in regular dialogue throughout the development of this PS and the Statement from the PRA, to ensure a consistent approach between the two.

Who does this consultation affect?

- 1.4** This PS will affect:
- with-profits mutuals
 - with-profits policyholders of mutuals
 - non-profit policyholders of mutuals
 - members of mutuals
- 1.5** The changes are not intended to have any effect on proprietary with-profits firms or on their policyholders.

Is this of interest to consumers?

- 1.6** Yes. The guidance will be of particular interest to
- with-profits policyholders of mutuals

- non-profit policyholders of mutuals
- members of mutuals (who may also be with-profit or non-profit policyholders of the mutual)

The FCA's guidance provides a framework through which mutuals may identify which parts of their common fund should be:

- treated as relating to with-profits business and be covered by COBS 20.2
- treated as mutual capital and not be directly affected by COBS 20.2

The framework will also be used, as highlighted in paragraph 2.27 below, to assess any alternative proposals with similar aims.

Context

1.7 After the publication of CP12/38, the UK Government implemented a comprehensive reform of the structure of UK financial services regulation. The FSA was abolished and regulatory responsibilities allocated to:

- The Prudential Regulation Authority (PRA) (a subsidiary of the Bank of England) – responsible for prudential supervision of deposit takers, insurers and significant investment firms
- The Financial Conduct Authority (FCA) – responsible for:
 - regulating conduct in retail and wholesale markets (including both exchange-operated markets and over-the-counter dealing)
 - supervising the trading infrastructure that supports those markets
 - prudential regulation of firms not prudentially regulated by the PRA

1.8 As set out in CP12/38, the FCA and PRA will separately need to consider any application to modify the definition of a with-profits fund, because the definition appears in each regulator's rulebook.

To comply with section 138A of FSMA, each regulator will need to be satisfied that:

- compliance with the current rules would be unduly burdensome for a mutual, or would not achieve the rules' intended purpose
- the modification would not adversely affect the advancement of any of its objectives

1.9 The FCA's guidance will, in our view, advance our objective of promoting effective competition in the interests of consumers, and our consumer protection objective.

Background

- 1.10** Since the introduction of the rules concerning with-profits business in COBS 20 in 2005, with-profit mutuals have told us that some of the current rules and guidance are too prescriptive. They have highlighted that, where with-profits business is declining, the current rules prevent mutuals moving beyond their with-profits funds and into new non-profit business, even where firms consider that this would be demonstrably fair to all their policyholders and in the interests of their members. The FCA Handbook includes guidance that firms can make proposals for continuing to carry on new non-profit business, if agreed by their with-profits policyholders.
- 1.11** With-profits mutuals have said that the rules in COBS 20 raise the risk of firms having to close to new business and go into run-off. Many have other substantial businesses which would then be at risk.
- 1.12** With-profits mutuals approached the FSA with these concerns, and the FSA – along with sector representatives – carried out work to resolve this issue from April 2007. This work was known as Project Chrysalis. Further representations were made in 2011 following publication of CP11/5, *Protecting with-profits policyholders*¹, and in December 2012 the FSA published CP12/38, *Mutuality and with-profits funds: a way forward*.² This proposed that COBS 20 should explicitly recognise the potential for with-profits mutuals with a single common fund to identify within that fund a mutual members' fund which COBS 20 would not directly apply to. The mutual members' fund could then, for example, be used for new business without being restricted directly by the limitations contained in COBS 20. We proposed that firms could achieve this split for regulatory purposes by applying for a modification of relevant parts of COBS 20.
- 1.13** A more detailed summary of the history of with-profits regulation was included in Annex 4 of CP12/38.

Summary of feedback and our response

- 1.14** We received 26 responses from mutual with-profits firms, trade bodies, consultancy firms, consumers and interested individuals. We are grateful to all who responded and have included a list of non-confidential respondents in Annex 1. The following chapters set out the comments we received on the four questions included in the CP, along with our responses:
- 1.15** **Chapter 2** covers general reactions we received to our proposal. We asked in CP12/38, amongst other things, whether our proposed framework was fair to with-profits policyholders and appropriate for mutuals.

Most of the respondents supported the proposed approach. However, some respondents suggested that the requirement that the identification of mutual capital should be approved by a vote of with-profits policyholders should be retained in all cases, or suggested appropriate alternatives to this process.

There were also concerns about a lack of clarity around the legal position concerning the rights and interests of with-profits policyholders in a mutual. However, most concerns related to the process rather than the principle. In particular there were concerns expressed about the duration of any modification, and whether it could be reversed in the future.

¹ www.fsa.gov.uk/pubs/cp/cp11_05.pdf

² www.fsa.gov.uk/library/policy/cp/2012/12-38.shtml

- 1.16** In this chapter we set out our responses to these points, along with further developments to our proposals.
- 1.17** **Chapter 3** covers details of the modification process. Respondents generally had questions about which rules would apply to the mutual members' fund, how the new fund would be affected by Solvency II in reference to ring-fenced funds, and whether rule modifications would be required for other areas of the Handbook.
- 1.18** **Chapter 4** covers the responses on the guidance proposed to support the rule modification process, including:
- our expectation that firms would commission an independent expert's report
 - the high-level principles that the FCA would use in its assessment of rule modification applications
- 1.19** Respondents generally supported the use of independent experts, although some respondents suggested that smaller mutuals should be able to rely on their with-profits actuary or actuarial function holder. Most of the respondents also asked for more clarity about what the regulator would consider when assessing rule modification applications. In particular, there was concern about whether we would require firms to assess a mutual's with-profits policyholders' interests against those of with-profits policyholders in shareholder-owned firms. We address this in our response below.
- 1.20** **Chapter 5** covers two related issues:
- encouraging with-profits mutuals to communicate more effectively with their members
 - continuing to explore ways to make mutual membership more meaningful

Respondents broadly agreed these were important issues that the sector needed to address and was committed to improving. It was also suggested that our cost estimates included in the CBA for independent experts and advisors and internal FSA costs were too low.

Equality and diversity considerations

- 1.21** As stated in CP12/38, we have assessed the equality issues that arise in our proposals. We continue to believe that these proposals, as amended by the final guidance, do not give rise to discrimination and are of low relevance to the equality agenda.

Next steps

- 1.22** Firms should now consider if this guidance is appropriate to them, and if so follow the processes explained in this PS.

2. Summary of responses to CP12/38

- 2.1** This chapter summarises the responses we have received to our analysis of the problem and the overall proposals. Respondents were broadly supportive of our proposals and generally commented on the details of the proposal rather than its overall desirability.

Analysis of the issues

- 2.2** In CP12/38 the FSA analysed the issues currently facing mutuals whose with-profits business is written into a single common fund but is in decline. We recognised that, under the existing rules, these mutuals may be obliged to close to new business when their with-profits business enters run-off.
- 2.3** While this may be a desirable outcome for some firms, for mutuals with viable businesses other outcomes may also be fair – and more likely to advance our objectives. We recognised that the implications of the current position could adversely impact diversity in the provision of retail financial services, and also affect competition. With-profits policyholders do not necessarily represent the sole relevant consumer interest in a mutual, and there may be many situations in which our guidance would produce a better outcome for with-profits policyholders than the current position.
- 2.4** In particular we were concerned about the following points:
- Mutuals often provide products and services that are specific to particular groups of consumers, or niche areas. Exits from these niche markets may lead to markets with only a few players, which would hamper product innovation and make it harder for consumers to access relevant services. This in turn would hamper competition.
 - If certain mutuals transferred robust businesses to their proprietary company competitors and run them along the same business lines, this might reduce competition. The mere fact that there are fewer providers could also have a negative impact on competition.
 - There would be significant wind-up or transfer costs for firms, impacting on consumers.
- 2.5** The FCA's guidance, by avoiding or mitigating these outcomes, will maintain diversity in the provision of retail financial services, and promote competition in the interests of consumers.
- 2.6** With-profits policyholders in mutual firms are currently affected by uncertainty and a lack of clarity over their rights and interests in the assets held in the common fund their policies were written into. Our understanding of the legal position is set out in Appendix 2. On this interpretation, with-profits policyholders whose policies have been written into a mutual's common fund may, as a class, ultimately be entitled to all of the assets in that fund. However, many mutuals who have taken external legal advice have expressed their disagreement with

this view, and, as recognised in Appendix 2, there is consequently uncertainty surrounding the rights and interests of with-profits policyholders in a mutual. Therefore, our understanding of the legal position reflects the fact that there are different opinions on respective rights and interests. In some circumstances, it may be in the interests of the with-profits policyholders to resolve this uncertainty by agreeing an appropriate compromise with the mutual.

- 2.7** Lastly, non-profit policyholders will benefit, as they will be able to remain customers (and, if applicable, members) of their chosen mutual. Under the current position that mutual might have had to close to new business and, in due course, sell its existing business to another long-term insurer.

Promoting competition in the interests of consumers

- 2.8** In CP12/38, the FSA set out the benefits of this proposal to find a way forward for with-profit mutuals.
- 2.9** The key benefit described in CP12/38 was maintaining diversity in the provision of retail financial service. We consider that this advances our competition objective, as well as our duty to discharge our general functions in a way which promotes effective competition in the interests of consumers (as long as this is compatible with our other objectives). As this guidance advances the competition objective the competition duty is met, as we are satisfied that it is compatible with acting in a way that advances the other objectives (see for example paragraph 2.23 below).
- 2.10** To assess the impact of our guidance on competition, it is important to assess its impact against what would happen without it. In the absence of this guidance, with-profits mutuals have two options for their non-profits businesses at the point of wind-up. They can either wind the business up or they can sell these business units on (to proprietary firms or other mutuals with different business models).
- 2.11** The wind-up of mutual businesses may have both short and longer term impacts on competition and consumers. If firms exit from markets there may be a direct reduction in competition as there are fewer market participants. In many instances there may be enough firms remaining in the market to ensure that the level of competition is not reduced. However, mutuals often provide products and services that are specific to particular groups of consumers, or niche areas. Exit in these markets may lead to only a few players with serious reductions in competition for these consumers, or no suppliers at all.
- 2.12** It should be noted that if a mutual's non-profit business is profitable, then it is more likely to be sold as a going concern rather than wound up. However, this does not necessarily mean that competition will be unchanged in the market. The fact that these businesses are no longer run by mutuals could lead to less competition.
- 2.13** If a mutual does not wind up its non-profit business, the business may well be transferred to a proprietary company. If this happens, it may not participate in the market in the same way as it did before. For example, it may focus on the most profitable lines of business, dropping lines that are marginally profitable or not aligned to its business model. As was mentioned in CP12/38, there is evidence that non-profit ownership plays a role in limiting firms' incentives to exploit consumer biases. Therefore the presence of mutuals in markets can reduce the social costs that may result from consumers' mistakes. Finally, having a wide variety of different business models may lead to greater innovation compared to insurers more generally. Losing

some of this diversity may reduce the scope for innovation in the longer term and lead to worse long-term outcomes for consumers. Reduction in products or services directed at particular consumer groups or niches may make it harder for those consumers to access financial services, especially where they are affected by social or economic deprivation.³ Further detail on the FCA's view on the promotion of effective competition is set out at Annex 2.

The rights and interests of with-profits policyholders and members

- 2.14** We identified in CP12/38 that one of the main reasons why the FSA had not achieved its aspiration of 'enabling firms with declining levels of with-profits business to maintain their mutual status and their independence' was the legal uncertainty as to the relative rights and interests of with-profits policyholders and members of the mutual in the assets in a mutual's common fund. We said that in the absence of a Court ruling on the issue in relation to a given mutual, it is impossible to say for certain which assets should be attributed to with-profits policyholders as a class, and which assets to the members of the mutual.
- 2.15** In light of the responses to consultation, described in more detail below, and more generally in light of the FCA's assumption of responsibility from the FSA for conduct of business regulation, the FCA considered it appropriate to review its understanding of the legal position⁴ on the rights and interests of with-profits policyholders in a mutual's with-profits fund (and connected matters). The results of this review are set out in a note in Appendix 2. In that note we set out our understanding of the legal position⁵, but recognise that there is some legal uncertainty⁶ and believe this may lead to disputes between with-profits policyholders and their mutual. It may be in the interests of with-profits policyholders to resolve such disputes with an appropriate 'compromise'. In the FCA's view an independent expert, and any independent legal adviser they appoint, should take this fact into account when considering a firm's proposals – as well as taking into account the particular circumstances of the firm in question.
- 2.16** In CP12/38 we explained the key elements of our proposed new option for mutuals to address this uncertainty. These include the following:
- Recognising the potential for mutuals to identify a mutual members' fund and a with-profits fund. This would not necessarily depend on the mutual, or the appointed independent expert, finally and conclusively accepting any particular legal view of the respective rights and interests of with-profits policyholders and members.
 - Firms could apply for a modification to COBS 20 to give regulatory effect to a separation between the mutual members' fund and the with-profits fund.
 - If the rule modification is granted, COBS 20 would still apply to the with-profits fund but would not apply directly to the mutual member's fund. However, rules applicable to the with-profits fund may indirectly affect the mutual members' fund, and broader protections such as the FCA's Principles for Business would continue to apply to the mutual.

³ See section 1E(2) of FSMA, which states that the matters to which the FCA may have regard in considering the effectiveness of competition in the market for regulated financial services include, amongst other things, the ease with which consumers who may wish to use those services, including consumers in areas affected by social or economic deprivation, can access them, and how far competition is encouraging innovation.

⁴ Having sought advice from external Counsel.

⁵ Our understanding of the legal position is unchanged from the FSA's understanding of the legal position, as already published in the various documents referred to in paragraph 2 of Appendix 2. However, our note aims to provide the detailed reasoning, as well as commenting on alternative views that we have been provided with and recognising the fact of legal uncertainty.

⁶ See paragraph 51 of Appendix 2.

- Firms could choose to go through another available legal process (such as a Court-sanctioned scheme of arrangement) to separate the assets in the with-profits fund fairly.
- We intended to remove the existing guidance on a vote of with-profits policyholders.⁷

2.17 This will allow firms to establish a mutual members' fund which can be used to write new business even when the with-profits business has run-off. As highlighted in paragraph 2.27 below, our proposed framework could also be used to assess any alternative proposals with similar aims.

2.18 The FCA recognises that if a mutual was granted the proposed rule modification, with-profit policyholders could arguably suffer detriment. For example:

- The FCA's understanding of the legal position (as set out in appendix 2) is that the assets in a with-profits fund will, generally speaking, ultimately be attributable to with-profits policyholders as a class. If that is correct, then if the proposed rule modification is granted the pool of assets in which with-profits policyholders as a class have an interest will be diminished.
- At present, COBS 20.2.60G(2) says that a mutual may continue to carry on a non-profit insurance business after the end of the life of the with-profits business, if the with-profits policyholders agree. This gives with-profits policyholders the ability to block such alternative arrangements.
- Depending on a particular firm's proposals, there may be issues arising from the level of recourse that the with-profits fund may have to the mutual members' fund.

2.19 The starting point is that the question of whether with-profits policyholders will suffer detriment will depend on the firm's particular circumstances and its particular proposals. The FCA will retain the discretion not to approve a proposed rule modification if the statutory tests have not been met.

With-profits policyholders' rights

2.20 Regarding the first point raised at paragraph 2.18 above:

- The nature of the legal uncertainty means there is no guarantee that a court will agree with our understanding of the legal position. Given the existing uncertainty, it may therefore be in the interests of with-profits policyholders to agree a compromise with their mutual, which may give them more than they would achieve in Court proceedings.
- The particular circumstances of the mutual may mean that our understanding of the generally applicable legal position will not apply to that firm.
- Where with-profits policyholders who are also members remain (or become) entitled to discretionary distributions, in their capacity as members, from the mutual members' fund, that may be taken into account in assessing the likely overall impact on with-profits policyholders.

⁷ In our response following paragraph 3.8 we note that we will keep the guidance generally, but will change it to note that it may not apply where a firm has successfully applied for a modification in line with these proposals.

Where with-profits policyholders could arguably suffer detriment, we consider that on the facts applicable to a particular mutual this may be balanced by the corresponding benefit to those policyholders of achieving clarity and certainty in a difficult and complex legal area. Following any successful modification application the with-profits policyholders would have an identified pool of assets which they would have an exclusive interest in as a class.

- By contrast, some mutuals suggest that it is essentially an accident of history that the capital of the 'owners' of the mutual – the members – has been intermingled with the assets of the with-profits fund, and that it is not unfair for the position to be regularised. As noted in CP12/38, we don't intend with-profits policyholders in a mutual to be left worse off than their equivalents in a proprietary company.
- In any event, and importantly, we believe that our guidance will promote our competition objective for the reasons outlined above, and set out in more detail in Annex 2.

2.21 Regarding the second point, we believe that our guidance will promote our competition objective for the reasons outlined above and set out in more detail in Annex 2. As noted in CP12/38 and below, our guidance includes a number of safeguards to ensure that with-profits policyholders are treated fairly and engaged by the mutual appropriately.

2.22 The third point raises the same or similar issues as the first two points. We will pay close attention to what firms propose regarding the availability of mutual capital for capital support, and the extent to which with-profits funds bear costs that may reasonably have been expected to be borne by the mutual members' fund.

2.23 We therefore consider that our guidance (together with the additional elements set out in this Policy Statement) will both promote competition in the interests of consumers, and secure an appropriate degree of protection for consumers.

Question from CP12/38

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

2.24 Most respondents broadly agreed with our assessment of the situation and the conclusions we had drawn. These respondents particularly supported the flexibility a rule modification would give as an additional option for with-profits mutuals wanting to continue writing new business after the run-off of their with-profits business.

We were asked to clarify when we would expect firms to use existing legal processes rather than apply for a modification to COBS 20 rules.

Some respondents questioned what we meant when we said such other options may not be 'available or viable in the circumstances of a particular firm'.

One respondent questioned what we meant when we said the separation of the fund will not depend on 'any particular legal view'.

Another suggested the legal analysis remained an important starting point for assessing fairness and in establishing the relative interests of policyholders and members.

Respondents also questioned how the process would recognise mutuals' previous practices, suggesting it may be difficult for firms to evidence previous policyholder communications.

Our response

We are pleased that the majority of the respondents agreed with our conclusions. Having taken the responses into account, we have decided to proceed with the proposed changes to our Handbook, subject to the changes set out below, and give firms the opportunity to apply for the modifications described.

We do, however, note that this may not be the best option for some mutuals which may want to continue to pursue other options. We note that one of the options mutuals have is to use existing legal processes in order to resolve any uncertainty about the extent of policyholder rights and interests in a with-profits fund. For example, for firms incorporated under the Companies Acts, these existing legal processes include the option to propose a 'solvent scheme of arrangement', which would be binding on policyholders following a vote by relevant identified classes of policyholder. Firms proposing a scheme of arrangement can advance broader proposals, involving changes to policyholders' rights and interests that are ultimately approved by vote and the court.

We understand that a court process may not be viable for some firms in light of the size of the with-profits fund in question, mainly due to the cost.

We also recognise that some firms, such as friendly societies, cannot effect a Companies Act scheme of arrangement.

We agree with the respondents who stated that an important starting point in establishing the nature and extent of stakeholders' interests in a with-profits fund is for firms to take their own legal advice⁸, to ensure that their proposals are appropriate and legally defensible in the context of their particular circumstances.

However, we must ensure that policyholders have an appropriate degree of protection. Where the advice obtained by particular firms or industry representatives differs from our understanding of the legal position (see Appendix 2), we are concerned to ensure that with-profits policyholders' interests are appropriately protected.

One option would be for the FCA to insist that its understanding of the legal position is the one that firms must adopt as part of their proposals. However, in light of the legal uncertainty, we do not intend to require this.

In section 2.16 of CP12/38, the FSA said that the outcome of the process 'will not depend on any particular legal view of the respective rights and interests'. This meant the FSA would not insist on its understanding of the legal position

⁸ Some firms have taken external advice.

on rights and interests in a with-profits fund⁹ being used by firms as the benchmark to measure the fairness of their proposals against.

However, we agree with concerns that a firm's proposals would need to take account of the legal position. We propose to include additional guidance clarifying that the independent expert appointed by a mutual will need to take into account all relevant legal views when considering a firm's proposals.

We believe this should include taking into account legal views which are more advantageous for with-profits policyholders than those held by the firm's own legal advisers, including the arguments that the FCA and/or with-profits policyholders themselves might make. In order to assist this process, a detailed description of our understanding of the legal position is in Appendix 2.

Where the independent expert is faced with a degree of legal uncertainty, we would expect them to obtain their own independent legal advice. This is our expectation in other related areas, such as insurance business transfers under Part VII of FSMA.

We expect that the firm, the independent expert and the FCA would have an interest in the appointment of an appropriate legal adviser, and in the terms of reference and questions asked of them.

The independent legal adviser may confirm that the legal position is uncertain. In that situation, we consider that this legal uncertainty is itself a relevant factor for the independent expert to take into account when assessing the firm's proposals.

We realise that our expectation that experts obtain independent legal advice may mean that our estimate for the costs of retaining an independent expert may need to be increased. However, we feel this is necessary to ensure an appropriate degree of protection for policyholders, and improve the prospect of an effective resolution of the differing legal positions as part of the rule modification process.

Where a mutual contends that it has a past practice of recognising mutual capital as separate from the with-profits fund, the firm and its advisers should in the first instance state what relevant evidence and practice it is relying on. We would expect some clear evidence of a supporting past practice to substantiate the position that the mutual is seeking to advance.

Alternative processes and alternative approach suggestions

- 2.25** Several respondents suggested that a rule change rather than a modification would be a more cost-effective process, and give greater certainty to with-profits mutuals.
- 2.26** Other respondents made detailed points about our approach to a rule modification. Some respondents were concerned that a rule modification process would create uncertainty, because

⁹ Described in paragraph 2 of the note in Appendix 2.

of the possibility of the modification being reversed in the future. Many of those respondents were also concerned about how long the modification would last. These respondents were concerned that it would be difficult for with-profits mutuals to unwind the mutual member's fund if the modification was subsequently withdrawn.

- 2.27** Some respondents suggested that, where a mutual can demonstrate that an alternative approach to a rule modification application provides a strong foundation for fairness to all policyholders and members, it should be encouraged to explore that approach with its supervisors. An example of an alternative approach given was the development of new forms of participating product backed up by an appropriate impact assessment.

Our response

We appreciate that firms want certainty before making long-term business decisions. However, as suggested in the CP, we believe that there is no 'one size fits all' solution, and that it is appropriate for the regulators to review mutuals' proposals on a case-by-case basis (including considering the viability of ongoing business proposals). Firms' proposals will reflect their individual circumstances and rule modifications may need to reflect individual factors, including the imposition of any conditions we consider appropriate. Therefore, we intend to implement the proposals on the basis of a rule modification process rather than make a change to the rules.

We understand the concerns over applying for a rule modification which is time limited and which regulators will, in theory, have the power to revoke. The restructuring of a with-profits fund would have long-term implications and it is unclear how it could easily be reversed. We therefore intend to allow firms to apply for a modification of a duration appropriate to the run-off of its remaining with-profits business. However, this must be balanced by the fact that it is appropriate for us to retain the discretion to revoke a modification, and to monitor the continued appropriateness of the modification in the context of our objectives. However, the long term implications, and the difficulties which any proposal to unwind a separation would cause, would be an important factor that we would take into account when considering the exercise of our statutory powers.

Since the modification will only achieve its objectives for mutuals if it has effect over COBS 20 and related requirements in both the PRA and FCA Handbooks, it will be desirable for both regulators to grant modifications for the same duration.

If it becomes appropriate to revoke a modification, we will follow the process described in SUP 8.8.2G of the FCA Handbook. This states that we should give the firm notice of, and reasons for, the proposed revocation, and allow the firm to make representations.

In terms of other alternative approaches that mutuals may adopt to resolve the current situation, we acknowledge that there are other approaches that may be more appropriate for some. Product innovation may be one of those approaches, and in those cases the FCA encourages mutuals to approach their supervisors to discuss the proposed products and their potential effect on policyholders' interests. If a firm's proposed approach would achieve the same or similar outcomes as our guidance for separating out mutual members' funds, we would expect to apply broadly the same principles we would for the rule modification process, tailored as necessary. As respondents have mentioned, mutuals will probably need to apply for an appropriate waiver in this situation.

With-profits mutuals not in run-off

- 2.28** Several respondents suggested that mutuals whose with-profits business was not yet in run-off should also be allowed to recognise a mutual members' fund, to allow them to pursue other lines of business more easily. Linked to this suggestion, one respondent also wanted greater clarity on whether capital held outside of the with-profits fund could be used to finance new with-profits business, and asked for our general view on transfers in and out of the with-profits funds.

Our response

The proposals in CP12/38 were not intended to apply solely to mutuals whose with-profits funds are either already in run-off or entering run-off, but could also be available to mutuals whose with-profits fund was open to new business but would face run-off if a solution was not found.

However, with-profits mutuals who are continuing to write material volumes of new with-profits business have the option to finance new business through the with-profits fund, as long as they are able to satisfy the relevant COBS 20 rules relating to the writing of new with-profits business. It may be therefore that such firms are unable to show how they are able to meet the statutory tests for granting a modification, for example, that without a modification the operation of the rules would be unduly burdensome. However, if firms wish to separate the fund and apply for a modification for a mutual members fund, we will consider these on a case by case basis against the principles set out in the guidance.

We will consider individual proposals from firms, but any proposals to write new with-profits business backed by capital from the mutual members fund will need to demonstrate how the firm will comply with regulatory requirements (including those in COBS 20 and INSPRU 1.5). Transfers in and out of the with-profits funds will need to be assessed on a case-by-case basis by reference to the relevant regulatory requirements including those in COBS 20 and INSPRU 1.5.

Concerns over reattribution rules

- 2.29** Some respondents said that, whilst they read CP12/38 as saying that the creation of a mutual members' fund would not be considered a reattribution, in some situations this position could conflict with the COBS 20 Handbook text included in the CP. These respondents asked us to clarify our position.

Our response

We thank respondents for highlighting this concern. The CP12/38 text said that separating out the mutual members' fund would not constitute a reattribution where the existing rights and interests in the assets in the with-profits fund are unclear and undetermined, but this will depend on the particular circumstances of a firm and its proposals. This is why we consider that firms will need to demonstrate whether their proposals amount to a reattribution on a case-by-case basis. We expect it to be part of the independent expert's remit to consider this. However, we have acknowledged that the legal uncertainty over the rights and interests of with-profits policyholders, as described in paragraph 51 of Appendix 2, may also be relevant to the question of whether what firms are proposing is a reattribution within the meaning in the FCA Handbook.

3.

Process for recognising a mutual members' fund

- 3.1** This chapter considers the comments we received on the proposed rule modification process, and our responses to those comments. It also considers comments relating to removing related guidance in COBS 20, interactions with EU legislation, and other parts of the FCA and PRA Handbooks.

The rule modification process

- 3.2** We proposed a framework through which firms could apply for a modification of the definition of a with-profits fund as it relates to COBS 20. This would be through the processes set out in s138A of FSMA, and if successful would remove the mutual members' fund from the direct application of COBS 20.
- 3.3** We also indicated that each regulator would need to be satisfied that the proposal met the relevant statutory tests for rule modification. These are that:
- complying with the unmodified rules would be unduly burdensome
 - complying with the unmodified rules would not achieve the purpose of the rules
 - the modification would not adversely affect the advancement of any of the regulator's objectives

The FCA's objectives for these purposes are to:

- secure an appropriate degree of protection for consumers
 - protect and enhance the integrity of the UK financial system
 - promote effective competition in the interests of consumers
- 3.4** In order for us to grant a modification, a firm must provide sufficient evidence that the modification would not adversely affect the advancement of any of these objectives. We also proposed removing existing guidance in COBS 20.2.60G, which says with-profits policyholders need to agree alternative arrangements for carrying on non-profit business.

Question from CP12/38

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

- 3.5** Most of the respondents supported the process, as they said it allowed mutuals to be considered on a case-by-case basis, and allowed past practice to be considered when assessing a rule modification application. However, one respondent noted that parts of COBS 20.2 were shared between the PRA and FCA, and was concerned that applying to both regulators for rule modifications would make the process more complicated. Another asked how the regulators would interact in the assessment process and which part of each organisation (the waivers team or the supervision team) would lead the assessment. Some respondents also asked about the basis on which we would make the modification. We take this to be a question about which arguments might be more likely to lead to a successful application: those based on the burden to a firm, or those based on the rules not achieving their intended purpose.
- 3.6** Many of the respondents supported the removal of the guidance in COBS 20.2.60G. There were two respondents who did not support the removal of the guidance because they were concerned about the impact this could have on with-profits policyholders. These respondents saw the policyholder vote as vital to their rights. One respondent considered that, even if a vote was not retained, the independent expert should act as a 'member advocate' to afford proper protection to all members, including whether or not there should be a with-profits policyholders' vote.
- 3.7** Some respondents also made detailed comments on the draft guidance. One respondent suggested we make changes to the draft guidance referring to 'a single common fund'. This respondent said that many mutuals operate multiple common funds, and so suggested that we change the wording to 'a common fund'.
- 3.8** It was also suggested that, in respect of the proposed COBS 20.2.1(2A)(vii), we should replace the reference to 'other policyholders' with 'other members', as a mutual's membership does not necessarily align completely with its policyholders.

Our response

Since the with-profits definition and the COBS 20 rules which the proposed modification applies to are included in both the FCA and PRA Handbooks, we agree that both regulators will need to be involved in considering the information provided by the mutual and deciding whether the application meets the respective statutory tests. We will liaise with each other on the decision in accordance with the statutory duty to ensure coordinated exercise of our functions under section 3D FSMA, and as laid down in the agreed Memorandum of Understanding.¹⁰ Where each regulator is satisfied that its statutory tests have been passed, each regulator will issue a modification (usually in a joint PRA/FCA direction). It is important to point out, however, that the PRA and the FCA will take separate decisions about their respective handbooks and the different tests for granting a modification.

As with all modification applications, the firm should specify the rules that they are asking to be included in the modification, and the justification for its scope.

¹⁰ <http://www.fca.org.uk/your-fca/documents/mou-between-the-fca-and-the-pracoordination>

Both regulators aim to consider modification applications as promptly as possible, and in accordance with their relevant published standards. In practice, the time which the two regulators would need in order to reach a decision on a modification application would depend on the quality of the original submission and the complexity of the mutual's specific circumstances.

In terms of the likely basis upon which the FCA would consider granting a modification, it is possible that firms could argue that it would be unduly burdensome for the firm to close to new business and to go into run off due to the rules. It will be up to firms to demonstrate that this is the case.

We understand the concerns about the guidance relating to the need for a vote of with-profits policyholders. In the CP we indicated that cost was one of the main reasons for advocating this, but we also have concerns that would effectively give with-profit policyholders a veto over reasonable and fair proposals, as assessed by an Independent Expert and the regulators. As set out above and in Annex 2, we consider that allowing mutuals with viable non-profit businesses to continue in business would be likely to advance our competition objective. Where we consider that the proposals afford policyholders an 'appropriate degree of protection' without a with-profits policyholder vote, then retention of the vote is difficult to justify in light of our competition duty. Of the options which we consider give 'an appropriate degree of protection' to consumers we think the one which does not allow with-profits policyholders a 'veto' right is one which promotes effective competition in the interests of consumers.

To ensure that with-profits policyholders have an appropriate degree of protection in the absence of a vote, we propose that firms engage appropriately with their policyholders. We would expect this to include notification and taking into account policyholders' objections. By analogy, Part VII of FSMA (dealing with insurance business transfers) requires policyholder notification and the consideration of objections, and is intended to afford due protection for those policyholders who consider their interests are prejudiced in light of the fact that the statutory process removes their ability to refuse their contractual consent to the transfer. We also intend to make clear how we see the role of the independent expert, and in particular their responsibility to properly consider the interests of policyholders.

Our proposal to remove the guidance relating to the need for a vote is linked to the protections afforded by our proposals relating to the modification process. We are proposing a minor change to our proposals in CP12/38 to put this into effect. We will retain the guidance in COBS 20.2.60G(2) saying that a vote of policyholders is needed, but we will add additional guidance stating that this may not apply if the firm successfully apply to us to modify the relevant provisions.

As stated in Handbook guidance in Appendix 1 of this PS, we will expect to be involved in the agreement of the independent expert's terms of reference. As part of that we will require that the terms of engagement ensure that proper consideration is given to the interests of with-profits policyholders (which may mean that the expert is asked to give a view on any part of the proposals, including the extent of policyholder engagement).

We have set out our understanding of the legal position on the rights and interests of with-profits policyholders in the with-profits fund, which we expect the independent expert and advisers to take into account. We also consider that it is important that the expert's role remains an independent one, to allow a fair and balanced resolution of complex and difficult issues. As a result of this we consider that it would not be appropriate for the independent expert to become a member or policyholder advocate. We intend to review the independence of the proposed expert and advisers in individual cases.

On the point about 'common fund' instead of 'single common fund', we thank respondents for pointing this out to us and have amended accordingly.

We do not agree that the language in COBS 20.2.1G(2A)(c)(vii) should change from 'other policyholders' to 'other members' as we consider that, in general, when a person buys a policy with a mutual they obtain their membership rights along with the policy. Therefore, limiting the guidance to 'other members' would be unduly restrictive. We recognise in COBS 20.2.1(2A)(v) that the mutual will need to comply with its constitutional requirements in relation to its wider membership.

Interactions with the Solvency II directive

- 3.9** Many of the respondents were concerned about how the concept of a mutual members' fund would interact with the concept of a ring-fenced fund being introduced under Solvency II. Many were concerned that fund surplus could become trapped in the mutual members' fund, and asked if the new fund could be exempt from the Solvency II requirements.

Our response

This matter is being dealt with in the PRA's own Supervisory Statement on CP12/38, which is being published concurrently with this PS. We refer the reader to this.

Interactions with other parts of the Handbook

- 3.10** Some respondents also questioned whether the change of definition of a with-profits fund through the modification would apply to COBS 20 only, or would apply to other related areas of the FCA and PRA Handbook, such as certain parts of INSPRU.
- 3.11** Respondents also asked how the creation of the mutual members' fund interacted with the requirement to have a Principles and Practices of Financial Management (PPFM) document.

Our response

We have amended the guidance to include references to waiving COBS 20 and any connected provisions (for example, those in INSPRU which rely heavily on the definition and scope of a with-profits fund).

We do not intend there to be a separate PPFM for the mutual members' fund, but there will remain a need for a PPFM for the with-profits fund. This will need to describe and take into account the relevance of the mutual members' fund to the with-profits fund.

For example, the PPFM may need to describe any continuing capital support from the mutual members' fund, and state where compensation or redress costs will be paid from, for example from the mutual members' fund as opposed to the with-profits fund.

Legal concerns

- 3.12** Some respondents asked us to clarify that the split between the mutual members' fund and the with-profits fund is a notional split, as this would help firms manage tax issues better.
- 3.13** Six respondents also asked which regulatory rules would apply to a mutual members' fund if it was not covered by the COBS 20 rules.
- 3.14** One respondent asked how the proposals would affect Holloway income protection products, which are already exempt from COBS 20.

Our response

We are not able to comment on the impact of these changes for tax purposes. We have said that the effect of the rule modification would be that the split would be recognised for regulatory purposes.

In terms of the mutual members' fund, it may continue to be indirectly impacted by COBS 20, for example in respect providing any capital support to the with-profits fund. The Principles for Business, including Principle 6 (Treating Customers Fairly), will continue to apply to the mutual as a whole. When a firm applies for a modification, it may be that conditions are applied to it which impose specific ongoing requirements on the operation of the mutual fund as it applies to with-profits policyholders. Firms must continue to comply with other FCA and PRA handbook provisions, and INSPRU in particular.

It should be clarified that Holloway income protection products are already exempt from COBS 20 and we do not envisage any change to this position.

4. Supporting the application process

- 4.1** This chapter summarises the responses we received on proposals to support the application process. Respondents were generally supportive of a requirement for firms to get an independent expert's report, and of having high-level principles which can be used to consider applications. Respondents did, however, raise points of detail, in particular seeking clarity on the meaning of some of the high level principles the FSA set out for assessing applications.

Independent expert report

- 4.2** We proposed that firms should obtain an independent expert's report, with the expert and their terms of reference being agreed by the FCA (in consultation with the PRA) in advance.
- 4.3** We also recognised that the key factors to consider when assessing an application would vary between mutuals.

High-level principles for application

- 4.4** We also elaborated on the high-level principles which would guide us in considering applications. They are:

1. The firm has a convincing and robust business case. What we are proposing is not an alternative to run-off for firms where that would be a better choice for their members.
2. The firm can demonstrate that its proposals are compatible with its obligations to treat policyholders fairly.
3. An independent assessment of the proposals and how they affect policyholders is carried out.
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.
5. The firm has a strategy to ensure that with-profits policyholders and the wider membership of the mutual are appropriately engaged and informed.
6. Balance sheet safety and soundness issues are identified and addressed appropriately.
7. The rule modification meets the appropriate statutory tests.

We then posed the following question:

Q3: *Do you agree with the support elements we are proposing for the process and the principles outlined?*

- 4.5** Most of the respondents broadly supported a requirement for firms to get an independent expert's report as part of the process of identifying and recognising the mutual members' fund. However, many respondents said the figure which we included in the cost benefit analysis (CBA) as the cost of engaging an independent expert was an underestimate. We suggested it would cost £32,000. This was based on experience of the costs we have seen for an independent expert to assess a complex case. Several respondents, however, suggested that the cost would be closer to £100,000.
- 4.6** One respondent stated that it was unclear who could act as an independent expert on this issue, asking whether it would be limited to the skilled person provider list.

Our response

We still consider that under a value-for-money arrangement there is no reason why a mutual firm cannot negotiate a fee commensurate with the size of the firm.

As to who could act as an independent expert, this would not be limited to the skilled person provider list. However, it should be someone with appropriate skills and expertise, probably an actuary or some other similarly qualified individual, who must be demonstrated to be independent of the firm. Crucially, the FCA, in consultation with the PRA, will have to agree to the individual and also agree to the terms of their remit.

Process for small mutuals

- 4.7** Some respondents supported a more cost effective approach for smaller mutuals, with one suggesting that firms whose with-profits fund was less than £100m should be able to use their own actuarial function holder or with-profits actuary. They suggested that the cost of engaging an independent expert would be disproportionately high for small mutuals.

Our response

We must be satisfied that the application meets the statutory tests before granting a modification. This is necessary, in part, to ensure that an appropriate degree of protection is afforded to policyholders. Whilst we accept that provision of such evidence might be a relatively large burden for smaller firms, we do not believe that policyholders of such mutuals should be afforded less protection than policyholders of larger mutuals. We do not believe it will be disproportionate in any particular case to require that the expert is independent of the mutual; it is important in our view that the expert is seen to be properly independent in all cases. In addition, we consider that part of the expert's remit will be to ensure that they have properly considered the interests of all relevant policyholders and ensure that fair outcomes are achieved for all. If the expert is

not independent of the firm it is difficult to see how that person would provide appropriate challenge and independence of view.

Clarity on the principles

- 4.8** Respondents agreed that setting high level principles was helpful, but many asked for more clarity on what we would expect from firms. Several respondents questioned how we would assess “a convincing and robust business case” under the first of the high level principles above.
- 4.9** In addition many of the respondents said that comparing the position of with-profits policyholders in the mutual firm with their equivalents in proprietary with-profits firms would be difficult in practice. Others asked for clarity on what we were looking for in terms of engaging and informing with-profit policyholders and the wider membership.

Our response

What would constitute a convincing and robust business case will depend on the circumstances of the individual firm, but we would expect to be provided with a medium-term business plan based on credible estimates of new business volumes and profitability. Firms should be prepared to demonstrate that their products are sustainable. We would normally expect the business plan, at least for the early years, to be based around products which the mutual already provides, or for which it can demonstrate relevant knowledge and expertise.

Regarding the comparison of the position of with-profits policyholders in the mutual firm with their equivalents in proprietary with-profits firms, one of our concerns is to ensure that allowing part of the with-profits fund to be categorised as ‘mutual capital’ does not leave policyholders worse off than they would be if, all other things being equal, their policy had been with a proprietary company.

So for example, we will be giving close attention to whether, if the same policyholders of the mutual would instead have invested in a standard 90:10 fund of a proprietary company, and all other circumstances are equal, the outcome could mean that the size of the inherited estate in the mutual is smaller than it would have been in the proprietary company.

Likewise, as an example, we would pay close attention to any proposals where compensation or redress, or any other cost, is being proposed to be paid from the with-profits fund where it would have fallen to shareholder funds in a proprietary company. The same point arises, for example, in relation to any proposals of ongoing capital support from the mutual members’ fund. The FCA considers that a relevant consideration will be the ability of the firm to provide a robust demonstration that the mutual has an established practice of keeping back established surplus in its with-profits fund to serve the wider membership, in a manner akin to shareholder capital.

We do, however, realise that this is an area where firms have concerns over practical difficulties. We will be prepared to discuss these with firms on a case by case basis.

Later in CP12/38, at paragraph 2.19, we said that it is important to note that our proposals have no bearing on proprietary companies – for with-profits policyholders of both proprietary companies and mutuals, our view remains that with-profit policyholders' interests are not limited to receiving smoothed asset share.

One way of engaging appropriately with policyholders and other members would be to propose that policyholders were notified in advance of a rule modification application, and given an opportunity to object. These objections would then be carefully considered by firms, the independent expert, the FCA and (to the extent they referred to prudential matters) the PRA. As a result, we consider that firms would be able to demonstrate that policyholder interests had been adequately protected.

We appreciate that firms may have concerns around the costs involved in an exercise to notify policyholders and consider all objections, including dealing with any queries not amounting to objections. It may be possible to save costs by bundling the proposals with other communications, such as the annual statements or other mailings. There could be timing issues, but that would need to be balanced against the cost of independent mailings and the priorities of each firm to resolve its current position. We will want to be assured that the clarity, fairness and content of the communications to policyholders are not prejudiced by being combined with other mailings, and that the communication maintains the appropriate degree of prominence.

5. Other issues

- 5.1 In this section we set out two further concerns raised by respondents.

Governance

- 5.2 We encouraged all mutuals to review their engagement with policyholders and members and describe how they engage in their proposal for a modification. We also encouraged them to describe how continuing membership rights will benefit with-profits policyholders and other policyholders. We stated that this would have a bearing on the overall fairness of a modification and whether it met the statutory tests.

Future distributions

- 5.3 Connected to governance, we encouraged firms to further develop ways of distributing positive returns to their members, to make membership more meaningful. To this end we asked the following question in CP12/38.

Q4: *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.*

- 5.4 Respondents who commented on this question recognised that these were important and related issues. Most of them highlighted the sector's commitment to better communication with members, and the importance placed on making membership more meaningful. Some respondents said that work to make the membership more meaningful was already underway in their firms.
- 5.5 One respondent was surprised the CP did not make more reference to the role of With-Profits Committees in relation to the split of the common fund, suggesting the committee had an important role to play in considering the impact.

Our response

We are grateful for the views we received on these issues and for the positive approach the sector is taking

In terms of the With-Profits Committee or equivalent, we believe that it should have a key role in any proposals by a firm to split the common fund, and will need to agree that any proposals meet the relevant fairness tests. Our guidance does not propose that the responsibility of the With-Profits Committee is any less than would otherwise be required by virtue of COBS 20.5 and/or the firm's ordinary governance processes. But we still believe that for this proposal to work in a credible and effective way there should be an independent expert, separate to any expert instructed by a With-Profits Committee.

- 5.6** Regarding the CBA, we received a number of comments saying the suggested cost to firms of the independent expert was too low, and also that the suggested costs to the FCA were too low.

Our response

The costs in the CBA were based on our view of what an independent expert report might cost. Based on previous experience, we set these costs at £32,000 per firm. We acknowledged that for larger firms this may be greater, and there may be the need for the expert to obtain further legal advice. That said, we do not feel that the cost would be prohibitive for most firms where a robust business plan can be justified. Even if this cost was considerably higher, it would not alter our position on our stated approach.

We acknowledge that internal FCA (and PRA) costs may be more than we suggested, especially given the complex nature of some of the firms. We estimated these costs at £60,000 in total. However, this would have to be compared against the ongoing costs of reviewing the firms as they went into run-off and closed to new business, which would be incurred anyway.

Annex 1

List of non-confidential respondents

Association of Financial Mutuals
Barnett Waddingham
Clifford Chance LLP
City of London Law Society's Insurance Law Committee
Clyde & Co
Dentists & General Mutual
Financial Services Consumer Panel
Herbert Smith Freehills LLP
Institute and Faculty of Actuaries
Investment & Life Assurance Group
KPMG
LV=
Milliman
Nottingham University Business School
OAC Actuaries and Consultants
Peter Bloxham
Peter Morris
Police Mutual
Reliance Mutual
Royal London Group
Scottish Friendly Society
Sheffield Mutual

Small Business Practitioner Panel

Telos Solutions

Towers Watson

Wesleyan Assurance Society

Wiltshire Friendly

Annex 2

Relevance to the FCA's competition objective

Material supporting the FCA's view that the guidance will promote effective competition in the interests of consumers

As highlighted in the policy statement (PS), the FCA considers that its proposals advance the FCA's competition objective. We set out in this annex some of the detailed factors and material that helped us reach that view.

Loss of providers from markets

As we set out in the PS, if with-profits mutuals are wound up then their non-profit business, and some with-profits business, will exit the market(s) in which they previously operated. We also considered that these non-profit businesses may no longer supply the same types of service if they are transferred to proprietary firms or other firms with a different business model. This will reduce choice for consumers in the relevant market(s) and, as a result, reduce competition. In particular we note the following:

- There are examples of mutuals whose product cover may not be available in the proprietary market - for example, specific types of cover offered to the farming community which may not be deemed sufficiently profitable for other firms.
- A number of mutuals have expressly noted that they offer products, including non-profits products, designed for their particular affinity group.
- Holloway products are an example of products developed within certain mutuals which have benefits for certain types of consumer (those on low incomes and certain types of employment), who may otherwise find themselves financially excluded. Products such as these are unlikely to be attractive to proprietary companies or mutuals with different business models.
- Certain mutuals have said they innovate by developing products with very low starting premiums, which may also have benefits to the financially excluded. These products may not provide the kind of margins required by proprietary companies or mutuals run along different business lines.
- According to the AFM, 35% of its members have an express charter or commitment relating to the areas they operate in or the affinity groups they serve. 19% of AFM members work mainly with a clearly defined affinity group or profession, and 19% work within a localised geographic area. Such commitments and consumer group focus may not be consistent with business models of other mutuals or proprietary companies.
- While the impact of exit in these markets (it may lead to only a few players, with reduced competition or no suppliers at all for these consumers) may only be for short periods of time

until new players enter, consumers could potentially face permanently higher prices if there are barriers to entry in this market.

The benefits of mutual firms to consumers

The mutual business model is attractive for some consumers, compared to the proprietary firm model. Consequently, the presence of well-performing, well-run mutuals will increase the engagement of some consumers with important financial products, and ensure that these consumers receive products that provide them with real benefits. For example:

- Consumer research carried out by the AFM and others suggests that policyholders value mutuality and member-owned organisations, particularly in relation to customer service, 'responsible' business and possible concerns around shareholder profits.
- The FCA is aware of proposals by mutuals that seek to develop their business models in line with this kind of consumer research. Consumers are likely to be presented with products which bring out the particular features associated with mutuality, providing more choice and encouraging innovation.
- There are examples of mutuals innovating with products in a way that may not be attractive to proprietary companies or mutuals with different business models – for example, products with very low starting premiums.
- Some products offered by mutuals are targeted at groups which may otherwise find access to financial services difficult, including those in socially or economically deprived areas. These products may not be attractive to other firms run along different business lines.
- Some mutuals also run community programmes which are likely to increase awareness of the mutual, which may improve take up of and access to financial products for those who may otherwise be excluded. An express reason that mutuals engage in these programmes is to attract new members and retain existing members (as well as, amongst other things, reinforcing traditions and values).
- There is also evidence from the AFM that their members have high persistency rates and very low complaints volumes.
- There is some evidence of mutuals having better payouts on savings products. If mutuals' businesses were to be transferred to proprietary companies this could change, which would reduce the benefits to consumers in the medium to long term.
- There is some evidence that non-profit ownership plays a role in limiting firms' incentives to exploit consumer biases and, as a result, that mutuals' presence in markets can reduce the social costs that may result from consumers' mistakes. The change in control of a mutual's non-profit businesses to proprietary firms could therefore see an increase in the exploitation of consumers' biases. These benefits to consumers could arise whether or not the consumers themselves are aware of them. So whether or not these benefits inform consumer choices, they arise as a result of competition from mutual. We consider that it is 'in the interests of consumers' to preserve them. It may well be that a renewed focus by mutuals on how the benefits of mutuality are presented means that these sorts of benefits will inform consumer choices more than they have to date.

Diversity improving competition

Even if mutuals' non-profit businesses remain in the same market selling the same products and services, competition in these markets may still be reduced if the businesses were transferred

to proprietary firms. This is because the incentives and objectives of a mutual firm, especially when supplying its members, may be different to a proprietary firm. These mutuals may price their products particularly keenly in markets, causing other firms in the market to improve their offer to win customers.

Appendix 1

Made rules (legal instrument)

CONDUCT OF BUSINESS SOURCEBOOK (MUTUALS) INSTRUMENT 2014

Powers exercised by the Financial Conduct Authority

- A. The Financial Conduct Authority makes this instrument in the exercise of its powers under section 139A (Power of the FCA to make guidance) of the Financial Services and Markets Act 2000 (“the Act”).

Commencement

- B. This instrument comes into force on 28 March 2014.

Amendments to the Handbook

- C. The Conduct of Business sourcebook (COBS) is amended in accordance with the Annex to this instrument.

Citation

- D. This instrument may be cited as the Conduct of Business Sourcebook (Mutuals) Instrument 2014.

By order of the Board of the Financial Conduct Authority

27 March 2014

Annex

Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text.

20.2 Treating with-profits policyholders fairly

...

20.2.60 G ...

- (2) Where it is agreed by its *with-profits policyholders*, and subject to meeting the requirements for effecting new *contracts of insurance* in an existing *with-profits fund* (COBS 20.2.28R), a *mutual* may make alternative arrangements for continuing to carry on *non-profit insurance business*, and a *non-directive friendly society* may make alternative arrangements for continuing to carry on non-insurance related business. Where a *mutual* has been granted a *waiver* in accordance with COBS 20.2.61G, the agreement of its *with-profits policyholders* to alternative arrangements for continuing to carry on *non-profit insurance business* may not be needed.

20.2.61 G (1) A *mutual* operating a common fund may seek to undertake an exercise to identify that part of the fund to which the *mutual* considers it would be fair for relevant provisions in COBS 20 not to apply.

- (2) To give regulatory effect to the identification exercise, the FCA expects that a *mutual* will need to apply to the FCA to modify the relevant provisions in COBS 20 and elsewhere which are dependent on the definition of the *with-profits fund*.

- (3) A *mutual* will need to demonstrate that the appropriate statutory tests in section 138A of the Act are met. The FCA expects that *mutuals* will need to do at least the following to allow the FCA to consider whether granting the modification would adversely affect the advancement of the FCA's consumer protection objective:

- (a) demonstrate that the exercise does not amount to a *retribution*;
- (b) demonstrate that its proposals are fair to its *with-profits policyholders*, and other relevant *policyholders*, having regard to the *mutual's* own particular structure, origins and other relevant circumstances, and including reference to the items in

(c) to (j) below;

- (c) obtain the report of an independent expert approved by, and whose terms of reference are agreed with, the FCA on the terms of the *mutual's* proposals and the likely impact and effects on, and fairness to, the *mutual's with-profits policyholders* and other relevant *policyholders*. This report should consider whether the *firm* has sufficiently demonstrated the absence of a *retribution* under (a). The FCA will consider using its powers in section 166 of the *Act* (Reports by skilled persons) in appropriate circumstances;
 - (d) demonstrate that the *mutual's with-profits policyholders* and other *policyholders* are appropriately engaged and informed about the proposals;
 - (e) demonstrate that it has complied with the relevant requirements in the *mutual's* constitutional documents, for example that members are appropriately involved in agreeing to any proposals;
 - (f) demonstrate that the *mutual* has a convincing and robust business case for continuing in business, as opposed to run-off;
 - (g) demonstrate how, and the extent to which, continuing membership rights will benefit *with-profits policyholders* and other *policyholders*;
 - (h) explain the nature and terms of any continuing support to be provided to the *with-profits fund* from outside the *with-profits fund*;
 - (i) 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*; and
 - (j) explain how it proposes to pay any compensation or redress that is, or may become, due to a *policyholder*, or former *policyholder*.
- (4) For the purposes of (3)(a) and (c), where the issues to be considered by the independent expert include the extent or value (in the particular circumstances of the *mutual*) of the rights and interests of *with-profits policyholders* in the *with-profits fund*, the FCA expects the independent expert's terms of reference to require them to take into account other available analyses of such rights and interests which may be

more favourable to *policyholders* than the *mutual's* own analysis. The *FCA* considers that any uncertainty in the extent or value of such rights and interests in the case of a particular *mutual* may mean that the independent expert will need to obtain their own independent legal advice on the issue. In the *FCA's* view the fact of any uncertainty as to the extent or value of the relevant rights and interests, following receipt of independent legal advice, may itself be taken into account by the independent expert when producing their report. The *FCA* will consider on a case by case basis what further information it may provide to the expert and/or independent legal adviser to ensure that the rights and interests of *policyholders* have been appropriately taken into account.

- (5) The *FCA* expects to consult and/or seek information or advice from the *PRA* in accordance with section 3D of the *Act* and the Memorandum of Understanding between the *FCA* and the *PRA* required by section 3E. As part of any such process the *FCA* expects that the *PRA* will wish to consider, among other things, that balance sheet safety and soundness issues have been identified and addressed appropriately.

Appendix 2

The FCA's understanding of the legal position

The FCA's understanding of the legal position

RE: THE LONG-TERM FUNDS OF MUTUAL LIFE INSURERS

AND RE: PROJECT CHRYSALIS

THE RIGHTS AND INTERESTS OF POLICYHOLDERS IN THE LONG-TERM FUNDS OF MUTUAL LIFE INSURERS AND CONNECTED ISSUES

1. In this document the Financial Conduct Authority (“FCA”) sets out its understanding of the legal position¹ in relation to the rights and interests of policyholders in the long-term funds of mutual life insurers (“mutuals” or “mutual societies”). It also sets out the effect of some of the rules relating to these long-term funds in Chapter 20 of the Conduct of Business Sourcebook (“COBS”).
2. Having taken advice, the Financial Services Authority (“FSA”) previously set out its understanding of the legal position in, amongst other things:
 - (a) A “Dear CEO” letter dated 13 October 2009.²
 - (b) A “Dear CEO” letter dated 28 September 2010.
 - (c) Consultation Paper 11/5.
 - (d) A document entitled “Rights and expectations of with-profits policyholders in mutuals: the FSA’s legal position”, published in March 2011.
 - (e) Policy Statement 12/4.

¹ Having obtained the advice of external Counsel.

² Partly superseded by subsequent FSA publications and communications.

3. However, in light of the FCA's assumption of responsibility from the FSA for conduct of business regulation of the mutual sector, and the proposals considered in Consultation Paper 12/38 and the responses thereto, the FCA, having taken advice, believes it is appropriate to set out its understanding of the legal position in this document. A summary of the FCA's understanding is set out at paragraph 20 below.
4. This document deals first with the rights and interests of with-profits and non-profit policyholders in the long-term fund of a mutual society, both prior to winding-up and upon a winding-up. It then considers the effect of certain parts of COBS 20.2.

The rights and interests of policyholders in the long-term fund of a mutual society

Introduction

5. The volume of with-profits long-term insurance business transacted by some mutual societies has been declining and is predicted to continue to do so. In a number of cases, it is foreseeable that a mutual society may cease to write a material number of, or any, new with-profits policies.
6. This raises the question: what are the rights and interests (if any) of with-profits and non-profit policyholders, both in their capacity as policyholders and in their capacity as members, in relation to the assets held in the fund into which their policies have been written and in relation to any assets held by a mutual outside that fund?
7. There are two types of interest that a policyholder may have in the long-term fund of a mutual society. First, he may have an interest in his capacity as a policyholder. Secondly, he may have an interest in his capacity as a member of the mutual.
8. A with-profits policyholder's rights and interests in his capacity as policyholder can be divided into two main types. First, contractual rights arising under his policy, being the right to a guaranteed sum and accrued bonuses (if any). This document refers to these as a policyholder's "contractual rights" or his "contractual entitlements". Secondly, his reasonable expectations in his capacity as policyholder, arising out of a mutual society's statements and practice and the FCA's own rules. These reasonable expectations are held by with-profits policyholders as a class. The content of policyholders' reasonable

expectations is considered in various contexts below, but they include an expectation that the policyholders will receive their smoothed asset share.

The definition of a “with-profits fund”

9. The definition of “with-profits fund” in the FCA Handbook Glossary is, so far as is material:

“(a) a long-term insurance fund (or that part of such a fund) in which policyholders are eligible to participate in any established surplus; and

(b) where it is an insurer's usual practice to restrict policyholders' participation in any established surplus to that arising from only a part of the fund (or part fund) falling within (a), that part (or that part of the part fund).”

10. The word “participate” does not usually connote exclusive participation. There is nothing in the definition to suggest that the usual meaning of the word was not intended. This accords with the clear intention of the FCA as to the practical scope of the definition. For example, it was clearly intended to cover the with-profits funds of proprietary life insurers, where surplus is not solely attributable to with-profits policyholders but is distributed both to those policyholders and to shareholders. If the word “participate” was construed to mean “participate exclusively”, then the definition would not cover these funds.
11. It follows that the definition of a “with-profits fund” will apply to any mutual’s long-term fund where with-profits policies have been written into that fund. Mutual societies typically only operate a single long-term “common fund”, into which both with-profits and non-profit contracts are written. As a matter of practice, therefore, it will generally apply to the long-term funds held by mutuals.
12. The analysis set out below applies only to the particular fund or sub-fund into which a with-profits policy has been written. As noted above, in a mutual society that fund is usually the main “common fund”. However, if a with-profits policy has been written into a formal sub-fund or a separate fund, or has been transferred into such a fund pursuant to a valid transfer of insurance business, the analysis below only applies in relation to excess surplus generated in that particular fund or sub-fund.

13. If a mutual has had a usual practice of restricting policyholders' participation to any established surplus arising from only part of a long-term fund or sub-fund, and where the FCA's rules have been complied with in relation to policyholder communications, this could constitute that part of the fund or sub-fund as a self-contained and independent "with-profits fund" within the meaning of limb (b) of the Glossary definition.

Mutual societies

14. The analysis below is premised on a mutual where the membership does not solely consist of with-profits policyholders. Where the only members of a mutual are with-profits policyholders, the with-profits policyholders as a class will be entitled ultimately to all the assets in the long-term fund in the event of their distribution, other than those assets required to satisfy the contractual entitlements of non-profit policyholders, if any (none of whom, on this hypothesis, have membership rights).

15. If the mutual is incorporated (either as a company or as an incorporated friendly society), it has a separate legal existence and has both the legal and beneficial interest in the assets which it holds. The assets of a registered friendly society are held by its trustees for the members of that association from time to time in accordance with a contract on the terms of the friendly society's rules.

16. Some assets belonging to the mutual will be required to satisfy in due course the contractual rights of policyholders and their reasonable expectation of receiving their smoothed asset share. Further assets will be required, so long as the business continues, to provide the additional capital reserves required by the rules and regulations applicable to mutuals and to provide the capital backing new business written by the mutual. And some may be surplus to such requirements and potentially distributable to policyholders (by way of addition to their asset shares), or to any other persons to whom a distribution is permitted by the constitution. For the purposes of this document, the surplus described in the previous sentence corresponds to what is referred to as "excess surplus" in the FCA Glossary and regulated by COBS 20.2.21R and COBS 20.2.22E (and not, for the avoidance of doubt, to surplus identified by mutuals on an annual basis and distributed to with-profits policyholders by way of annual bonuses).

17. In general, the potentially distributable surplus assets of the long-term fund consist of profits that have accumulated over the generations during which policies (both with-profits and non-profit) have been written into the long-term fund. If there was any initial capital derived in some other way (for example, from subscriptions by the original members), this will usually have happened so long ago that any surplus assets currently in existence can only sensibly be treated as surplus accumulated profits.
18. Some mutuals take the position that, regardless of the correctness of the FCA's understanding of the legal position in general terms, that analysis does not apply to them because they only began to sell with-profits business relatively recently and/or have only ever sold low levels of with-profits business. Clearly, such a contention needs to be considered on a case-by-case basis.
19. However, some mutuals have sought to adopt that position despite the fact that they have been selling with-profits policies for decades, and/or when with-profits policies now represent a significant proportion of the long-term fund by number and/or value. The FCA understands that the legal position set out in this document will nevertheless apply in such circumstances.

Summary of conclusions

20. In relation to surplus accumulated profits:
- (a) if there is a distribution of surplus accumulated profits whilst a with-profits fund remains open, the holders of with-profits policies written into that fund have the reasonable expectation that with-profits policyholders as a class will in their capacity as policyholders receive all of that distribution, unless, in a manner compliant with FCA rules, they have been told otherwise by the mutual, or the mutual's usual practice prevents such an expectation arising;
 - (b) with-profits policyholders have no reasonable expectation of a distribution during the life of their policies. However, the effect of Principle 6 and COBS 20.2.21R is that, in some circumstances, a mutual may be obliged to make a distribution;

- (c) the same principles ought to apply if a distribution is made once a with-profits fund has closed to new business and is being run off. This is so despite the fact that the closure of a with-profits fund may have the consequence that the mutual is unable to write any new business and thus ultimately leads to a winding-up of the mutual;
- (d) if a with-profits policyholder is also a member of his mutual, he may have an interest in his capacity as member in the assets distributed upon the winding-up or dissolution of that mutual. Whether or not he has such an interest, and the extent of that interest, will depend on the terms of the mutual's constitution and the applicable statutory provisions. If a winding-up does not occur, and the assets that would otherwise be distributed to the members in their capacity as members upon a winding-up are not distributed, the members will not be able to require those assets to be distributed (unless the relevant majority votes to do so under the mutual's constitution). This applies equally to members who are with-profits policyholders, and notwithstanding the fact that they may be the last generation of with-profits policyholders.

The entitlements of with-profits policyholders in their capacity as policyholders

21. In relation to sub-paragraph 20(a) above, whilst no particular generation of with-profits policyholders has the expectation of a distribution of surplus from the mutual's common fund (over and above an expectation that they will receive their smoothed asset share) during the lifetime of their policies, and certainly not a right to insist on it, the very nature of the policies they have taken out means that with-profits policyholders as a class are the only group of policyholders that have contracted to share on an ongoing basis in the mutual's profits. It is clear, therefore, that if a distribution of excess surplus were to be announced by a mutual, at least part of that excess surplus would be attributable to the with-profits policyholders.
22. Thus, where a distribution of surplus accumulated profits takes place, the question arises: who is potentially interested in that distributable surplus apart from the with-profits policyholders?

23. The answer to that, at least in theory, is that the members in their capacity as members may have such an interest. That is so, not (as some corporate mutuals have suggested) by virtue of section 172 of the Companies Act 2006 (the duty of directors to promote the success of the company for the benefit of members as a whole), but rather because, as the owners of the mutual, the members are the other class of persons who are potentially interested in assets belonging to the mutual.
24. However, the proportion of the distributable surplus profits attributable to the members in their capacity as members would reflect the value of their present rights and the present value of their future or contingent rights. The value of those rights in practice seems always (except perhaps on a demutualisation) to have been disregarded, or treated as being of negligible value.
25. There are several possible rights that may be given to members by the constitutional documents of a mutual. These are likely to include (and may well be limited to) the right to vote at general meetings, and (subject always to the provisions of the mutual's constitution) the (very remote) right to participate in any surplus upon winding-up or dissolution of the mutual. In the context of a distribution of excess surplus such rights, if considered at all, are unlikely to be regarded as of any significant value. So it is not surprising that if there is distributable excess surplus in practice it all goes to with-profits policyholders, who are the members who have contracted to share in the mutual's profits.
26. The analysis set out in the previous paragraph may differ slightly if a mutual has an established practice of distributing benefits to members in their capacity as members. Such a practice may produce the result that, when the directors of a mutual consider the exercise of their discretion in relation to a distributable excess surplus, they attribute slightly more of that surplus to the members in their capacity as members than they otherwise would have done. For the directors validly to take this sort of established practice into account, the practice would have had to have been one whereby specific material benefits in money, or money's worth, were provided to members in their capacity as members. In any event, however, the effect of any such practice is unlikely to be particularly material, given the strength of the competing interest of with-profits policyholders in their capacity as policyholders in a distributable excess surplus.

27. Moreover, even if some small proportion of the distributable surplus accumulated profits is attributable to the members, that would not mean that the mutual would be obliged to distribute that proportion to them.³ Whether the mutual decides to distribute the proportion (if any) of the surplus accumulated profits attributable to its members to those members is a matter for it.
28. Some mutuals have suggested that the duties of the mutual's directors are inconsistent with the analysis above. For the reasons set out below at paragraphs 35-36, that is not the FCA's understanding of the legal position.
29. In summary, as set out at sub-paragraph 20(a) above, if there is a distribution whilst a with-profits fund remains open, the holders of with-profits policies written into that fund have the reasonable expectation that with-profits policyholders as a class will in practice receive all of the distributable surplus profits, unless, in a manner compliant with the FCA's rules, they have been told otherwise or the mutual's usual practice has prevented such a reasonable expectation arising. With-profits policyholders have that expectation for two reasons. First, because the distribution is of accumulated profits, the entitlement to which is the fundamental characteristic of a with-profits policy and which were promised to the with-profits policyholders when they bought their policies. Secondly, because the only other class to which the surplus accumulated profits are attributable are the members of the mutual, and as set out above the value of their interest is likely to be negligible.

With-profits policyholders' reasonable expectations in relation to distributions

30. The principle set out at sub-paragraph 20(b) above is that with-profits policyholders have no reasonable expectation of a distribution during the life of their policies. This follows from the discretion vested in the directors of a mutual in relation to the distribution of that mutual's surplus accumulated profits.
31. However, the FCA has made rules, COBS 20.2.21R and COBS 20.2.22E, which require a firm to determine on an annual basis whether it has an "excess surplus", and to distribute such of that surplus as is attributable to with-profits policyholders if it would

³ Assuming that the constitution does not require the directors to do so.

be a breach of the FCA's Principle 6 to retain it. As a result of Principle 6, mutuals are subject to the same obligation. With-profits policyholders have a legitimate and reasonable expectation that these rules and Principle 6 will be complied with.⁴

32. When a firm's directors are considering the exercise of their discretion in relation to an identified excess surplus, the effect of Principle 6 and COBS 20.2.21R in the context of the conclusion set out at paragraph 20(a) above is that those directors are obliged to distribute that identified excess surplus if they do not have a good reason for retaining it (i.e. unless it is fair to their customers to retain it).
33. Accordingly, although with-profits policyholders do not have a reasonable expectation that they will ever receive a distribution, in the circumstances contemplated by COBS 20.2.21R and COBS 20.2.22E their reasonable expectation that the mutual will comply with FCA rules produces, in practice, an outcome identical to the outcome that would result if they did have a reasonable expectation of a distribution in those circumstances.
34. Any firm considering its obligation to treat its customers fairly should take into account all relevant circumstances, including those arising as a result of a firm's other legal obligations. In some circumstances these other legal obligations may legitimately impact on whether a firm's conduct is fair. In the present case, however, a mutual's other legal obligations will, by definition, have been taken into account during the process by which the amount of surplus accumulated profits (if any) is ascertained.
35. Some mutuals have suggested that the analysis above is inconsistent with a director's duty to act in good faith in the best interests of the mutual's members as a whole, and in particular a duty to have due regard to the long-term interests of the mutual's members. It is suggested that this duty may allow, or even compel, a director to conclude that it is in the best interests of the mutual for an identified excess surplus not to be distributed, or not to be distributed to with-profits policyholders in their capacity as policyholders.
36. The FCA does not accept that there is any inconsistency. In one sense it is correct to say that satisfying a regulatory obligation to treat customers fairly may not be in the "best interests" of a mutual and its members, because it may leave the mutual worse off;

⁴ See the statement of Norris J. in In the matter of Commercial Union Life Assurance Company Ltd and Ors [2009] EWHC 2521, paragraph 40

however, it is axiomatic that a mutual must nevertheless comply with its regulatory obligations. The analysis above sets out why a mutual may be obliged to distribute an identified excess surplus if it does not have a good reason for retaining it. It also sets out why the holders of with-profits policies have the reasonable expectation that with-profits policyholders as a class will in practice receive all of such a distribution (unless, in a manner compliant with the FCA's rules, they have been told otherwise or the mutual's usual practice has prevented such a reasonable expectation arising). These propositions flow ultimately from a mutual's obligation to treat its customers (i.e. its policyholders) fairly. Any duty on a director to act in the long-term interests of a mutual's members cannot affect or override the mutual's obligations to its policyholders. For its policyholders are its customers; and the fact that some or all of its customers may also be members⁵ does not alter those obligations.⁶

Run-off of a with-profits fund

37. As set out at sub-paragraph 20(c) above, the principles set out at paragraphs 20(a) and 20(b) above ought to apply in relation to distributable surplus accumulated profits once a with-profits fund has closed to new business and is being run off. The treatment of the surplus in the closed fund that remains after the strict contractual rights of with-profits and non-profit policyholders have been met should be consistent with the treatment of excess surplus in an open fund. On this analysis, it makes no difference whether that with-profits fund constitutes the only fund owned by a mutual or whether the mutual has other, separate funds which remain open to new business. This outcome is analogous to the outcome in the case of a proprietary long-term insurance company.

38. The closure of a with-profits fund may have the consequence that the mutual is unable to write any new business and thus ultimately leads to a winding-up of the mutual. This is essentially an accident of the structure of mutual societies, which usually write all of their business into a "common fund".

⁵ This document does not deal with the case where the membership of the mutual consists exclusively of with-profits policyholders – see paragraph 14 above.

⁶ The FCA notes that a director's duty to treat a mutual's members equally does not require him to treat them identically: Mutual Life Insurance Co of New York v The Rank Organisation Ltd and others [1985] BCLC 11, 24 *per* Goulding J. If there are material differences between the rights and interests of different classes of a mutual's members (such as between those members who are with-profits policyholders and those who are non-profit policyholders), a director's duty does not oblige him to ignore those different rights and interests.

39. In such a case, the analysis above will continue to apply. Although it would seem to follow that, as the closure of the common fund to new business makes it inevitable that a winding-up of the mutual will eventually occur, the present value of the members' contingent right in their capacity as members to participate in a distribution will increase as the relevant contingency becomes more likely. However, the quantum of the accumulated profits that the members' right, when crystallised, will relate to is likely to still be relatively small, as the mutual is likely to be obliged over time during run-off to distribute those profits as excess surplus before any winding-up occurs.
40. Further, it is likely to be the case that, when the number of remaining with-profits policies reaches a certain level, the mutual will need to consider whether to take steps to transfer its remaining policies to another provider or to take other steps to ensure the fair run-off of all the policies in the fund, as the alternative will be effectively to convert the with-profits fund into a form of tontine scheme in a manner inconsistent with the fair treatment of with-profits policyholders.

The entitlements of with-profits policyholders in their capacity as members

41. Finally, sub-paragraph 20(d) above relates to the rights and entitlements of members to any surplus accumulated profits remaining on a winding-up which are distributed after the contractual entitlements and reasonable expectations of the policyholders have been satisfied and the other liabilities of the mutual have been met. The amount of these accumulated profits is unlikely to be large when compared to the surplus existing at the time that the with-profits fund closed to new business, as most of that surplus will have been distributed to the with-profits policyholders during the course of run-off.
42. Moreover, as already mentioned, remaining policies are likely to have been transferred to another provider well before winding up or dissolution, so what follows is likely to be academic, at least as regards a solvent mutual; and if the mutual is insolvent, the question of how to distribute surplus will not arise.
43. On a winding-up, with-profits policyholders who are members will receive the aggregate of their entitlements in their capacity as policyholders and in their capacity as members. The entitlements of policyholders and members will depend on the applicable statutory provisions and the relevant provisions (if any) of the mutual's constitution. However, the

result, although important in theory, is unlikely to matter much in practice for present purposes. If the mutual is insolvent there will *ex hypothesi* be no surplus to be distributed. If it is solvent and has existing policyholder liabilities, a winding-up is highly unlikely to happen, as a transfer of the business during the course of run-off will almost certainly be preferable for policyholders.

Alternative analyses

44. The analysis above reflects the FCA's understanding of the legal position. It is right to observe, however, that other arguable legal analyses can be put forward. It will suffice to identify two of these alternative analyses drawn from responses made by mutuals the detail of which has been developed in the following paragraphs based on our understanding of, or inferred from, the position of mutuals.
45. The first accepts the propositions set out at paragraphs 20(a) and 20(b) above, but suggests that those propositions will not apply in a run-off situation. The FCA cannot see why this should be so. Nevertheless, it is arguable that the different commercial character of a run-off means that the principle of fairness should apply differently to distributable surplus identified during the course of a run-off.
46. The second alternative analysis parts company from the FCA's analysis set out above in relation to the issue of what interest, if any, with-profits policyholders as a class would have in any identified excess surplus which was being distributed.⁷ The argument proceeds on the basis that, although with-profits policyholders have contracted to share in the mutual's profits, they have done so in the context of membership of a mutual society where the assets are held ultimately for the benefit of the membership as a whole, and that with-profits policyholders have no expectation of receiving anything beyond their contractual entitlements and their smoothed asset share (plus any distributions of excess surplus actually made to date). If excess surplus were to be distributed at all, it would be to the membership as a class, not to with-profits policyholders as a class. The position of with-profits policyholders in a mutual is different from that of with-profits policyholders of a proprietary company, who join on the express contractual basis, or

⁷ For the avoidance of doubt the second alternative analysis does not adopt as its starting point, or depend on the correct legal assessment of, the position of policyholders and members on a winding up or dissolution.

with the reasonable expectation, that any excess surplus which is distributed will be split between them and the shareholders, typically on a 90/10 basis.

47. On this analysis, the directors' decision set out above is based both on the interests of members in their capacity as members and on the absence of any other relevant interests or expectations held by the with-profits policyholders.

48. Insofar as the members are not customers, Principle 6 will not apply.

49. Insofar as the members are customers, the second alternative analysis recognises the obligation imposed by Principle 6 but accepts that it is reasonable for the directors to decide to give effect to the interests of members in their capacity as members by retaining the excess surplus within the mutual, as by doing so they are perpetuating the mutual's existence and preserving its assets (which it is reasonable to assume is the members' wish, as they have not yet voted to dissolve the mutual in accordance with its constitution).

50. Thus, all assets held by a mutual which are not required to satisfy either the contractual entitlements of policyholders or the reasonable expectations of with-profits policyholders (limited to smoothed asset share plus any distributions of excess surplus actually made to date) are immediately attributable to their legal and beneficial owner – the mutual – and ultimately attributable to the members in their capacity as members. The mutual will have to deal with these assets in the interests of its members from time to time, as set out in its constitution, but will not be obliged to distribute these assets save to the extent that the constitution requires such a distribution. This will almost certainly be only on a winding-up or dissolution of the mutual.

Legal uncertainty

51. As already indicated, the FCA's understanding of the legal position is different to the alternative legal analyses identified above. However, the FCA accepts that they could lead to disputes. Accordingly, in general terms the FCA recognises that there is a degree of uncertainty surrounding the rights and interests of with-profits policyholders in the long-term fund of a mutual which, depending on the circumstances of a particular

mutual, it may be in the interests of the mutual's policyholders to resolve by an appropriate "compromise" with the mutual.⁸

The meaning and effect of the FCA's rules relating to new types of with-profit policies

52. Having considered the various rights and interests of with-profits and non-profit policyholders in the long-term fund of a mutual society, this document now considers the meaning and effect of the FCA's rules applicable to mutuals which wish to sell new types of with-profit policies.

53. There is a recognition by some mutuals that their volumes of with-profits business are declining and may start to decline irreversibly. The FSA was and the FCA has been approached in relation to proposals to create and market new types of with-profits policies ("New Products")⁹.

54. This document first considers a proposal to sell New Products instead of more traditional with-profits policies, and then considers the position of a mutual which proposes to sell New Products at the same time as more traditional with-profits policies. This document considers the position on the assumption that New Products will fall within the definition of a "with-profits policy" contained in the FCA Handbook.¹⁰

55. COBS 20.2.28R provides that, if a firm proposes to effect new contracts of insurance in an existing with-profits fund, it must only do so if (amongst other things) the firm's governing body is satisfied so far as it reasonably can be, and can demonstrate, that the terms on which each type of contract is to be effected are likely to have no adverse effect on the interests of the with-profits policyholders whose policies are written into that fund.

56. No particular generation of with-profits policyholders has an expectation that the capital used by a mutual society to support both their policies and the entry into new policies

⁸ Such uncertainty may also be relevant to the issue of whether such a compromise constitutes a reattribution within the meaning of the FCA Handbook.

⁹ See for example the Dear CEO letter dated 13 October 2009 paragraphs 17-23.

¹⁰ The question of whether a New Product is a "with-profits policy" as defined in the FCA Handbook will depend on the terms and nature of the product. In general, terms which do not confer a material participation right are unlikely to make a New Product a "with-profits policy".

will be distributed to them during their lifetime as a policyholder.¹¹ It cannot therefore be said that the continuing entry by a mutual society into with-profits policies of a type similar to the policies held by its existing with-profits policyholders could constitute a breach of COBS 20.2.28R on the sole basis that such continuing entry had the effect that the existing generation of with-profits policyholders would ultimately receive less than they would have if the with-profits fund was closed to new policyholders and the existing policies run off.

57. However, where (a) it is proposed to sell New Products which are substantially different to those contained in the policies held by existing with-profits policyholders¹², and (b) this may have an adverse effect on the existing generation of with-profits policyholders, the question of whether COBS 20.2.28R is being complied with arises.¹³

58. This being so, the board of a mutual society considering the introduction of New Products will, in order to comply with COBS 20.2.28R, need to consider whether the introduction of New Products will have an adverse effect on existing with-profits policyholders.

59. This will require the board to compare the position of the existing with-profits policyholders if the New Products are introduced with their position if the New Products are not introduced. This may involve a comparison with the position of with-profits policyholders if the with-profits fund was closed to new business and run off.¹⁴

60. Some mutuals have suggested that the analysis above is inconsistent with a director's duty to act in good faith in the best interests of his mutual. Clearly, ascertaining what course of action is in the best interests of a mutual will require consideration of the

¹¹ Although if a distribution is announced, they do have an expectation that they will participate in this distribution.

¹² For example, because the New Products only gave a right to participate in specific types of capital or surplus rather than a right to participate in any distribution made from a mutual's long term fund (and therefore the risk to the mutual attaching to such policies as a whole would be materially less than the risk attaching to existing with-profits policies), and/or where there was no significant extra charge made for the inclusion of the participation right over and above the cost of an analogous non-profit policy.

¹³ Where COBS 20.2.28R is engaged, COBS 20.2.29G sets out possible ways in which a material adverse effect on existing with-profits policyholders could be avoided.

¹⁴ See COBS 20.2.41BG, COBS 20.2.54R and 20.2.55G and Dear CEO letter dated 13 October 2009 paragraph 21. A transfer of business to another provider may involve some of the assets in the long-term fund being used to fund the costs of the transaction or the ongoing costs required by the receiving fund, and therefore not being available for distribution. A mutual may take this into account when considering what fair treatment of its with-profits policyholders involves. The legal uncertainty described in paragraph 51 may also be relevant when considering the position of a with-profits fund which closes to new business and enters run off.

particular circumstances of that mutual. However, three general observations can be made:

- (a) The FCA believes (and does not understand any mutual to disagree) that a director's duty to act in the best interests of his mutual does not compel, and may well not permit, him to have regard to the interests of future members if this would disadvantage the interests of existing members.
- (b) The obligations on a mutual and its Board arising under COBS 20.2.28R arise in relation to a mutual's policyholders in their capacity as customers. COBS 20.2.28R sets out, in a particular factual scenario, what the fair treatment of those policyholders in their capacity as customers involves. As already noted above at paragraphs 35 - 36, a mutual could not refuse to treat its customers fairly on the basis that it did not regard that as being in the mutual's best interests.
- (c) Further, the FCA does not understand how directors of a mutual could legitimately decide that, because some or all of its policyholders were also members of a mutual, it was entitled to treat them in a less advantageous way because the directors believed this would be in the best (long term) interests of the mutual's members as a whole. Nor does the FCA understand how any duty on a director to act in the best interests of the mutual's members as a whole could affect the meaning and content of its obligation to treat its customers (including with-profits policyholders, whether or not they are members) fairly.

61. Next, some mutual societies may like to continue to sell "traditional" with-profits policies alongside New Products. Here the board would not only have to consider the effect of such business on its existing with-profits policyholders but also whether any conflict might arise in the future between the interests of new policyholders with traditional products and those with the New Products.¹⁵

62. However, the FCA will need to consider a mutual's proposal to sell New Products into an existing with-profits fund on a case by case basis, in the light of that mutual's particular circumstances.

¹⁵ See COBS 20.2.29G.

Financial Conduct Authority



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