Future Regulatory Framework Review
Financial Services Strategy
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

4 February 2022

AFM Response to HMT consultation on its regulatory framework review

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

    - Comment on the proposals, and their consequences for the UK financial services sector, including members of AFM.

About AFM and its members

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of around £25 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2] and to take account of corporate diversity[3].

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[1] ICMIF, https://www.icmif.org/publications/market-insights/market-insights-uk-2016 with updates from EY and AFM
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

AFM comments on the proposals

4. We welcome the latest consultation on the review of the regulatory framework in the UK. We agree with the need recognised by the government for the financial services sector to remain vibrant and innovative, and of critical value to the UK economy.

5. We share the same ambitions as the government, and agree with much of the proposals. We consider though that in some respects there is an opportunity to be more ambitious and more creative in ensuring that the regulatory framework supports, and does not hinder a growing sector, that contributes to the overall success of the UK economy.

6. Mutual organisations are habitually compliant, and always seek to meet the expectations of regulators, in the understanding that by doing so they are working in the best interests of their customers. In the past we could be criticised for sacrificing growth for compliance, and we think that the new regulatory framework will help remove unnecessary barriers to firms seeking to grow their businesses and better benefit their customers, as well as the community at large.

7. As part of the Government's Levelling Up plan[4], all government departments will need to assess how they support the transformation of the UK, and spread prosperity to all parts. The regulatory framework provides an ideal opportunity, for HM Treasury and the regulators, to explore their responsibilities and commitments. Whilst the paper rightly focuses on the obligations of the regulators for fostering international competitiveness, the risk remains that the current one-size regulatory rulebook makes it more difficult for smaller businesses, including mutuals, to deliver meaningful change. The high costs of regulation, and the barriers to entry for new mutuals, mean that the traditional customer base of the sector, including people striving to protect themselves and their family from an uncertain financial future, face less choice and less affordable products. For example:

   a. Health cash plans, provide a means for people to pay for regular healthcare costs, like dental or optical care, as well as a wide range of other services, but their business model, which relies on low premiums (less than £10 a month) and regular claims, is becoming marginalised by recent FCA rule changes;
   b. Friendly societies offer hardship grants, non-contractual benefits, fraternity and care services, to their members, often using the

[4] https://www.gov.uk/government/news/government-unveils-levelling-up-plan-that-will-transform-uk

legacy estate, built up over generations, to fund awards, but this is coming under attack from private equity and other sources, due to a lack of protection;

c. Not-for-profit healthcare providers make significant donations every year to community projects and local NHS trusts, as a means of sharing their profits, but are increasingly at risk due to regulation which fails to understand and facilitate their business model;
d. Most mutuals are based outside of the south-east, delivering economic value into local communities across the country, but continued consolidation and the obstacles to creating new mutuals, mean that the sector is rapidly diminishing;
e. Regulatory constraints on investments by mutuals mean that their capacity to invest in infrastructure programmes and other levelling up programmes is severely constrained, depriving local communities and members of the opportunity for longer-term, social investments;
f. We have held initial talks with HM Treasury on opportunities to revise the Friendly Societies Act 1992, and Mutuals Deferred Shares Act 2015, and action to review the legislation would contribute to resolving many of the points above, and enable our sector to make a more worthwhile contribution to the levelling-up agenda.

8. We note elsewhere that HM Treasury plans to consult on an Insurer Resolution Regime for the UK. Whilst we recognise plans for this may be at an early stage, our discussions with mutuals in Europe indicate that proposals of a similar nature there are being strongly resisted, as they fail to reflect differences in business model. We would be very keen to discuss this with HM Treasury, to avoid problems of a similar nature in the UK.

9. We have responded to the specific questions raised in the consultation below, and would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Martin Shaw
Chief Executive
Association of Financial Mutuals

AFM responses to questions raised in the consultation

1. *Do you agree with the government's approach to add new growth and international competitiveness secondary objectives for the PRA and the FCA?*

We agree that the objectives relating to growth and international competitiveness are essential to enabling the financial sector to continue to contribute effectively to the UK economy.

Indeed they are so fundamental to the success of the sector that we question whether they should be primary objectives rather than secondary. By establishing such vital issues as of secondary importance, there is a likelihood that the regulators will only consider them once they have discharged their primary obligations. Under those circumstances there is a real risk that nothing really changes as a result.

That said, we anticipate that the effect of the new objectives, on growth and international competitiveness, will be that regulators will think more expansively about the nature of regulation in the UK, and the role of financial services in the broader economy.

To illustrate, the ongoing review of Solvency 2 in the EU and UK need not end in the same place, and there is a great deal of scope for PRA to ensure the rules are more proportionate, and avoid the compromises that are necessary in the EU by seeking to apply common standards over a range of countries with varying historical approaches, and maturity in their insurance markets. Equally, where the EU is consulting on proposals for an Insurance Recovery and Resolution Regime (IRRD), we think there are significant risks in applying a similar approach in the UK, which fails to recognise the specifics of the UK insurance market, and of the mutual sector.

We agree that the PRA and FCA should be required to report on their performance in respect of these objectives, and consideration should be given to what action is available if they fail to undertake this commitment properly. We consider reporting against their objectives is an important accountability, and we consider the obligation to report on performance should be extended to the regulatory principles.

For example, via the Bank of England and Financial Services Act 2016, a requirement was added to the regulatory principles, to take proper account of corporate diversity[5]. However, we have seen no active consideration by

[5] Section 20: https://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

either PRA or FCA to act on this, and in part the absence of any obligation for them to account for how they have undertaken this responsibility gives them an easy way to overlook or neglect the responsibility. That failure would be avoided by greater transparency and an obligation to report.

We consider the objectives will support a more coherent and consistent regulatory environment, and foster greater cooperation between the PRA and FCA. We support the intentions of the Wider Implications Framework, to improve dialogue and information sharing across conduct regulation.

2. *Do you agree that the regulatory principle for sustainable growth should be updated to reference climate change and a net zero economy?*

   We agree. Whilst a lot of the risks that firms need to manage on climate change are already inherent in capital standards, such as Solvency 2, a high-level principle ensures a clear and collective commitment to action.

3. *Do you agree that the proposed power for HM Treasury to require the regulators to review their rules offers an appropriate mechanism to review rules when necessary?*

   We agree. It is not clear whether measure 3 applies equally to PRA as FCA, and we think PRA should be incorporated into this.

   Challenge to rulemaking is important. Pre-Brexit, the rulemaking process was too convoluted, making any progress difficult- though much of that was a result of the differing maturity of financial markets in different EU states. However, much of the scrutiny was very valuable, and the rule-makers, such as EIOPA were regularly challenged by the European Commission, and this improved the rulemaking process. The UK does not need such an elaborate control process, and in our assessment, the mechanism proposed offers an effective balance.

4. *Do you agree with the proposed approach to resolve the interaction between the regulators' responsibilities under FSMA and the government's overseas arrangements and agreements?*

   We agree. Since the UK left the EU, we have seen a range of problems for AFM members in respect of overseas customers. This includes:

- Last minute intervention from the PRA on a transfer between two friendly societies, on the basis of a de minimus number of customers in a number of EU countries, whose interests PRA placed above the 99% plus customers in the UK due, we consider, to a misplaced understanding of the way it should interpret the Friendly Societies Act 1992;
- FCA has been unwilling to engage with national supervisors in EU countries, to ensure customers in those countries did not lose entitlement to the product whilst a UK citizen. We first raised this issue in 2019, but an absence of engagement between UK supervisors and their EU counterparts meant that every small business had to seek legal advice for every country where they had any customers. This imposes unnecessary additional costs on smaller firms, which ultimately will be passed onto their members.

5. *Do you agree that these measures require the regulators to provide the necessary information to Parliament on an appropriate statutory basis to conduct its scrutiny?*

   We agree, and consider that scrutiny by Parliament is vital and that the proposals are proportionate.

6. *Do you agree with the proposals to strengthen the role of the panels in providing important and diverse stakeholder input into the development of policy and regulation?*

   We agree with the overall approach.

   We suggest that regulators should provide a ring-fenced budget for research for each panel, to enable them to add value into their review role. We don't think this should be significant, but the absence of a fund reduces the potential value panels can offer to the regulators.

   We would like to see greater transparency on the engagement with panels, including which policy proposals are presented to them, and at what point in the process. In our view, regulators would benefit considerably by engaging with panels much earlier in the development of new regulations, to sense test proposals and to avoid unintended consequences.

   Whilst we consider the practitioner panels offer a vital role, the degree to which the regulators act on their feedback appears quite limited. In addition, we do not consider they are a replacement for sector engagement, especially as panel members don't represent a particular sector. However, in our experience, FCA and PRA have increasingly hidden behind panels to justify reduced engagement with trade bodies.

7. *Do you agree that the proposed requirement for regulators to publish and maintain frameworks for CBA provides improved transparency for stakeholders?*

   The primary weaknesses in current CBA work relate to: the limited efforts made to quantify benefits; the lack of transparency in assessing costs; and the limited commitment to post-implementation review.

   PRA does not publish a list of the questions it is consulting on, so it is difficult for firms to recognise the key issues to respond on, and easy for PRA to avoid demonstrating it is acting on or that it has responded to the issues raised.

   The legislation relating to consultations on regulatory fees excuses PRA and FCA from including a CBA of their fees proposals. We feel strongly that this gives regulators a free pass on the fairness of its approach, and a lack of accountability to the industry or to parliament. It is very easy for the regulators to raise fees, in the expectation that extra focus might be given to a particular product area, only for that work not to materialise. No account is made for this in the next fees consultation; equally no effort is made to quantify the actual work delivered in each fee area each year. As a result, the inexorable rise in fees across the regulatory landscape (including FOS and the FS Compensation Scheme) goes unchecked.

   To illustrate, some of our members saw fees increase by 50% in the last year, but this was not matched by any increase in regulatory engagement, new policy-making, or supervisory attention. There is no practical basis to query or appeal the way fees are set.

8. *Should the role of the new CBA Panel be to provide pre-publication comment on CBA, or to provide review of CBA post-publication?*

   We consider a CBA Panel would be a valuable addition, as long as it has clear terms of reference that the regulators are bound by, and the right calibre of members, with analytical skills and the capacity to interrogate, and add value to, the regulator's assessment.

We think post-publication review is most useful. If post-publication is taken up, regulators should submit a summary/ checklist to the Panel, each time they produce a CBA, to set out why the CBA was necessary, what evidence they considered, and whether and how financial estimates were arrived at- plus what degree of confidence they had in their estimates, particularly for the proposed benefits.

We consider that pre-publication review would delay the process, give regulators a safety net for incomplete work, and remove the need for continuous internal learning.

9. *Do you agree that the proposed requirement for regulators to publish and maintain frameworks for how the regulators review their rules provides improved transparency to stakeholders?*

We agree, and we consider that for CBAs, the regulators should assess the impact over time, to review whether the benefits have been realised, and that the costs are fully understood.

One particular feature we have observed is that regulatory initiatives are established at significant cost to the industry, but with limited capacity for benefits to emerge before the next new idea is launched. We have illustrated this through a table at the end of our response, showing consumer protection initiatives that impact AFM members.

Roughly speaking, a new major consumer protection initiative has been launched every 18 months since the FCA was established. Most of these are iterative, but each one imposes very significant implementation and running costs on industry. Previous initiatives have not bedded in before another is launched, and the benefits are readily merged from one into another, such that the impact is obscured.

The enormous increase in the cost of regulation in recent years inevitably has consequences, and as a result mutuals in particular have had to pass costs onto customers (as they have no shareholders to fall back on). Equally, we have seen otherwise viable businesses conclude that the constant ratcheting of regulation, and increases in costs, mean that they are no longer able to continue. And whilst the increase in regulatory fees has been dramatic, that has been the tip of the iceberg in overall compliance costs.

We agree that there should be no alternative dispute resolution mechanism for challenging regulatory decisions. Whilst the judicial review process is seldom used, the nature of disputes is likely to require a full legal review.

Recently, FCA consulted on a proposal for a Private Right of Action: it has withdrawn that proposal for the present, and with the opportunity for a consumer to raise concerns with the FOS or the courts, there is no sense at all in opening up new mechanisms. We see an alternative dispute resolution for challenging regulatory decisions in the same light.

10. *Do you agree with the government's proposal to establish a new Designated Activities Regime to regulate certain activities outside the RAO?*

    We agree; the role set out in the consultation is appropriate. We agree with the value of the DAR in retaining EU law, and in going beyond those in future.

11. *Do you agree with the government's proposal for HM Treasury to have the ability to apply "have regards" and to place obligations on the regulators to make rules in relation to specific areas of regulation?*

    We agree that government should be able to apply a limited range of 'have regards', and that these should include areas currently covered by retained EU law. We consider the range of 'have regards' set out should be limited, as otherwise it creates a risk that government has undue influence over the activities of the regulators.

    We agree with the proposal from the Financial Inclusion Commission, that one of these 'have regards' should be in relation to financial inclusion:

    "The FCA should be required to have a cross-cutting "must have regard" to financial inclusion. This should include a statutory duty to report to Parliament annually on:

    - *the state of financial inclusion in the UK*
    - *measures that the FCA has taken, and is planning to take, in order to advance financial inclusion*
    - *recommended additional measures which could be taken by government and other public bodies to promote financial inclusion."*

How consumer protection in insurance has evolved over time

(Draft, January 2022)

The following bullet points give a (non-exhaustive) list of where regulation and legislation has given particular focus to policyholder protection over time. The notes are intended to support AFM members in recognising both the evolution of standards, and the need to constantly appraise how actions today might be assessed in the future.

Insurance **contracts** have always been used to set out what a policyholder should expect from their insurance provider, and the nature and content of contracts has evolved over time via a combination of legislation, regulation and case law. In the case of a mutual insurer, the contract may, and will often, overlap with the rules or constitution of the insurer.
Policyholders' Reasonable Expectations were first established in insurance law in 1973, in relation to with-profits life insurance. PRE was described as influencing the fair treatment of policyholders, and to codifying the practices of the business, and the approach to entitling customers to a fair share of the profits.
Oversight of the financial services industry prior to 2001 was undertaken by a range of different bodies, including the Department of Trade, the Friendly Societies Commission, the **Securities and Investment Board** and the General Insurance Standards Council.
The notion of **Treating Customers Fairly** first appeared in rules made under FSMA 2000. At around the same time, a series of court cases brought significant developments in PRE (e.g. Equitable Life, 1999, and Axa, 2000), which indicated that the actuarial interpretation of PRE had diverged over time. TCF was built into FSA/ FCA rules in *principle for business 6*.
The insurance industry response to TCF and new regulatory focus, was to develop the **Raising Standards** self-regulatory scheme, to define best practice and to demonstrate the commitment of the sector to high standards and external assessment.
Where FSMA secured the creation of the **Financial Services Authority**, which gained its powers on 1 December 2001, it also led to the creation of the Financial Ombudsman Service and Financial Services Compensation Scheme. Together with the enforcement powers gained by FSA, the new regulatory bodies collectively brought a sea change in consumer protection.

Alongside TCF, the **Sandler Review** in 2001 sought to introduce a range of stakeholder products, with defined terms and charges, to simplify product design and increase transparency. Much of the original concepts remain in regulatory rules today. The **Retail Distribution Review**, in 2006, similarly sought to provide greater clarity around costs and fees. Also, in 2007, the COBS and ICOBS sourcebooks were introduced (to replace COB and iCOB rulebooks).
In 2004, FSA introduced the **Principles and Practices for Financial Management** (PPFM) for with-profits products, and two years later required the production of a shorter Consumer-Friendly PPFM.
Conduct Regulation evolved from TCF, with a closer focus on both behaviours and outcomes. The creation of the FCA, in 2013, brought a sharper focus on conduct, though the concept arguably came out of an EU study of the 2008/9 financial crisis. Conduct regulation encompasses consumer regulation, corporate governance, fit and proper standards and product governance.
FCA first developed a focus on **vulnerable customers** in 2015, initially to develop a common understanding of vulnerability, before going on to test the levels of vulnerable customers in the UK, via research, and to introduce an 'Approach to Consumers' to set out a vision for well-functioning markets in 2018. Consultations in 2019 and 2020 lead to finalised guidance on vulnerability in February 2021.
The **Insurance Distribution Directive** was fully implemented in 2018, and adding extra protections for consumers buying insurance, and new expectations for firms on product governance and oversight.
The **Senior Managers and Certification Regime** (SMCR) replaced the approved persons regime in 2019, with the intention of strengthening market integrity and reducing harm to consumers. The SMCR is designed as a catalyst for a healthier culture, and more effective governance, by increasing accountability and establishing higher standards of conduct.
As part of its review of the GI market, FCA introduced **GI value measures** reporting in 2021, to tackle poor product value and harm to consumers through ineffective competition.
FCA's **Consumer Duty** initiative follows on from the previous consumer protection regulation, and aims to set 'higher expectations for the standard of care that firms provide to consumers'. In addition to past themes on behaviours and outcomes, the Consumer Duty adds an explicit focus on culture. The new rules apply from July 2022, and aim to deliver a more consistent standard of consumer protection.
FCA published an **overview of its 2021 consumer protection** work; see here.

Association of Financial Mutuals, January 2022