CLIFFORD

CHANCE

Briefing note May 2012

UK Regulatory Reform: Adapting to the new approach to regulating insurers

"Perhaps the most obvious failing of the UK system, however, is the fact that no single institution has the responsibility, authority or powers to monitor the system as a whole, identify potentially destabilising trends, and respond to them with concerted action".[1]

In the aftermath of the financial crisis of 2008, there emerged a consensus of opinion both on the global stage and in the domestic arena that failures in regulation played a significant role in the crisis. In the UK, in particular, the view of the then Labour government was that that failure was caused by weaknesses in the Tripartite system of regulation. However, whilst the Labour government's proposals for change did not involve a wholesale dismantling of the Tripartite system, George Osborne made clear from the outset that the Coalition government believed that the Tripartite system *"failed spectacularly in its mission to maintain stability"* and nothing less than a *"programme for radical reform"* would suffice, which *"places the judgement of expert supervisors at the heart of regulation"*.

This Client Briefing looks at some of the key proposals in the Financial Services Bill (the "Bill"), which was formally introduced into Parliament in January 2012 and highlights some of the regulatory challenges facing the UK insurance market.

[1] HM Treasury: A new approach to financial regulation, July 2010.

The Solution – A new regulatory structure

The new regulatory structure embeds the twin peak model of regulation, with responsibility for macro prudential oversight resting with the FPC, which may give directions and recommendations to both the PRA and the FCA. For insurers and reinsurers (including the Lloyd's market), this means that they will now need to deal with two regulators: the PRA on prudential issues and the FCA on conduct matters (such firms referred to in this briefing as "dual-regulated"). For around 25,000 firms, including over 6,000 insurance brokers (and Lloyd's members' agents), the FCA will be both prudential and conduct regulator.

There should be no doubt, however, that the Bill does much more than just tinker with the regulatory structure; it strikes right at the heart of the culture of regulation and firms' day to day interaction with their regulator. Many firms have already been experiencing the effects of the changes in the FSA's approach to supervision and, following the FSA's move to the internal twin peaks model on 2 April, this is likely to intensify.

PRA Objectives

The objectives of the PRA will be to promote the safety and soundness of banks, insurers and other dual-regulated firms primarily by ensuring that the way such firms carry out their business does not cause any adverse effect on the stability of the UK financial system and also minimises the adverse effect of a failure of the firm on that stability. The PRA also has a specific insurance objective of contributing to the securing of an appropriate degree of protection for those who are or may become policyholders and also in relation to with-profits insurance policies which is discussed further below.

One concern raised by the insurance industry is the lack of insurance expertise required amongst the members of the PRA Board. Many of the insurers and trade bodies who responded to HMT consultations agreed that there should be a requirement for such expertise and the Joint Select Committee appointed to conduct pre-legislative scrutiny on the Bill concluded that the Bill should include provision for at least one member of the board of the PRA to have specialist expertise in the area of insurance. However no requirement has made it into the Bill (so far) and, with the departure of Hector Sants, who has of course gained that experience during his years at the helm, the experience gap becomes even wider. Of course, this does not preclude the PRA appointing an insurance expert but to date no proposals are forthcoming. The risk, then, of a closer alignment in the PRA's approach to banking and insurance regulation must surely increase, notwithstanding the special "insurance" focused statutory objectives for the PRA in the Bill.

FCA Objectives

The draft FCA objectives have been amended through pre-legislative scrutiny of the Bill to emphasise that it is much more than a pure conduct regulator. The all encompassing but somewhat esoteric objective of the FCA is "to ensure the relevant markets function well". The "operational objectives" of the FCA are to secure protection for consumers, enhance the integrity of the UK financial system and promote effective competition in the interests of consumers in the market. In the insurance market, the FCA will, for example, review sales and advice processes and the appropriateness of insurance products marketed and sold by firms. It will also have wide powers under the Bill to ban products before they reach the market or ban a firm from selling particular products if, for example, sale processes are unacceptable.

Insurers: Authorisations and Permissions

- Application to the PRA with consent of the FCA required.
- Each regulator has power to instigate an own initiative removal of permission requiring only consultation with the other regulator.

Comments

- *The Government is to consider revising threshold conditions to set out two separate standards for the PRA and FCA and, as the PRA and FCA each have power to create further threshold condition codes, firms will need to demonstrate compliance with both regulators' requirements.*
- *The requirement for FCA consent may, in reality, lead to two separate approval processes and time delays.*
- *The power of individual regulators to vary permissions and the lack of clarity around the "consultation" requirement adds further uncertainty for firms.*

Internal Twin Peaks

The FSA moved to the internal twin peaks structure on 2 April 2012, so that its internal divisions reflect, so far as possible under the current FSMA regime, the regulatory twin peaks structure to be implemented by the

Part VII transfers

- The approval of the Independent Expert and the Independent Expert's report will be made by the PRA which will consult with the FCA beforehand.
- Each of the FCA and PRA will have the right to participate at the court hearing (the draft MoU contemplates that each regulator may make its own written report to court and, therefore, we assume, to be represented by Counsel at the hearing).
- The PRA will also consult with the FCA before approving notices published in the press and sent to policyholders.

Comments

- *It remains unclear how the PRA and FCA will interact in Part VII transfer processes, in particular, the extent to which the FCA will exercise its rights to be heard and demand equal say in the process.*
- *There is some uncertainty over the form and content of the Independent Expert's report, which must consider the objectives of each regulator if they are to be able to refer to it in their reports and whether this will further delay the process.*

Bill. The FSA hopes that this will allow it to pilot new regulatory processes, train its staff, and assess the effectiveness of the proposed new structure prior to the PRA and FCA formally commencing their functions during 2013.

The Prudential Business Unit (PBU) and Conduct of Business Unit (CBU) have been created internally to mirror the PRA and FCA. The two "internal regulators" will have separate approaches and firms must be ready to deal with two sets of supervisors going forward. Both the PBU and CBU will operate a forward-looking, proactive and judgement based supervisory approach which Hector Sants recently noted will be evidenced by a willingness to intervene and stop a firm behaving in a way contrary to the regulatory objectives for the financial services industry.

The FSA's business plan 2012/2013 sets out how supervision will change for firms including the phasing out of ARROW assessments and the split approach. Hector Sants has confirmed that there will likely be one set of requirements given to firms following a supervisory review, but divided into two sections, with no priority between addressing prudential and conduct risks. As regards the nature of assessments, the PBU will maintain the dedicated supervision process for insurers which may have a systemic impact but the CBU will move to undertake firm assessments through a more flexible resourcing approach and make more interventions on a thematic (rather than firm specific) basis.

Although the FSA continues as a single regulator, we expect this internal reorganisation, at least in the short term, to cause delays to regulatory processes, as the organisation and its staff adjust to the new regime. Firms will also need to implement changes to the way they communicate with the FSA to cater for the separate functions of the PBU and CBU. Perhaps more significantly, the shift in supervisory culture will be felt most keenly by those firms discussing new business ideas with the regulator.

Supervisory Approach

Judgement based supervision

"The reason we want to move towards a twin peak approach….is a question of judgement and culture, not structure."[2]

Sir Mervyn King, in particular, has been highly critical of what he perceived to be the legalistic and bureaucratic approach to regulation under the FSA, believing it to be inappropriate for prudential matters. He has stated that problems arise when firms take the view (and are so advised by their lawyers) that they can carry out their business as they wish provided it is not in breach of the rules and consequently firms choose to comply with the strict letter of the rules but avoid the spirit of the regulation.

The regulators' approach to supervision will, therefore, be forward-looking and judgement based, with a greater focus on early intervention rather than reactionary changes. There will be a greater involvement of the regulators' senior management in supervisory decisions. Both HMT and the FSA have recognised that "*if supervisors are making forward-looking judgements there will be times that, with the benefit of hindsight, those judgements can be questioned*" and that, at times, the supervisor's judgement will differ from the approach of the firm.

Such judgement based supervision necessarily implies a reduction in reliance on the rules and an increased emphasis on the spirit of regulation. Inevitably this creates a tension between firms and the

2 Sir Mervyn King, oral evidence to the Joint Committee, 3 November 2011.

regulators and creates a level of uncertainty for firms making commercial decisions, as they can no longer take comfort that compliance with the rules will avoid regulatory intervention or provide them with a robust defence in the event of such intervention. On the other hand, in an environment where an ever increasing volume of rules is emerging from the new European supervisory authorities, the degree of "judgement" which the regulators can exercise might well be much less than they anticipate.

Proactive Intervention Framework

The ARROW framework will be replaced with a revised continuous risk assessment process for all firms. For insurers, this will be commensurate with the level of risk the firm poses to policyholders and the stability of the system. Higher risk firms will be prioritised and will have regular interaction with their supervisors. This implies a lighter touch supervision approach for lower risk, smaller insurers.

The PRA will introduce a pro-active intervention framework ("PIF") which will provide for early identification of risks and provide for the regulatory actions required for resolution of a firm in difficulty. The PIF will have five stages, each prescribing actions of the PRA ranging from normal course supervision to increased supervision, requiring recovery and resolution plans and changes to the business, removing authorisation and working to provide continuity and/or compensation for policyholders. The PRA will also assess a firm's planned resolution and recovery plans and how it would exit the market in a way consistent with the objectives of the PRA. It is uncertain the extent to which this will result in the PRA requiring comprehensive recovery and resolution plans for insurers in the normal course. It remains to be seen how this approach fits alongside the requirement under Article 144 of the Solvency II Directive (2009/138/EC) to remove the permissions of an insurer which does not meet its minimum capital requirement within three months.

The general supervisory approach of the PRA will be mirrored by the FCA where the number of firms supervised on a "relationship managed basis" will be significantly reduced. The FCA has confirmed that it will build on the FSA's conduct strategy of intensive forward looking supervision, early intervention and credible deterrence. It is interesting to note that the FCA will also place greater emphasis on wholesale conduct but has not elaborated on what this means for the wholesale insurance markets. For insurers, in particular those which are subject to a more continuous supervisory scrutiny, it is conceivable that a level of detailed scrutiny from two regulators, each pursuing separate objectives, will lead to a significant increase in compliance costs and also in management time.

Twin Peaks Supervision in Australia

Australia adopted twin peaks regulation in 1998. The Australian Prudential Regulation Authority (APRA) was established with supervisory and standard-setting jurisdiction over banks, insurance companies and superannuation funds while the Australian Securities and Investments Commission (ASIC) was charged with conduct-of-business supervision, encompassing licensing and oversight of corporations, markets and financial services providers. Therefore, similar to the proposals under the Bill, the Australian regulators have different objectives and approaches which impact upon dual-regulated firms. The Australian Government has stated in relation to the twin peaks structure that "problems *arose when there appeared to be divergences between guidance provided on meeting*

Insurers: Change in control

- In the case of the change in control of an insurer, the PRA will determine whether to approve a change in control, whilst the FCA may only make representations and only have power to stop approval/impose conditions if it considers there may be money laundering/terrorist financing issues.
- Where a firm is regulated by the FCA only but a member of its group is dual-regulated or the proposed controller is dual-regulated, the FCA will determine whether to approve the change in control but the PRA may make representations to the FCA on any matter and has power to stop approval/impose conditions in certain circumstances (which relate to financial soundness and effective supervision of the group).

Comments

- *The extent to which one regulator's representations will influence the other is uncertain and it is unclear whether applications for changes in control will have to address objectives of both regulators. Again, it is reasonable to expect that delays in the process may occur while the PRA reviews representations of the FCA and vice versa.*

Approved persons

- Each regulator in relation to insurance, will designate controlled functions (i.e. a PRA or FCA controlled function) and for each such function the designating regulator will manage a single application process for approval for that function.
- The PRA will control functions bearing on safety and soundness and the FCA will control functions which are conduct focused roles
- Both the PRA and the FCA must consent to the approval of each "significant influence function".

Comments

- *There is a real risk that obtaining approval will become a complicated and arduous process. Persons performing key functions of an insurer may require dual consent which could result in uncertainties, delays and disagreements as each regulator will have different requirements for such persons (see Netherlands example below).*
- *Approved persons may also be subject to disciplinary action by two regulators.*

regulatory requirements and subsequent enforcement outcomes... [thus] leading to other regulated entities adopting the higher standard and incurring the additional compliance costs to avoid the risk of regulatory action".[3] Additional costs are also imposed on regulated entities in Australia through the need to maintain separate compliance and reporting procedures applicable to each agency. Although Australia's twin peaks regulatory structure has apparently worked well on the whole, ASIC and APRA's regulatory models do appear to have resulted in higher transactional and compliance costs for insurers.

Decision Making and Accountability – who is in charge?

"A new culture of regulation that judges unacceptable risks, while creating the space for innovation and commercial success"?[4]

As noted above, judgement based supervision naturally brings with it uncertainty of outcome for firms. Dual-regulated firms will need to manage their relationships with the regulators more strategically and ensure that the regulators have a good understanding of their business, particularly in the PRA, which has no requirement for insurance expertise at board level. Furthermore, the degree of flexibility granted to the regulators in a judgement based environment, coupled with the more intrusive approach to supervision which firms are already experiencing, ultimately begs the question as to who is in charge – the firm's decision making body or the supervisor exercising his or her judgement? Who draws the line between unacceptable risks and innovation? It is not difficult to identify the tension between the executives driven to achieve commercial success and the natural conservatism of a regulator, notwithstanding that the UK will not operate a "no fail" regime.

The implementation of a judgement based approach in place of the more certain rules based approach must be accompanied by an increased emphasis on consistency, fairness and transparency of the regulator's decision making processes. Firms should expect both the PRA and FCA to apply a decision making process that is transparent, reasonable, fair, rigorous and indeed properly documented.

However, the Bill does not currently include any provisions whereby firms can make representations to the PRA or FCA to dispute their decision making and there has been no confirmation of the continued existence of the RDC in any form in either regulator. Notably, the chair of the RDC, Tim Herrington, took up a post at the Upper Tribunal earlier this year. Firms will, of course, be able to appeal decisions of the PRA and FCA to the Upper Tribunal. The Upper Tribunal, upon disagreement with such decisions, may only, under the Bill, remit the decision back to the relevant regulator and may not substitute its own opinion on the regulatory actions which should be taken.

Whilst there is argument that this approach is in keeping with the principle of judgement-based regulation, the time, costs and publicity which sit alongside such a referral must be a deterrent to a firm wishing to challenge the decisions of the regulator and make it more likely that firms' hands are tied by the judgements made by supervisors at first instance.

In this environment, strategic

[3] Australian Government Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (Regulation Taskforce, 2006) 93.

[4] George Osborne, Speech at the Lord Mayor's dinner, 16 June 2011.

management of supervisory relationships will be crucial. These issues were considered in a recent report by the Treasury Select Committee on the FCA which recognised that the current legislative proposals do not provide adequate accountability and that the board of the FCA should publish minutes of meetings and be subject to greater scrutiny by Parliament.

The Bill will, however, directly require the FCA and the PRA to put in place a scheme for the prompt, independent investigation of complaints made against them in respect of their relevant functions. In addition, the Bill sets out the requirement for the FCA to consult consumer representative panels.

Regulation of With-Profits

The complexities of twin peaks regulation are nowhere more apparent than in the field of with-profits business. The current proposal is that the PRA will have sole responsibility for matters relating to the interests of policyholders which could have an effect on the financial position of the firm and will be obliged to afford a reasonable degree of protection for policyholders in relation to "*decisions by insurers relating to the making of payments under with-profits policies at the discretion of the insurer (including decisions affecting the amount, timing or distribution of such payments or the entitlement to future payments)".* In other words, the PRA will have responsibility for both prudential and conduct regulation of with-profits business. The PRA must maintain arrangements for the provision by the FCA to the PRA of information and advice in relation to with-profits matters of which the FSA may have particular expertise but the extent of such consultation is not comprehensively documented, nor is there any statutory requirement on the PRA to act on the advice of the FCA. The current draft Memorandum of Understanding (**MoU**) (described below) simply states that they will establish mechanisms for coordinating responsibilities and that the PRA will seek the FCA's advice, as described above, "balancing that against prudential risk to the safety and soundness of the insurer".

It is not clear how the PRA will fulfil these statutory responsibilities for with-profits business as, in doing so, it will be required to act as a conduct regulator in relation to this business but with neither the resources nor the tools to do so. The MoU does little to address the inherent conflicts that will arise between prudential and policyholders' interests in with-profits.

PRA and FCA: Working together?

In order to meet their statutory duties under the Bill, the PRA and FCA must coordinate with each other and prepare a MoU setting out how they will comply with that duty. A draft of the MoU has been published, which contains further information on authorisations, approvals, passporting, change in control, disclosure of information, appointing investigators and international coordination. Several regulatory processes will be carried out on a joint basis but in the normal course the PRA and FCA will operate independently.

Enforcement

- Either the PRA or FCA may take disciplinary action against a firm depending on whether the perceived breach relates to a PRA or FCA function.
- The FCA will have the power to publish warning notices publicly in advance of potential enforcement actions by the FCA for a firm's regulatory breaches. There is a requirement to notify the firm before publication of the warning notice but it is worth noting that several respondents to the HMT consultations stated that the publication of the warning notice can potentially be very detrimental to a firm (who will not have had chance to contest its perceived breach).

Comments

- *A degree of uncertainty exists in cases where both the FCA and PRA could take disciplinary action, such as where an insurance company is performing regulated activities without the required permission. There is a duty, referred to in the draft MoU, that the regulators consult each other in advance of regulatory actions and investigations (and any notices to be published) and consider whether such actions should be co-ordinated jointly, which may result in a combined approach, but there is no obligation to take any action on a joint basis.*
- *Insurers must remain alert to the possibility of investigations by two regulators in certain circumstances and the fact that the approach of each regulator in enforcement action may be very different given their contrasting objectives.*
- *Little information is available at this stage on the Enforcement function within the PRA. It appears that the FSA's Enforcement division will move in its entirety to the FCA, whilst the role of the RDC remains unclear.*

In most areas, the MoU sets out the duties of each of the regulators in each area but does not expand upon how the regulators will work with each other day to day. There will be duties of cooperation between the two regulators and most regulatory processes involving dual-regulated firms will require either consent of both the PRA and FCA or at least consultation between them. However, at the moment we have no guidance on the proposed methods by which the PRA and FCA will consult with each other.

The draft MoU and its accompanying annexes sets out clearly where consent or consultation requirements will lie and how specific processes will work but there is, however, no time periods for receipt of representations from the other regulator nor any guidance as to what will constitute "consultation". There is also no guidance on how disagreements will be resolved where consent or consultation is required from both regulators and in most cases, such as approval for a significant influence function, no decision from the regulators will not be an option for the firm in question.

The PRA will share information in relation to prudential matters, such as the firm's resolvability, the position of the firm in the PIF structure and its capital and liquidity assessments. The FCA will provide information to the PRA on the risks and issues involving the conduct of the firm and also the prudential risks of other firms in the group which are not dual-regulated. To support this the regulators will create supervisory colleges for firms and groups. The size of the firm or group will determine how often the college will meet, for example six months for major firms and every twelve months for medium size firms. For a small insurer, the FCA and PRA will discuss issues at a sectoral level and there will be flexible and ad hoc rules determining when such sector colleges will meet.

The PRA will have, under the current draft of the Bill, a veto to direct the FCA not to exercise a regulatory power in relation to a dual-regulated firm (or such firms in general) if the PRA considers it necessary to avoid threatening the stability of the UK financial system or the failure of a dual-regulated firm in a disorderly manner. In January 2012, the House of Commons Treasury Committee issued a report on the current proposals for the FCA and strongly concluded that the case for the inclusion of this veto has not been made out and that, if it was maintained, the veto should lie within the FPC (in line with its overall mandate to consider systemic issues) and only be used in exceptional circumstances. There is a possibility that this veto will be amended during Parliamentary scrutiny of the Bill.

Lessons from the Netherlands

The Netherlands provides examples of the types of problems which may arise where two regulators, given different duties and objectives, face seemingly inevitable disagreements. Twin peaks style regulation was implemented in 2002, with De Nederlandsche Bank (DNB) performing the role of prudential supervisor and the Netherlands Authority for Financial Markets (AFM) supervising conduct of business.

The supervisors have duties of consultation under a supplementary "Covenant", similar to the proposed MoU under the Bill, whereby if a decision has relevance to both prudential and conduct of business standards, the supervisor making the decision has a duty to consult with the other. If one supervisor is required to make an assessment on whether an applicant meets requirements which also fall under the responsibility of the other supervisor, it must request the other's opinion, giving it a reasonable period of time to provide its views, and cannot depart from this opinion without having given the other the opportunity to give a verbal explanation of its opinion. Where one supervisor is 'primarily authorised' to give an opinion on data or intelligence received from a regulated entity, the other supervisor must follow its opinion to ensure that their approaches are consistent.

Certain provisions of the Covenant aim to reduce the burden of providing information for dual regulated entities. Before requesting information from a regulated entity, for example, a supervisor must first check if this information can be provided by the other supervisor. The AFM and DNB also inform each other of their examination schedules in advance and incorporate the other's examinations at its request, meaning that regulated entities only need to be subject to one set of examinations.

A problem faced by the Netherlands' twin peaks system is that there is no built-in mechanism for dealing with a case where both supervisors disagree but each have valid claims to make judgements. This issue came to the fore in 2010, where both the AFM and

DNB were asked to consider whether ABN Ambro chief and former Finance Minister Gerrit Zalm was fit and proper for the role. The AFM concluded that he was not; the DNB concluded that he was. The Ministry of Finance was forced to commission a report by an independent committee to determine the case. The committee sided with the DNB and found Zalm fit for purpose.

The Dutch government accepted that this case exposed a serious weakness of the twin peaks system in that it was unrealistic to two regulators with different objectives to agree in all cases. Proposals to address these issues in the Netherlands include giving one supervisor the lead in certain determinations and the other the power to veto its decisions. However, the issue of the need for mutual agreement in fundamental regulatory processes would still remain. A recent report of the Dutch Institute for Public Expenditure Studies also concluded that in areas where it was not clear which supervisor was the lead supervisor, there was a risk of overlap, with both supervisors taking action, or a lack of action due to each supervisor assuming the other was primarily responsible – exactly the type of risk the UK twin peaks model is intended to mitigate!

Next steps

We have highlighted in this Briefing some of the changes to the key regulatory processes our clients deal with. Whilst it will take some time for both firms and the regulators to get to grips with the practicalities of these new processes, it seems that the greater challenge will lie in firms' understanding, and then adapting to the new supervisory approaches of the regulators.

Contacts

Katherine Coates
Partner

T: 020 7006 1203
E: katherine.coates@cliffordchance.com

Carol-Ann Burton
Senior Associate

T: 020 7006 4480
E: carol-ann.burton@cliffordchance.com

Jack Hardman
Associate

T: 020 7006 1781
E: jack.hardman@cliffordchance.com