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FSA consultation paper on with-profits funds

On 23 February 2009, the FSA published Consultation Paper 09/09 "With-profit funds – compensation and redress". This refines and develops the FSA's thinking in CP08/11. CP09/09 sets out the FSA's proposals regarding compensation and redress payments arising from operational failures including mis-selling that life insurance companies may currently charge to their with-profits funds.

Under the current rules, a firm is allowed to pay compensation and redress from assets attributable to shareholders or from the inherited estate of its with-profits fund (if any). The consultation paper proposes that:

- proprietary firms will no longer be able to pay compensation and redress payments from their with-profits funds, where they arise out of events that occur after the rule takes effect;[1]
- the position in relation to events prior to the effective date will be unchanged;
- as an exception to the rule, compensation and redress payments may be made from any assets in a with-profits fund that are attributable to shareholders. 'Assets attributable to shareholders' are that part of any declared distributable surplus, which have been earmarked for shareholders (usually 10%) but not yet been distributed, or assets belonging to shareholders; and

1 In CP08/11, the FSA proposed that the shareholders alone should meet the cost of future compensation and redress payments. In CP09/09, the FSA propose restricting the rule to costs which are payable in respect of events after the rules come into force.

- the rule will not apply to rectification payments where both the policyholder and the fund are put back into the position that would have existed if the error being corrected had not occurred.

The FSA considers it unfair for risk-sharing in a with-profits fund to be unconstrained if it leads to, for example, the costs of the firm's negligence and misconduct falling on the interest in the fund held by with-profits policyholders. The FSA believes that fair treatment of policyholders should require that such payments cannot be made from with-profits funds, except from assets attributable to shareholders.

The consultation period closes on 22 May 2009.

International Association of Insurance Supervisors (IAIS) publishes progress reports responding to G20 and Financial Stability Forum (FSF) recommendations

On 26 February 2009, the IAIS published two progress reports which respond to recommendations made in 2008 by the G20 and the FSF to enhance sound regulation, strengthen transparency and reinforce international cooperation.

The IAIS reports outline specific action which the IAIS has taken recently. This includes:

- developing a new focus on the supervision of internationally active insurance groups;
- working with the International Organisation of Securities Commissions and the Basel Committee on Banking Supervision in order to identify important gaps in regulation and areas for enhanced supervision; and
- providing guidance on the use of supervisory colleges in group-wide supervision.

The IAIS also notes that it has identified a number of issues facing insurers and insurance supervisors. These include:

- the risks posed by, and liquidity demands of, unregulated entities within an insurance group;
- the complexities of supervising cross-border groups due to varying legal environments and coordination challenges amongst supervisors; and
- regulatory arbitrage by taking advantage of differences in regulatory requirements.

Response to consultation on implementation of Acquisitions Directive

A summary of responses to the HM Treasury and FSA consultation on implementation of the Acquisitions Directive (the **"Directive"**) was published on 3 March 2009. The Directive aims to improve the supervisory approval process for mergers and acquisitions in the banking, insurance and securities sectors in order to stop supervisory authorities in the EU from improperly blocking merger and acquisition proposals. The Directive must be implemented into national law by 21 March 2009 and is being implemented

through changes to FSMA.

A key amendment which the HM Treasury and FSA have made to the draft statutory instrument following responses to the consultation relates to notification arrangements, which have been simplified so that notifications received before 21 March 2009 will be treated under the old regime, rather than being brought under the new regime on that date.

Respondents agreed with the following proposals (amongst others):

- ***Threshold***: the Directive text revises the definition of who is a proposed acquirer for the purposes of requiring approval before undertaking an acquisition. Sections 180 and 181 of FSMA specify the thresholds where a person is considered to have increased or decreased his control over a UK authorised person and must notify the FSA . Control is increased or decreased when the percentage of shares held in or voting powers which may be exercised in relation to a UK authorised person or in their parent increase above or decrease below the thresholds of 20 per cent, 33 per cent and 50 per cent or when a person becomes, or ceases to be, a parent undertaking of a UK authorised person. The proposal to lower the 33 per cent threshold to 30 per cent was supported by respondents as being in the interests of simplicity. The other thresholds remain the same; and
- ***Non-Directive Firms regime:*** the regime for non-directive firms will have a single threshold at 20 per cent. This will have the advantage of being the same as required for insurance intermediaries under the Insurance Mediation Directive.

For a copy of the summary of responses please click here: http://www.hm-treasury.gov.uk/d/consult_imp_acquisitions_sumresponse_feb09.pdf

A route map for future EU Financial Regulation?: Key points from the de Larosière Report

The de Larosière Report (the **"Report"**), which reviews the EU's existing financial regulatory infrastructure and makes recommendations for how it should be improved, was published on 25 February 2009. This report is likely to have a permanent impact on the regulatory landscape, at EU level and beyond. It contains more than 30 specific recommendations for improving both substantive financial regulation and supervision to be implemented over the coming years. The recommendations include:

- ***Solvency II:*** Solvency II should be "adopted urgently", but with stronger cross-border supervision. The Report hopes for the supervisory framework to be agreed by May 2009;
- ***Remuneration:*** Compensation incentives should be aligned with shareholder interests and long-term profitability for proprietary traders and asset managers. Bonuses should be assessed over "a multi-year framework" and should not be guaranteed. It is not clear how assessment over a cycle will cohere with a flexible and liquid labour market;

- ***Supervision:*** Creation of a new European System of Financial Supervisors (**"ESFS"**) – a network of national supervisors and European Authorities (replacing CEBS, CEIOPS and CESR). The timetable for completion of this is 2011-2012. Although the existing level 3 committees will be transformed into these "European Authorities" and have strengthened powers to create binding standards, the ESFS is specifically described in the report as "*a largely decentralised structure, fully respecting the proportionality and subsidiarity principles of the Treaty*".

In respect of many of the "regulatory" areas that the Report highlights, action is already being taken. It is at the supervisory-institutional-level that this Report breaks new ground, in calling for the creation of the ESFS and ESRC, but rejecting the creation of a single "super-regulator".

Buyback and treasury shares

A leading insurance-based financial services provider recently announced that it will not be proposing the cancellation of shares bought through its 2008 buyback programme. Instead, the shares will be kept as treasury shares for use in connection with the funding of potential acquisitions or for employee share-based compensation.

Treasury shares are a company's own issued shares that it has bought but not cancelled. Under the Companies Act 1985, public companies listed or traded on the London Stock Exchange, the Alternative Investment Market or elsewhere in the European Economic Area may buy and hold in treasury up to 10% of the nominal value of the issued shares, with these shares available for resale, transfer to an employees' share scheme, or subsequent cancellation. The purchase must be financed out of the company's distributable profits.

Benefits of holding treasury shares include the company's ability to sell new shares in the market without having to discount the price to the levels commonly needed for rights issues, placings or to meet underwriting costs and the ability to enhance earnings per share.

Tax: worldwide debt cap

On 9 December 2008, HMRC issued draft legislation on the taxation of foreign profits, which includes a proposal to limit intra-group interest deductions by UK companies to the worldwide group's net external financing costs.

The worldwide debt cap is intended to prevent large worldwide groups of companies from pushing more debt into the UK part of the group than the worldwide group as a whole has borrowed from external sources, and to discourage groups from repatriating profits to the UK via loans from overseas subsidiaries. Subject to certain anti-avoidance provisions, deductions relating to external borrowing by UK companies remain allowable, and costs relating to intra-group borrowing will be deductible provided that those costs do not exceed the net finance costs of the worldwide group.

The cap was considered an essential complement to the introduction of the corporation tax exemption for dividends received from foreign companies and is intended to work in conjunction with existing transfer pricing and thin capitalisation rules rather than override them.

In applying the cap, groups will need to do the following:

- calculate the gross UK intra-group financing expense (defined as the "tested amount");
- calculate the net external financing costs of the worldwide group (defined as the "available amount");
- if the tested amount exceeds the available amount, disallow the difference and allocate the disallowed amount between the relevant UK companies;
- apply compensating adjustments to reduce any intra-group financing income received by UK companies on a pro-rata basis.

It is proposed that there will be special rules for businesses in certain sectors such as banking and insurance in which debt finance is used as an integral part of a trade. Interest expense and income from debt finance entered into by businesses in these sectors will be excluded from the debt cap. An exclusion for group treasury companies is also being considered.

HM Treasury has recently announced that these reforms will not now come into effect on 1 April 2009 (as previously envisaged). Instead, HM Treasury plans to consult with business throughout 2009 with a view to introducing detailed proposals in the 2010 Budget.

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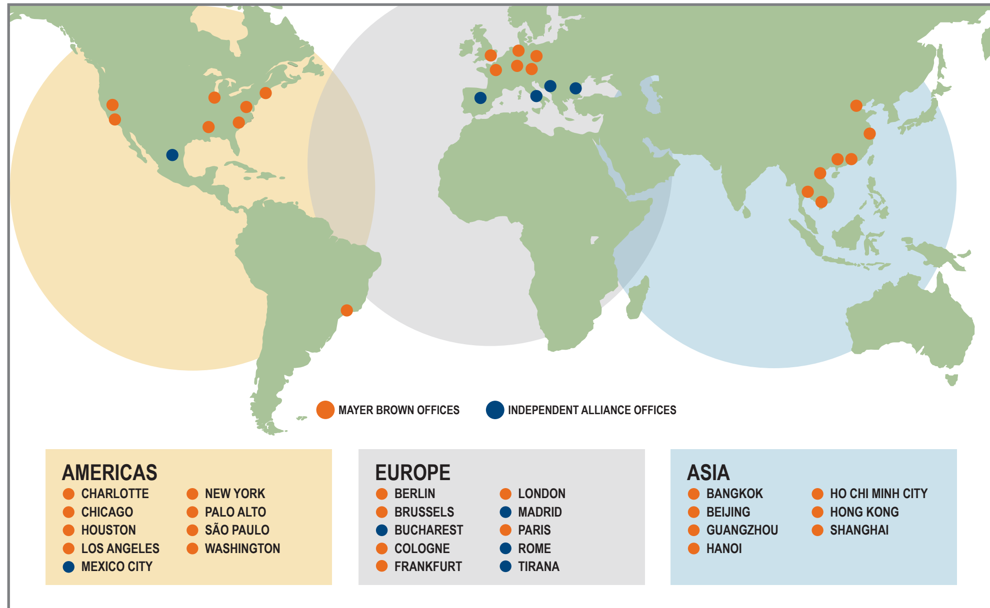

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