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Insurance & Reinsurance Industry Group: Corporate Insurance & Regulatory Bulletin

Introduction

We have reached a small landmark with this month's edition of the Bulletin. This is our first anniversary edition of our monthly Bulletin.

The past year has certainly been an interesting one to say the least. In the Bulletin, we have covered the regulatory fallout from the financial crisis.

Fearful of a regulatory backlash, the insurance industry's worst fears will, no doubt, have been assuaged by the Chairman of the FSA, Adair Turner's, comments, that a revolution was not required in terms of insurance regulation. However, Turner did note that the era of light touch regulation and soft touch supervision was over. The industry can certainly expect there to be more intense and vigilant supervision from the FSA.

We have also monitored the progress of Solvency II. The implementation date of no later than 31 October 2012 is fast looming, and a great deal of work still needs to be done in terms of working up the detailed implementing measures to flesh out the bare bones of the framework contained in the EU Directive. No doubt, there will be plenty of devil in the detail.

Solvency II may well encourage portfolio sales, other types of M&A activity, and increased use of derivative and other structured finance arrangements as a way of mitigating risk and achieving increased capital and cost efficiencies. Risk mitigation and capital management are likely to remain key themes for the foreseeable future. One by-product of this may well be an increased appetite for more simple business models and products, which customers can better understand.

We have also covered developments over the pond, and, in particular, the Obama Administration proposals for an Office of National Insurance embodied in a draft "Office of National Insurance Act of 2009" which was released by the U.S. Department of the Treasury on 22 July 2009.

We have considered hot topics such as corporate migrations from the UK and provided a detailed analysis of the key issues for companies considering such a step.

We have had some good feedback on the Bulletin over the past year which has been great. If there are any particular issues which you would like covered, or if you have any other suggestions as to how we can improve the Bulletin, do please let us know.

Thank you.

Editor

A new competition law framework for the Insurance sector: the Commission's proposals for a new block exemption

On 5 October 2009, the European Commission (the "Commission") published a proposed new Block Exemption Regulation for the insurance sector (the "Draft IBER"), to replace the current Block Exemption Regulation (the "Existing IBER") when that expires on 31 March 2010.

If adopted, the revised Draft IBER will significantly restrict the types of co-operation among insurers and reinsurers that are automatically exempt from the EC and national rules prohibiting anti-competitive agreements. Companies have the opportunity to comment on the proposals in a public consultation ending on 30 November 2009.

THE CURRENT FRAMEWORK

Since 1992, insurers and reinsurers have benefited from a block exemption for co-operative arrangements whose benefits outweigh their potential adverse impact on competition. A block exemption allows an agreement that meets certain criteria, laid down in an EU regulation, to benefit from automatic exemption from the EU and national competition law prohibitions on anti-competitive agreements. Where no block exemption applies, the parties and their legal advisors must assess competition compliance for themselves, from first principles, laid down in Article 81 of the EC Treaty and Chapter I of the UK Competition Act 1998 – a more time-consuming and complex process.

The Existing IBER, contained in Commission Regulation 358/2003/EC exempts, subject to certain conditions, co-operation on the following:

- the establishment and distribution of joint calculations, tables and studies;
- the establishment and operation of co-insurance and re-insurance pools;
- the joint establishment and distribution of non-binding standard policy conditions for direct insurance ("SPCs"); and
- the joint establishment, recognition and distribution of technical specifications of security devices.

Following the Commission's policy of restricting industry-specific exemptions as far as possible, the Draft IBER will restrict the block exemption to the first two of the above categories of co-operation only, subject to stricter conditions than before.

CONTINUED EXEMPTION: INFORMATION SHARING AND JOINT STUDIES

The Draft IBER covers:

(a) "the joint compilation and distribution of information necessary for the:

(i) calculation of the average cost of covering a specified risk in the past (hereinafter 'compilations'); and

(ii) construction of mortality tables, and tables showing the frequency of illness, accident and invalidity in connection with insurance involving an element of capitalisation (hereinafter 'tables'); and

(b) the joint carrying-out of studies on the probable impact of general circumstances external to the interested undertakings, either on the frequency or scale of future claims for a given risk or risk category or on the profitability of different types of investment (hereinafter 'studies'), and the distribution of the results of such studies."

The Existing IBER has been amended in two key ways.

TYPE OF INFORMATION THAT CAN BE EXCHANGED

Firstly, the type of information that companies can safely exchange under this heading has been cut back. Whereas previously, companies could jointly establish and distribute average cost calculations, they can now only jointly compile and distribute the information that is necessary to make those calculations. Similarly, whereas previously, insurance firms could jointly exchange and distribute mortality and other life tables, now only the joint compilation and distribution of information necessary for the construction of those tables will fall within the block exemption.

CONDITIONS APPLYING TO THE COMPILATIONS, TABLES OR STUDY RESULTS

Secondly, the conditions for exemption of compilations, tables or study results have been amended and expanded. Compilations, tables and study results must be made available on affordable (as well as reasonable and non-discriminatory) terms, to any insurance undertaking which requests a copy of them. They must also not contain any indication of the level of commercial premiums; and except where non-disclosure is justified on grounds of public security, they must be made available on reasonable, affordable and non-discriminatory terms, to any interested third party, such as a consumer organisation, requesting a copy.

CONTINUED EXEMPTION: INSURANCE AND REINSURANCE POOLS

Subject to a market share threshold and certain other conditions, the Draft IBER covers:

> "agreements entered into between two or more undertakings in the insurance sector with respect to the setting-up and operation of pools of insurance undertakings or of insurance undertakings and reinsurance undertakings for the common coverage of a specific category of risks in the form of co-insurance or co-reinsurance."

There are four key changes to the existing exemption.

TYPES OF CO-INSURANCE AND CO-REINSURANCE POOLS COVERED

The block exemption will not apply to ad-hoc co-insurance or co-reinsurance arrangements on the subscription market, where a certain part of a given risk is covered by a lead insurer and the remainder is covered by follow insurers. This reflects the Commission's concerns, expressed in the September 2007 final report on its sector inquiry into business insurance[1], that co-(re)insurance on the subscription market usually involves premium alignment, which may restrict competition. This proposition has not been properly tested, and it is likely that the Commission will vet these types of arrangement more closely in the future.

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1 Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2007:0556:FIN:EN:PDF

METHOD OF CALCULATING MARKET SHARE

Recognising the current inconsistency with other general and sector specific competition rules, market share figures have been amended to include the market share held by the participating undertakings not just inside, but also outside, a pool. This is likely to mean that a number of pools which would be exempt under the Existing IBER may not be exempt under the new IBER and will need to be assessed individually for their compatibility with EC and national competition rules.

INCREASED MARKET SHARE THRESHOLDS

The third key change is a rise of 3% in the flexibility percentage for market share thresholds below which the exemption will apply. The suggested position is as follows:

Co-insurance pools: Where the pool's initial market share is below or equal to 20%, but subsequently rises:

- above 20% without exceeding 25%, the exemption will continue to apply for two consecutive calendar years following the year in which the 20% threshold was first exceeded;
- above 25%, the exemption will continue to apply for one calendar year following the year in which the level of 25% was first exceeded.

The 25% 'flexibility percentage' in the Existing IBER is 22%.

Co-reinsurance pools: Where the market share initially is below or equal to 25%, but subsequently rises:

- above 25% without exceeding 30%, the exemption will continue to apply for two consecutive calendar years following the year in which the 25% threshold was first exceeded;
- above 30%, the exemption will continue to apply for a period of one calendar year following the year in which the level of 30% was first exceeded.

The 30% 'flexibility percentage' in the Existing IBER is 27%.

WIDER DEFINITION OF NEW RISKS

As in the Existing IBER, the Draft IBER grants an exemption for a period of three years to co-insurance or co-reinsurance pools which are created in order exclusively to cover new risks, regardless of the pool's market share. However, the Commission has suggested a broadening of the definition of "new risks". This now includes:

"in exceptional cases, risks whose nature has, on the basis of an objective analysis, changed so materially that it is not possible to know in advance what subscription capacity is necessary in order to cover such a risk."

This reflects the concern expressed to the Commission during an earlier phase of consultation, that the uncertainty surrounding the existing definition hinders pools with innovative policies, as the parties are reluctant to co-operate on risks that may not be considered as new and so fall foul of competition law.

WITHDRAWAL OF THE EXEMPTIONS FOR SPCS AND SECURITY DEVICES

The Commission does not propose to renew the remaining two of the four exemptions in the Existing IBER – the exemptions for SPCs and security devices – on the basis that they are not insurance-specific. It may cover both forms of cooperation in the general standardisation chapter in its Horizontal Guidelines which are currently being revised[2]. If so, these may provide useful guidance on the Commission's approach.

However, there will be no legal "safe harbour". From expiry of the Existing IBER on 31 March 2010, companies will need to assess with their advisers, whether any agreement or co-operation they are contemplating in relation to SPCs or security device standards is likely to infringe competition law.

THE FUTURE

The Commission's review comes at a time when the US Congress is considering revoking the 1945 McCarran-Ferguson Act, which exempts health and medical malpractice insurance issuers from federal antitrust laws. If this occurs alongside the adoption of a much-restricted new IBER, insurers' and reinsurers' competition/antitrust risks will increase significantly in both the EU and US, creating pressure for companies to assess the extent to which their current agreements and practices comply with competition law.

The Commission's public consultation on the Draft IBER ends on 30 November. Following that consultation, which it is anticipated will only result in minor changes to the wording of the draft, the new IBER will be published and will come into force on 1 April 2010.

Solvency II – ABI publishes Solvency II timeline

On 1 October 2009, the Association of British Insurers published a Solvency II timeline, covering the period from Autumn 2009 to 2015. We have set out below the key dates in late 2009 and early 2010.

- On 29 September 2009, the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS") Managing Board met with the FSA to discuss liquidity premium.
- In October 2009, Deloitte will present the first progress report on the external study on the impact assessment.
- In late October 2009, CEIOPS will provide its final advice on waves 1 and 2; there will be a European Commission stakeholders' meeting; and the European Commission will make changes to Solvency II to take into account the new supervisory architecture.
- In early November to mid December 2009, there will be a CEIOPS third wave of consultation.
- From November 2009 to February 2010, CEIOPS will draft the QIS5 technical specification including a comprehensive calibration paper.

2 Available at: http://ec.europa.eu/competition/consultations/2009_insurance/index.html

- In late Autumn to the end of 2009, the Solvency II Directive is expected to be adopted formally by the European Council and published in the official EU Journal.
- In January 2010, CEIOPS will provide its final advice on the third wave and the impact assessment.
- In the first half of 2010, there will be a public hearing on Solvency II.
- Between January and March 2010, the European Commission will start to draft the Impact Assessment Main Report and Executive Summary and will finalise the draft Impact Assessment package by the end of June 2010.
- Between January and June 2010, there will be informal discussions on the Level 2 advice and Level 3 guidelines.

The FSA focus on City bonuses

The FSA has increased its focus on remuneration practices within regulated firms as part of the fallout from the credit crunch. For example, this now forms part of its Arrow Programme. An important element of this is the eagerly awaited FSA Code of Practice on remuneration policies, which was published on 12 August 2009. Whilst the final version of the Code does not contain any surprises, the FSA has watered down several proposals.

The Code will be of particular interest for larger banks, building societies and broker dealers as it applies specifically to them. However, the Code is also an important issue for all FSA regulated firms, trade bodies and consumer groups as it sets out the FSA's position on financial services pay practices. Many financial institutions will want to be seen to be exercising good practice even if the Code does not apply to them directly. In addition, in October 2009, the FSA will report on whether to extend the Code to apply directly to all FSA regulated firms. This feedback statement from the FSA is still awaited.

WHAT IMPACT DOES THE CODE HAVE?

The main principles remain broadly the same as the draft consultation published in March 2009. However, the FSA has given firms greater leeway in devising remuneration packages than anticipated. As a result the final version of the Code is much less prescriptive than the March draft although the key aim remains to get firms to establish remuneration policies that are consistent with and promote effective risk management.

The FSA has softened its approach on the implementation of low risk remuneration structures by reducing the applicability from all employees to employees in a "senior influence function" or employees whose activities could have a material impact on the firm's risk profile. In addition three of the Code's proposed "rules" have been amalgamated and their status reduced to "guidance". Whilst there may now be scope for firms to interpret this guidance more widely, it must still be taken into account when deciding how to meet the rule.

Three highlights of the Code on remuneration structures are:

- firms must not offer guaranteed bonuses for more than one year;
- at least two thirds of any bonus payment should be deferred and spread over at least a three year period for senior employees in circumstances where such bonus is significant when compared with the fixed part of such employee's remuneration; and
- remuneration awards should be based on an appropriate combination of factors including the future performance of the firm and a division or business unit.

The FSA has stated that it intends to police compliance with the Code and enforcement action will be taken where appropriate.

WHO IS AFFECTED BY THE CODE?

The FSA believes the Code will apply to around 26 banks, building societies and broker dealers operating in London rather than the 47 originally anticipated. The Code will not apply to UK branches of firms headquartered elsewhere in Europe as responsibility for controls in those cases is for the appropriate home country authorities. However, the Code will apply to overseas branches of UK firms (both inside and outside Europe) where certain tests are satisfied. Concerns have been raised that the Code could have adverse competitive implications for the UK, if other countries do not implement similar or identical principles.

At present the FSA has not published a list of the firms affected but it will contact them in writing shortly. Firms who believe that they are caught by the Code, but who do not receive a letter, should contact the FSA.

WHEN DOES THE CODE TAKE EFFECT?

The implementation date has been delayed from 6 November 2009 to 1 January 2010. The FSA expects changes to policies and procedures to be fully in place by 1 January 2010 and changes to remuneration structures and contracts being implemented with effect from the same date.

Some additional time is offered for terms in contracts of employment which were entered into before 18 March 2009, where these are not compliant with the Code. These must be amended by 31 March 2010, with all offending practices ceasing by 31 December 2010.

Prior to the implementation date, affected firms will need to submit remuneration policy statements to the FSA by 31 October 2009. These will have to be signed off by remuneration committees and are intended to enable the FSA to check compliance with the Code.

WIDER IMPLICATIONS

The extent to which the City bonus culture contributed to the ongoing market turmoil has been the subject of much debate and discussion. The FSA concedes that the Code is not going to change "bonus culture" overnight. Commentators have questioned whether the Code will make any impact on remuneration practices at all.

Hector Sants, Chief Executive of the FSA, appeared to shift responsibility for controlling City pay away from the FSA to the Government. In a recent interview on BBC Radio 4 he stated that "there may well be a debate as to whether bankers should be paid multiples of [the pay of] doctors or others but that debate is for Government". It has been suggested that the only way to stop the City maintaining the "bonus culture" is for Parliament to adopt legislation dealing with the issue. With reports circulating of certain banks anticipating large bonus pools for 2009 we are certain that this issue will continue to generate debate and further scrutiny.

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