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Insurance & Reinsurance Industry Group: Corporate Insurance & Regulatory Bulletin

New structure for the UK financial services industry

On 16 June 2010, HM Treasury presented the details of the new coalition government's proposals to reform the financial services regulatory system in the United Kingdom. The Chancellor of the Exchequer, George Osborne, gave a speech at Mansion House in which he announced government proposals to abolish the current tripartite system. At present, responsibility for the financial system (including financial stability) is shared between HM Treasury, the Bank of England and the FSA which organise and respond to financial risks in the UK. Abolishing this would mean that the FSA would cease to exist in its current form.

Before the general election, the Conservative Party had criticised the tripartite authority system for failing to provide effective leadership during the financial crisis. Key members within the Party also described the system as "*confused and fragmented*" and believed that too much responsibility had been given to the FSA.

In place of the tripartite system, the government intends to establish the following new bodies by the end of 2012:

- **Prudential Regulation Authority (PRA):** As a subsidiary of the Bank of England, the PRA will be responsible for regulating banks and other financial institutions such as building societies and insurance companies. Hector Sants, the FSA Chief Executive, will assume the Chief Executive role at the PRA and become a Deputy Governor at the Bank of England;
- **Consumer Protection and Market Authority (CPMA):** The CPMA will become responsible for consumer protection and will regulate the conduct of financial firms that provide a service to customers, whether in retail or wholesale. In its policy white paper (the **"White Paper"**) of July 2009 (which outlined most of the proposed new structures), the Conservatives suggest that this body (then to be called simply the Consumer Protection Agency) would also take over responsibility for consumer credit from the OFT;
- **Financial Policy Committee (FPC):** The FPC will operate as a committee of the Bank of England and will be responsible for macro-prudential regulation and issues affecting economic and financial stability. The Governor of the Bank of England will chair the FPC; and
- **Serious Economic Crime Agency:** This organisation will tackle serious economic crimes, taking on functions currently fulfilled by various government departments and agencies.

The Financial Ombudsman Service and the Financial Services Compensation Scheme will also continue to exist, as well as the Consumer Financial Education Body which was introduced by the Financial Services Act 2010.

The Chancellor's speech on 16 June was not specific in that it did not explain in detail how the FSA will be divided or how some of the new bodies will enforce activities. Further details of the changes were given on 17 June by Mark Hoban, Financial Secretary to the Treasury. Mr Hoban insisted that the right regulatory architecture was essential in tackling the (perceived) risks involved in the present arrangement and wished to ensure the protection of consumers. A detailed consultation is expected to be published in July to consider the implementation of these new bodies.

It remains to be seen how it is proposed that the current system, which as noted the Conservatives regard as "*confused and fragmented*", will be remedied by the introduction of four new bodies in place of the single FSA. Added to this, we are still awaiting details as to how current FSA functions such as enforcement, authorisations, perimeter matters and the UKLA will fit into the new system.

The Chancellor also announced that Sir John Vickers (formerly head of the OFT) will chair an Independent Commission on Banking which will consider structural reform of the banking sector and be responsible for formulating policy recommendations. The terms of reference given to the Commission task it with considering the reduction of risk in the banking sector, mitigating the moral hazard and promoting competition. Perhaps more fundamentally, it will consider whether it is appropriate to separate out retail and investment banking functions. It is due to report by the end of September 2011.

Impact on the insurance industry

Overall, there has been very little discussion by the Government of the impact of these changes on the insurance industry. Nonetheless, in response to questioning in Parliament, Mark Hoban made it clear that insurers would come under the supervision of the PRA for prudential matters and the CPMA for conduct matters. Regardless of whether the thrust of these changes is intended to affect the insurance industry directly or not, there will inevitably be a large amount of upheaval for insurance firms of all types as the various pieces are put together.

UK VAT refunds to non-EU traders

Following the 2004 Court of Appeal decision in *WHA Ltd and others v HM Customs & Excise*, the UK amended its VAT legislation to deny non-EU established providers of financial and insurance services the right to repayment of UK VAT incurred on supplies made to them in the course of their business (on the basis that, if located within the EU, they would be making VAT exempt supplies of insurance and so would not be able to recover VAT they incur).

In 2008, the European Commission sent a formal notice to the UK questioning the compatibility of the amended legislation with EU law.

On 20 May 2010, Advocate General Jääskinen issued his opinion in the case of *European Commission v United Kingdom* that the UK legislation does not infringe articles 169 to 171 of the VAT Directive (2006/112/EC) or the provisions of the 13th VAT Directive (86/560/EEC). In coming to his opinion, Advocate General Jääskinen found that the wording of the EU legislation was clear and unambiguous. He suggested that the European Commission should amend the EU legislation accordingly. He considered that it was irrelevant (and wrong) that most member states permit non-EU established providers of financial and insurance services to claim a refund of input VAT in these circumstances.

Although this is only an advocate general's opinion, it is generally the case that the European Court of Justice, in its final judgment, follows the advocate general's advice.

Emergency Budget 2010 – changes to Insurance Premium Tax ("IPT")

IPT at the standard rate applies to most general insurance, including property, motor and medical insurance. The higher rate applies to travel insurance and to insurance (e.g. extended warranties) sold alongside motor vehicles and certain consumer goods, which was introduced in 1997 to stop VAT avoidance through value-shifting between goods (subject to VAT) and related insurance (exempt from VAT).

The rates will increase from 4 January 2011 from 5% to 6% for the standard rate and from 17.5% to 20% for the higher rate (in the latter case to match the new rate of VAT).

Why Insurers Differ from Banks

The CEA, the European insurance and reinsurance federation, published on 24 June 2010 a report setting out its views as to "Why insurers differ from banks". For instance, the CEA notes that, compared to banks, insurers usually have more stable, up-front and long-term funding, a simpler balance sheet structure, and significantly lower exposure to liquidity risk.

As a result of these differences, the CEA is not in favour of regulatory measures which are proposed to apply to the insurance sector and which have been drawn up by policymakers in response to issues identified in the banking sector in the wake of the financial crisis.

The CEA comments as follows: "*Imposing a banking regulatory and supervisory framework on the insurance sector would ... result in a permanent weakening of the insurance business model, damaging the potentially stabilising role insurance plays for individual citizens, businesses and the economy.*"

The CEA does acknowledge the need to strengthen financial supervisory and regulatory structures. The CEA adds: *"[g]lobal cooperation on regulatory and supervisory frameworks is...fundamental.*"

However, instead, the CEA proposes a number of recommendations which include the following:

- regulatory response should be targeted, first and foremost, at closing regulatory gaps, thereby also addressing the issue of regulatory arbitrage;
- relevant supervisory expertise must be ensured – the CEA notes that in many countries, "*government reaction to the financial crisis seems to be resulting in a reorganisation of supervisory structures, although so far no structure has proved its superiority*";

- excessive regulatory reaction and inappropriate read-across of regulation from other sectors should be avoided – the CEA is of the view that such over-reaction would have a negative impact on consumers and the economy as it would lead to price increases and the insurance industry becoming less attractive to investors; and
- insurers should have appropriate group supervision at a consolidated level by a group supervisor.

To view a copy of the CEA's full report, please click here.

If you have any query in connection with anything in this Bulletin, please do not hesitate to get in touch with your usual Mayer Brown contact or one of the contacts referred to below.

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