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Insurance Industry Group: Global Corporate Insurance & Regulatory Bulletin

UK – Update on replacements to the FSA

HM Treasury issued a summary of responses (the **"Summary"**) that it had received to the Government's consultation document *"A new approach to financial regulation: judgement, focus and stability"* (the **"Consultation"**) on 24 November 2010. The Consultation was published on 26 July 2010 and discussed the Government's plans to change the structure of regulation of the financial services industry. The key elements of the proposed structure are that there will be:

- a new macro-prudential regulator – to be called the Financial Policy Committee, which will be a sub-committee of the Bank of England;
- a new prudential regulator – to be called the Prudential Regulation Authority (the **"PRA"**), to be a subsidiary of the Bank of England; and
- a new conduct of business regulator – to be called the Consumer Protection and Markets Authority (the **"CPMA"**).

Whilst the Summary (in keeping with the original Consultation) does not consider the regulation of the insurance industry specifically, it considers a number of points that will be of interest to readers:

- **UKLA to be housed within the CPMA.** Under initial proposals, the UKLA would have been linked with the Financial Reporting Council in a new separate body. The Summary states that this is no longer being considered and, instead, the UKLA will remain under the legacy markets division of the FSA at the CPMA. This is a sensible decision by the Government. In separating the UKLA from the main functions of the CPMA (which will be responsible for regulating the conduct of investment firms), the primary securities market would have been separately regulated from the secondary market. Not only could this have led to confused regulation, but it would also weaken the UK's negotiating position in Europe at the new European Securities and Markets Authority.
- **Integrated model or overlapping responsibilities?** The Consultation asked for views on whether the PRA and the CPMA should each have responsibility for all decisions within their remit or whether there should be a more integrated approach (so that, for example, one authority becomes responsible for all authorisations rather than each of the PRA and the CPMA looking at different applications). The Summary stated that three-quarters of respondents preferred the integrated approach. Whilst this may be a practical approach for some types of financial services firm, insurers should consider carefully what this may mean for them. Under the current proposals, insurers will already be separately regulated from insurance intermediaries (falling under the ambit of the PRA and the CPMA respectively). If insurers were also to find that they were responsible to the PRA for most matters but then separately to the CPMA for authorisations

and approvals, this may lead to confusion and additional cost to the industry and, ultimately, to policyholders.

- **No Economic Crime Agency.** The Government had considered whether to establish a separate Economic Crime Agency (also taking in some of the responsibilities of the Serious Fraud Office) in addition to the PRA and the CPMA. The Summary stated that, for the time being, this will not be pursued and the FSA's current criminal enforcement powers (for example relating to insider dealing and market abuse and also perimeter matters) will be retained within the CPMA.
- **Timetable for change.** The Summary also gives more information on the proposed timetable. Key dates are: in December, there is expected to be a further consultation on whether the CPMA should take responsibility for consumer credit; in early 2011, there will be a consultation setting out more detailed policy and draft legislation; primary legislation to effect the new architecture is expected to receive Royal Assent in summer 2012; and the new architecture will take effect by the end of 2012. With the implementation of RDR and Solvency II due substantially to be completed in the same year, 2012 looks to be a busy year!

For a link to the HM Treasury page on the consultation, please click Here

Matthew Baker

Global – Solvency II – Third Country Equivalence

On 29 October 2010, the European Commission (the "**Commission**") wrote to the Committee of European Insurance and Occupational Pensions Supervisors ("**CEIOPS**") regarding its request for advice on the extent to which Bermuda, Japan and Switzerland meet the third country equivalence criteria. The Commission formally requested CEIOPS to carry out equivalence assessments of Bermuda and Switzerland with respect to all three equivalence assessments (Article 172 – Reinsurance; Article 227 – Group Solvency; Article 260 – Group Supervision) and Japan for Article 172 (Reinsurance) only. The Commission asked that CIEOPS's assessment of the third countries should include an analysis of the extent to which the criteria is fulfilled with reference to the legislation in place (and to be in place by 1 January 2013) and the implementation and application of that legislation within their supervisory regime.

Where CEIOPS identifies that equivalence is not possible, CEIOPS must identify what aspects of the third country's solvency regime are equivalent and what additional steps need to be taken in order for the remaining criteria to be met.

The Commission has not asked for assessment of all third countries for which a Solvency II equivalence finding is relevant as this would be time intensive and there are resource constraints. Instead, it has suggested a transitional regime for equivalence (which is not yet finalised). The transitional regime would allow eligible third countries to receive the same benefits as equivalent third countries but only for a limited time period, at the end of which they would be expected to have met the equivalence criteria. It has been indicated that the United States would be a primary candidate for this regime.

Sarah Russell

US – NAIC's Fall 2010 National Meeting

The National Association of Insurance Commissioners ("NAIC") held its 2010 Fall National Meeting from 16 October until 21 October 2010. Among the many matters considered at the meeting were the NAIC's solvency modernization initiative ("SMI"), reinsurance regulation reform, capital adequacy of insurance holding company systems, and revisions to the model Insurance Holding Company Act.

The NAIC's Solvency Modernization Initiative Task Force ("SMITF") adopted the "Solvency Modernization Initiative Roadmap" at its Summer National Meeting held in August. The "roadmap" continues to evolve over time based on the revisions of the NAIC. Various working groups within the NAIC are working on different aspects of this initiative. The "roadmap" addresses the key areas of SMI: capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance. At the Fall National Meeting, the status of SMI was discussed, updates from various working groups were received, and revisions to the roadmap were considered.

The NAIC has worked for years to modernize the U.S. reinsurance regulatory system. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), enacted in July 2010, addresses the reinsurance regulatory system, including the recognition of credit for reinsurance in any state if the ceding insurer's domiciliary state is accredited by the NAIC, or has solvency requirements substantially similar to the NAIC's accreditation requirements. In response to the Dodd-Frank Act, (i) the NAIC has adopted a set of recommendations outlining key elements of its reinsurance regulatory modernization framework that should be considered by the NAIC's Financial Regulations and Accreditation (F) Committee when determining whether any state credit for reinsurance reform meets NAIC accreditation standards, and (ii) the NAIC Reinsurance Task Force has stated that it will consider amendments to the NAIC's Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation to achieve consistency with the reinsurance modernization framework.

The NAIC's Group Solvency Issues Working Group ("GSI Working Group") continued to address the possible methods of monitoring the capital adequacy of all of the entities within an insurance holding company system by state regulators. Prior to the 2010 Fall National Meeting, the GSI Working Group had requested comments on certain alternatives for accomplishing this monitoring. One such alternative was the requirement that insurance holding company systems conduct an "Own Risk Solvency Assessment" ("ORSA") and file such assessment with state insurance regulators. An ORSA would consist of internal testing to assess the adequacy of capital levels for the group. This concept is drawn from the Solvency II proposal currently being considered in Europe. During the 2010 Fall National Meeting, the GSI Working Group took steps to move forward with the development of regulatory requirements for an ORSA. The potential implementation of a group ORSA would represent a noteworthy adoption of one of the core aspects of Solvency II by the NAIC.

The GSI Working Group is also requesting comments on an exposure draft of the Holding Company and Supervisory College Best Practices. The purpose of this document is to provide guidance and best practices for use by state insurance

regulators in their regulatory oversight of insurance companies within insurance holding company systems. The best practices handbook includes subjects such as facilitating communication and coordination between regulators, uniform practices for mergers and acquisitions of control (including coordination of Form A reviews), standards of management of an insurer within a holding company system (including Form A exemptions and corporate governance policies), affiliated management and service agreements, and best practices for participating in international supervisory colleges. Comments are due by December 2, 2010.

David Alberts, Vikram Sidhu and *John Drnek*

UK – Insurance VAT exemption

On 17 November 2010, the Ecofin Council held a policy debate on proposals (adopted in November 2007) to introduce a new directive and regulation clarifying the rules on the VAT treatment of insurance and other financial services.

Under the rules laid down in the VAT directive, financial services (including insurance) are exempt from VAT. EU Member states have, however, interpreted the directive differently, leading to distortions of competition. The proposals are deigned to reflect changes in the banking and insurance industry, particularly in respect of outsourced services and include an option to tax in respect of financial services and the pooling of exempt investments.

The Council agreed that further work should be undertaken on modernising the definition of exempt services and asked the permanent representatives' committee to oversee further work on the proposals.

Stephen Green

US – Treatment of Swap Agreements Under Insurance Insolvencies – State Developments

The treatment of derivatives, or "qualified financial contracts", under state insurance insolvency laws has received increased attention since the financial crisis. Four states passed laws in 2010 that allow for the exercise of certain netting collateral and termination provisions in an insurance insolvency without regard to the automatic stay mechanism and similar laws are anticipated in other states in 2011. Federal laws provide a level of certainty with respect to the treatment of certain swap agreement provisions in a general corporate bankruptcy. The U.S. Bankruptcy Code provides an exception from the automatic stay mechanism for specific provisions of swap agreements. These provisions include netting provisions, certain collateral provisions and termination provisions. A counterparty to a swap agreement with the insolvent financial institution may exercise its rights under these provisions of the agreement, unaffected by the automatic stay. This allows parties to enter into derivatives contracts knowing their rights in the event of a bankruptcy proceeding with a degree of certainty. This certainty has generally not been available with respect to swap agreements to which an insurance company is a party. The U.S. Bankruptcy Code does not apply to insurance companies. The insolvency of insurance companies is governed under state laws. State laws do not generally provide the exception to the automatic stay mechanism with respect to swap

agreements available under federal laws and, thus, do not provide the aforementioned level of certainty for counterparties to derivatives contracts with insurance companies. This lack of certainty has resulted in a degree of reluctance on the part of banks and other financial institutions to enter into swap agreements with insurance companies out of concern that they may be unable to exercise termination, netting and collateral realization rights under the agreements if the insurer becomes insolvent.

A number of states have addressed the concerns of potential swap counterparties to insurance companies by reconsidering state insurance insolvency laws with respect to "qualified financial contracts" and "netting agreements". Numerous states have enacted specific laws that allow for the exercise of certain provisions of qualified financial contracts or netting agreements in an insurance insolvency without regard to the automatic stay mechanism. There appears to be growing momentum towards adopting laws with similar provisions in response to the recent financial crisis. Illinois, Massachusetts, Minnesota, and Missouri added this type of language in the last year, and New York had such a bill under consideration that is likely to be proposed again in 2011. The provisions of these agreements that are exempt from the automatic stay provisions of the state insurance insolvency laws are generally the same as those provisions that are excepted under the U.S, Bankruptcy Code: netting provisions, collateral realization provisions and termination provisions. Connecticut, Illinois, Iowa, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Texas, and Utah are examples of states that have enacted laws with exceptions for qualified financial contracts or netting agreements from the automatic stay mechanism. These types of laws should provide banks and other financial institutions with more certainty with respect their rights when entering into swap agreements with insurers and could lead to an expansion of this market.

David Alberts and *John Drnek*

UK – European Commission update on the review of the Insurance Mediation Directive

The European Union adopted in January 2005 an Insurance Mediation Directive to set up a legal framework for insurance intermediaries. However, the European Commission (**"EC"**) highlights on the insurance mediation section of its website that "*how the Directive is actually applied varies considerably between EU countries. This has lead to fragmented insurance markets in the EU, with significant gaps and inconsistencies.*"

The update to the EC's website is in relation to a public consultation, to be launched in Autumn 2010, to request the views of all stakeholders regarding what changes are required to the current Insurance Mediation Directive to remove its main weaknesses. The stated aim of the consultation is "*to discuss the pros and cons of increased harmonisation, with the aim of establishing a real level playing field for all sellers of insurance products at EU level*".

The consultation will include a public hearing hosted by the EC on 10 December 2010 to discuss the revision of the Insurance Mediation Directive.

To view the European Commission's insurance mediation website, please click here.

Ian Slingsby

Global – International Association of Insurance Supervisors' annual conference closing press release

The International Association of Insurance Supervisors (**"IAIS"**) recently held its Triannual Meeting, 17th Annual Conference and General Meeting in Dubai on 29 October 2010. The theme of this year's conference was "*The Gateway to Trust in the Insurance Industry*" and it provided the opportunity for supervisors and insurance professionals to discuss "*prevailing market conditions, emerging trends and regulatory developments in this challenging financial environment*."

The IAIS press release stated that the following important steps had been taken at the conference:

- the adoption of a new Strategic Plan and Financial Outlook 2011-2015 which sets out the high level goals, strategies and action plans for the IAIS' key areas of work and aims to ensure that the IAIS has the necessary workplan and resources in place to address the challenges facing insurance supervisors;
- the approval of a two-year roadmap which is aimed at ensuring that the planned activities over the next two year period adequately meet the high level goals, strategies and action plans set out in the new Strategic Plan and Financial Outlook 2011-2015;
- the adoption of eight supervisory papers which are intended to be the first stage towards the revision of the insurance core principles and supporting standards and guidance material; and
- the signing of two further insurance supervisory authorities to the IAIS Multilateral Memorandum of Understanding which brings the total number of signatories to thirteen.

The press release also contains an annex summarising the panel discussions and keynote speeches which took place at the conference. To view the IAIS' full press release, please click here.

Ian Slingsby

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