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Insurance Industry Group: Global Corporate Insurance & Regulatory Bulletin

UK – Financial Services Authority ("FSA") speech on the future of insurance regulation

On 9 February 2011, the Chief Executive of the FSA, Hector Sants, delivered a speech as part of the Insurance Institute of London's lecture program at Lloyd's of London on the future of insurance regulation. Specifically, the speech aimed to address the following three key regulatory issues:

1). THE IMMINENT ADOPTION OF THE SOLVENCY II REGULATORY RULES

Hector Sants highlighted the specific benefits of Solvency II and acknowledged that concerns have been raised as to whether such benefits would be "*worth it*" in relation to both the associated implementation costs and whether the risk calibration is correct. He stated that the FSA will be laying out a UK cost-benefit analysis in the next year and that it was not the FSA's ambition to increase or decrease the amount of capital supporting the UK insurance industry, instead it is only seeking to ensure such capital is appropriately aligned with risks. Hector Sants further noted that the FSA is in the process of refining its proposed implementation methodology (to, amongst other points, focus on the key judgements during approval processes, ensure that a plan can be successfully delivered and executed and that the FSA's oversight is done at a reasonable cost to the industry) and is seeking to communicate the implications to individual firms shortly;

2). THE IMMINENT CREATION OF A NEW SUPERVISORY STRUCTURE IN THE UK

With regard to the new supervisory structure in the UK (comprising the Prudential Regulatory Authority (**"PRA"**), the Financial Policy Committee, and the Consumer Protection and Markets Authority (**"CPMA"**)), Hector Sants discussed the progress made to date on how the PRA and CPMA will regulate insurers in future. He explained that the PRA will supervise around 1,000 insurance companies with the high-level objective of "*promoting the soundness of firms and minimise the adverse impact that firm failures can have on the UK financial system. In particular it will be seeking to minimise and ideally eliminate the likelihood of cost falling on individual taxpayers and customers. In other words, an orderly firm failure without adverse consequences on the economy would not be seen as a regulatory failure*". Although Hector Sants noted the key differences between banks and insurers, specifically that insurers pose less systemic danger and, therefore, for the purposes of prudential regulation should be viewed differently from banks, he noted that the PRA will base its supervisory interventions for insurers and banks on the basis of a similar judgement-based risk assessment framework. The CPMA will "*have a primary objective of*

ensuring confidence in financial services and markets, with specific focus on protecting consumers and ensuring market integrity....and the CPMA's regulatory approach towards supervising all firms, including insurers, will be delivered using a risk model which puts a premium on early risk identification and prioritisation"; and

3). LAST MONTH'S CHANGE TO A NEW EUROPEAN REGULATORY STRUCTURE

Hector Sants noted that, effective from 1 January, a new European Supervisory Authority responsible for European insurance and occupational pensions (**"EIOPA"**) has been established with the principal feature of being the rule making body in Europe. The effect of this wide ranging mandate is that the FSA (and successor authorities) will essentially be supervisory arms of an EU policy setting body. The UK, therefore, needs to organise itself to effectively contribute to decision making in both the EIOPA and wider EU forums. He confirmed that the FSA, and himself, would invest considerable effort with engaging in the issues facing the insurance market at a European level.

Closing, Hector Sants commented that he hoped to have demonstrated *"the FSA's determination and commitment to ensuring that the substantial regulatory agenda that faces us all is executed in a manner which improves the regulatory framework for UK insurers, and in consequence brings benefit to their customers and capital providers....I hope I have demonstrated that the FSA and its successor bodies have a clear approach to address the key questions and that I have given a flavour of the likely answers. I also hope that there is certainly no doubt about the importance we attach to the insurance industry and that this commitment will continue into the new regulatory structure in the UK"*.

To read Hector Sant's full speech, please click here. To view Lloyd's of London's summary and initial reaction to Hector Sant's speech, please click here.

Ian Slingsby

UK - Bribery Act: Delay to Implementation

It has been widely reported that implementation of the Bribery Act, which had been due to come into force in April this year, is to be postponed. The reason is that explanatory guidance to be issued by the Ministry of Justice is not yet ready. The awaited guidance relates to compliance procedures. One innovation of the Act is a corporate offence of, failing to prevent bribery by persons performing services on your behalf. The only available defence for an organisation charged with this corporate offence is to show that it had adequate compliance procedures in place to prevent such an occurrence.

The Act requires the Secretary of State to publish guidance on what may constitute such procedures. The Ministry of Justice has consulted upon draft guidance built around high level principles. This attracted widespread calls for additional practical detail but also for better guidance on key aspects of the operation of the Act, such as the impact upon corporate hospitality, facilitation payments and gifts.

Justice Secretary, Ken Clarke, has reaffirmed the promise of the previous government that there will be a three month grace period following the publication of the "adequate procedures" guidance before the Act is brought into force. Given that the final guidance on adequate procedures has not been issued by the end of January this inevitably means that the target implementation date of April 2011 cannot be met.

The Ministry of Justice has not committed to a date when the delayed guidance will be issued but has indicated that it will release new details on the legislation "in due course". Due to this delay, the implementation of the Act will be postponed beyond April 2011 and not before May 2011 at the earliest. We understand that the delay is to enable the government to deliver what industry has requested; better practical detail on the operation of the Act to meet expressed concerns. We understand that this will be achieved by reading the Ministry of Justice guidance, when issued, together with guidance in preparation by the Serious Fraud Office and Director of Public Prosecutions. The latter guidance is to address how prosecutors will approach the new offences under the Act, including the corporate offence of failing to prevent bribery. We also understand that the delay will enable these streams of guidance to be better coordinated into a comprehensive overall picture.

Though the delay has drawn criticism from numerous observers and interested parties, including the Organisation for Economic Cooperation and Development's anti-bribery unit, Transparency International and CBI, it is our view that if the result of the delay is more comprehensive guidance when it is finally issued, then this is to the good of all. Companies should not use the delay as a reason to postpone work on considering and developing anti-corruption policies and procedures. The core Principles and draft text in the current Ministry of Justice guidance are unlikely to be changed, merely expanded upon. The Act itself is not anticipated to change. For businesses operating from multiple global centres or with links to high risk geographies, it would be very challenging to seek to develop and implement procedures in the space of three months' from the time the final guidance is issued. The starting point for any business must be a comprehensive and tailored root and branch assessment of risks facing that business and appraisal of the existing control framework. That work should proceed expeditiously.

Andrew Legg, Marc Cohen and Angela Hayes

US – 2012 Federal Budget Includes Proposal to Disallow the Deduction for Non-Taxed Reinsurance Premiums Paid to Affiliates

On February 14, President Obama released his proposed federal budget for 2012. The budget includes many proposals intended to increase revenue to the United States. Among these plans is a proposal to disallow the deduction for non-taxed reinsurance premiums paid to certain foreign affiliates. According to the Treasury Department, this proposal would (1) deny an insurance company a deduction for reinsurance premiums paid to affiliated foreign reinsurance companies to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (2) would exclude from the domestic insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied. The proposal would be effective for policies issued after December 31, 2011.

The effect of the proposal will be a higher tax burden in the United States for foreign insurance groups that have affiliates that operate in the United States and which cede risks to their foreign affiliates. Currently, some foreign-owned groups conduct business in the United States through their affiliates. These affiliates then use reinsurance contracts with the foreign-owned parent, which can have the effect of reducing the domestic entity's tax burden through the deduction that is currently permitted. There is usually no offset in tax paid to the United States due to an increased tax burden of the foreign parent since the foreign parent company is usually not engaged in business in the United States and is not subject to U.S. tax on its income. According to the proposed budget figures, the proposal would reduce the deficit by $1,103,000,000 from 2012-2016 and $2,614,000,000 from 2012-2021. This proposal is similar to the so-called Neal Bill, which had been proposed by Congressman Richard Neal of Massachusetts in the summer of 2010, as well as various other prior similar legislative efforts. A bill would have to be introduced as new legislation and pass in both chambers in order for the proposal to take effect.

George Craven

US - NAIC Adopts Modified Insurance Holding Company System Model Act and Regulation

On December 16, 2010, the National Association of Insurance Commissioners (**"NAIC"**) adopted final revisions to its model Insurance Holding Company System Regulatory Act (**"Model Act"**) and its Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (**"Model Regulation"**). The Model Act and Model Regulation apply to insurance holding company systems, which are defined as groups of two or more affiliated entities, at least one of which is an insurer. The revisions are part of the NAIC's larger Solvency Modernization Initiative (**"SMI"**), a comprehensive examination of the US insurance solvency regulatory framework.

The revisions represent a shift in emphasis of the NAIC's approach to the regulation of insurance holding company systems. Historically, such regulation has been designed to build "walls" around an insurer – through regulation of acquisitions, dividends and inter-affiliate transactions. The new approach adds to that traditional "walls" component a new "windows" component – giving insurance regulators access to enhanced information about the activities and risk profile of an insurer's non-insurance affiliates.

Significant aspects of the revised Model Act and Model Regulation include the following:

- Addition of the concept of "Enterprise Risk": Enterprise risk means, generally, any activity, circumstance or event involving an insurer's affiliate that is likely to have a material adverse affect upon the financial condition of the insurer or its insurance holding company system, including anything that would cause the insurer's risk-based capital to fall into the company action level, or would cause the insurer to be in hazardous financial condition. The ultimate controlling person of an insurer will be required to file a confidential annual report identifying the material risks within the insurance holding company system that could pose enterprise risk to the insurer.
- The introduction of supervisory colleges: In order to assess the business strategy, financial position, legal and regulatory position, risk exposure, risk management and governance processes, and as part of the examination of insurers with international operations, state insurance commissioners may participate in a "supervisory college" with other regulators charged with supervision of such insurers or their affiliates, including other state, federal and international regulatory agencies. Information provided by the commissioner to members of a supervisory college will receive confidential treatment.
- Additional filing requirements with respect to acquisitions and divestitures of insurers: Historically, any person seeking to acquire control of an insurer has been required to file a "Form A" with the insurer's domiciliary regulator, seeking prior approval of the acquisition. Under the revised Model Act, a "Form A" acquisition statement will need to be accompanied by a "Form E" pre-acquisition notification addressing the competitive impact of the acquisition. In addition, any controlling person of an insurer seeking to divest its controlling interest would be required to file a confidential notice of its plans with the commissioner 30 days prior to cessation of control.

- Expansion of information to be filed with the commissioner on "Form B": If requested by the commissioner, an insurer will be required to include financial statements from within an insurance holding company system (including affiliates) with its "Form B" holding company registration statement, including annual audited financial statements filed with the U.S. Securities and Exchange Commission. The registration statement will also need to include statements that the insurer's board of directors is responsible for and oversees corporate governance and that the insurer's officers or senior management have approved, implemented and continue to maintain and monitor that corporate governance and internal control procedures.
- More burdensome process to disclaim affiliation with insurers: Under the existing Model Act, "control" is presumed to exist where any person directly or indirectly holds 10% or more of an insurer's voting securities. Historically, that presumption could be rebutted by filing a disclaimer of control with the domiciliary state commissioner, and such a disclaimer became effective immediately unless disallowed by the commissioner after a hearing. In other words, the burden of disallowing a disclaimer of control was placed on the commissioner. Under the revised Model Act, disclaimers will no longer be automatically effective upon filing. Rather, they will become effective if not disallowed by the commissioner within 30 days after filing. If a disclaimer is disallowed, the applicant may request reconsideration at an administrative hearing, but will bear the burden of rebutting the presumption of control at that hearing.
- Increased oversight of inter-affiliate transactions: Historically, material transactions between insurers and their affiliates have required the filing of a "Form D" at least 30 days in advance of the effective date. The revised Model Act will augment the "Form D" requirements with 13 specific items that need to be included in management service and cost sharing agreements among insurers and their affiliates. It will also require insurers to file a "Form D" for amendments or modifications to previously filed agreements, explaining the reason for the change and the financial impact on the insurer. Additionally, it will require notification to the commissioner within 30 days of termination of a previously filed agreement.
- Expansion of the commissioner's powers with respect to access to books and records: Under the revised Model Act, the commissioner will have the power to examine not only the insurer but also its affiliates to ascertain the financial condition of the insurer, including the risk of financial contagion to the insurer by the ultimate controlling person, any affiliates or combination of affiliates, or the insurance holding company system on a consolidated basis. The commissioner will be able to order an insurer to produce information not in its own possession, but obtainable by the insurer through contractual relationships, statutory obligations or other methods. If the insurer fails to produce the information without a reason acceptable to the commissioner, such insurer may be subject to fines or the suspension or revocation of its license. The commissioner will also have the power to issue subpoenas and examine persons under oath, and may seek a court order to enforce subpoenas, under penalty of contempt.

The Model Act and Model Regulation still need to be adopted by individual state legislatures. The final language of the regulations may vary from state to state when they are enacted.

Lawrence Hamilton

US - NAIC Solvency Modernization Initiative Update – Own Risk and Solvency Assessment (ORSA) Proposal

On February 11, 2011, the National Association of Insurance Commissioners (the **"NAIC"**) conducted a conference call during which the International Solvency (EX) Working Group (the **"ISWG"**) provided an update on the U.S. Own Risk and Solvency Assessment (the **"ORSA"**) proposal. The ORSA is a key component of risk management under the NAIC Solvency Modernization Initiative, which is a critical self-examination process aimed at updating the U.S. insurance solvency regulation framework while also considering international models. The call began with a review of the principles contained in the International Association of Insurance Supervisors (**"IAIS"**) Insurance Core Principle (**"ICP"**) 16, which applies to insurance legal entities and insurance groups regarding any risk posed by non-insurance entities in the group and defines Enterprise Risk Management (**"ERM"**). ERM is a process for identifying, assessing, and managing risk through a self-assessment of reasonably foreseeable risks that focuses on the actions an insurer takes to manage and control risk. The ISWG will continue looking at ICP 16 and input from meetings on other regimes implementing ORSA tools. The ORSA document entitled "Own Risk and Solvency Assessment" has been exposed for comments. The comments on the exposure draft are due by March 18, 2011.

Generally, the purpose of an ORSA is to ensure that a company develops a risk management policy that identifies the type and amount of its material risk, and also monitors and manages such risk. The insurer would communicate the risk management policy to management so that they understand the impact of their day to day decisions on the overall risk assessment. An ORSA would assist state regulators in evaluating each insurance entity with respect to the amount of risk they are taking and could help focus the examinations.

U.S. insurance regulators believe that the output document of an ORSA should contain three major sections: Description of Risk Management Policy, Quantitative Measurements of Risk Exposure in Normal and Stressed Environments, and Prospective Solvency Assessment. The Description of Risk Management Policy would be answered in a qualitative form. It would identify risks, describe how such risks are measured, and discuss the policies implemented to manage and mitigate these risks. This section would catalogue investment policy, underwriting policy, anti-fraud policy, and asset liability management policy.

The Quantitative Measurements of Risk Exposure in Normal and Stressed Environments section of the output document include the quantitative measurements of risk exposure in either a normal or stressed environment for each risk category identified under the Description of Risk Management Policy. This is an important part of the ORSA document because it is necessary to quantify financially the size of the risk and how such risk will play out in the short term, considered for ORSA purposes to be three to five years, in both normal and stressed environments. This section should include descriptions of the identified risks, the measurement approaches used, key assumptions made, etc. The NAIC included three examples (life, property casualty, health) of how outcomes of risk measurement could be presented for identified risk categories within a company in the call preparatory materials.

The Prospective Solvency Assessment section of the output document will describe the manner in which an insurer combines the qualitative elements of its risk management policy and the quantitative measurements of risk exposure in determining the financial resources necessary to manage its business over a longer term business cycle. Such a prospective assessment would project forward three to five years and consider both a normal and stressed environment. The ultimate goal of the assessment is to verify through a feedback loop that the company has the ability to meet the regulatory and capital requirements considering its current risk profile, current risk management policy, current quality and level of capital and the impact of executing its three to five year business plan. While the prospective solvency assessment will be conducted for each individual insurance company legal entity, the assessment will take into account risks that come about from group membership. A prospective solvency assessment may involve a review of any group solvency assessment and also any constraints on group capital or the movement of group capital to legal entities.

David Alberts

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