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Bulletin
June 2011

Insurance & Reinsurance Industry Group: Global Corporate Insurance & Regulatory Bulletin

UK – HM Treasury publishes White Paper entitled "A new approach to financial regulation: a blueprint for reform"

On 16 June 2011, HM Treasury published a White Paper providing further detail on its new approach to financial regulation including a partial draft of its proposed Financial Services Bill and explanatory notes. The reforms to the UK system of financial regulation are the Government's response to the shortcomings of the UK system of financial regulation which were highlighted by its failure to predict and adequately respond to the financial crisis which started in 2007. The White Paper provides that the Government's primary objective in reforming financial regulation in the UK is "to fundamentally strengthen the system by promoting the role of judgment and expertise".

As has been widely discussed, the Government plans to reform the financial regulatory system by establishing a macro-prudential regulator, the Financial Policy Committee (**"FPC"**) within the Bank of England to monitor and respond to systemic risks; transferring responsibility for prudential regulation of banks, insurers and complex investment firms to a new regulator, the Prudential Regulation Authority (**"PRA"**) which will be a subsidiary of the Bank of England; and creating a focussed new regulator for conduct of business, the Financial Conduct Authority (**"FCA"**), to ensure that business across financial services and markets is conducted in a way that interests all users and participants. These regulators will be judgment-led and empowered to look beyond compliance and supervise proactively.

The draft Financial Services Bill provides for the PRA to be given a specific statutory objective for insurers "to ensure the insurer has a reasonably high probability of meeting claims from and material obligations to policyholders as they fall due."

Under the new system, insurers will be dual regulated. The PRA will be responsible for the prudential regulation of insurers whilst the FCA will be responsible for supervision of their conduct of business. The Society of Lloyd's and Lloyd's managing agents will be dual regulated firms whilst Lloyd's members' agents and Lloyd's brokers will be FCA-regulated firms.

The White Paper can be viewed at:
http://www.hm-treasury.gov.uk/d/consult_finreg__new_approach_blueprint.pdf

UK – Bank of England and FSA publish paper on Prudential Regulation Authority's approach to insurance supervision

On 20 June 2011, the Bank of England and the FSA published a joint paper detailing their current views on the approach the PRA will take to insurance supervision. The PRA is currently expected to be created at the end of 2012 as a subsidiary of the Bank of England.

The joint paper is intended to inform public debate and facilitate engagement with relevant stakeholders as the approach the PRA will take in this area is further refined.

It is noted that insurers' liabilities are fundamentally different to those of banks and that, as insurers are less leveraged than banks, they are in general much less vulnerable to a run resulting from a sudden loss of confidence.

The PRA will have two, complimentary, objectives for insurance supervision. It will:

1. Seek to secure an appropriate degree of protection for policyholders; and
2. As needed, minimalise the adverse impact that the failure of an insurer or the way it carries out its business could have on the stability of the system.

In order to ensure that an insurer is likely to have sufficient financial resources to meet its obligations to policyholders as they fall due, the PRA will assess an insurer's governance processes and whether these involve management making informed, forward-looking assessments of the firm's financial strength.

In tandem with the PRA's supervision of insurers, the FCA will be tasked with ensuring that consumers are treated fairly in all engagements with insurance firms. Arrangements will be put in place so that there is close co-operation between the PRA and the FCA.

The PRA's role will not be to guarantee that policyholders are protected in all circumstances, nor will the PRA seek to ensure that no insurer fails. However, policyholders will be protected through a combination of the PRA's supervisory approach, mechanisms by which insurers can exit the market in an orderly manner, and the existence of the Financial Services Compensation Scheme's insurance compensation scheme.

The PRA will seek to identify those insurance companies likely individually to pose risk to the stability of the system, and to supervise those companies in a way that reduces that risk.

The PRA's style of supervision will be judgement based. The nature and intensity of the supervision will be commensurate with the level of risk a firm poses to policyholders and the stability of the system. There will not be a one-size-fits-all approach, but when potential threats are identified the PRA will take supervisory action at an early stage to reduce the risk to its statutory objectives.

It is thought that much of the PRA's proposed approach will be achieved in practice through the application of Solvency II.

The PRA will ensure that major judgements involve its most senior and experienced individuals, using a process that is both rigorous and well-documented, and the PRA will recognise that accountability to the public is of the utmost importance.

The joint paper can be viewed here. The paper was launched at a conference on the PRA's approach to insurance supervision. The FSA has also published two speeches from that conference, made by Hector Sants and Julian Adams. Hector Sants' speech can be viewed here, and Julian Adams' speech can be viewed here.

UK – International Association of Insurance Supervisors: Issues Paper on Resolution of Cross-Border Insurance Legal Entities and Groups

In light of the fact that there is no international insolvency framework for insurance entities and very few practical examples of successful resolutions, the International Association of Insurance Supervisors (**"IAIS"**) has published a paper identifying the issues involved in the winding up of cross border insurance entities/groups aimed at encouraging international discussion on the resolution of complex cross-border insurance insolvencies/restructurings. The paper can be viewed here.

A major objective of the IAIS is to develop by-laws to contribute to the broader stability of the financial system. IAIS Insurance Core Principle 16 covers the winding up of insurance entities. The issues paper highlights the areas necessary to be explored in order to flesh out ICP16, undertaking a preliminary exploration of the issues whilst recognising a need for further analysis and consideration within the IAIS and internationally. The paper highlights the main causes of non-viability of insurance entities, the major challenges to the successful resolution of non-viable cross-border insurance entities and the different approaches to resolution together with areas of conflict that currently present obstacles to successful resolutions.

The paper does not put forward solutions but identifies key areas that need to be explored in order to enable the satisfactory resolution of non-viable cross-border insurance entities: the harmonisation of restructuring and insolvency laws; the acknowledgement and recognition of other insolvency laws and regulations in various jurisdictions; insurance regulation and supervision in any insolvency/restructuring context; cross-border co-operation, including supervisory and crisis colleges and plans; ring-fencing; consistent priority to be given to the policy holder; and necessary licensing. The paper also briefly compares resolution frameworks in Australia, Canada, Japan, Switzerland, the UK and the US and provides an overview of two case studies.

UK – FSA proposed guidance on the selling of general insurance policies through price comparison websites

The Financial Services Authority (**"FSA"**) published a consultation on 8 June 2011 on guidance for selling general insurance policies through price comparison websites. The guidance can be viewed here. The guidance relates to firms who sell regulated insurance products and services online both through price comparison websites and "white-label" websites.

The FSA's guidance is the result of thematic work conducted between June and September 2010 which looked into how firms sell insurance online. The conclusions of the thematic work were that there was a lack of understanding within the insurance industry about what regulated activities were being conducted by firms selling insurance online, and that this has consequently led to a number of failures to comply with FSA rules.

The FSA had concerns in three areas:

1) Potential breaches of the general prohibition and restrictions on financial promotions
   The FSA considers that firms who use price comparison tools are likely to be carrying out the arranging activities under Articles 25(1) and 25(2) of the Financial Services and Markets Act 2000 (Regulated Activities) Order (**"RAO"**), and may also be advising on insurance under Article 53. In addition, firms that use a third party's price comparison tool on a white-labelled basis may also fall within Article 25(2).

2) Non-compliance with the FSA's 'Insurance: Conduct of Business sourcebook' (**"ICOBS"**)
   As firms tended to consider that they were merely 'introducing' customers to authorised firms, the FSA found that they had not complied with the FSA's ICOBS requirements. In particular, those requirements relating to customer eligibility, status disclosure, suitability of advice, statement of demands and needs and ensuring that customers buy policies under which they are eligible to claim benefits.

3) Non-compliance with the 'Senior Management Arrangements, Systems and Controls sourcebook' (**"SYSC"**)
   The FSA was keen to remind firms that SYSC gives them a responsibility to have policies and procedures in place to ensure compliance with the FSA rules and to counter financial crime.

The FSA has also written to firms who sell general insurance policies through price comparison websites, and asked them to ensure that they have appropriate regulatory permissions (or ate otherwise exempt) for the activities they carry out, ensure that they only enter into contracts with firms with appropriate regulatory status, review their sales documentation to ensure it complies with FSA rules, and establish appropriate systems and controls to prevent breaches of the appropriate FSA rules.

The FSA invites comments on the consultation until 8 August 2011.

PRC – Government's Refinement of Proposed Insurance Regulatory Regime

The Financial Services and Treasury Bureau published the "Proposed Establishment of an Independent Insurance Authority Consultation Conclusions and Detailed Proposals" (**"Consultation Conclusions"**) and the relevant "Frequently Asked Questions" (**"FAQs"**) on 24 June 2011. Whilst the proposed insurance regulatory framework, based on the existing framework for the securities and banking industries, is broadly the same as that set out in the consultation paper published in July 2010, we seek to highlight in this bulletin some of the Government's refinement

of the proposed regulatory regime. For further information on the overall proposed regulatory framework, please refer to our Legal Update dated 14 July 2010 entitled "The End of Self-Regulation? Proposals to Establish an Independent Insurance Authority".

Broad Additional Function of the IIA

In concluding that the proposed independent Insurance Authority (**"IIA"**) should assume an expanded role beyond the functions of the existing Insurance Authority to align with the international standards, the Government proposed in the Consultation Conclusions that the function of the IIA should also include "to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the insurance industry". Comparing with the originally proposed three additional functions of the IIA (namely, (a) to perform direct regulation on the conduct of insurance intermediaries; (b) to organise public education programmes; and (c) to conduct thematic researches and studies concerning the industry), this latest proposed function of the IIA is drafted more broadly and is therefore expected to facilitate the IIA in carrying out its duties, within the power granted, by giving it a broad legal basis.

3-Year Deemed Licensed Period For Pre-existing Insurance Intermediaries

Whilst a new licensing regime for insurance intermediaries will be introduced under the proposed regime, the Government proposed in the Consultation Conclusions that the pre-existing insurance intermediaries validly registered with the current three self-regulatory organisations (i.e. the Insurance Agents Registration Board, the Hong Kong Confederation of Insurance Brokers and the Professional Insurance Brokers Association) would be deemed to be licensed with the IIA for three years from the establishment of the IIA before obtaining their licences. The Government further proposed that the IIA may consider mandating the pre-existing intermediaries to submit their license applications within a fixed period upon the IIA's establishment if they wish to obtain licenses under the new regime.

Given that there are currently more than 70,000 insurance intermediaries, the proposed transitional arrangement would allow the IIA to have sufficient time to process the large volume of license applications from pre-existing insurance intermediaries in addition to those license applications made by new joiners to the industry. At the same time, the proposed 3-year transition period appears to be a reasonable time period for enabling the pre-existing insurance intermediaries to comply with any proposed eligibility requirements under the proposed licensing regime. To allay pre-existing intermediaries' concerns in relation to the transition to the proposed licensing regime, the Government clarified in the FAQs that the eligibility criteria under the proposed licensing regime would refer to the pre-existing registration conditions and that there was no intention to introduce any changes to the eligibility requirements through the legislative exercise to establish the IIA.

Restricted Power Delegation to HKMA

Whilst the Government's stance remained that the IIA should work closely with the Hong Kong Monetary Authority ("HKMA") in regulating the insurance intermediary activities of banks, the Government provided more details in the Consultation Conclusions in relation to the proposed demarcation of the regulatory roles assumed by the IIA and HKMA.

Inspection Power: The Government proposed that inspection of insurance intermediary activities of banks would be jointly carried out by the IIA and HKMA. Whilst this proposed arrangement may incur resources from both regulators, it would allow the IIA, as the primary and lead regulator, to have first-hand information to the insurance intermediary activities of banks for the purpose of making any sensible and prompt regulatory response in relation to the insurance intermediary activities of both banks and non-banks.

Investigation Power: The Government proposed that the investigation power with respect to alleged wrongdoings of bank's insurance intermediaries be generally delegated to the HKMA by the IIA subject to the IIA's decision to carry out any investigations itself, take over any investigations from the HKMA or send staff to participate in the investigation team of the HKMA. This proposal should send a clear message to the insurance intermediaries industry that the IIA is the ultimate regulator of insurance intermediaries in practice, whether or not they are bank related.

Disciplinary Power: The Government proposed that the decisions of whether to impose disciplinary sanctions on an insurance intermediary lie in the IIA whether or not the investigation is conducted by the HKMA. This proposal would ensure that all intermediaries are subject to the same disciplinary standards even if the HKMA may be involved in the inspection and investigation process.

Levy Cap on Non-life Insurance Policies

Whilst the Government maintained that one of the funding sources for the IIA would be a levy of 0.1% on insurance premiums for all insurance policies, it responded to the public request that a cap on such levy be imposed. In the Consultation Conclusions, the Government proposed to (a) cap the levy on non-life insurance policies with annual premiums at or above HKD 5 million and that on life insurance policies with single or annualised premiums at or above HKD 100,000; and (b) exempt reinsurance contracts from the levy. Such levy cap and exemption should alleviate concerns from the insurance industry that high premium policies may otherwise be driven offshore and that it would be unfair for the same insurance policy to be subject to double-levies due to reinsurance arrangement.

Conclusion

The Government's refinement of the proposed insurance regulatory regime set out in the Consultation Conclusions is welcome. In particular, the transitional arrangement for pre-existing insurance intermediaries appears to be sensible and that the restricted delegation of regulatory power to the HKMA appears to be a fair response to allay concerns from non-bank related insurance intermediaries.

The next step forward for the Government is to involve the insurance and banking industry and the relevant stakeholders in further refining the detailed proposals for the drafting of legislation by early 2012.

US – Update – Additional States Adopt Statutes Providing for Limited Purpose Subsidiary Life Insurance Companies

Three additional states have followed the lead of Iowa and have recently adopted statutes allowing life insurers domiciled in their states to create limited purpose

subsidiary (**"LPS"**) life insurance companies. Those states are Georgia (effective 1 July 2011), Indiana (effective 6 April 2011) and Texas (effective 17 June 2011).

An LPS performs a function that is similar to a captive reinsurer and may only reinsure the risks of its parent life insurance company or of other affiliated life insurance companies that are domiciled in the state. (In Georgia, unlike the other three states, only risks of the parent may be reinsured, and the parent must itself be a life reinsurer.) An LPS has the authority to issue debt securities and access financial markets and alternative sources of capital through securitizations and other like transactions. An LPS is required to maintain a certain level of unimpaired paid-in capital and surplus determined by state law and comply with risk-based capital requirements. An LPS is permitted to purchase reinsurance to cede the reinsurance risks that it has assumed if given permission by the state regulatory body.

For more detail on the Iowa LPS regulations that became effective on 22 December 2010, please see our prior article, "Iowa Limited Purpose Subsidiary Life Insurance Companies" from our December 2010 bulletin.

US – New York Passes Bill Regarding Treatment of Qualified Financial Contracts Under Insurance Insolvencies

On 22 June 2011, the New York Assembly passed Senate Bill 2713A/ Assembly Bill 6603A which, if signed by the Governor, will add provisions to the New York Insurance Law regarding the treatment of qualified financial contracts in an insurance insolvency proceeding.

"Qualified financial contracts" include derivatives, securities lending, repurchase agreements, futures contracts and other financial instruments. These contracts are typically documented under master agreements providing for netting of obligations between the parties. The agreements also establish a right of the non-defaulting party to close out, liquidate and terminate the agreements immediately upon the insolvency of the other party and provide for collateralization of obligations on a net, rather than gross, basis.

Although the U.S. Bankruptcy Code (governing the insolvency of most U.S. companies) and the Federal Deposit Insurance Act (governing the insolvency of U.S. banks) contain provisions exempting qualified financial contracts and netting agreements from the automatic stay mechanism, most state insurance codes governing the insolvency of insurance companies have historically not included such provisions, creating significant uncertainty for counterparties of insurance companies.

The Insurance Receivership Model Act (**"IRMA"**), adopted by the National Association of Insurance Commissioners in 2005, did include such provisions, and over time more and more states have been enacting those provisions into law. During the five-year period prior to 2010, only six states did so (Connecticut, Iowa, Maryland, Michigan, Texas and Utah), but that picture has changed substantially as ten more states have enacted the IRMA provisions in 2010 and thus far in 2011 (Arizona, Delaware, Illinois, Indiana, Maine, Massachusetts, Minnesota, Missouri, Nebraska and Virginia). If Governor Cuomo signs the recently passed New York bill, New York will become the 17th state to provide greater certainty for parties that enter into qualified financial contracts with insurance companies.

For more detail on this subject, please see our prior article, "Treatment of Swap Agreements Under Insurance Insolvencies" from our November 2010 bulletin.

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June 2011