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What future for the insurance block exemption?

The European Commission's (the **"Commission"**) review of the future of the insurance block exemption neared completion on Tuesday 2 June 2009, when the Commission held discussions with industry participants on its 24 March 2009 report and working paper on renewal of the insurance block exemption.

The current insurance block exemption[1] expires on 31 March 2010. The Commission has not yet made a final decision on whether to renew it. However, the indications are that it will adopt a new, but more restricted, block exemption.

A block exemption allows an agreement or arrangement that meets certain criteria, which are laid down in the relevant block exemption regulation, to benefit from automatic exemption from the EU and national competition law prohibitions on anti-competitive agreements. Where no block exemption exists, the parties must assess competition compliance for themselves, from first principles, laid down in the EC Treaty and the UK Competition Act 1998 – a more time-consuming and complex process than checking adherence to the conditions in the block exemption regulation.

Compliance with the current block exemption means that, although they are competitors, insurers and reinsurers are generally permitted to co-operate in four areas without being challenged as anti-competitive. The Commission recognises that, in certain circumstances, the benefits of co-operation in these areas outweigh any potential anti-competitive effects the co-operation may have.

After 31 March 2010, two of the four types of co-operation covered by the existing block exemption are likely to continue to be exempted by a new block exemption – co-operation among insurers and reinsurers on (i) joint calculations, table and studies and (ii) co-insurance and reinsurance pools. The Commission continues to recognise the benefits that co-operation on these matters brings. However, the conditions for exemption are likely to be stricter.

The bad news for insurers and reinsurers is that the remaining two types of co-operation are unlikely to continue to be exempted. If, as seems likely, the Commission decides to exclude from the new exemption co-operation among insurers and reinsurers on (i) standard policy conditions and (ii) standards for security devices, the parties to co-operation on these matters will face increased competition risks. They will need to assess with their advisers whether their individual

1 Commission Regulation 358/2003/EC

agreements or co-operation arrangements may infringe competition law and, if so, ensure that they make decisions on these matters independently. A thorough analysis of the co-operation will be critical: co-operation among competitors is viewed with particular suspicion by competition authorities, and the consequences of infringement are serious – they include fines, unenforceability of the infringing agreement or provision, actions for damages and, in very serious cases, personal liability for staff.

The Commission has indicated that it will come to a decision on the future of the current block exemption in the next few weeks. It has not specified a date, although a decision to abandon the block exemption altogether must be announced before the end of this year. If the Commission decides to adopt a new, probably more limited, block exemption, it is likely to publish a draft regulation for consultation within the next few months.

In the meantime, the Commission has confirmed that it continues to keep the insurance sector in general under close scrutiny following its sector inquiry, concluded on 25 September 2007.

The regulator's role in judging competence of senior management

As a result of the financial crisis and the recent Turner review, the FSA has sought to deal with the shortcomings in governance and risk management at regulated firms. The FSA is particularly concerned that senior management do not have a sufficient degree of competence or have been "cavalier" in their decision making; that there are insufficient checks on management (in particular boards); and firms have not been open enough with their regulators, shareholders and customers. On 7 May 2009, Hector Sants (CEO of the FSA) outlined a number of changes the FSA expects to make to how it judges the competence of senior management, which will form part of a wider programme of regulatory reform.

The FSA's proposed changes will have an impact on three different areas: (1) Non-Executive Directors; (2) Risk Management Functions; and (3) Significant Influence Functions. First, Non-Executive Directors will now be expected to demonstrate competence with regard to risk management, regulation, and the business model of the firm. This will mean a cost to firms as the FSA will expect more Non-Executive Directors to work on a full time basis and be compensated appropriately. Secondly, firms will need an effective risk management function with clear independent reporting lines to a risk committee, which should be able to provide a genuine challenge to business managers, and there should be an executive director solely responsible for risk on the main board. Thirdly, as part of the Significant Influence Function review, the FSA has introduced interviews for candidates for a number of the key functions in an authorised firm (for example, but not limited to, chair, CEO, finance director or risk manager). Assessment of SIF competence will be based on evidence in the following areas: knowledge (genuine knowledge about the sector), skills (business and interpersonal skills), behaviour (attitudes and ethical behaviour), and expertise (achieves positive and fair outcomes and meets performance standards expected for the post).

Association of British Insurers' ("ABI") "Restoring Market Confidence" report

On 3 June 2009, the ABI published a report entitled: "Restoring Market Confidence".

In this report, the ABI recognises that significant regulatory change is required in order to prevent another financial crisis and restore market confidence. The ABI does not want to see the insurance sector suffer major damage as a consequence of regulators and governments attempting to deal with the banking crisis.

In the report, the ABI aims to contribute some substantive proposals that chart a way forward in the following areas:

1) the macro-prudential regulatory framework;

2) the role of markets in the future; and

3) the need for better quality regulation and supervision at a national level and also across borders.

Commenting on the report, Stephen Haddrill, ABI Director General, said:

"Insurance is not banking and should not be regulated in the same way. We need targeted sector-specific changes, and not a lazy adoption of banking rules to other parts of the financial services sector. If this happens, UK-based insurance companies will suffer the damage to profitability, prosperity and innovation for a generation."

To view the entire ABI report, please click here.

Eligibility date for trade credit insurance top-up scheme

As reported in our May Bulletin, the UK Government has launched a trade credit insurance top-up scheme designed to help suppliers whose trade credit insurance limit has been reduced. On 9 June 2009, the Department for Business, Innovation and Skills published a press release announcing that the scheme has been extended to make it available to a wider range of companies. Previously the scheme was only available to companies whose trade credit insurance cover was reduced from 1 April 2009. This has now been backdated to include companies whose cover has been reduced since 1 October 2008. Companies whose cover was initially withdrawn completely after 1 October 2008, but subsequently partially reinstated, will also now be able to benefit under the scheme. HCC International Insurance Company plc have joined the credit insurers offering this scheme to policyholders.

Adair Turner speaks out

On 9 June 2009, Adair Turner, Chairman of the FSA, spoke at the ABI 2009 Conference. Turner noted the need for a radical change in the banking industry but that in insurance "there is no equivalent need for a revolution".

First, Turner noted the major changes in the capital regime for insurance companies which the FSA introduced in 2004 and which have helped to put the industry in a stronger position to meet the challenges of the current economic environment and to deal with market volatility. Second, Turner observed that liquidity risks are much less important for insurance companies than they are for banks.

Despite there not being a need for revolution, Turner did acknowledge that there will be major changes for the industry and he highlighted the following four changes:

- the need for the financial services industry in general to rebuild trust;
- the emergence of a more intensive supervisory approach with "no return to light touch regulation ... and supervision on the cheap";
- an increased focus on the role of institutional investors, including insurance companies, in corporate governance; and
- a restructuring of regulatory responsibility in the UK and across Europe, including it was suggested a need for the FSA and the Bank of England to work closely together to identify and manage macro-prudential risks, and a European financial services regulator, not involved in direct supervision, but with an extensive coordinating role at national level.

Turner certainly tried to strike a balanced note in his speech and, no doubt, the UK insurance industry will welcome one of his concluding remarks that the financial crisis does not call for major new initiatives in the substance of insurance regulation (for instance in the approach to capital adequacy).

Obama Administration Proposes Comprehensive Changes to Financial Services Regulation

The Obama Administration has released a detailed proposal to change the financial services regulatory regime in the United States. The "white paper," entitled "Financial Regulatory Reform: A New Foundation," calls for the most significant overhaul of the American financial regulatory landscape since the Great Depression and is intended to mitigate or forestall future financial crises. Among other things, the proposal would create a system for identifying and resolving systemically important financial firms, significantly expand the powers of the Federal Reserve Board and the range of institutions subject to its supervision, eliminate the thrift charter and create a new National Bank Supervisor, increase regulation of hedge funds and derivatives, impose new requirements on securitization activities, create a new federal Consumer Financial Protection Agency, and increase federal oversight of the insurance industry. Despite its length, the proposal leaves many details unresolved and raises almost as many questions as it answers. We highlight and discuss some of the most significant aspects of the proposal, including several of its less-publicized provisions.

Solvency II – development of Level 2 implementing measures and Level 3 supervisory guidance.

On 12 June 2009, the European Commission (the **"Commission"**) published a letter to the Committee of European Insurance and Occupational Pensions Supervisors ("**CEIOPS**") in which they provided an update on how they foresaw the rest of the Solvency II project proceeding and CEIOPS' on-going work on the development of the level 2 implementing measures and level 3 supervisory guidance.

The Commission went on to set out a timetable for the next stages, which provides for the level 2 measures to be in place at least 12 months before the new regime becomes operational and the level 3 supervisory guidelines to be in place at least 9 months before the new regime enters in force.

In order to meet these deadlines, the Commission would need to formally adopt the proposals for level 2 measures by the end of 2010, which would mean that CEIOPS would need to provide the Commission with final advice by January 2010 at the latest, although the Commission expects CEIOPS to provide final advice on most areas by October 2009. As regards the level 3 guidelines, the Commission suggested that CEIOPS work towards publishing draft supervisory guidelines for consultation in the first half of 2011. The Commission's letter also dealt with impact assessment and the fifth quantative impact study, which is likely to be run between August and November 2010.

On 16 June 2009, CEIOPS responded to the Commission's letter of 12 June. CEIOPS stated that they were strongly committed to contributing to Solvency II. However, they would have to reallocate their limited resources in order to do so. CEIOPS referred to the Council's letter of 11 March 2009 in which they were encouraged to set priorities. Accordingly, this would have some implications for the structure of their Solvency II advice to the Commission on the level 2 and level 3 work. Given the Commission's demand to get a full picture for both levels at the same time they would draft level 3 as best and as early as they could. Due to the current challenging times CEIOPS would also have to steer their level 3 work in such a way that they produce in good time the work that they deemed to be most appropriate to make Solvency II a success.

In short, whilst the Commission has set down a tight timetable for the implementation of Solvency II, in practice the limited resources of CEIOPS may lead to unavoidable delays in its implementation.

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