A critique of the territoriality rules applying to UK insurance regulation:

Part II

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9 Introduction

In the first part of this article[1] I discussed some of the territorial limits of UK insurance regulation. Territoriality in regulation refers to how regulators assert or limit the exercise of their powers in situations with a foreign element and where there may be an overlap with the jurisdiction of foreign regulators.

I pointed out that the UK rules gave rise to anomalies. These included:

- the fact that insurers authorised outside the European Economic Area (EEA) can insure UK risks without a local authorisation if they keep their activities offshore. By contrast insurers authorised in the EEA who intend to insure risks located in the UK must passport into a local authorisation[2],
- the financial promotion restriction does not extend to most non-EEA insurers promoting non-investment insurance products into the UK[3],
- most FCA conduct of business rules only apply to activities carried on from a UK establishment. By contrast insurance regulation in France, for instance, generally applies by reference to the law applicable to the insurance contract. This gives French firms selling into the UK an opportunity to arbitrage French rules where UK law applies and to arbitrage UK rules by not operating from a UK establishment[4],
- it is easy to arbitrage the UK "permitted link" rules applicable to linked long term products by ensuring that such products are underwritten outside (even if sold inside) the UK[5].

In this part of my article I discuss some further territoriality issues. These include:

- the identification and regulatory significance of various different types of office from which firms operate (e.g. registered office, head office, office not amounting to an establishment, establishment and "permanent establishment"[6],

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[1] Also published in issue 130 of the BILA Journal.

[2] See sections 3 and 4 of the first part of this article.

[3] See section 5 of the first part of this article.

[4] See sections 6.3 and 6.4 of the first part of this article.

[5] See section 6.8.3 of the first part of this article.

[6] See section 10 below.

- the territorial application of the high level rules of the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)[7],
- the territorial significance of the distinction between conduct of business rules and prudential rules[8],
- the territorial application of the Solvency II regime for the prudential supervision of insurance groups as applied by the PRA[9].

10 Different types of office

I start by discussing the different types of office which a firm may have and their territorial significance. I do this to the extent that this issue has not already been discussed in the first part of this article.

10.1 Establishment

We saw, for instance, in Part I, that many of the conduct rules of the Financial Conduct Authority (FCA) only apply to activities carried out by a firm from an establishment maintained by it, or its appointed representative, in the United Kingdom. A foreign firm may, however, deal with UK customers without there being any relevant establishment. In that event it will avoid the application of much of the FCA's conduct regime, although it will still need to passport into a UK "services" authorisation.

Article 13(12) of the Solvency II Directive[10] provides that an 'establishment' of an undertaking means its head office or any of its branches. Article 13(11) says that a 'branch' means an agency or a branch of an insurance or reinsurance undertaking which is located in the territory of a Member State other than the home Member State.

This is further explained in article 145(1):

> "Any permanent presence of an undertaking in the territory of a Member State shall be treated in the same way as a branch, even where that presence does not take the form of a branch, but consists merely of an office managed by the own staff of the undertaking or by a person who is independent but has permanent authority to act for the undertaking as an agency would."

This restates the effect of the judgment of the Court of Justice in *Commission v Germany*[11].

The European Commission has provided further guidance in an interpretative communication[12]. In particular it has expressed the view that where a firm, A, instructs an independent person, B, to

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[7] See section 11 below.

[8] See section 12 below.

[9] See section 13 below.

[10] i.e. the framework directive 2009/138/EEC containing the current prudential regime for regulation of (re)insurers.

[11] Case 205/84 *Commission v Germany* [1986] ECR 3755.

represent it in another EEA state, B must, to be treated as a branch or establishment, meet the following three cumulative conditions:

1) he must be subject to the direction and control of the insurance undertaking he represents;
2) he must be able to commit the insurance undertaking, and
3) he must have received a permanent brief.

Despite the different forms of guidance available, the task of distinguishing foreign firms with a UK establishment from those without is a difficult one in specific cases. What is the position, for instance, if the independent representative refers all business decisions to head office, but head office invariably follows his advice? Issues of this kind do not seem to have arisen in FCA enforcement cases – it may be they are resolved privately between firms and the regulator. There are doubtless a large number of firms passported on a services basis which should have passported on an establishment basis.

An additional reason why a firm might wish to arbitrage establishment status is that a firm authorised in state A with an establishment in state B will also usually, although not invariably, have a "permanent establishment" in state B for the purpose of being taxed there[13].

When the UK leaves the European Union, then absent any agreement to the contrary, UK firms will lose the right to passport into the EEA either on an establishment or on a services basis.

Accordingly many UK firms are incorporating subsidiaries in the EU so that those subsidiaries may enjoy passporting rights. This may be a necessary step not only for UK firms with an EEA establishment passport but also for services passporters. This is because the Commission and the European Insurance and Occupational Pensions Authority (EIOPA) do not seem to contemplate third country firms being able to carry on business in the EEA without an EEA establishment[14].

The same principles will apply to EEA firms operating in the UK, mutatis mutandis. Firms who already have a services or a branch passport will lose it, although if the host state seeks to close them down (where they have not subsidiarised) they will doubtless take action in the courts, relying, among other things, on their human rights and those of employees, policyholders and clients.

10.2 Registered office

Advocate General Sir Francis Jacobs in the *Eurofood* case[15] pointed out that:

> "In transnational business the registered office is often chosen for tax or regulatory reasons and has no real connection with the place where head office functions are

[12] Commission Interpretative Communication Freedom to provide services and the general good in the insurance sector (2000/C 43/03)

[13] See "Interpretation and application of article 5 (permanent establishment) of the OECD model tax convention" http://www.oecd.org/tax/treaties/48836726.pdf

[14] See section 4 above and EIOPA's "Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union (EIOPA BoS - 17/141 11 .07.2017)"

[15] Eurofood IFSC Ltd Case C-341/04.

> actually carried out. That is particularly so in the case of groups of companies, where the head office functions for the subsidiary are often carried out at the place where the head office functions of the parent of the group are carried out."

Under the original insurance and banking directives in the 1970s firms were authorised in the state of their registered office. This gave rise to problems, in particular the Bank of Credit and Commerce International had its registered office in Luxembourg but most of its head office operations in the UK. It "fell between two stools" in regulatory terms.

So the Post BCCI Directive[16] required financial firms, including banks, insurers and investment firms, to be authorised where they had their head office. It also required that their head office and registered office should be in the same state. This requirement is transposed in the Financial Services and Markets Act 2000 (FSMA)[17].

10.3 The Head office

There is no legal definition of a head office, least of all in Solvency II or the Insurance Distribution Directive[18]. The FCA state in COND 2.2.3G:

> "This is not necessarily the firm's place of incorporation or the place where its business is wholly or mainly carried on. Although the FCA will judge each application on a case-by-case basis, the key issue in identifying the head office of a firm is the location of its central management and control, that is, the location of:
>
> (1) the directors and other senior management, who make decisions relating to the firm's central direction, and the material management decisions of the firm on a day-to-day basis; and
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> (2) the central administrative functions of the firm (for example, central compliance, internal audit)."

It is arguable that this definition is not quite tight enough. Recital 7 to the Post BCCI Directive states:

> "Whereas the principles of mutual recognition and of home Member State supervision require that Member States' competent authorities should not grant or should withdraw authorization where factors such as the content of programmes of operations, the geographical distribution of the activities actually carried on indicate clearly that a financial undertaking has opted for the legal system of one Member State for the purpose of ***evading the stricter standards in force in another Member State within whose territory it carries on or intends to carry on the greater part of its activities*** [emphasis supplied]; whereas a financial undertaking which is a legal person must be authorized in the Member State in which it has its registered office;

[16] 95/26/EC "with a view to reinforcing prudential supervision"

[17] Schedule 6 paragraph 4C.

[18] Directive (EU) 2016/97

whereas a financial undertaking which is not a legal person must have its head office in the Member State in which it has been authorized; whereas, in addition, Member States must require that a financial undertaking's head office always be situated in its home Member State ***and that it actually operates there*** [emphasis supplied]."

The italicised passages suggest that a firm with what purports to be a head office in the UK, but which carried out all its business elsewhere might be in regulatory breach and might be subject to enforcement action in the host state where it carries on business.

The same principle applies under the Insurance Distribution Directive. Article 9(2) provides:

> "Moreover, this Directive shall not affect the power of the competent authority of the host Member State to take appropriate measures to prevent an insurance distributor established in another Member State from carrying out activity within its territory under the freedom to provide services or, where applicable, the freedom of establishment, where the relevant activity is entirely or principally directed towards the territory of the host Member State with the sole purpose of avoiding the legal provisions which would be applicable if that insurance distributor had its residence or registered office in that host Member State"

In *Eurofood* Advocate General Jacobs stated that a "head office can be just as nominal as a

registered office if head office functions are not carried out there". It was no doubt with this thought in mind that EIOPA has proposed[19] strict standards for the supervision of EEA subsidiaries of UK insurers following Brexit. The concern is that these firms will be over dependent on the UK operations of the group of which they are members. So, for instance, EIOPA has advised:

> "While it may be acceptable that undertakings with simple risk profiles or a small scale of business outsource a significant part of their key functions, it would not be acceptable that undertakings with complex risk profiles or a large scale of business do so. Considerations on proportionality on the outsourcing of critical or important functions should at a minimum consider the complexity of the business model, average number of employees, the total amount of the balance sheet and net annual turnover (earned premiums net of reinsurance)."

The identification of the head office of an insurance holding company may also be an issue in relation to group supervision. This is discussed below[20].

11 FCA Principles for business and PRA Fundamental Rules

The FCA and the PRA rely heavily in their regulation of firms on a set of high level rules expressed in very general terms. The FCA rules are described as "Principles for Businesses" and the PRA rules are

[19] Opinion on supervisory convergence in light of the United Kingdom withdrawing from the European Union (EIOPA BoS - 17/141 11 .07.2017)

[20] See section 13 below.

described as “Fundamental Rules”[21]. These rules are enforceable in a similar way to the FCA and PRA’s other rules, so the regulators may, for instance, apply for restitution for the benefit of customers against firms who are in breach of any of these rules[22].

Because they are so general the rules can be and are reinterpreted over time. There is common ground between the two sets of rules. They both say, for instance, “A firm must conduct its business with integrity”. The PRA Fundamental Rules focus on prudential rules and the FCA principles focus on conduct. The FCA Principles contain, among other things, its flagship Principle 6: “A firm must pay due regard to the interests of its customers and treat them fairly.”

Both sets of rules say:

- for an incoming firm, the [rules] apply only in so far as responsibility for the matter in question is not reserved by an EU instrument to the firm's home state regulator; and
- for an incoming EEA firm which has permission only for cross border services and which does not carry on regulated activities in the United Kingdom, the [rules] do not apply;

The first bullet point reflects section 137A(5) and 137G(5) of FSMA. This restricts the power of the regulators to make rules covering matters which are the responsibility of regulators in other countries.

The second bullet point applies the same approach to territoriality as had been noted above in relation to the Insurance Conduct of Business Sourcebook (ICOBS) and the Conduct of Business Sourcebook (COBS). As with COBS and ICOBS there is a risk that the UK rules will be dis-applied to incoming firms, while the rules in their home state will not apply either. The latter rules only usually apply in continental jurisdictions when the law of the home state applies to the insurance contract. The law of the home state usually will not apply when the policyholder is UK resident.

In practice, however, most services passporters opt into the jurisdiction of the Financial Ombudsman Service (FOS) because they will not be able to penetrate the UK market without doing so. FOS will apply what it considers to be a “fair and reasonable” outcome. This will usually include the application of standards giving effect to the FCA’s treating customers fairly principle.

Although the PRA cannot prudentially regulate EEA firms with branches in the UK there are indications that it may nonetheless “lean” quite heavily on those firms from time to time. In its 2016 publication “the PRA’s approach to insurance supervision” it comments:

> “Regardless of the corporate structure and location of the parent, the PRA expects all UK branches, like UK subsidiaries, to act responsibly in a manner that is consistent with safety and soundness and the appropriate protection of policyholders. The PRA expects branches to appoint a senior individual as head of the branch with

[21] The PRA and the FCA often seem to be determined to find different words to describe the same thing.

[22] See *British Bankers Association v Financial Services Authority and Financial Ombudsman Service* [2011] EWHC 999 (Admin)

> authority to act as a primary contact with the PRA in relation to their affairs[23]. This individual should also act as a channel for communication with the parent."

Where the PRA' concerns are not met it may take the issue up with the home state regulator or take emergency action under Part XIII FSMA. The same applies mutatis mutandis to any concerns the FCA may have in relation to passporting firms under Solvency II or the Insurance Distribution Directive.

12 The distinction between prudential and conduct regulation

12.1 Solvency II

The general principle underlying the financial services directives is that a financial firm, including an insurer or an insurance intermediary, is subject to prudential supervision by its home state supervisor. This is the supervisor of the state where the firm has its head office. Supervision of conduct, in particular relationships with customers, by contrast, is the responsibility of the host state supervisor. In the case of insurance this is the supervisor for the state where the risk under the insurance contract is located, or the state where the firm may have established a branch from which the business is carried out[24].

Recital 24 of the Solvency II Directive states that:

> "The supervisory authorities of the home Member State should be responsible for monitoring the ***financial health*** [emphasis supplied] of insurance and reinsurance undertakings. To that end, they should carry out regular reviews and evaluations."

"Financial health" should probably be construed in a wide sense, since the responsibilities of the home state under Solvency II (unlike the previous regime) now include prudential issues which are not primarily financial, such as governance, risk management, fitness and properness of personnel and outsourcing. "Financial health", however, does not cover the subject matter of conduct of business rules. Article 180 of the Solvency II Directive makes clear that such "general good" rules are the responsibility of the member state of the risk or commitment under the relevant insurance contract.

12.2 The Insurance Distribution Directive

Under the Insurance Distribution Directive it is not clear whether product governance, i.e. the standards for developing products which are suitable for customers, is a home or host state responsibility[25]. The power to develop rules in this area is reserved to the Commission and there is no provision for member states to "gold plate" these specific rules (although some notification requirements may be gold plated under article 29(3) of the Directive). When the UK leaves the EU its firms will doubtless have little alternative but to adhere to these rules if they want to continue to have access to the European market.

Recital 21 of the Insurance Distribution Directive states:

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[23] This is, in any event, required under article 145(2) of the Solvency II Directive.

[24] This is recognised in Chapter VIII of Solvency II

[25] See article 25.

> "Where … intermediaries pursue business in different Member States … the … Home Member State should be responsible for ensuring compliance with … this Directive with regard to the entire business ... If the … host Member State becomes aware of any breaches of obligations occurring within its territory, it should inform the … home Member State which should then … take the appropriate measures. Such is the case, in particular, as regards … the rules on good repute, professional knowledge and competence requirements or on the conduct of business. Moreover, … the host Member State should be entitled to intervene if the home Member State fails to take appropriate measures ..."

There is an equivalent provision in article 145 of the Solvency II Directive.

12.3 Doubtful cases

Sometime member states apply requirements which are arguably inconsistent with the allocation of responsibilities between home and host member state and thus, where the member state is the UK, with section 137A(5) and 137G(5) of FSMA[26].

So, for instance, article 42 of the Solvency II Directive requires firms to notify the home state supervisor of the identity of the persons who effectively run the undertaking or are responsible for key functions.

The PRA has the main supervisory responsibility for fitness and properness of personnel in PRA supervised firms (including (re)insurers). Yet the FCA does require that it should approve the personnel discharging a number of key functions related to conduct issues within EEA firms with a passported UK branch[27]. It is questionable whether this is lawful. Yet no-one has challenged the FCA on this point.

The International Association of Insurance Supervisors (IAIS) has expressed the following view[28]:

> "Unfair or misleading business practices can be symptoms of insufficient control over distribution channels, ineffective governance or inadequate internal controls. Such issues may contribute to financial difficulties whereby insurers need to reassess existing commitments or redress the mis-selling of products. In the same way, inappropriate claims payment policies can be a means to compensate for otherwise unprofitable products or other financial pressures. By identifying unfair customer outcomes, conduct of business supervisors can help prudential supervisors in anticipating emerging prudential concerns."

[26] See section 10 above.

[27] See SUP 10A.1.11R the functions include the moneylaundering reporting function, and in certain circumstances the significant influence function and the customer function.

[28] Issues Paper on Conduct of Business Risk and its Management, November 2015, section 2.1

13 Group supervision

13.1 What group supervision consists of

It is not only solo firms which are supervised under the financial services directives and FSMA. Prudential supervision has extended to banking groups since the 1990s, insurance groups since 2000 and financial conglomerates since 2005. A financial conglomerate is a group of companies which satisfies a number of minimum requirements as to operations in, on the one hand, the insurance sector and, on the other hand the banking/investment sector[29].

Under Title III of Solvency II an insurance group is, among other things, required to:

- maintain a minimum amount of capital at group level calculated by reference to a group solvency capital requirement (SCR),
- report on intra-group transactions and risk concentrations,
- apply the governance, risk management and reporting requirements contained in Solvency II at group as well as at solo level. These include the preparation of a group own risk and solvency assessment (ORSA).

The SCR is calculated by reference to a standard formula or, where supervisory approval is given, using internal models.

Care must be exercised to ensure that the various holdings of the group count fully towards group capital. That will often not be the case if the holdings are in subsidiaries based in jurisdictions which have not been determined by the European Commission to be equivalent to the Solvency II regime. This will become a problem for European groups with UK holdings if the UK is not recognised as equivalent following Brexit. Where the value of significant elements of the group's holdings has to be written down for group capital purposes the group may need to raise further capital, which may be an expensive exercise, putting the group at a competitive disadvantage compared to other firms and groups inside and outside Europe.

The report on intra-group transactions and risk concentrations may lead the supervisor to require the firms concerned to rectify any concerns that may arise. For instance the group may be required to reduce internal reinsurance arrangements and replace them with reinsurance ceded to a non group firm. This may be required to avoid an ENRON type domino effect within the group.

Where the group has inadequate governance and/or risk management systems a capital add-on may be applied requiring it to maintain a higher level of capital than that provided for under the SCR. Alternatively a skilled person might need to be appointed at the group's expense[30] to report and make recommendations on the problem.

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[29] There are only, as at 2016, 3 UK based groups being supervised as conglomerates: Lloyds Banking Group, Old Mutual and Sanlam. To reduce the complexity of this section the regulation of financial conglomerates is not further discussed.

[30] Under section 166 of the Financial Services and Markets Act 2000

13.2 Insurance holding companies

Some insurance groups, particularly mutuals, are themselves headed by a (re)insurer but most are headed by an "insurance holding company", whose only function is to manage the group, carry out the head office functions and be the vehicle for the group's stock market quotation (where the group is quoted at all). It will not, therefore be a PRA/FCA regulated firm. Large insurance groups may have an insurance holding company at the head of the group with intermediate holding companies for the group's operations in specific jurisdictions or regions or in specific product lines such as life and non life.

13.3 International issues

Some insurance groups only operate within one country, but many operate across Europe or around the world and there are some groups based outside Europe with significant operations in Europe,

Solvency II provides for the supervision of European groups at ultimate European level and where appropriate at sub-group level. Where the European group has holdings outside Europe, supervision will extend to those holdings.

Where a non EEA group has holdings in Europe the group supervision regime will be applied to that group unless the jurisdiction in question is determined by the Commission to be equivalent[31]. In that event group supervision in the equivalent jurisdiction will be "relied upon"[32]. "Reliance" is not a black and white concept however, so even where the third country supervisor is being relied upon, the EEA supervisors can be expected to remain keenly interested in any group supervision issues.

The process of gaining "equivalence" status is a long drawn out one. It may be granted on a permanent, temporary or provisional basis. It is not yet clear whether by the time Brexit takes effect the UK will be determined to be equivalent. If it is not, then UK insurance groups with EEA operations may be subject to group supervision from within the EEA, thus duplicating group supervision carried out by the PRA.

Only Bermuda and Switzerland have so far achieved full equivalence status. The value of that status has in any event been considerably diluted. This is because the Commission takes the controversial view that a finding of equivalence at the top level of the third country group does not rule out supervision within the EEA of European sub-groups.

13.4 The group supervisor

Only one EEA supervisor, the "group supervisor" will carry out group supervision in relation to any one group, although subgroups of the group may be group supervised in other jurisdictions[33].The PRA

[31] Article 280 of the Solvency II Directive

[32] Article 261 of the Solvency II Directive

[33].

doubtless keeps a close eye on the operations of UK sub-groups of groups which are group supervised in another jurisdiction. This is in any event contemplated under article 216 of the Solvency II Directive.

The group supervisor is assisted by a college of supervisors. One of the group supervisor's key functions is to approve or otherwise the group's internal model for calculating the SCR, subject to a right of appeal to EIOPA. When the internal model is approved that will generally reduce the amount of capital that the group is required to maintain.

The college consists of the supervisors in all jurisdictions where the group has subsidiaries[34]. The Group supervisor is identified in the first instance by reference to a complex formula set out in article 247 of the Solvency II Directive. It depends partly on the extent of the group's activities in each member state and partly on the location of the head office of the relevant insurance holding company.

The formula for determining the group supervisor may be departed from in specific cases. When there is disagreement EIOPA may rule on the point. It may be that a lot of discussion and disagreement arises on these issues behind closed doors, since the relevant supervisors can be expected to have very different agendas.

In any event it is clear that the larger supervisors are happy to be designated as group supervisors. By contrast smaller supervisors may prefer to avoid that status, particularly in relation to large and complex groups. Furthermore some supervisors may be more geared up than others to approve internal models.

13.5 Powers in relation to holding companies

Unlike its predecessors Solvency II provides for supervisors to have direct powers in relation to insurance holding companies, for instance to require them to report on intra-group transactions under article 245.

Accordingly to give effect to Solvency II and equivalent provisions in the banking and financial conglomerates directives, the powers of the PRA and FCA were enlarged in the Financial Services Act 2012. A new Part 12A was inserted into FSMA allowing the regulators to:

- give directions to holding companies (e.g. to inject capital into a distressed group company),
- adopt rules requiring the provision of information by those companies and
- take enforcement action against them when such directions or rules are not complied with.

So the PRA rulebook contains rules applying directly to holding companies[35]. However, in terms of territoriality, the Part 12A powers can only be exercised where the holding company is incorporated in the UK or has a place of business there[36]. It is not sufficient that the holding company should have its head office in the UK, although that is the factor assumed by article 258 of Solvency II to be the basis

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[34] Jurisdictions where the group only holds participations or "significant branches" may attend but do not have voting rights.

[35] See the PRA Rulebook section "Group Supervision" rule 1.1(3).

[36] Section 192B(2) FSMA.

on which the group supervisor would exercise jurisdiction against the holding company. Unlike regulated firms, holding companies do not need to have their registered office and head office in the same country, unless they use the Societas Europaea (SE) format, which is more popular on the continent than in the UK.

The "place of business" formula was inserted into the Bill at a very late stage and is arguably inapposite, since holding companies do not normally "carry on business". The PRA can of course ask a supervisor in another jurisdiction to give a direction to the holding company, but that supervisor may or may not have the power to do so and may or may not be inclined to co-operate.

14 Conclusion

There are a large number of anomalies, difficult distinctions or problems arising in how the regulators exercise territorial jurisdiction. They mostly arise within the remit of the FCA rather than the PRA.

I have summarised these issues in section 9 above.

These issues arise partly from FSMA and the statutory instruments made within FSMA (which are the responsibility of HM Treasury) and partly from the FCA's rules. They give rise to fewer practical problems than one might expect:

- first because firms are so reluctant to challenge the regulator,
- secondly because the market itself may constrain some foreign firms to comply with regulatory standards even when they are not strictly by law required to do so, and
- thirdly because there is little evidence of any firms being devious in arbitraging the regime.

All this could change quite quickly, however. In particular that might happen if firms became more determined to exploit loopholes in the rules. This might, in particular be the effect of a "hard"Brexit which could make import/export markets become more difficult to exploit

The FCA and the PRA might usefully carry out a review of territoriality issues and consider whether there is a case for some changes. Indeed they may have already done so.