Published in issue 123 of the Journal of the British Insurance Lawyers Association

Insurers and the "twin peaks" regulatory system - are two heads really better than one?

By Laura Hodgson and Simon Baker, Norton Rose LLP

Summary

Following the catastrophic collapse of financial markets in 2008, both national and regional governments, as well as international organisations have entered into a soul searching re-examination of how best to supervise financial services. In the United Kingdom this has led to proposals to move towards "twin-peaks" regulation, abandoning the one size fits all approach of the Financial Services Authority (FSA) in favour of two bodies: one with oversight of prudential supervision, the other supervising all conduct of business. This article considers the proposals and the likely impact upon insurers.

Proposals

The Conservative Party first set out its plans to reform the regulation of financial services in the UK in July 2009. The proposals published at that time included abolishing the tripartite system whereby the Bank of England, the Treasury and the FSA share responsibility for national financial stability. In its place, the Conservative Party proposed that both macro and micro-prudential oversight should be given to the Bank of England which, it was argued, was best placed to monitor systemic issues across the financial services sector.

In his first Mansion House speech delivered in June 2010, Chancellor of the Exchequer George Osborne announced that the Coalition Government would move to address what he considered the "spectacular regulatory failure of the City". He announced that the tripartite regime would be abolished and the FSA would cease to exist in its current form. A new prudential regulator would be created, operating under the supervision of the Bank of England, and an independent Financial Conduct Authority (FCA) would be established to regulate the conduct of firms providing services to consumers. The Government proposed that the process of dismantling the current regulatory system be completed by 2012.

Throughout the consultation period the Government has signalled its adherence to a 2012 deadline. In February 2011, the Treasury Select Committee urged the Government to revisit the Financial Services and Markets Act 2000 (FSMA) in its entirety to ensure a coherent piece of reforming legislation. Later in the same month, the Government published *A new approach to financial regulation: building a stronger system,* in which it confirmed that the reforms would be implemented by amending FSMA. According to the Government, the decision was taken so that the changes could be implemented with greater speed, whilst minimising the disruption to firms that would arise from repealing FSMA and starting with an entirely new Bill. Additionally, the FSA took its first step towards the new regulatory structure in April 2011 by conducting an internal

reorganisation in which the existing Supervision and Risk business units were replaced with a Prudential Business Unit and a Conduct Business Unit.

The proposed reforms have been criticised for failing to pay adequate regard to the regulation of the insurance industry. In light of this criticism the Government has recently given more detail on its plans for insurers. For example, when Hector Sants, FSA Chief Executive, gave a speech on the future of insurance regulation[1], he was at pains to reassure his audience that he understood the important difference between regulating banks and insurers.

The Financial Policy Committee

One of the main failures in regulatory oversight, identified following the financial crisis, was a lack of macro-prudential scrutiny. To address this perceived failure to spot systemic risks in financial markets, the July 2010 consultation paper entitled *A new approach to regulation: judgement, focus and stability,* proposed the establishment of a body within the Bank of England with primary responsibility for the oversight of financial stability. The Financial Policy Committee (FPC) will have a number of macro-prudential tools available to address systemic risk, including capital and liquidity tools. In response to the Government's proposals, the Treasury Select Committee stressed the need for clarity about what such 'stability' means and cautioned that ensuring the overall stability of the financial system should not mean that no firm will ever fail. Given that the most recent white paper *A new approach to financial regulation: the blueprint for reform* accepts that firm failure is always a possibility, these comments appear to have been noted.

Both the Treasury Select Committee and industry commentators have expressed concerns that the membership of the FPC is too heavily weighted towards banking. The Government has commented that it will gather views on the issue over the period of pre-legislative scrutiny. It has also stressed that, in collaboration with the Bank, it is committed to ensuring an appropriate balance and breadth of experience for both the interim FPC and the permanent body that will replace it. Stakeholders have welcomed the Government's views on the importance of ensuring that external members of the FPC have recent and relevant financial services experience in non-banking areas like insurance.

In order to bring both the macro and micro-prudential oversight of financial institutions within one body, the Prudential Regulation Authority (PRA) will be a subsidiary of the Bank of England. Where the FPC identifies wider market issues which need addressing, it will request that the PRA take regulatory action to address any concerns with individual firms.

The Prudential Regulation Authority

The PRA will be responsible for the micro-prudential regulation of, among others, all deposit taking institutions, insurers and banks. For insurers, its remit will be the oversight of those firms with permission for effecting and/or carrying out contracts of insurance.

A new section will be inserted into FSMA specifying the PRA's insurance objective. This requires the PRA to contribute to the securing of an appropriate degree of protection for those who are, or may become, policyholders. It complies with the Solvency II Directive which requires the protection of policyholders to be the primary objective of supervision. The application of the objective to those who may become policyholders has the potential to cause confusion and it will be interesting to see how it applies in practice. The City of London Law Society has also suggested that further clarification is required on the term "appropriate degree of protection".

The Bank of England and FSA joint paper entitled *The Bank of England, Prudential Regulation Authority - Our approach to insurance supervision* confirms that the PRA will have a concurrent objective under which it will seek to minimise the adverse impact that either the failure of an insurer, or the way it carries out its business, could have on the stability of the system. The objective further demonstrates that under the new regulatory landscape, regulators will not act to prevent firm failure in all circumstances. As the PRA's general objective of promoting the safety and soundness of PRA authorised persons is given the same status as its insurance objective, the "primacy" of the insurance objective has arguably not been achieved.

The PRA will employ a "judgement-based" supervisory approach. Practically, this means that the nature and intensity of the PRA's supervision will be commensurate with the level of risk a firm poses to policyholders and to the stability of the system. The joint paper lists some of the factors that the PRA will consider when judging the risk posed by a firm. For example, whilst there is an acceptance that insurers are not systemic in the same way as banks, the combination of insurance and banking in a single group may give rise to system-wide risk if the failure of the insurer threatens the financial condition of the bank. Furthermore, the investment decisions of insurers can accentuate movements in asset prices and groups containing an insurer may undertake non-insurance activities that bring risk to the system.

Policyholders will be protected by the PRA and the FCA. Essentially, the PRA will look to ensure that an insurer is likely to have sufficient financial resources to meet its obligations to policyholders as they fall due, whereas the FCA's role as conduct regulator will aim to ensure that consumers are treated fairly in all their engagements with insurance firms.

The Financial Conduct Authority

The FCA will have a single strategic objective of protecting and enhancing confidence in the financial system in addition to three operational objectives, namely: securing an appropriate degree of protection for consumers; promoting efficiency and choice in the market for financial services; and, protecting and enhancing the integrity of the financial system. The Government has also proposed that, so far as it is compatible with its

objectives, the FCA must discharge its general functions in a way that promotes competition. There will also be a free-standing duty to have regard to the importance of taking action to minimise the extent to which regulated business may be used for a purpose connected with financial crime. These objectives and the principles to which the FCA should have regard to in discharging them reflect the Government's new approach to regulation in the wake of the financial crisis. Notably, the requirements that the regulator considers the desirability of facilitating innovation and maintaining the competitive position of the UK are no longer included in FSMA. The deletion has been criticised by the Confederation of British Industry (CBI), who have suggested that a regulator that does not need to consider the competitiveness of the market might produce regulation that enhances stability or promotes good conduct while also damaging the market's competitiveness.

In addition to having responsibility for conduct issues, the FCA will be responsible for the prudential regulation of around 24,500 firms that are not regulated by the PRA. This means that insurance intermediaries will be solely regulated by the FCA. The British Insurance Brokers' Association and the Institute of Insurance Brokers have been openly critical of the current regulatory regime stating that the style and intensity of regulation is inappropriate for insurance brokers. They have argued that fundamental reform is essential to allow the FCA to deliver discernable value to regulated firms and their customers. Furthermore, the CBI has cautioned that the differing objectives of the FCA and the PRA could give rise to the potential for differences in their approach to prudential regulation. This could create a two tier regulatory regime for firms within the same industry and may damage competition between firms that are close to the dividing line between being supervised by the FCA or PRA.

The FCA was originally to have been named the Consumer Protection and Markets Authority and was branded a "strong consumer champion". This label was heavily criticised by the Treasury Select Committee who considered it to be inappropriate, confusing and dangerous. The crux of their argument was that the promotion of a regulator as a consumer champion would lead consumers to falsely believe that all financial products are risk free, potentially creating moral hazard. Whilst the Government has renamed the authority it has stressed that the term "consumer champion" should be viewed in the context of the FCA's role as a focused and proactive conduct regulator that is entirely independent and impartial.

The FSA recently published a document entitled *The Financial Conduct Authority: Approach to Regulation,* which confirms that the FCA will focus more closely on wholesale conduct and adopt a more issues and sector-based supervisory approach when compared to the FSA. This will build on changes which the FSA has already made, or to which it has signalled commitment. The essence of the new approach can be illustrated by considering the FSA's response to the mis-selling of payment

protection insurance (PPI). Whilst the FSA intervened robustly to secure redress of consumer detriment, in the future the FCA will look to ensure that fewer such problems develop in the first place. These sentiments signal a commitment to the approach discussed in the FSA's discussion paper *DPI1/1: Product Intervention,* which advocated a supervisory strategy involving earlier regulatory intervention and discussions with firms to ensure that new products serve the needs of the customers to whom they are marketed. The document also considers how the FCA will work effectively with the PRA.

Facilitating effective regulatory coordination between the new authorities

Effective coordination between the FCA and the PRA will be a vital part of the new regulatory framework. To this end, the Government has legislated for a variety of general coordination mechanisms including a statutory duty to coordinate the exercise of the authorities' functions (to be contained in a Memorandum of Understanding), cross-membership of boards and a veto mechanism for the PRA. This is with a view to reducing the risk of regulatory actions by the FCA threatening financial stability or the disorderly failure of a firm.

The general principle underpinning the Government's model of dual regulation will apply to insurance regulation. The FCA will be responsible for supervising the day-to-day conduct of insurance firms in dealing with their customers and clients whilst the PRA will look to promote their long-term soundness and stability. There are, however, certain areas which require further consideration.

The regulation of with-profits business

The Government has inserted a section into FSMA which gives the PRA sole responsibility for securing an appropriate degree of protection for the reasonable expectations of policyholders in regard to their returns under with-profit policies. This necessarily covers conduct as well as prudential issues.

The Government recognises that this is a complex area and emphasises that the PRA will need to consult with the FCA on matters relevant to achieving an appropriate balance between the interests of policyholders and the prudential position of the firm. The Government is in the process of considering whether explicit legislative provision is necessary to ensure efficient coordination between the PRA and the FCA, or whether current provisions in the draft Bill, such as the Memorandum of Understanding, are sufficient.

What remains unclear from the draft legislation is the division of responsibilities between the FCA and the PRA in relation to the Conduct of Business Sourcebook (COBS) 20[2], some aspects of which might lie more naturally within the remit of the FCA.

The regulation of Lloyd's

In the Government's original consultation paper, the Society of Lloyd's was hardly mentioned and Lord Myners described the consideration given to the regulation of Lloyd's as an "afterthought"[3]. This lack of thought was criticised by the Treasury Select Committee in *Financial Regulation: a preliminary consideration of the Government's proposals,* in which it was argued that Lloyd's merited greater focus than the consultation provided.

The Government has now provided more information on its proposals for the Society. The PRA will be lead regulator for Lloyd's as a whole and the FCA will play a role by regulating member's agents and brokers. The Society of Lloyd's and Lloyd's managing agents will be dual-regulated firms with the PRA responsible for prudential regulation and the FCA responsible for conduct. The FCA will be tasked with the oversight of market conduct and consumer protection.

The division of responsibility will largely follow the division of interests in relation to insurance business or activities but will also have regard to the unique nature of Lloyd's, including the way it operates as a specialist financial market and the distinctive roles played by certain participants in the market. The Memorandum of Understanding, which is yet to be agreed, will set out precisely how the two new regulators will coordinate the exercise of their functions.

The authorisation of insurers and approval of individuals

Firms must apply to the PRA for authorisation if they wish to effect or carry out contracts of insurance. The PRA will administer the application and be responsible for granting authorisation. Authorisation to carry out regulated activities will not be granted unless both the PRA, as prudential regulator, and the FCA, as conduct regulator, are satisfied that it should be. Before granting authorisation, the PRA will assess whether the firm satisfies the relevant statutory threshold conditions.

Interestingly, FSMA has been amended to include a new threshold condition, the so-called "business model" requirement, under which an applicant will need to demonstrate that their strategy for doing business is suitable, having regard to the regulated activities that they seek to carry on. The Bank of England and FSA joint paper explains that the importance of scrutinising firms' business models is one of the key lessons learnt from previous episodes of insurer distress. The requirement is designed to prevent insurers attracting business through aggressive pricing, without setting aside sufficient claim reserves (as occurred in the case of HIH Group and Independent Insurance) and to ensure that a firm's business model does not run ahead of its capital potential (as was the case in Equitable Life). Whilst interesting to note, the practical effect of the amendment may be negligible as firms seeking authorisation are already required to submit a business plan alongside their application.

The PRA will lead on the authorisation process for dual-regulated firms. The PRA and the FCA will seek to minimise the administrative burden on firms of the new authorisation procedures. The joint paper states that there will be a single administrative process with a single application form and timetable for decisions by each authority. Essentially, the paper attempts to provide reassurance to firms that the importance of ensuring that the authorisation process is both clear to applicants and handled efficiently is fully recognised.

In relation to the approval of individuals, it is the responsibility of an institution's board of directors to ensure that individuals appointed to senior management positions are competent to fill such roles. Given the risks that poor management can pose to the financial soundness of a firm, the PRA will wish to satisfy itself that key individuals running the firm are "fit and proper" to do so.

The PRA will lead on the process for approving individuals for roles with a bearing on the safety and soundness of firms, in close co-ordination with the FCA. The FCA will be responsible for approving individuals to conduct-focussed roles. The joint paper states that a full list detailing which functions will be approved by each authority will be published in due course. The PRA and the FCA will design a simple and transparent process for approving individuals to "significant influence functions" which minimises the administrative burden on individuals and firms.

The regulation of Part VII transfers

The process currently detailed in Part VII of FSMA sets out a framework to enable the transfer of insurance business from firm to firm. Under the current Part VII mechanism, the courts are ultimately responsible for sanctioning or rejecting an application for a business transfer, while the FSA has the right to make representations to court and is responsible for approving the necessary documentation. The Government does not intend to alter the substance of the current framework.

The PRA will be primarily responsible for the process but the FCA also has an interest and will need to satisfy itself that, as a minimum, the transfer will not adversely affect the customers of the firms involved in the transfer. Both authorities will be able to make representations to the court during the transfer process. Whether the involvement of both regulators will create administrative problems for insurers remains to be seen.

Cooperation with overseas regulators and supervisory colleges

For firms passporting out of the UK, the Government has confirmed that the relevant prudential authority will be responsible for issuing all relevant notices. In relation to insurers this will be the PRA. It is clear that the PRA needs to oversee the entire financial system in the UK, including parts made up of branches passporting in from other countries. Nevertheless, prudential supervision under European single market directives

remains within the remit of the home state regulator, with only conduct issues regulated by a host state under the "general good" provisions. Accordingly, the PRA will need to build close working relationships with overseas regulators and supervisory colleges supervising large firms passporting into the UK.

Notifications from overseas regulators in relation to the Reinsurance Directive, the Consolidated Life Assurance Directive and the First, Second and Third Non-Life Insurance Directives will go to the PRA, in order to mirror its responsibilities on a domestic basis. Notifications in relation to all other directives will go to the FCA. As conduct is regulated under the "general good" provisions, the draft legislation requires the PRA to give a copy of any notice received to the FCA without delay.

In their joint paper, the Bank and the FSA accept that the PRA's policies and supervisory actions will take place within an international context and that much of the PRA's proposed approach in relation to insurers will be achieved through the application of Solvency II. The joint paper states that the PRA will play an active and constructive role in shaping the development of the common framework for regulation and supervision at a global level and in the EU. As noted above, many international insurers operate in the UK and the PRA will collaborate with other organisations including the European Insurance and Occupational Pensions Authority (EIOPA) and the International Association of Insurance Supervisors to ensure that it is able to address risks that non-UK insurers may pose to its statutory objectives.

The Government has explained that the PRA will represent the UK in EIOPA. The PRA and the FCA will work together to ensure that the other regulator and any other relevant authorities are kept fully informed of any matters due to be discussed which fall within their sphere of responsibility. When another body has an interest, the PRA may bring along a non-voting representative of that national body. The regulators will be required to state in the Memorandum of Understanding how they will manage their engagement with foreign regulatory bodies. This is a particularly important point as conduct issues (such as the review of the Insurance Mediation Directive) fall within the scope of EIOPA. It is of vast importance that the regulators are able to effectively influence the European regulatory regime and the CBI has suggested that the legislation should provide for the establishment of an executive level international coordination committee, directly accountable to the boards of the regulatory bodies and ultimately to the Treasury.

Additional issues

Aside from the need for effective regulatory coordination between the two organisations, there are other issues that are worthy of note. For example, the power of the regulators to publish warning notices at an early stage of any enforcement action has been widely publicised. FSMA originally imposed a general prohibition preventing a regulator from publishing or giving details of any notice. The Financial Services Act 2010 lifted the

prohibition in relation to decision notices and the FSA utilised this power for the first time in May 2011.

The Bill now amends FSMA in order to relax the general prohibition against the publication of warning notices and the FCA and the PRA may publish information following consultation with persons to whom the notice is given or copied. According to FSMA, the FCA may not publish a decision or warning notice if, in its opinion, publication of the information would be: unfair to the person against whom the action was taken (or was proposed to be taken); prejudicial to the interests of consumers; or detrimental to the stability of the financial system. The PRA will apply different criteria in considering whether to publish a notice. Again, it will not publish a notice if this would be unfair to the person against whom the action was taken but it will also consider whether publication will be prejudicial to the safety and soundness of PRA authorised persons or to securing the appropriate degree of protection for policyholders.

Given the potential for reputational damage, this amendment will be of concern to an insurer. In the past, there have been examples of FSA enforcement actions that have not been taken forward or that have been challenged and it is unlikely that the publication of a notice of discontinuance will repair the damage that has been caused. How "fairness" will be interpreted in regard to publication of warning notices remains to be determined but it is likely to go beyond the impact of such a notice upon a listed company's share price. The recent decision of the Upper Tribunal in *7722656 Canada Inc and Peter Beck v the FSA [FS0017&0018] Upper Tribunal (Financial Services), 28 July 2011,* suggests that the Tribunal is unlikely to consider arguments based on necessity, fairness and privacy as compelling reasons to prevent publication of a notice unless exceptional circumstances apply.

Finally, it should be noted that the Government has confirmed that there will be no joint rulebook (analogous to the current FSA Handbook) as each authority should have the autonomy to make rules specific to their individual objectives and duties. It is anticipated that the current FSA Handbook will be divided into two regulatory strands with prudential rules being moved to the PRA and conduct rules being the preserve of the FCA. There is likely to be a gradual process of deletion and replacement of rules by both regulators. With many Solvency II requirements being introduced through delegated acts and other legislative instruments having direct-effect, rulebooks will not need to elaborate on many prudential requirements[4]. However, with Solvency II still some way off insurers face an interim period where FSA prudential standards will most likely be adopted by the PRA.

Conclusion

The finalised regulatory framework is expected to be in place by the end of 2012. The timing of these upheavals could not be more challenging for the insurance industry with the change to a new financial regulatory regime coinciding with preparations for Solvency II, the Retail Distribution Review and other initiatives affecting the insurance industry

(such as the FSA with-profits review and changes in the taxation and accounting regimes, including the move to International Financial Reporting Standards (IFRS) Phase II).

Coupled with concerns regarding timing is the worry that the reforms place an overemphasis on the banking sector. The Government has attempted to assuage these concerns by explaining that as the lessons of financial crisis have predominantly focused on the micro and macro-prudential regulation of the banking sector, it is inevitable that the presentation of proposals for improving regulation should focus on banking. Whilst this proposition is generally accepted, it is still concerning that the Government is yet to finalise all of its proposals relating to insurance. For example, the FSA is currently required to agree to any voluntary winding-up of a life insurer. The original aim of this provision was to protect policyholders but there are clear prudential and possible financial stability implications associated with the winding up of a life insurer. In its February consultation paper, the Government confirmed that it will consider the most appropriate division of responsibilities between the PRA and the FCA in this area. However, as yet a definitive statement has not been forthcoming.

In addition, until the mechanisms for cooperation are published (including the Memorandum of Understanding) and firms have experienced the operation and culture of the new authorities first hand, they face the uncertainty of not knowing whether the division of responsibilities will have a noticeable impact on supervision. The coordination between the two organisations has the potential to be a serious concern, as a simple consultation could lead to layers of bureaucracy, stifling quick commercial decisions. At present, the balance of power and the inclination of each authority to take enforcement action suggests that the FCA is likely to be of more relevance to a firm's day-to-day activities, with the PRA taking the lead on matters relating to solvency and risk management. However, more clarity is needed and it is hoped that the Government will provide additional information in the near future.

Laura Hodgson is a professional support lawyer specialising in insurance law and Simon Baker is a paralegal. Both work in the London office of Norton Rose LLP.

Endnotes

[1] In February 2011: http://www.fsa.gov.uk/pages/Libraiy/Communicatioii/Speeches/2011/0209_hs.shtml

[2] FSA Handbook Conduct of Business Sourcebook (COBS) 20: With-profits.

[3] See *House of Commons Treasury Select Committee, Financial Regulation: a preliminary consideration of the Government's proposals. Seventh Report of Session 2010-11, Vol. II, Evidence 21.*

[4] See, Finney, C. "The path to Solvency II implementation – rocks and hard places" in this issue of the BILA Journal, page 13