Prudential Regulation of Insurance – and How the FSA Often Wins Even When it Loses

By Jonathan Goodliffe and Michael Lewis, Lovells

Introduction

This article attempts a general introduction to how insurance business is regulated prudentially in the UK. It then highlights the significance of some of the rules contained in the Financial Services Authority's ("FSA") prudential sourcebooks, particularly in relation to how they may influence insurance companies' investment policies.

Prudential and Conduct of Business Regulation

There has been a historical distinction between, on the one hand, prudential and, on the other, conduct of business regulation of insurance business. The former is concerned with such matters as the adequacy of resources, fitness and properness of management and controllers and adequacy of systems and controls. The latter is concerned with marketing issues and the suitability of products for policyholders' needs. There are, of course, overlaps. For instance, compliance with FSA's Principle 6: *"a firm must pay due regard to the interests of its customers and treat them fairly"* raises prudential, conduct of business and other issues.

The significance of the distinction used to arise partly from the fact that before the Financial Services and Markets Act 2000 ("FSMA") came into force at midnight on 30 November 2001 ("N2"), responsibility for prudential regulation of insurance lay with the Department of Trade & Industry and then briefly with HM Treasury. Some forms of long term insurance were subject to conduct of business regulation by self regulating organisations ("SROs") under the Financial Services Act 1986. The conduct of general insurance was subject to regulation on a voluntary basis by a number of organisations including the General Insurance Standards Council and the Association of British Insurers. Lord Penrose's recent report on the Equitable Life Insurance Society has identified the historic split between prudential and conduct of business as a weakness in the Department of Trade & Industry ("DTI")'s regulation of that Society.

Moreover, under the Single Market Directives the responsibility for the prudential regulation of an insurance company, (and of other firms in the financial services sector), lies with the competent authority of the state, ("the home state"), where its head office is based. Regulation of the conduct of insurance business is the responsibility of the state, ("the host state"), where the risk or commitment under

the relevant insurance contract is treated as arising, (usually the state of residence of the policyholder). In the long term this may change. "Information society services" including financial services, provided online, are subject to "country of origin" regulation under the Electronic Commerce Directive. The country of origin principle is subject to a derogation in relation to direct insurance, but there are proposals for this derogation to be removed. The Directive on the Distance Marketing of Financial Services, which applies to insurance, among other things, also adopts the country of origin approach. Under the country of origin approach services are subject to conduct of business regulation primarily or exclusively by the member state from which the services are provided.

Since some time before N2 the FSA assumed responsibility for prudential regulation of insurance companies and conduct of business regulation of most forms of long term insurance. It did this under contracting-out and other arrangements with HM Treasury and other predecessor organisations. It assumed full legal responsibility for the same matters from N2. At the same time it assumed full responsibility (to the extent that it did not have it already) for aspects of regulation in many other sectors of financial services regulation. It will assume responsibility for the regulation of insurance mediation on 15 January 2005 ("N3(GI)").

FSA's Prudential Sourcebooks

In its Consultation Paper 31 ("CP31"), published in 1999, the FSA set out its proposed general approach to prudential regulation. It indicated that it would, in the long term, introduce a system which involved prudential regulation by reference to risks arising (such as credit risk, market risk, insurance risk, operational risk) rather than the nature of the activity (whether it be insurance, banking or investment). In the short term it proposed to reproduce the existing prudential rules of its predecessor organisations in "Interim Prudential Sourcebooks" which it intended should be replaced by an "Integrated Prudential Sourcebook" ("PSB") in March 2002. These Interim Prudential Sourcebooks came into force at N2.

The Interim Sourcebooks, and in particular the Interim Prudential Sourcebooks for Insurers ("IPRU(INS)") consist partly of rules (made under section 138 of FSMA) and partly of general guidance (given under section 157). The FSA has power to give individual guidance to authorised firms on the application of its general rules and guidance. It may also waive or modify its rules in their application to a specific firm under section 148 where the requirements of that section are met and where to do so would not involve an infringement of standards of prudential regulation laid down in European legislation. In practice this gives considerable scope for the grant

of waivers and modifications since many of the rules in IPRU(INS) impose more onerous or "superequivalent" standards than those contained in the EU Insurance Directives.

An initial draft of the PSB was published with CP97 in 2001, but its coming into force has been deferred for a number of reasons. These include delays in the work intended to lead to agreement at an international level of the Basel II Capital Accord on the capital adequacy of banks and investment firms and its adoption within the European Union. Most of the PSB is now intended to come into force for insurance companies in the fourth quarter of 2004 and at a later stage for banks and investment firms.

In the meantime many amendments have been made to the Interim Prudential Sourcebooks. Many Directions waiving or modifying its rules in their application to particular insurers have been granted under section 148. Although that section requires the FSA to be satisfied that:-

- compliance with the rules as unmodified would be unduly burdensome or would not achieve the purpose for which the rules were made, and
- the direction would not result in undue risk to persons whose interests the rules are intended to protect.

In practice getting a Direction can sometimes be quite an easy process, depending on the rule, whether previous Directions to the same effect have been made and the circumstances in which the application is made.

Some of the rules contained in IPRU(INS) are likely to be reproduced in substance in the PSB. Others, in particular rules on capital adequacy deriving from CP190 and CP195, will be radically different.

In a sense the Integrated Prudential Sourcebook will, therefore, be integrated in name only. In the medium term the substance may follow. The proposed rules on capital adequacy in CP190 and CP195 anticipate to a large degree the main principles likely to be agreed in the Basel II Accord and to be applied within PSB to banks and investment firms. In the longer term those principles will also feed into a major review ("Solvency II") at a European level of the prudential regulation of insurance, which is unlikely to bear fruit before 2008 or 2009. In any event other aspects of prudential regulation are already integrated in the rules contained in, for instance, the FSA's Principles for Businesses, Senior Management Arrangements, Systems and Controls and the Supervision Manual.

FSA's Regulatory Objectives

FSA's regulatory objectives, set out in section 2 of FSMA, are market confidence, public awareness, the protection of consumers and the reduction of financial crime. These influence, among other things, the rules and guidance contained in the prudential sourcebooks. Also worthy of mention in this connection is subsection 5(2)(d) which requires the FSA to take into account, among other things, the general principle that consumers should take responsibility for their decisions. So FSA seeks, so far as practicable, to reduce the risk of authorised firms failing and consumers losing out in consequence.

However, FSA does not run a "zero failure regime". Integrated prudential regulation by reference to types of risk may be one tool towards achieving the regulatory objectives in a balanced and proportionate way. It recognises the fact that financial markets are tending to converge. What are in substance the same products may often be offered in different guises through banking, insurance or investment firms. Where the regulatory burden is seen to be lighter for particular types of firm or particular regulatory jurisdictions, certain firms may be able to offer the product more cheaply than others. This "regulatory arbitrage" can work against the FSA's regulatory objectives and the interests of the consumers and market counterparties who purchase the products in question. Risk based prudential regulation, integrated across sectors and jurisdictions, may ultimately reduce this trend.

How the Prudential Rules Operate

The maintenance of appropriate prudential standards contributes to market confidence, one of the FSA's regulatory objectives, because people are more willing to invest in the products of firms who are subject to those standards. At the same time insurance companies regulated by the FSA control substantial funds, some of which will ultimately be paid to shareholders, policyholders or third party claimants. The rules in the Prudential Sourcebooks may sometimes have a significant effect on the financial markets in which insurance companies invest. Those markets may in turn be regulated by the FSA, through, for instance, its listing regime.

The Required Minimum Margin

All insurance companies with head offices in the European Union are required by the Insurance Directives to maintain a defined minimum margin of solvency ("RMM"), the calculation of which has recently been the subject of a minor update through the "Solvency I" Directives (2000/12/EC and 2000/13/EC), which were implemented by member states from the beginning of 2004. In practice the FSA, in common with other European regulatory authorities, may expect the insurance

company to do more than just maintain its RMM, but perhaps to cover it several times over, or, when the rules proposed in CP190 and CP195 are adopted, to maintain an "Enhanced Capital Requirement" or other measure of required capital based on the firm's own assessment of its position.

However, the rules in IPRU(INS) which define how assets are valued, liabilities are determined and how the RMM is calculated may be more or less "superequivalent". FSA may be willing to grant modifications or waivers of its rules to help an insurance company to maintain its RMM or a healthier margin over its RMM. Or it may be unwilling to do so if it considers that the superequivalent rules serve a useful purpose either generally or in their application to a particular insurance company and that to relax them would create a prudential risk.

Occasionally, to establish whether a proposed modification falls into one or other category an application for a Direction needs to be made. More often discussions with a supervisor at the FSA or researches on its web site will clarify the situation.

Sometimes specific Prudential Rules migrate from the "relatively easy" to the "difficult" category or vice versa when, for instance, a consultation paper is published proposing either more or less strict rules than currently apply. In the latter case insurance companies may apply for modifications in advance of the new rules being adopted.

In January 2003 when equity markets were in free fall and some long term insurance companies were at risk of breaching their RMM, the FSA wrote to them drawing their attention to specific superequivalent rules in relation to which they might consider applying for a modification. In making this suggestion it seems to have been concerned to balance the need to ensure that the companies in question maintained adequate assets with the need to avoid generating a further loss of confidence in equity markets. Strict compliance with the rules might have required further substantial sales of shares.

Admissibility Limits

Rule 4.14 and Appendix 4.2 of IPRU(INS) specify limits on what types of assets held by an insurance company can count towards its solvency margin. It can, of course, invest in other assets but may need to liquidate those investments if there is a risk to its margin. Moreover, a greater surplus of admissible assets over liabilities results in a healthier regulatory return. The results reported on the return will affect the market's assessment of the insurer's performance and credit rating - a particularly important issue when there is some pressure on insurers' solvency margins.

Under Rule 4.14, investments in, for instance, limited partnerships and collective investment schemes (including investment companies and unit trusts) can only count towards 1% of the insurer's "business amount" and there is a further limitation by reference to the aggregate of such investments and other defined types of asset. Moreover in certain circumstances (IPRU(INS)) Appendix 4.2 paragraph 11A) where insurer A and its "dependant" B (i.e. a subsidiary which satisfies certain conditions), both have exposures to the same types of assets, those exposures may be aggregated. The effect of this may be to reduce the admissible assets of A.

A considerable number of Directions modifying the admissibility rules in their application to particular insurance companies were made in the first few month after the FSA assumed its regulatory powers in December 2001. This "bunching" was partly due to the fact that most UK insurance companies have a 31 December financial year end and needed to get a Direction by that date.

The Directions actually granted are available on the FSA's web site. The motivation of the FSA in modifying the admissibility rules is usually not apparent. However, so far as one can guess, the intention seems to have been to enable the companies concerned to retain existing portfolios of equities even when their composition did not fully comply with the admissibility rules. This may have been partly motivated by the knowledge that the disposal of the shares in question would not have benefited market confidence.

More recently, however, and since the admissibility rules were changed in 2002, such directions have become less common.

Permitted Links

The "permitted links" rules specify the assets and indices to which benefits under linked long term contracts may be linked. The relevant assets and indices are set out in Parts I and II of Appendix 3.2 to IPRU(INS).

One issue that commonly arises is whether units in a collective investment fund may be regarded as linked assets under paragraph 5(b) of Part I of Appendix 3.2. For the units to fall within paragraph 5(b) the fund must invest in other permitted assets, the units must be readily realisable and the price of the units must be published regularly. If these conditions are not met, the insurer may, if it wishes to link to the fund, have no alternative but to accept responsibility for the acts and omissions of those managing the fund. Investment funds targeted at the UK institutional market may need to be designed around these rules.

The FSA's October 2002 Progress Report on the Future Regulation of Insurance, (a follow up to the "Tiner Report"), proposed a reform of the Permitted Links Regime, but this reform has not materialised. The current intention seems to be that the rules should "remain active" after the PSB comes into force, (page 8 of CP195). Under the FSA's integrated regulatory regime, it is questionable whether there is any justification for retaining restrictions on linking to specific assets when similar restrictions do not necessarily apply to, for instance, the promotion of investments in such assets through unit trusts. Most unregulated funds will not fall within paragraph 5(b) as the units will not be readily realisable.

From time to time the FSA has been prepared to modify the permitted link rules in their application to particular insurers. There may be more scope for such modifications in the future.

Group Supervision Rules

Suppose an insurer makes an investment in a limited partnership or an investment company ("the fund"). The investment results in its share in the fund exceeding 20% of its capital. The fund will then qualify as a "group undertaking" for the purposes of IPRU(INS) rule 4.2. This may result in the value of the insurer's holding being written down significantly in its regulatory returns. When other insurers in the same group have made similar investments in the same fund the total share in the capital may in certain circumstances be aggregated for the purpose of applying the 20% limit. These valuation rules were introduced at N2 in order to implement the EU Insurance Groups Directive (98/78/EC).

Clearly the rules become more of a problem the greater the investment made by the insurance company and the smaller the value of the fund. This problem does not apply to investments in unit trusts, since such units do not qualify as capital.

Further more, the rules in Chapter 10 of IPRU(INS) require insurance companies to report on group solvency, i.e. on the financial health of the group of which they are a member and in relation to which the ultimate holding company may be anywhere in the world.

The operation of Chapter 10, along with rule 4.2, thus has a significant influence on how insurance groups are structured and how investments in particular types of assets are held within or outside the insurance group. The rules are due for major modification in 2005 when the Financial Conglomerates Directive (2002/82/EC) comes into force. FSA's proposals for implementing that Directive are contained in CP205. Among other things insurance companies will, when the new rules come into force, be required to maintain group solvency and not just to report on it.

Guest Funds

A life insurer may in certain circumstances wish to give its policyholders access to "guest funds" operated by another insurer by entering into a reinsurance contract. The effect of such an arrangement, however, may be that the policyholders' rights through the direct insurer in relation to the "guest funds" would, in the event of the insolvency of the reinsurer, be subordinated to the claims of the reinsurer's direct policyholders. This would not apply, of course, if the reinsurer had no direct insurance business. This rule derives from Regulation 21 of the Insurers (Reorganisation and Winding Up) Regulations 2003. This regulation implements Article 10 of the EU Directive on the Re-organisation and Winding up of Insurance Undertakings (2001/17/EC).

Where there is a possibility of this subordination arising, the value of the policies reinsured with the guest fund might well be affected. Moreover, FSA's Conduct of Business Rules would require the direct insurer to make a full disclosure of this fact when marketing its own policies. A failure to give such disclosure might result in the insurer facing claims from its own policyholders.

A variety of ways of protecting the direct insurer's policyholders may be available, including most obviously cut through rights to the reinsurer, a floating charge arrangement, or reinsurance or retrocession techniques. Guest funds will also be subject to the "permitted link" rules.

It is significant that Article 10 of the Directive was applied retrospectively to existing contracts. It is not clear why this course was considered necessary or appropriate, having regard to the European doctrine in favour of the protection of legitimate expectations including the expectations of existing policyholders investing in guest funds.

The implications of Article 10 seem, as is often the case with European legislation, to have taken the insurance industry somewhat by surprise, even though the Directive passed through a long period of gestation. Since it was adopted the FSA has, however, taken a rather more pro-active approach towards involving regulated firms in the negotiation of European initiatives (as is apparent, for instance, from its "Guide" to the EU Financial Services Action Plan).

Financial Engineering

Insurers commonly organise their assets and liabilities and the structure of the financial groups of which they are members in order, among other things, to avoid regulatory breaches and optimise results on their regulatory returns. One way of

doing this is to interpose a special purpose vehicle ("SPV") between the insurer and the asset in which it proposes to invest or by reference to which it wishes to link, (for instance, a share in a limited partnership), for the purpose of transforming the identity of the investment under the admissibility or permitted link rules.

In its Consultation Paper 144, published in July 2002, FSA considered the regulatory implications of the use of "financial engineering". Proposed guidance to be contained in a new Guidance Note P4 to IPRU(INS) indicates that it is an "*umbrella term for certain types of arrangements used to improve, or sometimes to smooth, reported profits, or to improve the reported balance sheet position*".

Does the use of an SPV in the circumstances described qualify as "financial engineering"? It is not clear from CP144 whether the FSA would regard it as such, particularly since FSA has yet to issue a policy statement on this issue. If it is to be treated as a species of financial engineering, then the effectiveness of the use of an SPV may be questionable.

Principle 11

Any insurer involved in such an arrangement might, at the very least, be expected to notify the FSA of what was proposed under Principle 11 of FSA's "Principles for Business".

Principle 11 provides:

> *"A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice."*

So an over-elaborate device which appears to comply with the letter but perhaps not the spirit of the FSA rulebook may be self-defeating, if, when the FSA finds out about it, it indicates that the device raises its own prudential concerns.

Moreover, if the firm waits for the FSA to find out what has been done rather than taking the initiative in providing the information, its relationship with the regulator may be prejudiced and questions may arise as to the fitness and properness of those concerned. On the other hand, a recent reference to the FSMA Tribunal, (*Cox v FSA*, 12 May 2003), did result in the FSA's current, very wide, interpretation of the principle receiving a less than wholehearted endorsement.

In the final analysis, whatever the letter of the rule book may say, the FSA has the power to impose individual requirements on an authorised firm under section 45 of FSMA requiring it, for instance, to maintain a higher level of capital adequacy than

that provided for by the rules. Although that power may be rarely invoked, its existence strongly influences the relationship between regulated firms and the FSA.

So in a sense the FSA may often “win even when it loses”.

Jonathan Goodliffe and Michael Lewis are Solicitors at Lovells. This article is up-to-date as of 12 March 2004.