"1995/6: A BUSY YEAR FOR THE DTI"

by Jonathan Spencer

As in commerce or the law, so every year is in fact a busy year for financial regulators.

Most people assume that DTI regulation of insurance is about our fit and proper controls over senior people in the industry, about DTI returns, about insurance company failures, and more generally about policyholder protection but in a fairly narrow sense.

In the late 20th century, the DTI regulatory objectives of policyholder protection, coupled with the Department's wider responsibility for sponsorship of the industry, requires us to take an interest in a much wider range of issues than might at first sight seem to be relevant. This can perhaps be exemplified in two contrasting ways. First, the best guarantor of policyholder protection at least in a prudential sense is in fact a healthy and successful industry. Second, the underlying technique employed by any financial regulator is that of risk assessment and risk management. The visible artefacts of regulation (eg financial returns) are merely means to this wider end.

The DTI therefore takes an interest in, and is involved in, a wide variety of current issues for the insurance industry.

The DTI, for example, is bound to be concerned about the quality of senior company management, their ability to understand and manage the business that they are in, and their ability to prepare and take major decisions affecting their business that are both prudent from the standpoint of policyholders and to meet the commercial imperatives of the day.

The DTI is also increasingly interested in the systems of control through which senior managers ensure that insurance businesses are prudently managed, that policies and decisions they determine are properly carried through within the company, and that any adverse trend in business is recognised quickly and dealt with effectively and in a timely fashion. A particular systems issue that has been of both media interest and concern by financial regulators generally has been the increasing use of derivative instruments by financial institutions - though some

such instruments have been in widespread use for many years (eg foreign exchange futures). The issues in the insurance sector are somewhat different from those in securities trading: insurers are essentially end-users of derivative instruments, not traders in them. The DTI nonetheless has spent some time and effort over the last few years first in ensuring that insurers are not unnecessarily barred from using derivatives for the purposes of risk reduction and efficient portfolio management, while at the same time ensuring that the ways in which they are used and managed do meet the requirements of sound and prudent management as laid down in statute. To this end, the DTI issued extensive guidance to companies, within a regime designed to ensure its effective application.

Quite separately, the DTI returns, which form the core of the DTI's day to day monitoring of individual insurance companies have been given their first major overhaul since 1983. New requirements will come into effect for returns due from the end of 1996 onwards. This has been a major exercise in consultation with the industry, and will involve a good deal of further work over the next year or so both by companies, their auditors, and within the DTI as the new scheme beds down.

More generally, the DTI needs to keep abreast of developments in actuarial and accounting techniques, and indeed to contribute to them (with the assistance of the Government Actuary's Department in relation to the former): notably the development of more comprehensive Financial Reporting Standards, and Statements of Recommended Practice (SORPs) for the insurance sector with the ABI. The DTI also needs to keep abreast of developments in the law - where a series of landmark judgments have been given by the courts in the last two or three years of which the "pay as paid" case ***(Charter Re v Fagan)*** was merely the most prominent. All of these developments affect the environment within which the industry operates, the risks to which it is exposed, the way in which those risks are managed, and the ways in which the DTI in its day to day supervisory operations can monitor them.

It is sometimes said that the two biggest influences on the insurance industry in any country are regulation and tax. The DTI has been heavily involved over the last few years in developing with the Inland Revenue, and in extensive consultation with the industry, a scheme of tax relieved equalisation reserves for the non-life sector. This work has come to fruition in the course of 1996, and the

new arrangements for both reserving and tax will be available this year, with benefits both for the security of policyholders and the competitive position of the industry internationally.

It is also essential not to forget the never ending task of a financial regulator in controlling the perimeter of the regulated area. This is a task for the regulator in collaboration with the police and the prosecuting authorities, and takes a variety of forms. Companies may find themselves unwittingly or unintentionally carrying on insurance business in areas close to the legal boundary. In such cases, we aim to advise companies whether or not the business needs to be underwritten by an authorised insurance company, and if it does to make sure that appropriate underwriting is put in place, or the business terminated. There is also a regular trickle of opportunistic individuals or firms issuing dud policies without any financial backing, where in practice the only course is for the DTI and the police to seek the rapid closing down of such activities. And then there is the perennial but thorny problem of seeking to ensure that UK policyholders are on the one hand not denied the possibility of finding cover that suits their need from overseas sources (in these terms, meaning outside the European Union), while at the same time seeking to ensure that they are not put unduly at risk by the activities of companies that purport to be carrying on business offshore, but in reality are carrying on business within the UK - especially if they appear to be men of straw. This is a whole separate subject, which as many readers will know has been the subject of a number of recent judgments in the courts.

These examples are intended to give an indication of the variety of issues in which the DTI is engaged in pursuit of its main responsibilities for regulation and for encouraging the health of the industry generally. There are however two further major areas of DTI activity worthy of note here. First, insurance has a major impact on other parts of government and vice versa - governments frequently need the techniques and skills of insurance to solve their own problems, or see the sector as a source of additional revenue. In such cases - which vary from government legislation on environmental protection and waste disposal, to the debate about the future provision of long term care, the introduction a few years ago of Insurance Premium Tax, the rights of the disabled, and the control of dangerous dogs - the DTI is necessarily involved in

dialogue with other parts of government to ensure that they understand accurately the nature of insurance at a technical level (eg what is indemnity), the extent to which the insurance industry is in practice able to help solve government's problems, or the impact on the insurance industry of particular government proposals.

Second, the DTI has a major responsibility for the development of the regulatory framework for insurance internationally, through the development of the EU single market (where there are major current developments concerning the regulation of complex insurance groups, and in reviewing the current solvency margin regime); wider international work involving banking and securities regulators also in relation to the ways in which so called financial conglomerates are regulated; and a regular stream of visitors from other countries who wish to understand - and sometimes learn from - the UK regulatory experience.

In short, we frequently say that DTI regulation of the insurance sector is "light touch". But - if in a fairly discreet fashion - we touch rather more than many people perhaps suppose.

Equitas

However 1995/6 is bound to be marked in the regulatory record books by the work that led up to the authorisation of Equitas in March 1996, and the completion of Lloyd's Reconstruction & Renewal plans in September 1996.

Most public and media comment about Lloyd's over the last few years has focused on the losses incurred by Names, the Names' litigation (much of it in truth against each other), and the rights and wrongs of the various cases brought by Names. The commercial court has performed an heroic task in ordering and managing the torrent of Lloyd's litigation, in providing judgments in a logical order wherever possible, and in providing a framework to the out of court settlement of almost all the litigation through the Lloyd's Settlement Offer.

From a regulatory perspective, the Lloyd's Reconstruction & Renewal plan is the largest and most complex capital reconstruction seen in the UK - and indeed no institution that has lost some £8bn is likely to be able to survive the experience without some form of reconstruction. The DTI's perspective on R&R has been

primarily one of policyholder protection, and principally focused on the decisions involved in the authorisation of Equitas.

The Insurance Companies Act 1982 provides the framework within which authorisation decisions are taken. There is a clear expectation of policyholder protection as the objective (though this is nowhere explicitly stated); and, subject to the provision of specified information, the basic criterion set out in Section 5 of the Act is simply that "the Secretary of State shall not issue an authorisation unless ... he is satisfied ... that the application ought to be granted".

For normal new authorisations, where typically the company starts life with opening capital, no extant business and no extant liabilities, we have fairly well established ground rules for reaching authorisation decisions. In the Equitas case the company wrote some £14bn of premium income in about 10 minutes in early September 1996, wef 31.12.95; and then went into run-off. Not surprisingly, in these circumstances the conventional authorisation tests need to be thought about carefully to ensure that an appropriate outcome is achieved.

The main components in the preparations for the Equitas authorisation were:

- what has been called with some justice "the world's largest reserving exercise", which included both ground breaking work on the assessment of the 1985 and prior asbestos, pollution and health hazard liabilities incurred by Lloyd's both directly and through reinsurance and retrocession, together with a major syndicate by syndicate review of liabilities for the 1986-92 period, all heavily supported via independent actuarial, accounting and legal advice;

- 1992 and prior Lloyd's liabilities reinsured into Equitas and not novated, partly for practical reasons (it was not feasible to envisage the novation of all the outward syndicate reinsurance that would have been needed on a contract by contract basis), but also from the perspective which leaves the reinsured Names as ultimately liable should Equitas' assets prove insufficient to cover the liabilities;

- an extensive and financial legal review of the security of syndicate reinsurances;

- the employment of a "better than" test, ie that the consequences of authorising Equitas would be likely to be better for policyholders than the consequences of not doing so;

- the use of a conditional authorisation of Equitas (in March 1996), so that Names on the one hand could have a degree of certainty that the regulator was prepared to see the project go ahead, but on the other hand ensured that the company did not incur liabilities until it had assured access to the required quantum of assets;

- the introduction of the idea of proportional cover (derived from concepts used for many years in the marine mutual world and in a different form in the run off of Municipal Mutual), and backed by trust arrangements - all designed to ensure that should Equitas' assets look like being insufficient to cover its liabilities, the degree of disruption in claims payments, and short fall in their level, is kept to an absolute minimum, and much less than is involved in a conventional long tail insurance insolvency;

- an absolute need for the process of decision making both by Lloyd's and by the DTI to conform with the principles of administrative law at all times - the value of which was seen in the judgment given by the courts in the application for judicial review brought in August by the Paying Names Action Group.

It is too soon for all the implications of the creation of Equitas to be readily apparent. It is perhaps worth emphasising however that from a DTI standpoint, many of the features of Equitas are unique, and are not capable of being replicated elsewhere in the UK insurance market. The litigation of recent years - both Lloyd's specific, and some of the other cases deriving from the heavy losses and failures in the London market of recent years - have clarified the law in a number of valuable respects. In this connection, it is notable that established market custom and practice have largely been upheld (as in eg the Charter Re case), but going forward, it will be desirable for contract wordings to use words that say what is meant, rather than relying on the courts to uphold that wordings mean what they are meant to say rather than what they actually say. It is also noteworthy that all Lloyd's Names resigning from late 1995 onwards will be explicitly subject to explicit

DTI regulation, in the same way that companies in run off remain subject to regulation until such time as all their liabilities have been extinguished, and regardless of the extent of reinsurance protections available.

Finally, there is a visible determination on the part of Lloyd's - most vividly expressed by David Rowland at the ceremony on 4 September to mark the completion of Reconstruction & Renewal that the disasters of recent years must never be allowed to happen again. Both Lloyd's and the DTI are reviewing the consequences and implications of the events of the last few years to ensure from both the commercial and regulatory perspectives that the risks of repetition are reduced to the absolute minimum in future.

It has indeed been a busy year for the DTI's Insurance Directorate.

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