

Insurance Newsletter

April 2017

The PRA's Insurance Objective

The Independent Evaluation Office (IEO), at the request of the Bank of England's Court of Directors, has recently reviewed the PRA's use of its Insurance Objective and a report was published on 20 March.

The Insurance Objective (section 2C of FSMA)

- (1) In discharging its general functions so far as relating to a PRA-regulated activity relating to the effecting or carrying out of contracts of insurance or PRA-authorised persons carrying on that activity, the PRA must, so far as is reasonably possible, act in a way -
 - (a) which is compatible with its general objective and its insurance objective, and
 - (b) which the PRA considers most appropriate for the purpose of advancing those objectives.
- (2) The PRA's insurance objective is: contributing to the securing of an appropriate degree of protection for those who are or may become policyholders.

In general, the IEO found that the PRA was exercising the Insurance Objective in a way which advances policyholder protection. However, it considers that the PRA's approach should be more clearly articulated and communicated, internally and externally.

Some key points arising out of the report are:

- The IEO emphasizes the linkage between the General Objective and the Insurance Objective. Section 2C states that the PRA must act in a way which is compatible with its general objective *and* its insurance objective, and which the PRA considers most appropriate for the purpose of advancing those objectives. The insurance objective is not a stand-alone objective.

The IEO comments that “if an issue has no direct capacity to affect safety and soundness one way or the other, then the PRA may find it difficult when exercising its general functions (such as rule-making and policy determination) to justify taking action solely on the basis that it advances policyholder protection”.

The IEO also observes that the Prudential Regulation Committee (PRC) has not articulated clearly what approach should be taken by the PRA where there is a conflict or potential conflict between the two objectives.

- The PRA has some discretion in deciding what an “appropriate” degree of protection for policyholders is, and in practice does not appear to treat all policyholders equally. For example, in its Approach document it states that it focuses on types of insurance which have the greatest potential impact on its objectives e.g. annuities and mandatory cover without which economic activity cannot take place. It has also set different compensation limits for different types of insurance product under the FSCS.

The IEO notes, however, that the PRC has not had an in-depth discussion of the extent to which all policyholders are equal and therefore this approach does not represent a top-down, explicit PRA view. The IEO thinks that such a discussion should take place.

- Although the PRA has articulated a non-zero failure approach to supervision, the IEO considers that there is scope for greater clarity about what the PRA considers as failure within the context of insurance (e.g. does solvent run-off constitute “failure”?) and the PRA’s tolerance for insurer failure. For example, the PRA sometimes closely supervises small firms with short-term solvency issues, even though these do not create any systemic concerns.
- The IEO found room for improvement in the coordination between the PRA and FCA. In particular it found that informal coordination was preferred over more formal channels and considered that the efficiency of this might lessen over time as the shared legacy with the FSA became more remote.

In response to the report, the PRA has committed to:

- take a paper to the PRC by September 2017 on the legal interpretation of the Insurance Objective, the interaction of the objective with the General Objective and the definition of regulatory failure. As necessary, the approach document will then be updated and the updated approach will be communicated to PRA staff; and
- present a paper to the PRC by December 2018 on the appropriate levels of protection between different types of policyholders, the extent to which supervision should take the FSCS into account, the approach to firm categorisation and co-ordination arrangements with the FCA. The PRA says that the delay in taking forward this paper reflects prioritisation given to other work demands.

IEO report

PRA response

Brexit and financial services

On 29 March the UK formally wrote to the European Council giving notice under Article 50 of the Treaty on European Union of the UK’s intention to leave the EU. Although a significant step, the letter and the Prime Minister’s statement to the House of Commons on the same day did not divulge any new information regarding the Brexit process.

From an insurance sector perspective, it was positive that the Article 50 letter mentioned financial services as a sector which is crucial to the linked economies of the EU and UK in the context of

the negotiation of a Free Trade Agreement (FTA). It was less encouraging that European Council has indicated that the EU will expect progress to be made in negotiating the withdrawal agreement before engaging in discussions over the FTA. The details of the FTA, and of any transitional or interim arrangements, may therefore take some time to emerge.

Uncertainty regarding access to the EU for financial services firms post-Brexit continues as does contingency planning by international insurance groups. Most recently, Lloyd's has announced that it intends to set up a European hub based in Brussels. Other groups are also looking at Ireland and Luxembourg in particular as possible locations for new European operations.

Article 50 letter

European Commission press release

EIOPA review of the Solvency II Delegated Regulation - call for further advice

At the end of February, the European Commission issued a second call for advice to EIOPA in respect of its review of specific items in the Solvency II Delegated Regulation. These items relate to (potentially) “unjustified constraints to financing”.

The general theme is an attempt to introduce more flexibility into the standard formula for the calculation of market risk.

Advice is requested in relation to:

- the treatment of certain types of unrated bonds and loans in the spread risk submodule: the Commission asks EIOPA to provide criteria which could be applied to unrated bonds in order to allow them to be treated in the same manner as bonds with a credit quality step 2 (and, potentially, step 1 or 3); and
- the treatment of certain types of unlisted equities: the Commission asks EIOPA to provide criteria which could be applied to unlisted equity in order to allow it to be treated in the same way as listed equity in some cases.

For both categories, the Commission suggests objective criteria which might be considered, such as the financial state of the debtor, features of the debt instrument and diversification of equity portfolios. It also suggests that criteria related to the insurer's risk management system could be developed, although it is not clear how these would be assessed.

The Commission also asks for information from EIOPA regarding the current use by firms of the “strategic equity investment” reduced calibration in the equity risk sub-module.

Call for advice

ABI further submissions to the Treasury Committee inquiry

The ABI has made further written submissions to the Treasury Committee inquiry, raising 23 specific (in some cases related) points. The submission and the PRA's response to it have been published by the Committee.

The most significant points raised by the ABI relate to reporting and the risk margin. The ABI submission includes as appendices two documents regarding a proposal to allow assumed future management actions to reduce the risk margin. The PRA objects to this proposal largely on the basis that it could lead to the same assumed management actions being used to reduce the Solvency Capital Requirement (SCR). Some of the key points raised by the ABI and the PRA's responses are:

| ABI point | PRA response |
|--|---|
| Proposed management action mechanism to address the risk margin | The PRA is concerned that a similar approach might be adopted with regard to the SCR and/ or best estimate and that taking a unilateral approach the risk margin might prejudice the outcome of work being done at European level |
| The PRA should allow dynamic modelling of the level of the volatility adjustment, which is allowed in [some] other Member States. | The PRA's view is that modelling of a dynamic volatility adjustment is not consistent with or intended by the Directive (regardless of the approach of other regulators) |
| Restrictive rules compel firms to incur unnecessary restructuring costs to achieve matching adjustment compliance, e.g. in relation to Equity Release Mortgages | The PRA is constrained by the rules as set out in the Directive |
| The internal model approval process and model change process is overly onerous and costly | The PRA is actively looking at ways to reduce the burden of the internal model approval regime |
| The PRA requirement that firms undertake an external audit of the Solvency and Financial Condition Report (SFCR) is not required by the Directive, increases costs and should be removed | The PRA will assess the costs of the external audit vs the benefit to investors, policyholders and the PRA after it has received and considered the first set of audited SFCRs |
| The PRA should review the necessity of national specific reporting templates (NSTs), given the reporting burden | The NSTs were developed to address gaps in the reporting regime specific to the UK insurance industry. The PRA will, however, review the reporting burden more generally |

[Treasury Committee inquiry webpage](#)

The Insurance Distribution Directive - UK implementation

The Insurance Distribution Directive (IDD) entered into force on 22 February 2016 and is required to be transposed into national law by 23 February 2018. Although the UK regime is already super-equivalent to the directive it replaces (the Insurance Mediation Directive), the IDD will require a number of changes to the rules relating to the sale of insurance products.

HM Treasury (HMT) and the FCA have each recently consulted on implementation of the directive. The FCA intends to publish a second consultation later in the year which will address changes to the rules relating to the distribution of insurance based investment products, the new Insurance Product Information Document, and product oversight and governance.

The Treasury consultation

The HMT consultation largely addresses the scope of regulation of insurance distribution. As the IDD is on the whole minimum harmonising, HMT proposes that some aspects of the current UK regime which are super-equivalent to the IDD will remain unchanged.

Provision of data and information: Under the IDD, the mere provision of data and information on potential policyholders to insurers or insurance intermediaries or vice versa is not within the scope of regulated insurance distribution, provided no further steps are taken to assist in the conclusion of an insurance contract. HMT proposes to amend the relevant part of the Regulated Activities Order to bring the UK regime into line with this exemption. Currently, firms carrying out these activities in the UK are usually 'introducer appointed representatives'.

Add-on products: The IDD maintains the exemption which existed under the Insurance Mediation Directive for products sold as part of a package or as an 'add-on'. This applies where the principal business of the distributor is something other than the distribution of insurance products. It is subject to a number of conditions including the size of the annual premium payable for the product. In its implementation of the IDD, HMT proposes retaining a number of super-equivalent aspects of the existing UK regime:

- the exclusion of life insurance products and liability risk cover from the exemption, on the basis that these are complex and if mis-sold could lead to significant consumer detriment. HMT also asks whether there are any other complex products which should be excluded from the exemption
- the regulation of all sales of travel insurance (under both the IMD and now the IDD travel insurance is only required to be regulated as a standalone product, not as an add-on)
- the regulation of all sales of motor warranties, even where the annual premium is low enough to allow them to fall within the exception.

The FCA consultation

The FCA consultation focuses on conduct requirements for non-investment insurance business, training and competence, and complaints handling and out of court redress. In many cases the changes are relatively minor given the comprehensive scope of regulation of sales of financial products in the UK. Some aspects are new, however, including in respect of conflict rules and remuneration disclosures for the sale of non-investment insurance contracts.

The general principles

The IDD sets out general principles applicable to all insurance distributors, which the FCA intends to implement through a number of changes to the Insurance Conduct of Business Sourcebook (ICOBS) and the Senior Management Arrangements, Systems and Controls Sourcebook (SYSC), principally:

- adding a new rule in ICOBS requiring insurance distributors to act honestly, fairly and professionally in the best interests of their customers (the “customer’s best interests rule”)
- amending the current ICOBS rules on communications and financial promotion to require that all marketing communications are clearly identifiable as such
- including a new rule in SYSC to prohibit remuneration and performance management practices that would conflict with the customer’s best interests rule.

Conduct rule changes

- ICOBS will be amended to reflect new pre-contract disclosure requirements introduced by the IDD, including requirements to disclose the type of firm (insurer or intermediary), the type of remuneration the firm will receive and the source of that remuneration. The existing requirement to disclose the amount of commission received on request by a commercial customer will also be retained.
- Some amendments to the current ‘demands and needs’ requirements will be made to ICOBS, including introducing a requirement to ensure any contract of insurance proposed by a firm is consistent with the customer’s insurance demands and needs (whether or not advice is given).
- New rules on bundling of products (cross-selling) will be introduced requiring distributors to give information about whether the bundled products can be purchased separately. Where insurance is sold ancillary to another product the primary product must also be offered separately from the insurance.

Training and competence

The IDD introduces a new requirement that relevant staff complete 15 hours of Continuing Professional Development (CPD) per year. On the whole, more stringent requirements already

apply in the UK. The FCA requires a minimum of 35 hours CPD to be completed by relevant staff at firms subject to the Training and Competence regime. Where firms were not previously subject to this regime, the IDD 15 hour requirement will apply from February 2018. The IDD only mandates that CPD requirements are applied to insurance intermediaries but the FCA intends to apply them to relevant staff in all insurance distributors.

Complaints handling and out of court redress

The current FCA Dispute Resolution Sourcebook (DISP) and the Financial Ombudsman Service (FOS) already cover most of the IDD requirements in this area but some changes will be required to:

- expand DISP to cover all insurance distributors when carrying on distribution activities
- include within DISP complaints about distribution business carried on by UK firms from non-UK EEA branches
- introduce a requirement for EEA branches of UK entities to adhere to an appropriate alternative dispute resolution entity in the member state in which the branch is established.

It is also worth noting that the FCA has taken the view that the IDD requirements do not make it necessary to expand the scope of FOS to cover all complaints from commercial customers. Therefore no changes to scope will be introduced as part of the IDD implementation.

HM Treasury consultation

FCA consultation



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