Debevoise & Plimpton

Debevoise In Depth

Recent EU and UK Insurance Regulatory Developments

5 October 2022

Financial Services and Markets Bill (the "FSM Bill" or the "Bill")

Background

The FSM Bill was introduced before Parliament on 20 July 2020 and is a product of a number of public consultations on how to reshape the UK's financial services industry in light of Brexit. It presents an opportunity for the UK government and regulators to implement a financial services regime with rules and regulations that are better tailored to the UK.

Current status

The Bill had its first reading in the House of Commons on 20 July 2022 and its second reading on 7 September 2022. A call for written evidence published in September 2022 indicates that the committee stage of the Bill in the House of Commons will conclude by 25 October 2022. There is no set timescale by which the Bill will complete its passage through both Houses of Parliament, but it may take up to six months from its first reading (i.e., to January 2023) based on previous, similar bills like the Financial Services Bill 2019-2021.

What is in the Bill?

The Bill contains a whole package of measures, which involve reforming the legislative framework for the UK's capital markets to bringing the use of stablecoins within the UK regulatory perimeter. While these are interesting, they fall outside of the scope of this Debevoise In Depth.

Here, we focus on the key elements of the Bill that are directly relevant to the insurance industry.

Framework to implement UK's regime

- The FSM Bill sets up a legislative architecture to allow a smooth transition to comprehensive UK legislation. The regulators will introduce rules and HM Treasury will repeal relevant pieces of retained European Union (EU) law at the same time as the corresponding FCA and PRA rules come into force.

- The regulators will make and consult on rules in the usual way and conduct cost benefit analyses (although there are exemptions from these requirements). In fact, public consultation will be required even if the regulators are going to simply replace retained EU law with rules that are materially the same as those revoked. A live example of the consultation process is the UK's consultations regarding Solvency II.

- The government expects this process to take a number of years to fully complete.

Greater accountability over the UK regulators

- Increased levels of power come with greater accountability.

- Under the FSM Bill, the HM Treasury will have the power to require a regulator to review its rules based on a public interest test. This power is intended to be used exceptionally, and where the Treasury considers that it is in the public interest to direct regulators to review their rules.

- HM Treasury will also be empowered to require either the PRA or FCA to make rules but may not specify the content or outcomes that such rules should seek to accomplish. The regulators will be required to keep their rules under review and to publish a statement of policy on how they conduct such reviews.

- The FSM Bill will also require the PRA and FCA to notify relevant Select Committees when they launch a consultation on proposed rules, publish proposals on how they exercise their general regulatory functions or consult on proposals under a duty imposed by legislation. In June 2022, the Treasury Select Committee announced the creation of a new sub-committee—called the Sub-Committee on Financial Services Regulations—that will scrutinize financial services regulatory proposals, either ex-ante or ex-post.

- There is continuing debate as to whether the Bill should include amendments that will give the government further powers to direct the regulators to make changes on the basis of public interest. This came up recently in the second reading before the House of Commons and is a space to watch, as the new government under Liz Truss may legitimately want to control the direction of travel of regulatory developments.

Secondary objective for the UK regulators

- The Bill also introduces a new secondary objective for the regulators, which is to facilitate UK's economic growth and international competitiveness in the medium to long term.

- This was a much-debated proposal, with HM Treasury fearing that it would water down regulatory standards and result in a bonfire of investor protection. This concern is somewhat addressed by the fact that the objective is secondary, supplementing the FCA and PRA's primary objectives on consumer protection and the safety and soundness of firms it regulates. It is clear that the government hopes to ensure that giving the regulators a legal basis for advancing medium to long-term growth and international competitiveness removes what they see as over-regulation whilst not detracting from their existing objectives of financial stability, competition in the interests of consumers and consumer protection.

Climate commitment

- Following the November 2021 consultation on the Future Regulatory Framework, the government proposed to further strengthen the regulatory regime relating to climate.

- The Bill introduces a new regulatory principle for the FCA and PRA, when discharging their general functions, to have regard to the need to contribute towards achieving compliance with section 1 of the Climate Change Act 2008. The net zero regulatory principle seeks to cement the government's long-term commitment to transform the economy in line with its Net Zero Strategy by ensuring that the regulators must have regard to these considerations when discharging their functions.

- Furthermore, the Bill removes the existing sustainable growth principle for the regulators to avoid unnecessary duplication.

Insurers in financial difficulties

- The Bill also makes a series of amendments to insolvency arrangements for insurers, in light of the concern that the consequences of such insolvencies can be severe.

  - Writing down of liabilities:

    - The Bill clarifies and expands an existing provision of FSMA—s 377, which has not been used, potentially because of lack of clarity on how it is intended to work. The provision grants a court the power to reduce the value of one or more contracts of an insurer that has been "proved unable to pay its debts" as an alternative to making a winding-up order—a "write-down" of liabilities.

  - The new rules provide a wide list of persons who can apply for this "write-down" process including HM Treasury, the PRA and the insurer itself. The court may make such an order if it is satisfied that the insurer is, or is likely to become, unable to pay its debts and that the write-down is reasonably likely to lead to a better outcome for policyholders and creditors (taken as a whole) than not making the order.
  - Except with the permission of the court, there will be a statutory moratorium on certain legal actions (including security enforcement) against the insurer for so long as the write-down is ongoing, commencing from the date of the application.
- New moratorium preventing rights to terminate:
  - The Bill also introduces a new moratorium temporarily preventing suppliers and some financial contract counterparties from exercising rights to terminate contracts while an insurer is undergoing certain insolvency or write-down procedures.
  - However, the court may order that the prohibition does not apply in certain circumstances, including where enforcing it would cause hardship to a person other than the insurer.
- Temporary moratorium on life insurers:
  - The Bill also affects policyholder surrender rights, introducing a temporary moratorium on life insurance policyholder surrender and switching rights (which typically allows them to convert the contracts into cash). This will apply in the same circumstances as the moratorium on contractual termination rights.
  - This restriction will be subject to similar terms (including exemptions) as will apply to terminating supply and financial contracts.

Recent government announcements

The overarching sentiment is that the new government under Liz Truss will be looking to assert greater governmental oversight and control over the regulators. For example, it has been reported that the new government has suggested merging the PRA, FCA and Payments Systems Regulator into one organisation, to combat what has been viewed as the caution of regulators that has held back economic growth. The PRA and FCA were split out of the single regulator, the FSA, in 2013 under a previous Conservative

government following the financial crisis. Another example that reflects a centralisation of oversight is the new government's expected plans to review the Bank of England's independence and mandate, in light of its failure on tackling inflation.

Consensus in the market is that merging of the regulators would be very complicated and time-consuming and should not be pursued at this time. The independence of a country's central bank is seen internationally as a hallmark of good regulation so we will see whether the government's expected plans above will actually proceed or whether sensible heads will prevail.

What can the industry do now?

The best course of action for the industry is to respond to the calls for evidence by the Public Bill Committee and also to Solvency II consultations by the PRA. It is important to voice out any concerns at an early stage so that they can be taken into account.

UK and EU Solvency II Review

UK Solvency II review

In April 2022, the HM Treasury published a new consultation paper on the UK's Solvency II review setting out the package of proposed reforms, and the PRA published a discussion paper on the topic.

The PRA's CEO, Sam Woods, gave a speech in July that considered the industry's reactions to this discussion paper. It noted that:

- The PRA's view is that substantial capital release should be possible while continuing to protect policyholders adequately;
- While the industry has been broadly supportive of proposals concerning the cuts to risk margin and reforms intended to reduce bureaucracy, reactions to the PRA's proposals to put the matching adjustment on a more sustainable footing have been "strongly negative";
- The PRA's experience of operating the matching adjustment suggests that the broad mechanism works but that the EU design makes insufficient allowance for uncertainty and the difference in riskiness between assets and signals from the market; and
- Reform should occur in one or both of the two ways, these being

- Loosening the risk margin while tightening the matching adjustment to free up capital for insurers—with predictions that this could be a 10–15% capital reduction in year-end 2020 and 2021 economic conditions or 5–7% under a long-run "rates-up" scenario; and
- Widening the range of assets in which insurers can invest and speeding up the approval process.

The PRA is expected to publish further consultations on the proposed reforms later this year.

It is worth mentioning that Liz Truss' campaign promised broad reforms for the financial services sector—including reforming Solvency II to encourage insurers to invest more in infrastructure projects. It is questionable the extent to which the government will have capacity to pursue this ambitious agenda—however, the government will likely face pressure not to lag behind the EU on Solvency II reforms.

EU Solvency II review

At a high level, the European Commission's proposal for amendments to Solvency II covers:

- Updating and clarifying the application of the proportionality principle;
- Splitting the SFCR into two parts, with one being specifically directed at policyholders;
- Clarifications to group supervision rules and the introduction of more detailed group governance requirements; and
- Integration of macroeconomic considerations and analysis into the ORSA requirement and a requirement for firms to consider any material exposures to climate change risks in the ORSA.

Proposed amendments to the Level 2 Delegated Regulation are to be published—but these are expected to cover long-term equity investments, the risk margin, the volatility adjustment, matching adjustment, extrapolation of the risk-free rate structure and interest rate risk.

The Council agreed its position on the proposal in June 2022, and must now agree a final version of the text with the European Parliament. The European Parliament's Committee on Economic and Monetary Affairs—ECON—is currently considering over

600 proposed amendments from MEPs plus 200 from ECONs Solvency II rapporteur to the Commission's proposal. The proposed amendments would generally result in more capital relief to insurers than proposed by the Commission—100bn Euros as opposed to 30 bn Euros.

We should have a clearer idea of the direction of travel on this by the end of the year.

Temporary Permissions Regime

What is it?

Following Brexit, the passporting rights (rights that enabled firms authorised in any EEA state to trade freely in any member state with minimal additional authorisation) ceased with respect to the UK. EEA firms who were previously passporting into the UK now require authorisation from the PRA or FCA to be able to carry out regulated activities there.

The UK regulators set up the temporary permissions regime (the "TPR") to allow such firms who wished to continue carrying out business in the UK to operate for a limited period while they sought authorisation. The TPR came into effect on 31 December 2020.

Applicable rules for firms in the TPR

The UK regulators have the same powers in relation to firms in the TPR as they do with other UK regulated firms and the same supervisory framework and obligations apply.

With respect to the rules that apply to firms in the TPR:

- For PRA-regulated firms in the TPR with an establishment in the UK, they are required to comply with the same rules that apply to other third country branches (subject to any applicable transitional relief). For PRA-regulated firms in the TPR without a branch in the UK, a more limited set of rules apply.

- For FCA-regulated firms in the TPR, they must comply with all rules that applied to them when they passported into the UK before Brexit, as well as certain changes in very specific circumstances.

Popularity of the TPR

The PRA in April this year reported some useful statistics:

- 190 firms from 20 countries, which had previously operated in the UK under passporting rules, have transitioned into the TPR;
- Approximately 130 firms are expected to submit applications for authorisation to operate in the UK as third country branches. More than 80 applications have been received and 19 approvals have been made.

Landing slots

On 12 August 2022, the FCA announced that all TPR firms that it expects to apply for full authorisation should have received their "landing slot". If a firm fails to apply before the closing date of the "landing slot", they risk cancellation of their temporary permission.

Firms that did not receive a "landing slot" can still make an application for authorisation, which must be sent to the FCA by 31 December 2022 in order to avoid cancellation of their temporary permissions.

Application for authorisation

The FCA has indicated that in a firm's application for authorisation, a firm will need to demonstrate:

- How it will meet the FCA's threshold conditions for each of the regulated activities that it intends to carry out in the UK;
- How its UK business will be structured, and why the structure it proposes will mitigate the risks of harm; and
- That it has considered the UK's Senior Managers and Certification Regime, which covers people working in financial services and aims to reduce harm to consumers and strengthen market integrity by making individuals accountable for their conduct and competence.

Exiting the TPR

A firm exits the TPR:

- when the application for authorisation is decided (whether as an approval or rejection)
- if the UK regulators use their own initiative power to cancel the deemed permission; or

- at the end of the TPR's term.

In these circumstances, and where a firm has continuing contracts but did not apply to enter the TPR, the Financial Services Contracts Regime (the "FSCR") applies. Generally speaking, the FSCR is designed to ensure that EEA firms can wind down their UK-regulated activities in an orderly manner and operates as a backstop to the TPR to mitigate contract continuity risks.

The FSCR

There are two discrete mechanisms under the FSCR: supervised run off ("SRO") and contractual runoff ("CRO"). The key difference between SRO and CRO is in relation to their regulatory authorisations:

- A firm in SRO has a "deemed" authorisation and is considered an authorised person and therefore supervised by the UK authorities.

- A firm in CRO is one previously operating in the UK under a services passport and which did not enter the TPR. It is a necessary condition that the firm remains authorised and supervised by its EEA home state regulator, as the firm is not an authorised person in the UK.

The regime provides limited permissions for firms to perform existing contracts but, unlike the TPR, does not allow a firm to carry out regulated activities in relation to new contracts, except where necessary to service pre-existing contracts. Firms falling within the scope of the regime will be expected to run off, close out, or transfer obligations arising from contracts that exceed the time limit of the regime (15 years for insurance contracts and five years for other contracts). However, these limits are maximum periods, and the FCA expects firms in the FSCR to wind down their UK business promptly.

Third Country Branches

A firm may be authorised in the UK as either a subsidiary or a branch.

A subsidiary is a separate legal entity from its parent and, as such, must meet regulatory capital requirements with its own funds and have its own governance and risk management framework and is subject to the PRA's sole supervision. A branch, however, forms part of a legal entity headquartered abroad and responsibilities for the prudential supervision of branches are split between the supervisor where the insurer is headquartered and the PRA.

Generally speaking, the PRA expects third country branches to be appropriate where there would be under £500 million of insurance liabilities covered by the Financial Services Compensation Scheme, although the PRA has noted that this is not a hard threshold and they will consider the medium-term strategy, business plan and forecasts of branch business in assessing this threshold.

The authorisation process for each of a subsidiary and a third country branch is substantially the same, which has been a subject of criticism.

Regulation of third country branches

As a result of Brexit and the consequent push for deregulation in the UK from the government, the PRA has recently proposed certain changes to its approach to and regulation of third country branches, particularly following concerns that the structure is not sufficiently flexible. Some of these changes include:

- "Split of responsibilities" agreements with EEA supervisors, where the PRA has indicated that it intends to rely upon their regulatory supervision when it is prudent to do so.
- The PRA has also indicated that it is considering certain proposals to further reduce branches' regulatory burden by:
  - Waiving certain reporting requirements for small branches and insurance branches that exclusively write risks not located in the UK; and
  - Offering eligible firms a modification by consent, in respect of "reverse branch activity" which allows such branches to exclude risks outside the UK when calculating technical provisions and capital for the branch. These capital burdens could instead be assumed by their home office.
- We expect that the PRA will continue to reduce the regulatory burden on third country branches, particularly those only engaged in reinsurance business rather than direct business. The PRA has already exercised its existing powers to waive branch capital requirements for some pure reinsurance branches.

Improving the authorisation process

The PRA has indicated that it intends to encourage new capital into the London market by streamlining its approach to authorising traditional insurance ventures by addressing:

- The speed of the authorisation process;

- The depth of its review of applicants' proposed business plans; and
- The level of documentation required at the point of engagement with the PRA.

The expectation is that this will apply equally to subsidiaries being established as UK-authorised persons.

New FCA Appointed Representative Rules

On 3 August 2022 the FCA issued its Policy Statement and Final Rules (PS22/11) on Improvements to the Appointed Representatives Regime, following a Consultation Paper (CP21/34) issued in December 2021. The new Rules come into force on 8 December 2022 and are intended to help prevent consumers from being mis-sold or misled and prevent misconduct by Appointed Representatives, by imposing enhanced monitoring and reporting obligations on Principal firms.

Under the new Rules, Principal firms will need to:

- Apply enhanced oversight of their Appointed Representatives, including ensuring they have adequate systems, controls and resources to undertake their activities, and allocate sufficient amounts of their own resources to enable them to do so;
- Assess and monitor the risk that their Appointed Representatives pose to consumers and markets, providing similar oversight as they would to their own business;
- Review information on their Appointed Representatives' activities, business and senior management annually, and be clear on the circumstances under which they should terminate an Appointed Representative relationship;
- Notify the FCA of future Appointed Representative appointments 30 calendar days before it takes effect; and
- Provide complaints and revenue information for each Appointed Representative to the FCA on an annual basis.

The FCA will also be undertaking targeted supervision of Principal firms across the whole financial services sector, and increasing scrutiny of firms applying for authorisation and appointing Appointed Representatives. Principal firms can therefore expect to receive section 165 data requests from the FCA, asking for information about existing and new Appointed Representatives.

Legislation on the horizon

In addition to the new rules issued by the FCA, the FCA is engaging with the Treasury on its Call for Evidence which is looking at whether additional legislative change is required in this area.

In particular, the following reforms are being considered (among others):

- Changing the scope of the Appointed Representatives regime to prohibit Appointed Representatives from carrying out some activities where risk is perceived to be high;
- Amending the scope of regulated activities that an Appointed Representative can carry out; and
- Requiring the principal to carry on the same regulated activities as the Appointed Representative to ensure it has sufficient expertise to oversee the Appointed Representative.

Next steps for firms?

Firms will have two more months to consider the new requirements and put in place the required systems and controls to comply with the increased monitoring and oversight demands. Firms will need to seek advice on how to make sure that they fall on the right side of the line of these new rules. There is, for example, no real guidance as to how Principal firms should conduct their annual reviews etc, and the exact actions that are necessary to ensure compliance with these rules are not laid down specifically. Firms, whether operating as an Appointed Representative or Principal, will also want to seek advice on how these regulatory developments may affect their business in the future.

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Please do not hesitate to contact us with any questions.

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