Life Insurance Newsletter

A regulatory update from the Insurance Sector Team

Issue No.2 – December 2004

Introduction

Welcome to the second issue of the *Life Insurance Newsletter*.

The last quarter has seen a great deal of activity across a number of regulatory fronts. The main focus, unsurprisingly, has been on the implementation of the Prudential Sourcebook material for life insurers on 31 December 2004. In particular there has been significant progress on the implementation of the new Individual Capital Adequacy Standards (ICAS) approach. We have had active discussions with a number of firms on their Individual Capital Assessments (ICAs) and fed back some of our views at an industry seminar organised for us by the ABI. I am encouraged that there is already evidence that firms have recognised the incentives the ICAS framework creates for better and more integrated risk management.

As far as actuarial issues are concerned, we have been contributing fully to Sir Derek Morris's review of aspects of the profession, particularly in relation to our own reforms and the important question of actuarial standard setting. John Tiner, in his speech to the Life Convention in Edinburgh, set out our latest thinking on these and a range of related issues. We have also been engaging with the Institute and the Faculty of Actuaries to clarify certain aspects of our new requirements, particularly in relation to the report of the with-profits actuary, which take effect at the end of the year.

Finally, and to conclude this very brief introduction, there continues to be significant interest from all quarters in the closed with-profits fund sector. We set out our thinking on this in a Sector Briefing published in September. Reactions to this document indicate that it fully met its aim of setting the record straight on the issues surrounding closed funds and dealing with some of the misconceptions that have arisen. Supervisory work on closed funds is currently underway and we will be reporting back on this in a future issue.

Issues covered in this edition include:

- *Prudential Sourcebook;*
- *Individual Capital Adequacy Standards (ICAS);*
- *the role of actuaries in life insurers and the WPA's report to with-profits policyholders;*
- *an update on treating customers fairly;*
- *the Euro – Sterling value for insurance regulatory purposes;*
- *passporting under the Insurance Mediation Directive – life and reinsurance meditation;*
- *Distance Marketing Directive; and*
- *depolarisation and the menu*

I hope you find this issue useful and as ever we would be pleased to receive feedback and ideas for future issues.

David Strachan
Insurance Sector Leader

Prudential Sourcebook (PRU)

As firms will be aware *The Regulation of Insurance Review* resulted in amendments to the setting of prudential standards for insurers. The rules and text in PS04/16 have now been finalised and include -

- The ICAS framework for insurers;
- the requirement for life insurance firms with aggregate with-profit liabilities in excess of £500m to hold capital based on the higher of a 'regulatory' peak and a 'realistic' peak (the so called 'twin peaks' approach);
- prudential systems and controls requirements for insurers; and
- new capital adequacy rules for insurance groups.

The text included in PS04/16 was 'made' in November 2004 and will come into force on 31 December 2004. Firms that complete their annual returns ending 31 December 2004 will therefore do so on the basis of these new requirements.

Individual Capital Adequacy Standards (ICAS)

With effect from 1 January 2005 firms should be in a position to explain to us how they have assessed their Individual Capital Assessments (ICAs). We do, however, recognise that firms will continue to refine and develop ICAs beyond this date.

The FSA process

In this initial period of ICAS implementation, we plan to give firms three months' notice of the requirement to send us their ICA for review. This is a longer period than we are likely to give when the ICAS approach is fully implemented. Of course, we may ask firms at any time to demonstrate that they meet the requirement to have an ICA and the related documentation rules.

We are currently finalising the timetable for our review of ICAs. To start with, we will give priority to firms where the perceived risk or potential risk impact warrants early attention. The rest will be reviewed as part of the risk assessment (Arrow) process where resourcing permits. We will vary this though where there is good reason, for example where a firm plans a major change to its capital structure or where it is otherwise necessary to separate the two, for example for resourcing reasons.

We have also been reviewing our processes and training. In carrying out their review of ICAs and assessing the appropriate individual capital guidance (ICG) supervisors will be supported by members of our actuarial team and our Risk Review Department. To help equip supervisors with the skills they need we have established a continuous training programme.

The supervisor's view of the appropriate level of ICG will be reviewed by a panel drawn from independent senior FSA staff. This is to ensure that firms are treated fairly and consistently and that similar risks or similar perceived systems and control weaknesses receive similar weightings in giving ICG.

ICA implementation issues

We held discussions with a number of firms over the summer to understand the approaches they are adopting to their ICA. We identified a number of issues on which we felt we should communicate our views in more detail to the industry so we held a seminar at the ABI on 5 November 2004. This covered a range of issues including: instantaneous stresses versus 1-year approaches; new business; (diversification benefits) and the treatment of groups. If you would like a copy of the seminar pack please e-mail the insurancesectorteam@fsa.gov.uk. We expect to set out our views on how firms might appropriately deal with their potential obligations to defined benefit pension schemes in their ICA in an open letter to the ABI in the near future, which will be made available on the FSA website.

Other issues that we would like to clarify are:

What is the FSA expecting on operational risk? The quantification of operational risk is an area that may not be receiving enough attention from firms. We expect firms to have identified their most material operational risks and to have stress or scenario tested the exposure to assess the appropriate level of capital resources for operational risk. Firms should already be embedding an operational risk management framework in their businesses. We recognise that it will take time for firms to develop appropriately sophisticated and proportionate operational risk capital assessment methodologies.

Are the stress tests in the realistic capital margin (RCM) plus an assessment of operational risk an appropriate basis for a firm's ICA? The RCM is calibrated for a well diversified firm and only covers certain risks explicitly, for example there is an implicit allowance included to cover some elements of operational risk. Furthermore, the RCM stress tests are assessed after taking credit for risk diversification benefits the nature and extent of which will vary between individual firms. It is therefore unlikely that the RCM stress tests will be appropriate for a particular business. More generally, it is clearly important that the firm can justify that the process used to develop the stress tests applied in their ICA results in these being appropriate to the firm's own circumstances.

Role of actuaries in life insurers

Our final rules and guidance on the role of actuaries in life insurers were made in November 2004 (Handbook Notice 38, November 2004) and are available on our website at www.fsa.gov.uk/pubs/handbook/hb_notice38.pdf.

These take effect on 31 December 2004 and will replace the role that to date has been fulfilled by the Appointed Actuary with two advisory actuarial roles, requiring FSA pre-approval.

All firms carrying on long-term insurance business will be required to appoint an **actuarial function-holder** whose main duties will be to advise the governing body on any material risks to the firm's ability to meet liabilities to policyholders and the methods and assumptions for the valuation of policy-holder liabilities, and to calculate these liabilities.

Firms carrying on with-profits business will also be required to appoint a **with-profits actuary** (WPA) whose main duties will include advising the governing body on key aspects of its use of discretion as this relates to the fair treatment of policyholders.

The WPA or anyone performing both roles will be prohibited from being a member of the board. However, an actuarial function holder who only performs this role could be a member of the board. Our rules also prevent a person performing either the role of the actuarial function or with-profits actuary from being chairman or chief executive and holding other posts that could give rise to significant conflicts of interest.

WPA's report to with-profits policyholders

Our rules also require the WPA to make a report, in respect of firms' financial years commencing on, or after, 1 January 2005, to relevant classes of with-profits policyholders. As stated in Policy Statement 04/16 'Integrated Prudential Sourcebook for insurers' we are still considering our position on whether it would be more appropriate for this report to be addressed to the firm's directors, though still disclosed to policyholders.

Further information

Our final rules and guidance on the new actuarial roles can be viewed on our website at www.fsa.gov.uk/pubs/handbook/hb_notice38.pdf. Other relevant documents include the Policy Statement 167 'With-profits governance and the role of actuaries in life insurers - Feedback on CP167, made and near-final text' (June 2003) and Chapter 6 of PS04/16, both of which set out our policy on the two new actuarial roles. PS04/16 also sets out our final policy on our reviewing actuary proposals.

Update on Treating Customers Fairly (TCF)

In the last edition of the newsletter, we reported on our work on Treating Customers Fairly and outlined what we planned to do next.

We have now made good progress in the targeted supervisory work that we promised to do. We are working on six clusters which are looking at:

- product design;
- the interfaces between producers and distributors;
- remuneration;
- management information;
- complaints handling; and
- depolarisation.

For each cluster, we are visiting a number of firms, including some life insurers. In addition, we are also doing similar studies to look at financial promotions issues. The firms being visited as part of these clusters are being contacted by the relevant supervision teams. Visits have started for some clusters and the rest should be completed by the end of March 2005.

We also promised to establish a Consultation Group to help clarify what TCF means and to develop a better understanding of what makes for good or bad practice. The Group has now been set up and has representatives from the FSA Practitioner and Consumer Panels, 8 trade associations (including the ABI), representing a cross section of the financial services industry, two consumer groups, the Financial Ombudsman Service and a personal finance journalist. The Group, which will meet roughly every six weeks, had its first meeting on 4 November. If you have comments or questions about TCF, please speak to your supervision team.

Bonus Declarations – 2004

Around this time last year we wrote to with-profits offices to underscore the importance of firms taking prudent decisions on payouts. We said that it is important that with-profits offices continue to exercise prudence in setting their annual bonus rates. It is also the responsibility of firms' senior management to ensure that the level of bonus rates being paid takes account of both fairness to policyholders and broader prudential considerations.

As you will all be aware, the initiatives to progress the regulatory environment for insurance firms continue. The PPFM regime has now been implemented, and consumer friendly PPFMs will be prepared for the first time in 2005. Realistic reporting and the new regime of Individual Capital Assessments (ICAs) become mandatory where relevant, on 31 December 2004.

Each of these will clearly have an impact on the way in which with-profits funds are managed. We expect that when firms are considering the 2004 bonus rates they will be taking steps to ensure that they are adopting a consistent approach to strategy and the clear communication to policyholders across all of these initiatives. Management should also consider the inter-relationships between setting bonus rates and the illustrations they make of potential future returns.

The Euro – Sterling value for insurance regulatory purposes

The sterling value of the Euro for insurance regulatory purposes for the 12-month period beginning 31 December 2004 is 69.565 pence. This value should be used for the calculation of capital resources requirements and will apply to the relevant regulatory returns that insurers are required to deposit under the Interim Prudential Sourcebook for insurers (IPRU (INS)) or friendly societies (IPRU (FSOC)).

Policy Statement 04/24 published in November 2004 contains the made text of the Integrated Prudential Sourcebook (PRU) to come into force on 31 December 2004 that will replace the prudential requirements in IPRU(INS). Rules 2.1.29 and 7.2.50 of PRU provide that:

- for the purposes of the base capital resources requirement and PRU 7.2.45R(1) and PRU 7.2.47R(1), the exchange rate from the Euro to the pound sterling for each year beginning on 31 December is the rate applicable on the last day of the preceding October for which the exchange rates for the currencies of all the European Union member states were published in the Official Journal of the European Communities.

Rule 4.7(7) of IPRU (FSOC) provides that

- for the purposes of the rules in Chapter 4 and the definition of *non-directive friendly* society, the exchange rate from the Euro to the pound sterling for each year beginning on 31 December is the rate applicable on the last day of the preceding October for which the exchange rates for the currencies of all the European Union member states were published in the Official Journal of the European Communities.

This year the date in question was 29 October 2004, when the sterling value was 69.565 pence (published in the Official Journal of the European Communities, C 267, dated 30 October 2004). It is important to note that this rate applies from **31 December 2004** (not from 1 January 2005) and is therefore the rate to be applied in calculations for the regulatory returns carried out in respect of the 2004 calendar year end.

Amount of minimum guarantee fund

The amount of the minimum guarantee fund and certain other amounts expressed in Euro are liable to increase from year to year to reflect inflation. There will be no such increase before the fourth quarter of 2005.

Depolarisation and the Menu

In November we published the Policy Statement "Reforming Polarisation: Implementation – Feedback to CP04/3", which included 'made' rules. This is the culmination of the phased review of polarisation consulted on in CPs 80, 121,166 and CP04/3. This is a significant deregulatory measure that will result in:

- removal of the polarisation restrictions for advice on packaged products; and
- enhanced disclosure to consumers by introducing the initial disclosure document and the menu.

Depolarisation

Depolarisation is a liberalising measure which should result in greater competition and innovation. It is likely to lead to fundamental changes to the distribution channels for packaged products and greater commercial flexibility. Firms will be able to sell not only their own products (if they produce any) but will also be able to sell the products of any other product provider. Furthermore, depolarisation will permit firms to offer different ranges of products, to gap fill, to substitute products and sell competing products.

Enhanced Disclosure Safeguards

As part of the package of reform, we have introduced two new disclosure documents to increase transparency and assist consumers to understand better the choices available to them in the new and possibly more complex market structure.

Initial Disclosure Document

Consumers need to be given sufficient information about the nature and scope of what a firm offers. The initial disclosure document satisfies this need by setting out the scope of advice a firm can offer. For example a firm could offer advice from:

- a single product provider;
- a number of product providers (multi-tie distributor firm); and
- the whole of the market.

It also requires firms to provide information about their product range. The requirement to provide information given in the initial disclosure document is also necessary for the UK to meet its obligations under the Insurance Mediation Directive which comes into force on 14 January 2005.

Menu

We want consumers to be able to identify, understand and compare key information before buying financial products. The fees and commission statement, commonly known as the 'Menu' will be provided upfront and will disclose a firm's cost of advice from across all distribution channels. It aims to provide more effective disclosure of the cost of advice by telling consumers the maximum commission the firm is likely to receive for a transaction for a number of product groups and also provides an indication of what the market pays in the form of a market average. It also sets out and explains the various payment options available to consumers in the market.

From 1 December 2004, there is a 6 month voluntary transitional period during which firms can depolarise if they so wish. If a firm chooses to depolarise, then it is an 'all or nothing approach'. Firms taking advantage of the new rules will have to give consumers copies of their menu with appropriate price information. The new rules become mandatory on 1st June 2005 after which all firms giving advice on packaged products will have to comply with the new rules.

Passporting under the Insurance Mediation Directive (IMD) – life insurance and reinsurance mediation

We are currently in the process of implementing the Insurance Mediation Directive (IMD), which applies to the selling of most types of insurance, including life insurance and life reinsurance.

Our new rules will come into force on 14 January 2005. Whilst this is predominantly a general insurance concern there are issues relating to "passporting" that are of relevance to all insurers.

The IMD places a requirement on insurance intermediaries operating, or wishing to operate, in other EEA states (either through a branch or on a cross-border basis) to give prior notification to their home state regulator. A host state has the option of requiring home states to pass on such notifications received from their authorised firms. So far most of the other EEA states have said they wish to have such notifications forwarded to them. Once the IMD comes into force it will be illegal to operate in other EEA states without first having made a passporting notification to us. This is of particular importance to intermediaries that are already operating in other EEA states, and wish to continue doing so from **14 January 2005**. Firms will need to give notification to the FSA in the next week or so as we will need so that we can forward this on to the relevant host states by the 14 December 2004.

Appointed Representatives (ARs) of both intermediaries and insurers also need to submit a passporting notification Frequently Asked Question (FAQs) were prepared titled **"Do Appointed Representatives have passporting rights under the IMD?"** for intermediaries that will become authorised for the first time as a result of our new regime for selling general and pure protection insurance, but apply equally to intermediaries selling life insurance. The FAQs can be found the FSA website at www.fsa.gov.uk/mgi/faqs_passporting.html.

Any firm that considers it might need a passport to operate should contact our Passport Notification Unit. Forms for making passporting notifications under any of the EU directives are also available at passport.notifications@fsa.gov.uk.

Distance Marketing Directive (DMD)

We made rules in April and September 2004 to implement the DMD as were reported in Handbook Notices 32 and 36 and Policy Statement 04/11 (April 2004). Firms will by now have made the changes required in order to implement the new provisions; but we thought it might be helpful to reiterate here the impact on some areas of business.

What and who

The DMD applies to financial services generally but only to distance contracts with retail customers.

Disclosure

The DMD requires information to be provided ‘in good time before the consumer is bound by any distance contract or offer’.

To implement these requirements we made changes to our rules governing key features and other product disclosure requirements, financial promotion rules and terms of business requirements. By now firms will have made sure that their material takes account of any content changes, and that their processes deliver to customers all the material and information the DMD requires.

We recognise that this particular challenge for direct offer financial promotions where (unless an exception applies) the material has to be delivered before the customer is bound by the contract.

The DMD and our rules require the information to be provided to the retail customer on paper or another ‘durable medium’. This is particularly important for web-based sales. For example, a scroll box used to display contractual terms and conditions will probably not meet the requirement to be provided in ‘durable medium’.

Telephone sales

The DMD allows for a contract to be concluded with a retail customer on the telephone on the basis of a limited range of specified information. There must be ‘explicit consent’ from the retail customer to go ahead on that basis and the customer must be told that other information is available and what the information is. Full information must be provided on a durable medium immediately after conclusion of the contract. As such any telesales operations must be set up so as to meet these requirements.

Cancellation rules

The DMD gives retail customers cancellation rights for all distance contracts for financial services, but subject to a number of exceptions. We made numerous changes to our cancellation rules to take account of the Directive’s requirements. Firms will by now have integrated all these into their systems. Separately, the DMD introduced an important change to life policies by extending the period in which a policyholder has the right to cancel an individual life assurance contract from 14 days to 30 days, whether the sale is at a distance or face to face.

Financial promotions

Over the last year the FSA has increased the emphasis and resources committed to regulating financial promotions, as part of our work under the overarching theme of Treating Customers Fairly (TCF).

Our approach to financial promotions is driven by:

- regularly **reviewing** promotions in the press, on television and on the internet and carrying out ad hoc ‘themes’ to look specifically at certain products or media;
- **investigating** complaints made to us by members of the public and firms concerning material that they feel is not compliant;
- **assessing** firms’ systems and controls through visits; and
- **communicating** with the industry and consumers about the work we are doing and what they can do to help themselves and us.

If we find a financial promotion that we believe breaches our rules we can:

ask the firm to amend the promotion, or to withdraw it – we can apply to the High Court for an injunction to prevent continued publication of the financial promotion, but in practice it has not so far been necessary to take such action, as firms have agreed to withdraw the promotion.

If we believe that customers are likely to have been misled, we can ask the firm to contact customers who have bought the product after responding to the promotion and offer them the chance to withdraw at no cost.

Finally, we can also refer the cases to Enforcement; where disciplinary action could be taken against the firm or its senior management, or both. This action could result in a fine, public censure, restitution, injunctions or even a combination of these.

As part of our effort to engage with stakeholders, we have been meeting with the ABI Financial Promotion Group and will maintain a regular dialogue with them and other trade bodies. We are keen to increase our understanding of how the financial promotions regime impacts upon the industry and to explain to practitioner representatives how we interpret the Rules and what we expect from firms.

Recent Publications

Insurance Sector Briefing: The regulation of closed with-profits funds

At the end of September the Insurance Sector Team published a briefing paper on the regulation of closed with-profit funds detailing the current regulatory regime; forthcoming changes in regulatory requirements; future challenges for the industry; and finally challenging some of the commonly held myths about the operation or investments in closed with-profits funds. A copy of this publication can be found on the FSA website at www.fsa.gov.uk/pubs/other/isb_withprofits.pdf.

Morris – Review of the Actuarial profession

In March 2004, in response to Lord Penrose' report on Equitable Life, Ruth Kelly MP, the former Financial Secretary to the Treasury, announced an independent review into the actuarial profession. The review is being conducted by Sir Derek Morris, the former Chairman of the Competition Commission.

As the statutory regulator of the financial services sector we have a keen interest in the effectiveness of actuaries and the actuarial profession more generally. In our response to the consultation we focussed on our interest in our capacity as financial services regulator, although we also commented, where relevant, on issues of interest to us as an employer of actuaries and a user of the services of actuarial consultants. The review publication is expected in mid December 2004, but a copy of our response is available on the HM Treasury website at www.hm-treasury.gov.uk/independent_reviews/morris_review/review_morris_resp.cfm

Myners – Review of corporate governance in life mutuals

Also in response to Lord Penrose's report, the former Financial Secretary to the Treasury commissioned a review into the governance of mutual life insurance offices in the UK. The review was conducted by Paul Myners and will report by the end of 2004.

We welcomed the opportunity to provide our views on the questions posed in the consultation as we believe that strong and effective corporate governance in the firms we regulate is central to the continuation of efficient, clean and orderly financial markets. The review publication is expected soon, but a copy of our response is available on the HM Treasury website at www.hm-treasury.gov.uk/independent_reviews/myners_review/review_myners

PS04/16 – Policy Statement on prudential standards for life insurers

In PS04/16 we stated that we intended to 'make' the final Prudential sourcebook (PSB) text at our November board meeting, to come into force for 31 December 2004. We also said that while the final PSB text would be substantially similar to that in the policy statement, in the interim between publishing PS04/16 and making the PSB text we would conduct further work to ensure that the PSB text is an adequate legal expression of FSA policy. Limited aspects of the text have generated queries from several firms, and when we 'make' the text we intend to incorporate clarifying amendments. We wrote to the ABI in October clarifying our policy intention and set out in high level terms the nature of the textual amendments we proposed to make, which have now been ratified by the FSA board. A copy of the letter can be found on the FSA website at www.fsa.gov.uk/pubs/other/abi_letter_ps0416.pdf.

Forthcoming publications

Financial Risk Outlook

The FSA's Finance, Strategy and Risk (FSR) division is currently working on its main publication, the *Financial Risk Outlook* (FRO). The FRO is published annually, and the 2005 edition is due out in mid-January. The report highlights economic, financial, political and social developments that affect the FSA's ability to meet its statutory objectives. The document puts the regulatory work in context by highlighting the risks we are responding to. The FRO is published to increase awareness of these risks and understanding of our actions. The report will be available on the FSA's website at www.fsa.gov.uk/pubs. The next edition of this newsletter will include a report on some of the key life insurance themes discussed in the FRO.

International Regulatory Outlook

The first edition of the FSA's *International Regulatory Outlook* (IRO) will be published in January 2005 alongside FRO. The two documents will complement each other. The IRO will offer a more extensive analysis of regulatory change being driven by EU legislation and other international initiatives. The IRO will also allow us to explain the FSA's role within EU and international fora while providing stakeholders with key information about the international policy agenda and what it might mean for them.

Regulatory timetable – implementation

31 December 2004	Integrated Prudential sourcebook for insurers (PRU)
31 December 2004	New roles for actuaries in life insurers
31 December 2004	Provision of the With-Profits Actuary's report
1 January 2005	For financial years ending on or after 1 January 2005 change to the Euro value for regulatory reporting purposes
14 January 2005	Implementation of the IMD

Authorisation of new insurers

Following our article in the last edition about the approach we take to authorising insurance firms, we thought it would be helpful to provide details of those firms which have been authorised by the FSA this year. Such information is, of course, available on our website together with the firms' Part IV permissions. Future editions of the newsletter will detail newly authorised entities for the previous period.

The following new insurance companies have been authorised this year, some of which operate as branches in the UK –

Life insurance companies

- Financial New Life Company Limited (4 June)
- Just Retirement Limited (13 August)
- Friends Provident Reinsurance Services Limited (26 November)

General insurance companies

- Everest Reinsurance (Bermuda) Ltd (20 February)
- MBIA UK Insurance Limited (18 May)
- Arch Insurance Company (Europe) Ltd (28 May)
- Assured Guaranty (UK) Limited (26 July)
- Allied World Assurance Co (Reinsurance) Ltd (18 August)
- Prudential Health Ltd (17 September)
- Connie Lee Insurance Company (20 September)
- London & European Insurance Management Company Ltd (29 September)
- Aioi Motor & General Insurance Company of Europe Ltd (12 November)
- FGIC UK Ltd (26 November)

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