Chapter 1

Introduction

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1.1 Financial services regulation in the UK

Many financial services practitioners will now have practiced for more than six years under the framework of legislation and regulation established by the Financial Services and Markets Act 2000 ("FSMA 2000") since it became effective on 1 December 2001. The introduction of the FSMA 2000 and the establishment of the Financial Services Authority ("FSA") as the UK financial services industry's single statutory regulator represented a new modern era of regulation across the UK's insurance, investment and banking industries. The regulatory landscape in the UK continues to change and develop as a responsive and ambitious FSA strives to play a leading role in further European harmonisation and meet the challenges of regulating a diverse and often highly sophisticated and fast-moving UK financial services industry.

1.1.1 Pre-FSMA 2000

Before the introduction of the FSMA 2000, the UK's banking, investment and insurance industries were not regulated under a single statutory framework. In contrast, the financial services industry was regulated through a variety of statutes, principally enacted in the 1980s following a series of crises and financial scandals in the 1970s and early 1980s which exposed the need for increased regulation and investor protection. However, the response was piecemeal and failed to provide the level of investor protection seen today.

The Financial Services Act 1986 introduced a system of self-regulation within a statutory framework for the investment sector. That is, whilst it required the authorisation of those operating in the investment industry and established the Securities and Investments Board ("SIB"), which possessed statutory powers to oversee the industry, the SIB's principal function was to oversee the self-regulating organisations ("SROs") that regulated sectors of the investment industry through membership and antecedent rules. There were three such organisations, namely the Securities and Futures Authority ("SFA"), which regulated securities and futures firms; the Investment Management Regulatory Organisation ("IMRO"), which regulated fund managers; and the Personal Investment Authority ("PIA"), which regulated investment advisory firms and certain aspects of life assurance business.

The banking sector saw the enactment of the Banking Act 1987, which required authorisation and supervision for banks, but this did little to change the informal approach to regulation in the sector.

For the insurance sector, the Insurance Companies Act 1982 brought authorisation requirements to long-term and general insurance and reinsurance firms, but it placed the responsibility of oversight and enforcement on the Department of Trade and Industry ("DTI"). However, business conducted through the Lloyd's insurance market was principally regulated by Lloyd's.

The introduction of the FSMA 2000 brought an end to this fragmented approach to regulation of the industry, repealing (amongst other legislation) the Financial Services Act 1986, the Insurance Companies Act 1982 and parts of other legislation regulating specific sectors of the financial services industry, such as the Building Societies Act 1986 and the Friendly Societies Act 1992. The FSA assumed the role and functions of the SROs, which ceased to exist post-FSMA 2000. The FSA also assumed the regulatory responsibilities of the DTI, the Bank of England, the Friendly Societies Commission and the Building Societies Commission. Thus, for the first time in its history the UK financial services industry had a single statutory regulator responsible for regulating the industry under a common statutory framework. The FSA currently regulates some 29,000 firms.

1.1.2 The framework of legislation and regulation under FSMA 2000

1.1.2.1 FSMA 2000 and subordinate legislation

The FSMA 2000 is a large and significant piece of legislation. However, it does not operate in isolation. In order for the FSMA 2000 to achieve its objectives it has been necessary for a plethora of secondary legislation to be enacted.

Central to the regulation of financial services under the FSMA 2000 is the requirement for all firms carrying on regulated activities by way of business to be authorised by the FSA to do so, unless otherwise exempt. This is known by practitioners as the "general prohibition" and is discussed in detail in Chapter 2 below. The regulated activities that give rise to the need for authorisation are specified in one of the key pieces of secondary legislation made under the FSMA 2000 – the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)(the "RAO"). As the FSA's remit has widened, since December 2001 the RAO has grown to include, for example, the regulation of the provision of mortgage advice and insurance broking and intermediation services.

In addition to the general prohibition, a cornerstone of the FSMA 2000 is the so-called "financial promotions regime" which regulates the promotion of financial services in the UK. Under Section 21 FSMA 2000, a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity unless that person is authorised under the FSMA 2000, the content of the communication is approved by such an authorised person or an exemption applies. The activities and types of investment that fall within the financial promotions regime, together with the applicable exemptions, are set out in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (SI 2005/1529)(the "FPO"). The FSA's high-level principles and conduct of business rules described below supplement the FPO, with the overall objective being that all financial promotions and communications with clients should be clear, fair and not misleading.

The FSMA 2000 also introduced a new system, commonly referred to as the "approved persons regime", under which those carrying on

certain "controlled functions" on behalf of a firm (broadly persons with managerial or customer responsibilities) need to be individually approved by the FSA as being fit and proper and having the appropriate qualifications to assume those responsibilities. The approved persons regime is considered in further detail in Chapter 3 below.

1.1.2.2 The FSA's statutory objectives

The FSMA 2000 sets out the regulatory objectives of the FSA and the supervisory principles to which the FSA must have regard when discharging its functions.

The FSA has four statutory objectives:

(a) to maintain confidence in the financial system;
(b) to promote public understanding of the financial system;
(c) to secure the appropriate degree of protection for consumers;
(d) to reduce the extent to which it is possible for a business to be used for a purpose connected with financial crime.

In pursuing its objectives, the FSA must have regard to the following "principles of good regulation":

(a) efficiency and economy in the use of the FSA's resources;
(b) the responsibility of a firm's management for its activities and regulatory compliance, so that the FSA should avoid unnecessary intrusion into a firm's business;
(c) restrictions must be proportionate to their resulting benefits;
(d) facilitating innovation in connection with regulated activities;
(e) the international character of financial services and markets and maintaining the competitive position of the UK;
(f) minimising the adverse effects on competition that may arise from the FSA's activities and the desirability of facilitating competition between regulated firms.

1.1.2.3 The FSA Handbook

Since becoming the single regulator of the financial services industry in 2001, in accordance with its rule-making powers under the FSMA 2000, the FSA has issued and maintained a handbook of rules and guidance for regulated firms (the "FSA Handbook"). The FSA Handbook has changed and grown, in line with the FSA's developing

remit and approach to regulation. The FSA Handbook as a whole is a large tome indeed. However, it is relatively user friendly for practitioners as a result of its division into "blocks" and then "manuals" or "sourcebooks".

The two principal categories of FSA Handbook provisions are rules and guidance. Rules create binding obligations and their contravention may result in enforcement action, while guidance is intended to explain the effect of the rules. Guidance provisions are not binding and their breach has no direct disciplinary implications, but the FSA will generally regard firms that follow guidance as having complied with the relevant aspects of the rule to which the guidance relates. As is explained in more detail later in this Chapter there has recently been a shift by the FSA towards principles-based regulation. This has resulted in a simplification of some parts of the FSA Handbook and a greater focus by the FSA on compliance with principles, which are in turn interpreted by reference to guidance in the FSA Handbook and elsewhere. Non-compliance with guidance may therefore give rise, in some cases, to disciplinary action in respect of breach of one or more high-level principles.

Figure 1.1 shows the structure of the FSA Handbook, highlighting the sections most relevant to insurance firms. What follows is a high-level overview of the contents of the blocks and manuals.

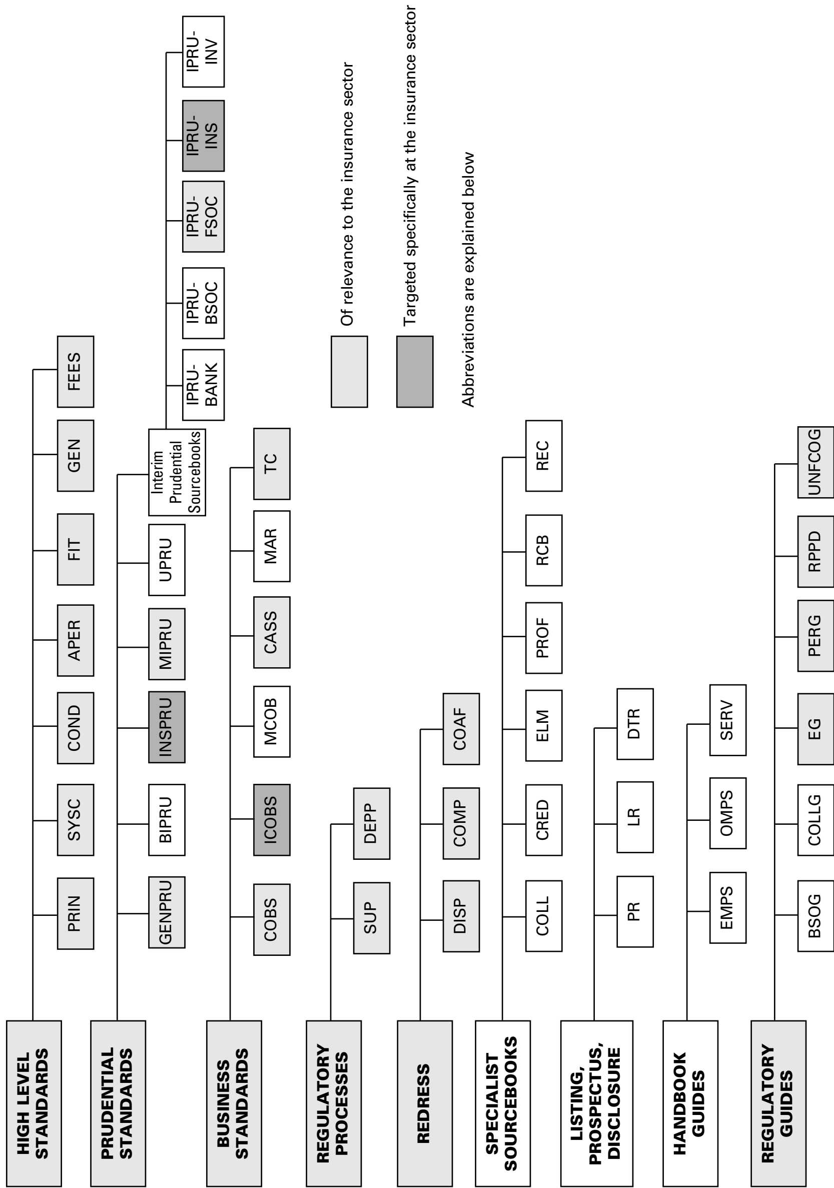
High-Level Standards

The High Level Standards block is a key part of the FSA Handbook that sets out standards that apply to all firms and their approved persons. It is comprised of seven manuals, which are central to the regulation of all firms.

(a) Principles for Businesses ("PRIN") – this manual sets out the fundamental obligations of all FSA regulated firms, including eleven principles for business that all firms must adhere to in the conduct of their business. These principles are of increasing significance as the FSA's approach to regulation becomes more principles-based. This is discussed further in Section 1.3 of this Chapter.

(b) Senior Management Arrangements, Systems and Controls ("SYSC") – this manual sets out the responsibilities of directors

Figure 1.1 Structure of the FSA Handbook



and senior management and certain high-level organisational systems and controls requirements.

(c) Threshold Conditions ("COND") – this manual contains the minimum standards for a firm becoming and remaining authorised by the FSA.

(d) Statements of Principle and Code of Practice for Approved Persons ("APER") – this manual sets out the fundamental obligations of approved persons.

(e) The Fit and Proper test for Approved Persons ("FIT") – this manual contains the minimum standards for becoming and remaining an approved person.

(f) General Provisions ("GEN") – this manual contains (amongst other things) provisions relating to the interpretation of the FSA Handbook, fees, status disclosure and insurance against fines.

(g) Fees Manual ("FEES") – this manual contains the fees provisions for funding the FSA, the Financial Ombudsman Service ("FOS") and the Financial Services Compensation Scheme ("FSCS").

Prudential Standards

The prudential standards block has undergone much change since its inception. Initially, the FSA issued prudential standards for banks, building societies, insurers, friendly societies and investment firms in separate sourcebooks. However, with effect from January 2007, the FSA has issued a single General Prudential Sourcebook ("GENPRU") for all banks, building societies, insurers and investment firms. It primarily comprises rules and guidance on capital resource requirements and the management of prudential risks. GENPRU is then supplemented by more specific rules and guidance for each of the following sectors:

(a) Prudential sourcebook for Banks, Building Societies and Investment Firms ("BIPRU").

(b) Prudential sourcebook for Insurers ("INSPRU").

(c) Prudential sourcebook for Mortgage and Home Finance Firms and Insurance Intermediaries ("MIPRU").

(d) Prudential sourcebook for UCITS Firms ("UPRU").

During the development of the FSA Handbook, "interim" sector-specific prudential sourcebooks were issued pending the consultation on and adoption of fuller sector-specific prudential sourcebooks. Certain of these interim prudential sourcebooks remain in place,

albeit that in many cases the majority of the content has been deleted and is now dealt with in GENPRU or BIPRU, INSPRU, MIPRU or UPRU, as applicable. Until such time as the remaining provisions of the interim prudential sourcebooks are replaced in full, practitioners will need to continue to have regard to them. The interim prudential sourcebooks are:

(a) Interim Prudential sourcebook for Banks ("IPRU-BANK").
(b) Interim Prudential sourcebook for Building Societies ("IPRU-BSOC").
(c) Interim Prudential sourcebook for Friendly Societies ("IPRU-FSOC").
(d) Interim Prudential sourcebook for Insurers ("IPRU-INS").
(e) Interim Prudential sourcebook for Investment Businesses ("IPRU-INV").

Business Standards

This block comprises detailed requirements relating to the conduct of a firm's day-to-day business. In line with the FSA's drive to implement a less prescriptive, more risk- and principles-based approach to regulation, the conduct of business rules for firms were significantly restructured and simplified in November 2007. The block contains the following manuals:

(a) New Conduct of Business sourcebook ("COBS") – this manual sets out conduct of business requirements applying to all firms.
(b) Insurance: New Conduct of Business sourcebook ("ICOBS") – this manual sets out requirements applying to firms with non-investment insurance business customers.
(c) Mortgages and Home Finance: Conduct of Business sourcebook ("MCOB") – this manual sets out requirements applying to firms with mortgage business customers.
(d) Client Assets ("CASS") – this manual sets out the requirements relating to holding client assets and client money.
(e) Market Conduct ("MAR") – this manual contains the Code of Market Conduct, price stabilising rules, endorsement of the Takeover Code, Alternative Trading Systems and guidance on acceptable market conduct and what constitutes market abuse.
(f) Training and Competence ("TC") – this manual sets out the requirements concerning staff competence.

Regulatory Processes
Previously, in addition to the two manuals referred to below, the regulatory processes block included the Authorisation Manual ("AUTH") which set out the procedures and guidance relating to obtaining authorisation from the FSA to conduct regulated activities. However, with effect from January 2007, in order to streamline the regulatory processes materials, AUTH ceased to have effect and the relevant rules and guidance were moved to other sections of the FSA Handbook (for example PERG and SUP) or to the FSA's special publication on applying for authorisation. The block now contains the following manuals:

(a) Supervision ("SUP") – this manual contains supervisory provisions including those relating to auditors, waivers, individual guidance, notifications and reporting.
(b) Decision Procedure and Penalties Manual ("DEPP") – this manual describes the FSA's procedures for making statutory notice decisions, the FSA's policy on the imposition and amount of penalties and certain interview procedures.

Redress
This block is concerned with the processes for handling complaints and compensation and is comprised of three sourcebooks:

(a) Dispute Resolution: Complaints ("DISP") – this manual contains detailed requirements for the handling of complaints and the FOS arrangements.
(b) Compensation ("COMP") – this manual contains the FSA's rules governing eligibility under, and levies for, the FSCS.
(c) Complaints against the FSA ("COAF") – this manual contains details of the scheme for the handling of complaints against the FSA.

Specialist Sourcebooks
In addition to the prudential and business standards sourcebooks described above, there are six specialist sourcebooks that contain additional requirements applying to individual business sectors, namely, collective investment schemes, credit unions, firms issuing electronic money, professional firms, regulated covered bonds, and recognised investment exchanges and clearing houses.

Listing, Prospectus and Disclosure
In May 2000, the FSA assumed primary responsibility from the London Stock Exchange ("LSE") for vetting public companies for listing on the LSE. Since that time, this responsibility has rested with a division of the FSA known as the UK Listing Authority ("UKLA"). With effect from July 2005, the UKLA Listing Rules ("LR"), together with the Prospectus Rules ("PR"), became part of the FSA Handbook. The current version of the Disclosure Rules and Transparency Rules ("DTR") came into effect in January 2007.

Handbook Guides
This block contains guides for specific market participants, sectors and entities to assist them in understanding the FSA Handbook as it applies to them. The guides are for energy market participants ("EMPS"), oil market participants ("OMPS") and service companies ("SERV") and are unlikely to be of relevance to the insurance sector.

Regulatory Guides
This block contains guides to various regulatory topics as follows:

(a) The Building Societies Regulatory Guide ("BSOG").
(b) The Collective Investment Scheme Information Guide ("COLLG").
(c) The Enforcement Guide ("EG").
(d) The Perimeter Guidance Manual ("PERG").
(e) The Responsibilities of Providers and Distributors for the Fair Treatment of Customers ("RPPD").
(f) The Unfair Contract Terms Regulatory Guide ("UNFCOG").

See 1.2.2.3 below for further information on these.

1.1.3 European harmonisation

1.1.3.1 The Insurance Directives
The European Community ("EC") Insurance Directives influence and seek to harmonise the regulation of insurance across the European Union ("EU") and the wider European Economic Area (the "EEA", comprising the 27 Member States of the EU plus Iceland, Liechtenstein and Norway). Understanding the EC legislation is

important both as a background to the UK regulatory regime and as an indication of likely future developments.

Before the adoption of the Insurance Directives described below, the EEA Member States developed their own widely varied approaches to the regulation of the insurance industry and, to a degree, these disparate attitudes persist to this day. Fortunately, EC insurance legislation has been successful in achieving a compromise so that, at least to a certain extent, a single insurance market now exists within the EEA.

The EC Treaty provides in very general terms for the creation of a common market in insurance, by requiring that national businesses be free to establish themselves (Article 43), and provide services (Article 49), in other Member States. Article 51(2) states that "the liberalisation of banking and insurance services connected with movement of capital shall be effected in step with the progressive liberalisation of movement of capital."

From this broad outline, three "generations" of directives have fleshed out the details of the common insurance market as follows:

(a) the first generation, being principally the Reinsurance Directive of 1964, the First Non-Life Directive of 1973 and the First Life Directive of 1979 (also called the Establishment Directives);
(b) the second generation, being principally the Second Non-Life Directive of 1988 and the Second Life Directive of 1990 (also called the Services Directives); and
(c) the third generation, being principally the Third Non-Life Directive of 1992, the Third Life Directive of 1992 (also called the Framework Directives) and the Accounts Directive of 1990.

The first generation directives allowed insurers incorporated in any Member State to establish branches or agencies in other Member States without having to provide a deposit or security. However, the host Member States were nonetheless required to authorise the establishment of such branches or agencies. Of enormous importance to the industry is that the directives also provided that an insurer established in multiple Member States need only demonstrate its solvency to a single regulator in the country of its head office on the basis of one test applied to its worldwide business.

The second generation directives enabled insurers incorporated in one Member State to cover risks situated in another Member State without having to establish a branch there.

The third generation directives provided that the carrying on of insurance business within the EU, whether by way of establishment or the provision of cross-border services, should only be subject to a prior authorisation from the regulatory authority of the Member State in which the insurer has its head office (the "home Member State"). They also introduced some additional harmonisation in areas such as the establishment of technical provisions, matching and localisation of assets, calculation of margins of solvency and the regulation of control and management.

In 2002 the Life Directives were consolidated in a single Consolidated Life Directive.

In 2001, a directive on "the reorganisation and winding-up of insurance undertakings" was adopted to harmonise the laws and procedures for insurers in the event of insolvency. It provided that supervision of the winding-up of an insurer was to be undertaken in the insurer's home Member State and contained provisions as to the priority of insurance claims in a winding up. The directive was implemented in the UK in April 2003.

The Insurance Groups Directive of 1998 facilitated the assessment by insurance regulatory authorities of the solvency of corporate groups whose main business is insurance. It aimed to avoid "double gearing", where the same assets are used to support the solvency requirements of multiple insurers in the same group. Another directive, adopted in 2003 and implemented in the UK in August 2004, contains provisions to ensure that financial conglomerates (corporate groups with operations in the insurance, banking and securities sectors) have adequate capital. It introduces additional methods for monitoring the solvency position and intra-group transactions of such conglomerates. The impact of these two directives is discussed in Chapter 4.

In addition, a number of more specific directives have been adopted, dealing with topics such as intermediaries, co-insurance, tourist

assistance insurance, credit and suretyship insurance, legal expenses insurance and motor insurance.

1.1.3.2 Recent EU developments

Intermediation
The Insurance Mediation Directive of 2003 harmonises the hitherto varied approach of the Member States to insurance intermediaries. It was implemented in the UK in January 2005. The Directive has had at least three important effects on insurance intermediaries:

(a) as with insurers, they are now able to operate throughout the EU using freedom of services and establishment;
(b) they are subject to a common set of minimum professional and financial requirements throughout the EU; and
(c) they are required to provide extensive pre-contractual disclosure for most personal lines and certain commercial insurance business.

The impact of the Insurance Mediation Directive in the UK is described in further detail in Chapter 7.

Reinsurance
In December 2007 the Reinsurance Directive came into force, extending the EU insurance regime to insurers that only write reinsurance risks. Under the Directive, a reinsurer authorised in one Member State has a right of establishment in all other Member States. Financial supervision can only be carried out by the reinsurer's home Member State, and host Member States are prevented from imposing measures amounting to indirect supervision of EU authorised reinsurers.

In the UK, reinsurance was already regulated similarly to direct insurance and, furthermore, many of the technical rules in the Reinsurance Directive (such as those relating to solvency margins and minimum capital requirements) had already been implemented through the FSA Handbook. As a result, implementation of the Directive has required only limited changes to UK law. These changes have largely been effected by amendments to the FSA Handbook and some changes to the FSMA 2000 and related secondary legislation.

The FSA Handbook amendments, most of which took effect in December 2006, brought about the following principal changes and these include some relaxation of the previous regulations for pure reinsurers:

(a) replacing the restrictive rules on admissible assets with certain high-level "prudent person" investment principles;
(b) allowing pure reinsurance firms and mixed reinsurance firms that provide life reinsurance protection and permanent health insurance to use the non-life solvency tests to calculate their minimum capital requirements;
(c) reducing the margin of prudence applicable to the calculation of technical provisions of pure reinsurers;
(d) widening the permitted activities of reinsurers to include reinsurance-related operations such as providing actuarial advice and claims management services;
(e) facilitating the use of insurance special purpose vehicles ("ISPVs"); and
(f) introducing a single, high-level principle requiring effective transfer of risk before a firm can take credit for reinsurance.

The FSMA 2000 changes were effected using a number of statutory instruments which came into force in December 2007. They also extend the provisions on business transfers to cover the transfer of reinsurance business and enable EEA firms (including UK firms) to utilise the passporting rights contained in the Reinsurance Directive.

Solvency II
The EU regulation of insurers' solvency is currently being overhauled. The proposed new regime, "Solvency II", aims to bring capital adequacy requirements into line with modern standards of risk management and harmonise regulatory requirements across all Member States, thereby enhancing competition and improving consumer protection. Insurers will need to assess regularly and monitor continuously their own capital requirements and will be subject to enhanced public disclosure requirements relating to their financial and solvency position.

A framework directive has been proposed to put Solvency II into effect and the new system is currently expected to be implemented by

the end of 2012. The capital adequacy aspects of Solvency II are considered in further detail later in this Chapter and in Chapter 4 (4.3.7), but it is important to recognise that the framework directive also restates the relevant continuing provisions of 13 other insurance directives and will effectively consolidate insurance regulation into a single directive (the Financial Conglomerates Directive being the only relevant existing directive which is outside its scope). It is also the first directive in the insurance sector to be proposed under the Lamfalussy procedure. This means that it adopts a high-level, principles-based approach and leaves flexibility for the Commission to adopt implementing legislation to expand the provisions in greater detail and for regulators to adopt more detailed rules and practices.

1.2 Overview of the FSA regulation of insurance

1.2.1 FSMA 2000

Insurance and insurance mediation activities fall within the general prohibition and are therefore within the remit of regulation by the FSMA 2000 and the FSA. Chapters 2 and 7 describe the regulated activities associated with insurance business and insurance mediation services in further detail.

1.2.2 FSA Handbook

The rules and guidance in the High Level Standards, Regulatory Processes and Redress blocks apply to all authorised firms. The Prudential Standards and Business Standards blocks also apply to all authorised firms, except that these blocks have been tailored, to some extent, for the insurance industry.

1.2.2.1 Prudential Standards
GENPRU applies to insurance, banking and investment firms and includes rules and guidance on:

(a) adequacy of financial resources and management of prudential risks;
(b) recognition and valuation of assets, liabilities, exposures, equity and income statement items;

(c) calculation of capital resources requirements (and admissible assets in insurance); and
(d) financial conglomerates and their capital adequacy requirements.

INSPRU supplements GENPRU for insurance firms and includes additional rules and guidance on:

(a) capital resources requirements and technical provisions for insurance business (including rules on mathematical reserves, the with-profits insurance capital component, equalisation provisions, internal-contagion risk and ISPVs);
(b) credit risk, market risk, liquidity risk, operational risk and group risk in insurance groups;
(c) individual capital assessments; and
(d) the application of INSPRU and GENPRU to Lloyd's.

In addition to GENPRU and INSPRU, insurance firms must continue to have regard to IPRU-INS, which currently contains rules and guidance on:

(a) the identification and application of assets and liabilities by long-term insurers, more specifically payment of dividends, allocation of established surplus to policyholders and arrangements to avoid unfairness between separate insurance funds;
(b) the appointment of a chief executive by overseas insurers with a UK branch; and
(c) financial reporting.

MIPRU contains the prudential rules and guidance and capital resources requirements for insurance intermediaries.

1.2.2.2 Business standards

COBS applies to insurers and intermediaries in respect of long-term insurance business and includes rules and guidance on, amongst other things, communicating with clients (including financial promotions), distance marketing, provision of information about the firm and the product, suitability, cancellation rights and reporting requirements. It also contains specific chapters on insurance mediation in respect of life policies, claims-handling for long-term care insurance, with-profits business and permitted links for linked long-term business. COBS is considered further in Chapter 10.

ICOBS applies to insurers and intermediaries in respect of non-investment insurance business and includes rules and guidance on topics that are broadly similar to those contained in COBS. ICOBS is considered further in Chapter 7.

CASS applies to firms that hold client money. It is of particular relevance to intermediaries and is considered further in Chapter 7.

The rules and guidance on the training and competence of employees that are contained in TC apply in respect of those employees of insurers and intermediaries who carry out certain advisory and administrative functions.

1.2.2.3 Handbook guides and regulatory guides
Of particular relevance to the insurance sector are EG (guidance on the FSA's approach to enforcement against authorised firms, its powers and the sanctions available), PERG (guidance on, amongst other things, the definition of insurance mediation activities and the identification of contracts of insurance), RPPD (guidance on fair treatment of customers) and UNFCOG (guidance on the regulations governing unfair contract terms).

1.2.3 Thematic reviews

The FSA takes a "risk-based" approach to supervision and this is considered further in the next section of this Chapter. As part of this approach the FSA monitors markets and authorised firms to identify areas of risk and conducts thematic reviews to further analyse those risks that it considers significant. Firms are often asked to change their practices or take specific actions as a result of these thematic reviews.

The FSA's key focus in its thematic reviews is the fair treatment of customers, a concept which features repeatedly in FSA publications and which is discussed in further detail later in this Chapter. In the insurance sector, the FSA has recently undertaken, or is in the process of conducting, thematic reviews in the following areas, all of which relate to the fair treatment of customers:

(a) Payment Protection Insurance ("PPI") – the FSA has identified poor PPI sales practices resulting in a failure to treat customers

fairly when selling PPI. The focus is on improving sales practices as well as improving consumer understanding of PPI.

(b) Quality of post-sale communications in the life sector – the FSA found instances of firms failing to treat customers fairly, for example by not mentioning valuable product features such as guaranteed annuity rates.

(c) The availability of ongoing advice to with-profits policyholders – the FSA found that many advisers were not providing sufficient ongoing advice for with-profits policyholders about their policies.

(d) With-profits governance arrangements – the FSA found that industry practice in respect of management of with-profits funds, specifically governance arrangements and run-off plans for closed funds, did not follow the FSA's rules and guidance in this area.

(e) General insurance call centres – the FSA found that the standard of sales was poor when policies were sold through cold calling.

Other reviews are underway which will have an impact on the insurance sector, for example reviews on measures taken by firms to implement the principle of Treating Customers Fairly ("TCF"), on the quality of advice given to consumers in respect of investment products and the FSA's wider retail distribution review.

The FSA's thematic reviews do not always result in rule changes. Instead, the FSA often issues guidance as a result of its thematic work. Although the guidance is not legally binding, the FSA is likely to regard those firms that follow the guidance as having complied with the regulatory principles in question. This is particularly important in the area of TCF, where an emphasis on achieving a fair outcome for consumers, rather than reliance on prescriptive rules, is considered a more effective tool for promoting understanding of TCF.

1.2.4 The structure and role of the FSA

The FSA is the sole statutory regulator of insurers and insurance intermediaries in the UK. It is responsible for authorising, regulating and supervising insurers and intermediaries and monitoring their compliance with the provisions of the FSMA 2000 and the FSA Handbook. Figure 1.2 shows an outline of the organisational structure of the FSA.

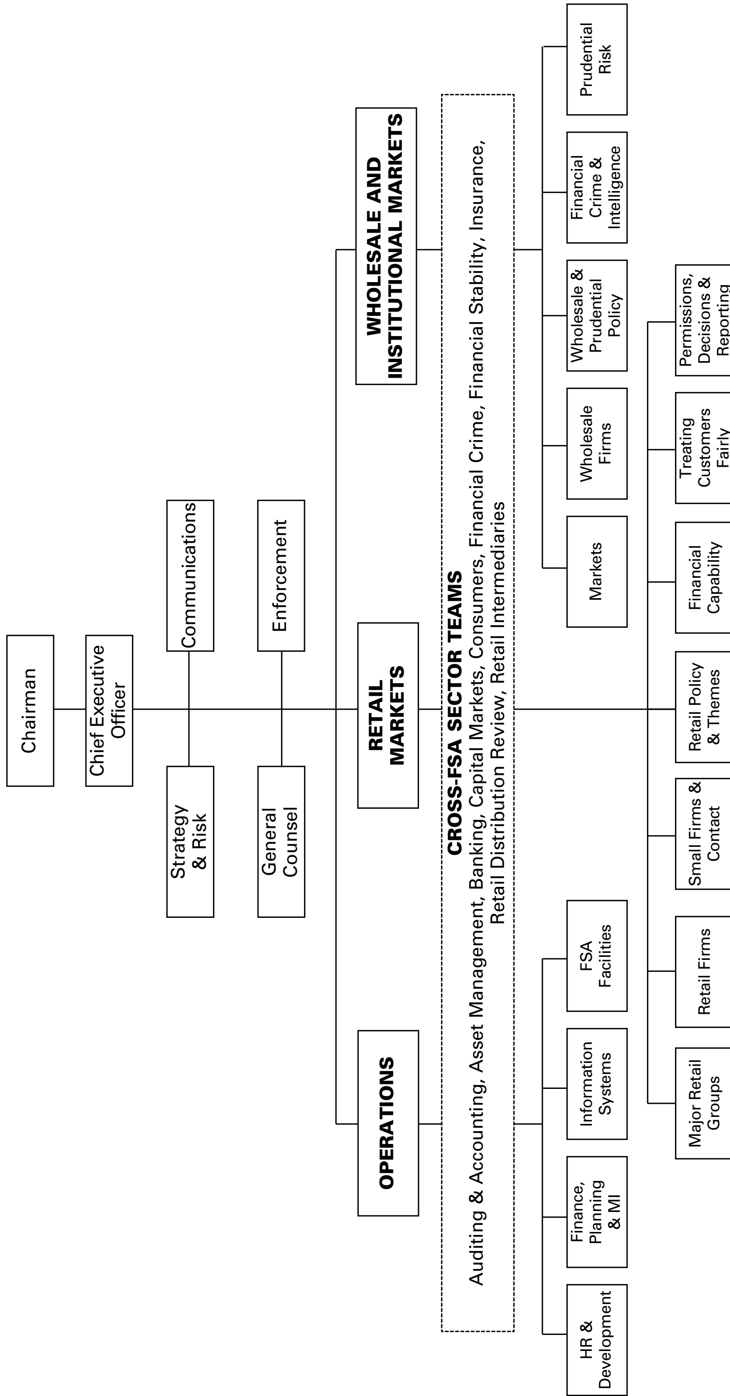


Figure 1.2 *Organisational structure of the FSA*

1.2.4.1 Supervisory teams

The FSA supervisory function is divided into three main business units: a Retail Markets unit, a Wholesale and Institutional Markets unit and an Operations unit. The Retail Markets and Wholesale and Institutional Markets units comprise the supervisory function of the FSA. The Retail Markets unit supervises most insurers and intermediaries on the basis that their business relates mainly to the retail markets. The Wholesale and Institutional Markets unit supervises commercial insurers, reinsurers, the London insurance and reinsurance market (including Lloyd's), general insurers in run-off and intermediaries with a largely commercial customer base (in the London and regional markets). The Wholesale and Prudential Policy Division of the Wholesale and Institutional Markets unit maintains and develops prudential policies for insurers.

The Operations unit acts as the main point of initial contact for firms and consumers. It deals with the receipt and processing of data, decisions and policy development on certain regulatory matters, information and knowledge management systems and services to the FSA itself.

1.2.4.2 Industry focus

The specialist insurance sector team of the FSA is charged with identifying potential market risks and coordinating strategies for mitigating them. It works alongside the supervisory teams and its contacts in the insurance industry to gather intelligence in order to fulfil this function. It also acts as the FSA's insurance spokesperson in respect of external stakeholders such as professional bodies, trade associations, rating agencies, overseas regulators, the political community and the media. An important function of the insurance sector team is to ensure that the FSA maintains a coherent approach to the FSA's requirements and policies as they affect the insurance industry.

1.2.4.3 Think tank

The FSA has shown willingness to engage with industry participants by constituting the Insurance Standing Group ("ISG"). The ISG is composed of FSA insurance policy advisers and industry participants drawn from insurers (life and non-life), reinsurers, friendly societies, Lloyd's and trade associations. It serves as a pre-consultation forum that informs and assists the FSA in the formulation of FSA policy prior to consultation, although it is not a substitute for consultation.

The ISG's remit currently includes policy issues arising from Solvency II.

1.2.4.4 Enforcement
The enforcement division of the FSA is divided into retail, wholesale and legal units. It carries out investigations into possible regulatory infringements by firms. If a matter appears to merit disciplinary action, the enforcement division refers it to a decision-making body in the FSA, usually the Regulatory Decisions Committee ("RDC"), whose members are independent from the investigating enforcement staff. The RDC then decides what disciplinary action, if any, the FSA should take.

If the firm is dissatisfied with the RDC's decision it may refer the matter to the Financial Services and Markets Tribunal (the "Tribunal"), an independent body run by the Department of Constitutional Affairs, for determination.

The enforcement process is described in further detail at 1.4.2 below.

1.2.5 The Financial Ombudsman Service

The FOS is an informal dispute resolution service for financial services consumers, including individuals and small businesses. It provides a rapid means by which consumers can obtain impartial adjudication on disputes with financial services firms where they consider that the response by the firm to their complaint has been inadequate. The FOS was established to satisfy the requirement of the FSMA 2000 for a scheme "under which certain disputes may be resolved quickly and with minimum formality by an independent person" (Section 225(1)) and it is operated by a separate corporate entity, the Financial Ombudsman Service Limited ("FOS"). The service is free for consumers. It is funded by a combination of a general levy on authorised firms and a fee per case payable by the firm involved.

The FOS only has jurisdiction over complaints relating to activities that are carried out from an establishment in the UK by FSA-authorised firms. Firms that carry on their business from an establishment elsewhere in the EEA can submit voluntarily to the FOS's jurisdiction in certain situations but otherwise are not subject to that jurisdiction.

The FOS uses an inquisitorial investigatory process, avoiding the need for consumers to be legally represented. It decides individual cases on the basis of what it considers to be fair and reasonable in the circumstances, taking into account relevant law, regulations, regulators' rules and guidance, industry standards, codes of practice and, where appropriate, good industry practice at the relevant time. Such a broad remit allows the FOS the flexibility to achieve what it considers to be a fair result, but means that its decisions can be somewhat unpredictable since it is not bound by legal precedent or the procedural rules of the courts.

The FOS can award compensation to the consumer of up to £100,000.

If the consumer accepts the FOS's decision, it is binding on both the consumer and the relevant firm. There is no right of appeal against the decision and the firm can only challenge it by way of judicial review, for example on grounds that the decision is illegal, irrational or improper. If the consumer rejects the decision it is not binding and the consumer remains free to pursue the case in the courts. FOS decisions are widely influential because consumer bodies and the media expect firms to apply the same principles in other similar cases and firms expect FOS to act consistently with its previous decisions.

1.2.6 The Financial Services Compensation Scheme ("FSCS")

The FSCS provides compensation to eligible financial services consumers (mainly individuals and small businesses) with claims against firms that have ceased trading and have insufficient assets to meet the claim. The scheme covers claims relating to regulated activities carried out by FSA-authorised firms, including claims under insurance policies and in respect of insurance-broking services. Claims relating to reinsurance contracts, Lloyd's policies and marine and aviation lines are not covered.

Like the FOS, the FSCS was established by the FSA pursuant to the FSMA 2000, but it operates as an independent body. Compensation for claims arising out of each type of regulated activity is funded by levies charged to firms authorised to undertake that particular activity. The scheme is free for consumers.

A consumer with a claim against an authorised firm must first approach the firm itself for compensation and can only claim under the FSCS if the firm is unable to pay. If the firm is able but unwilling to pay, the FOS and/or the courts are the appropriate channels.

The maximum compensation available under the FSCS varies according to the regulated activity giving rise to the claim. Compensation for insurance activities is not subject to any maximum except as specified below. For claims relating to compulsory general insurance (e.g. third-party motor insurance), including the intermediation of such insurance, the entirety of the claim is paid. For non-compulsory general insurance (e.g. home insurance) and its intermediation, the entirety of the first £2,000 of the claim and 90 per cent of the remainder is paid. For long-term insurance contracts, the entirety of the first £2,000 and at least 90 per cent of the remainder is paid. The level of compensation for intermediation of long-term pure protection contracts (other than long-term care contracts) is the entirety of the first £2,000 and 90 per cent of the remainder of the claim, and for intermediation of all other long-term contracts it is 100 per cent of the first £30,000 and 90 per cent of the next £20,000 of the claim (with an overall maximum of £42,000). Compensation is only available for financial loss. In January 2005 the FSCS was extended to cover claims relating to general insurance intermediaries; compensation is not available for claims against such intermediaries in relation to policies arranged before that date.

1.3 FSA approach to the regulation of insurance business and key regulatory issues

1.3.1 A regulatory philosophy focusing on risk

In pursuing its statutory objectives, the FSA has three principal aims – to promote efficient, fair and orderly markets; to help retail consumers achieve a fair deal; and to improve its own business capability and effectiveness. To achieve these aims the FSA has developed a risk-based approach to regulation, focusing its limited resources on areas that pose material risk to its objectives rather than striving to achieve a zero-failure regime. Indeed, a complete elimination of risk is not palatable. The financial markets operate on the basis that

investment decisions involve an element of risk – the FSA recognises this and is reluctant to stifle innovation through disproportionate and overly burdensome regulation.

The FSA therefore concentrates its resources on identifying and mitigating those risks that pose the greatest threat to markets and consumers. The identification of risks in the insurance sector is achieved primarily through the monitoring of markets by the insurance sector team and supervision of individual firms.

1.3.1.1 Monitoring insurance markets

As discussed earlier in this Chapter, the insurance sector team regularly conducts thematic reviews in areas where market events and industry intelligence point to potential market or consumer detriment. Risks identified by thematic reviews are usually mitigated through industry guidance and, if individual firms have been examined as part of the review, through firm-specific programmes designed to rectify areas of weakness.

1.3.1.2 Supervision of insurers and brokers

An Advanced Risk Response Operating Framework ("ARROW") is used as a means to evaluate the level of risk that each firm poses to the FSA's statutory objectives. In addition to the supervisor allocated to each authorised firm, more complex groups that contain multiple authorised firms are allocated a lead supervisor to assess group-wide risk and coordinate supervision across the group. Where the authorised firm is part of a multinational group, the FSA also works closely with overseas regulators to ensure that risk is assessed at a group level.

As part of ARROW, the FSA conducts baseline monitoring through a review of the firm's regulatory returns and may make specific information requests, followed by onsite visits (commonly referred to as ARROW visits). Once the risks have been assessed against the FSA's statutory objectives, a risk mitigation plan is put in place and the FSA will monitor the firm's implementation of the plan.

The FSA's relationship with individual firms is risk-based and consequently it affords a lighter regulatory touch to those firms that have demonstrated prudent management of risk. Consistent or material

regulatory breaches by a firm will lead to closer and more intrusive ongoing scrutiny. The failure by a firm to implement risk mitigation measures can also lead to enforcement action by the FSA against the firm or its approved persons.

1.3.2 Principles-based regulation

1.3.2.1 A new concept?

Although some may perceive this to be a recent shift in the FSA's approach to regulation, the FSA's outlook has been principles-based from the beginning, as evidenced by the high-level principles set out in PRIN with which all authorised firms must comply. The high-level principles are:

(a) Principle 1: Integrity. A firm must conduct its business with integrity.
(b) Principle 2: Skill, care and diligence. A firm must conduct its business with due skill, care and diligence.
(c) Principle 3: Management and control. A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
(d) Principle 4: Financial prudence. A firm must maintain adequate financial resources.
(e) Principle 5: Market conduct. A firm must observe proper standards of market conduct.
(f) Principle 6: Customers' interests. A firm must pay due regard to the interests of its customers and treat them fairly.
(g) Principle 7: Communications with clients. A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
(h) Principle 8: Conflicts of interest. A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
(i) Principle 9: Customers: relationships of trust. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
(j) Principle 10: Clients' assets. A firm must arrange adequate protection for clients' assets when it is responsible for them.

(k) Principle 11: Relations with regulators. 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.

In addition to its powers in respect of breaches of the detailed rules set out elsewhere in the FSA Handbook (for example ICOBS or INSPRU), the FSA is able to take enforcement action for a breach of these high-level principles where no other specific rule breach can be identified. Principles have always been at the heart of FSA regulation. The recent shift of emphasis should not be considered deregulatory in nature, but is likely to result in a different compliance structure for firms as senior management now need to be fully engaged to ensure that the firm is making the right judgments consistent with the FSA's desired outcomes.

1.3.2.2 What does it mean?

The FSA is now placing greater emphasis on encouraging corporate and individual behaviour which is consistent with its objectives to achieve better outcomes for consumers and markets rather than simply requiring compliance with prescriptive rules and guidance.

Various factors have driven the FSA to adopt this principles- and outcomes-based approach:

(a) Detailed rules, such as the old conduct of business rules, have not always resulted in a fair deal for consumers – witness the major mis-selling practices exposed in the personal pensions, mortgage endowment, split-capital investment trusts and precipice bond industries.

(b) Detailed rules often draw attention away from the desired outcomes and focus resources on strict compliance with the letter of the rules rather than on risk analysis and adherence to the underlying principles. This results in a poor deal for consumers and a heavy compliance burden on firms.

(c) Prescriptive regulation can stifle innovation and competition (which ultimately leads to higher costs and less choice for the consumer) and does not necessarily keep pace with industry and product developments or respond well in times of market turbulence.

(d) A principles-based approach to regulation ensures that senior management are more attuned to, and involved in, ensuring compliance with the regulatory requirements applicable to their business and should result in greater alignment of the regulatory and risk-management objectives.

In focusing on outcomes, the FSA is in the process of simplifying the FSA Handbook with the intention that it comprises the high-level principles together with those rules that the FSA considers necessary to achieve a desired outcome. Two recent examples of this are:

(a) streamlining the conduct of business sourcebooks (*see* below for further detail on COBS and ICOBS);
(b) replacing the detailed money laundering rules that were contained in the money laundering sourcebook with high-level anti-money laundering risk assessment requirements and guidance designed to permit firms to develop systems that are commensurate with the nature and complexity of their business.

Mindful of the need to provide firms with certainty as to what is expected of them, in place of detailed rules the FSA intends to issue guidance on particular subjects and publish case studies and other documents showing examples of good and poor practice.

The FSA places responsibility squarely on senior management to engender a principles-based culture within firms, an approach which is discussed in more detail below in the context of TCF.

In addition to the thematic reviews referred to earlier in this Chapter, the following are examples of how the FSA is applying this principles-based approach in its regulation of the insurance sector.

COBS

The new COBS marks a significant step forward in the implementation of the principles-based regulatory regime. The sourcebook has been shortened and simplified to focus on regulatory outcomes rather than procedures and to emphasise the responsibility of senior management in achieving those outcomes. The new provisions are designed to give firms more flexibility to decide what measures will best allow their particular business model to meet the regulatory requirements.

The provisions of COBS relating to with-profits business are a good illustration of the principles-based approach. With-profits funds are of particular concern to the FSA because of their investment risk profile, a lack of consumer understanding and the mis-selling practices with which they have historically been associated. In the new COBS, the with-profits section has been rearranged under three principal headings: treating with-profits policyholders fairly; principles and practices of financial management; and communications with with-profits policyholders. Within each subsection, the previous detailed requirements have been compressed into a smaller number of high-level principles and rules.

Unfortunately for the FSA, its attempts to streamline the conduct of business rules coincided with the implementation of the Markets in Financial Instruments Directive ("MiFID") in the UK. One of the purposes of MiFID was to harmonise certain conduct of business rules across the EU, which meant that the FSA had to include in its new COBS a number of detailed rules which were required by MiFID at the same time as it was trying to reduce the number of detailed rules. COBS is therefore currently something of a mixture of high-level obligations and detailed requirements.

ICOBS

The new ICOBS sourcebook is a good example of how the FSA is moving towards a less prescriptive approach in areas where the perceived risks are lower, whilst maintaining more detailed rules for high-risk products.

ICOBS represents a relaxation in the conduct of business rules relating to general insurance business (for example, household, motor or pet insurance) and a move to more high-level principles and rules. For example, as part of the sales process firms are no longer required to produce policy summaries in the prescribed format provided that they give consumers appropriate information in good time to enable consumers to make informed decisions.

However, for protection products (critical illness, income protection, term assurance and PPI), ICOBS imposes certain additional rules that are designed to improve poor sales practices, particularly in respect of PPI. For example, firms are required to inform customers orally of

the key features of the product (including benefits, exclusions, term and price) before the customer makes the decision to purchase.

ICOBS is considered in further detail in Chapter 7.

ICAS

As part of its prudential reforms, the FSA introduced the Individual Capital Adequacy Standards framework ("ICAS") in December 2004. The central tenet of ICAS is that, rather than following prescriptive rules to determine precise capital requirements, insurers must undertake their own regular assessment – the Individual Capital Assessment ("ICA") – of the amount and quality of capital that is adequate for the nature and size of their business. Insurers are encouraged to develop internal models to evaluate the impact on their business of various risks, such as market risk and insurance risk. The FSA then reviews the ICA and issues individual capital guidance either confirming the adequacy of the assessment or adding capital where it perceives a shortfall. ICAS is described in further detail in Chapter 4 below.

The FSA believes that ICAS has not led to a significant decrease in capital in the industry overall, but has enabled capital requirements to be better focused on the nature of the particular risks relating to specific businesses. It considers ICAS to have been successful in encouraging a greater risk-management culture within firms, with senior management now often using the ICA as a key decision-making tool. It sees the internal modelling processes now used by firms as a good example of how its principles-based rules promote market-led solutions and provide greater flexibility for the industry.

Permitted links

In October 2007 the FSA introduced a new set of principles governing linked long-term business and widened the previously restrictive list of assets to which benefits could be linked, with a view to providing greater flexibility for firms undertaking this type of business. The principles are designed to give senior management greater responsibility for managing risks within the linked business. The new principles and rules can be found in COBS.

Insurance Special Purpose Vehicles ("ISPVs")
As part of the implementation of the Reinsurance Directive, the FSA introduced a special process for the authorisation of ISPVs. Recognising that the structure of these vehicles poses less threat to its regulatory objectives than traditional reinsurers, the FSA:

(a) has tailored its information requirements so that ISPVs will need to provide less information than traditional insurers and reinsurers when seeking authorisation;
(b) has imposed less stringent solvency requirements on ISPVs;
(c) will supervise ISPVs on an ongoing basis through its supervision of the ceding insurer.

The capital credit given to an insurer placing reinsurance with an ISPV will be determined on a case-by-case basis.

Contract certainty in wholesale markets
The FSA has identified the widespread practice of "deal now, detail later" as a significant operational risk in the wholesale insurance industry. Through the issuance of guidance and as part of its ARROW assessments the FSA has been able to ensure that the majority of firms are now implementing contract certainty working practices and are putting a greater emphasis on accurate documentation, leading to greater efficiency and order in the market.

General insurance client money
Thematic work revealed that general insurance brokers were not adequately protecting client money and that there was a lack of understanding of certain of the CASS rules. The FSA published explanatory material to clarify the rules and through its subsequent supervisory work established that firms were better able to understand and comply with the requirements.

1.3.3 Treating customers fairly ("TCF")

Treating customers fairly is an example of principles-based regulation, yet it is of such central importance to the FSA's objectives that it merits separate discussion.

There are four main elements to the FSA's aim to promote the effective and efficient operation of retail markets in order to deliver benefits to consumers:

(a) capable and confident consumers;
(b) provision of simple and comprehensible information for use by consumers;
(c) well-managed and adequately capitalised firms that treat their customers fairly;
(d) risk-based, principles-based and proportionate regulation that seeks to encourage market-led solutions.

Prior to implementing the TCF initiative, the FSA had found that the existing detailed rules were not delivering all of these benefits. To improve matters, the FSA now requires senior management to ensure that TCF is considered at every stage of the "product lifecycle" including product development and design, marketing, sales, advising, after-sales information/service, fund management (particularly with-profits) and complaints handling – with the objective of meeting six outcomes:

(a) Outcome 1: consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
(b) Outcome 2: products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
(c) Outcome 3: consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
(d) Outcome 4: where consumers receive advice, the advice is suitable and takes account of their circumstances.
(e) Outcome 5: consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.
(f) Outcome 6: consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

Embedding a culture of TCF within the firm, in line with Outcome 1, is the responsibility of senior management, who must ensure that

their TCF aspirations filter through to consumer experience. Leadership, controls, internal communications, training and competence of staff and sales commissions/rewards should be focused on TCF.

Senior management must also ensure that adequate management information is available in order for them to assess compliance with TCF, take action where necessary and demonstrate that the Outcomes are being achieved.

Delivery of TCF is monitored through thematic work and ARROW visits. The FSA takes TCF seriously. If firms are found deficient in this area, the FSA may take enforcement action against the firm and against senior management personnel that have failed in their responsibilities. In this regard, firms that follow the guidance issued by the FSA from time to time in relation to TCF (in the circumstances for which it is intended) are unlikely to face action.

PPI is currently one of the insurance sector team's principal TCF concerns. The FSA's PPI initiatives have already been discussed in the context of thematic reviews and the additional rules for protection products in ICOBS. The FSA has published the results of its thematic reviews and has issued guidance to firms which, together with the new ICOBS rules, is aimed at ensuring firms give consumers the opportunity to understand the features and costs of the product and their cancellation/refund rights. Simultaneously the FSA intends to raise public understanding of this type of insurance. Fines have recently been imposed on several firms whose PPI sales practices have led to a breach of TCF and the FSA continues to closely monitor this area.

The with-profits industry is another important area of focus in the context of TCF. Firms must ensure that their with-profits policyholders are treated fairly, for example by providing sufficient information about policies' investment and return characteristics and risks and managing the use, distribution or re-attribution of any inherited estate properly. The FSA has directed that effective governance arrangements, including some independent scrutiny of management's decisions, are implemented to oversee this outcome. It has also undertaken a number of thematic reviews of the issue and

intends to continue scrutinising with-profits businesses in its ongoing supervision of firms.

Insurers should also have regard to their TCF obligations when designing products and dealing with distributors. This requires them, amongst other things, to identify their target market and stress test their products. They should consider whether the information they provide to their distributors is sufficient, appropriate and comprehensible. Further detail on the obligations of product providers is contained in the FSA's Responsibilities of Providers and Distributors for the Fair Treatment of Customers ("RPPD") sourcebook.

1.4 Enforcement of insurance regulation

1.4.1 Regulatory enforcement powers

As the sole financial services industry regulator, the FSA is responsible for ensuring that firms comply with the regulatory regime. To make the FSA effective in this role, FSMA 2000 confers upon the FSA wide powers of supervision, investigation, enforcement and discipline. The majority of these are exercisable only against firms authorised, and persons approved, under FSMA 2000. What follows is a brief overview of the enforcement regime. For further details *see A Practitioner's Guide to FSA Investigations and Enforcement Second edition* (City & Financial, April 2007).

1.4.1.1 Investigation

The FSA has considerable information-gathering and investigatory powers, both informal and formal. The FSA's high-level principles require individuals and firms to cooperate with the FSA, allowing it to obtain information by way of informal requests. Under Principle 11 there is also a positive duty on firms to disclose information likely to be of relevance to the FSA as regulator. The FSA rules contain requirements for specific types of cooperation and assistance from firms. Under FSMA 2000, firms have formal obligations to provide information, or obtain a report from a skilled person (such as a lawyer or accountant), on any matter considered by the FSA to be relevant to the exercise of its statutory functions.

The FSA has wide-ranging powers to investigate the business, ownership and control of a firm and possible criminal and regulatory contraventions and offences by a firm. It also has sector-specific investigatory powers, for example to investigate listed companies and applicants for listing. HM Treasury and the Office of Fair Trading also have investigatory powers under FSMA 2000.

1.4.1.2 Discipline

The FSA has power to impose a fine (of any amount it considers appropriate) and/or publicly censure FSA-authorised firms for breach of the FSA rules, high-level principles or FSMA 2000 itself. In certain circumstances it may issue informal private warnings rather than take formal disciplinary action. In some situations it can require a firm to pay compensation to consumers who have suffered losses as a result of the firm's regulatory breach. It can also apply to the court for a civil injunction to halt an ongoing regulatory breach or to freeze a firm's assets. A civil injunction would usually be used against firms not authorised by FSMA 2000 since the FSA's other powers are normally sufficient as against authorised firms.

1.4.1.3 Direct intervention

The FSA also has so-called "own-initiative" powers to intervene directly in the business of firms in pursuance of its regulatory objectives. These powers are used rarely, for example to restrict the business a firm can undertake or require it to maintain particular assets. In serious cases, the FSA can cancel a firm's FSMA 2000 authorisation.

1.4.1.4 Criminal offences

The most serious breaches of regulatory provisions constitute criminal offences under FSMA 2000 which can give rise to fines and imprisonment. Offences relevant to insurance include falsely claiming to be an authorised or exempt person, unlawful financial promotions, breach of a prohibition order, breach of the asset identification rules in the insurance business regulations, breaches in connection with changes in control over authorised persons and certain breaches committed by directors of long-term insurers. The FSA is empowered by FSMA 2000 to act as a criminal prosecutor in relation to these offences.

Enforcement of the regulatory regime as it applies to Lloyd's is somewhat different to the system described above. For further information

see A Practitioner's Guide to the FSA Regulation of Lloyd's Second edition (City & Financial, December 2004).

1.4.2 The enforcement process

When a firm has breached the financial regulations, the FSA's enforcement division carries out an initial fact-finding investigation and then refers the matter to the RDC for consideration. The RDC issues a "warning notice" to the relevant firm, commencing the enforcement process proper. It then hears representations from, and enters into settlement negotiations with, the firm before making a final determination and issuing a "decision notice" to that effect.

If the firm is unhappy with the decision of the RDC, it may refer the matter to the Tribunal. The Tribunal acts as a tribunal of first instance, examining all the available evidence before deciding what disciplinary action, if any, the FSA is to take. There is a limited right of appeal to the courts against decisions of the Tribunal on points of law.

After a final decision has been reached and the appeals process exhausted, the FSA issues a "final notice" and the enforcement action takes effect.

1.4.3 The FSA's approach to enforcement

The FSA conducts its enforcement activities in pursuance of its four statutory objectives and in accordance with its supervisory principles. It adopts a risk-based approach, concentrating its available resources on issues that it considers pose the greatest threat to consumers and the financial system and using enforcement strategically as a tool to change behaviour in the industry. Accordingly, it will often address minor regulatory breaches informally, with a private warning or even no action at all, particularly when the breach has been rectified rapidly by the offending firm. In contrast, where a breach is serious or concerns an area that the FSA considers is of particular importance, such as the protection of consumers or the orderliness of markets, it takes the view that strong and public enforcement action is the best means of maintaining market confidence and sending an effective message of deterrence.

Importantly, the FSA follows a principles-based approach to enforcement, meaning it will look for breaches not merely of detailed rules but also of their underlying principles, including those set out in the PRIN (*see* 1.3.2.1 above). Where it believes a firm has acted improperly but there is no clear breach of a specific rule, the FSA may take action for breach of a principle alone and the FSA has indicated that it is likely that in the future there will be more enforcement cases where principles rather than specific rules have been breached. Recent examples of such cases include a fine of £1.225 million for General Reinsurance UK Limited in November 2006 for breaching Principles 2 and 3, and a fine for HFC Bank Limited in January 2008 for breaching Principles 3 and 9 in the context of sales of PPI products.

The FSA is also showing an increasing tendency to take enforcement proceedings against individuals within authorised firms. Anyone who is an approved person (*see* Chapter 3 for more details) is personally subject to the FSA's jurisdiction and potentially subject to FSA sanctions. There have been a number of examples of the FSA imposing fines against members of senior management within a firm in circumstances where they can be considered personally culpable for a regulatory failure.

1.5 Future regulatory developments in the insurance sector – Solvency II

Capital adequacy requirements for insurers are undergoing an EU-wide review, called the Solvency II project. Solvency II aims to establish a common set of capital requirements and risk management standards to replace the current Solvency I system. The reforms are intended to enhance competition by making it easier for insurers to operate across Member States and to increase consumer protection by closely aligning insurers' capital requirements with their risk profiles. The new rules will apply to all EU insurers and reinsurers except those with an annual premium income of €5 million or less. In addition, as stated above, the framework directive implementing Solvency II aims to consolidate the relevant provisions of the existing insurance directives into a single directive.

1.5.1 Reasons for reform

Solvency II is intended to effect sweeping reform of the current EU capital adequacy regime to bring it into line with modern standards of risk management, ameliorating a number of widely recognised deficiencies in the existing system. Significant differences have arisen between the regimes of Member States as a result of their differing approaches to the implementation of the Insurance Directives. Further, the banking sector capital regulatory regime has been updated under the Basel II Accord, leaving the insurance industry behind. These factors impede the development of a single, EU-wide insurance market and result in "regulatory arbitrage" where, for example, insurers establish head offices in Member States perceived to have lighter regimes but carry on most of their business in another Member State, or where financial services products are structured so as to fall within the more lightly regulated sector.

Another problem under the current rules is that they permit inappropriate methods for valuing insurers' liabilities and assets, resulting in inflexible capital adequacy requirements that can be too strict in some cases and too lax in others. Some existing capital adequacy rules are considered in any event to be set too low, which has led certain Member State regulators to impose their own, stricter, standards.

1.5.2 The Pillars

The changes proposed by Solvency II are largely based on the three-pillar structure implemented in the banking and investment industry by the Basel II Accord. Pillar 1 deals with minimum capital requirements, Pillar 2 details a supervisory review process and Pillar 3 sets out provisions for public transparency and market discipline.

1.5.2.1 Pillar 1

The first pillar sets out insurers' quantitative capital adequacy obligations. It requires insurers to make technical provisions against insurance liabilities, imposes a Minimum Capital Requirement ("MCR") and sets out a Solvency Capital Requirement ("SCR").

The technical provisions are reserves to be held by insurers against a best estimate of their insurance liabilities. They are calculated as the

theoretical cost to the insurer of immediately transferring its contractual obligations to another undertaking (the "current exit value"), plus a risk margin for non-hedgeable liabilities.

The MCR represents a minimum industry-wide standard for capital adequacy, with serious regulatory implications for firms that fail to comply. Subject to an absolute minimum of €1 million for non-life companies and €2 million for life companies, it will otherwise be set through a simplified modular calculation or as a fixed proportion of the SCR.

The SCR is a capital adequacy requirement in excess of the technical provisions which is designed to reflect the actual risk profile of a specific insurer. It will be calculated in accordance with a standard formula or using the insurer's own internal model. It will likely be positioned at a level significantly above the MCR and the consequences for its breach will be considerably less serious and will depend on the surrounding circumstances. The SCR is intended to factor in all the risks to which the insurer is exposed, including market risk, credit risk and specifically operational risk, as well as insurance risk, and will take account of the impact of risk mitigation techniques employed by the insurer. Much of the important detail of the calculations is likely to be left to the secondary implementation measures under Lamfalussy and will be informed by a series of industry questionnaires known as Quantitative Impact Studies.

As in the Basel II Accord, Pillar 1 also sets out the extent to which different categories of assets can contribute to meeting capital requirements. Eligible capital will be divided into three tiers according to characteristics such as permanence and efficacy in absorbing losses, and there will be limitations on the extent to which the lower, less robust, tiers of capital can be put towards the MCR and SCR.

1.5.2.2 Pillar 2

The second pillar deals with assessment of individual firms' capital requirements by both senior management of insurers and the regulator and supervision of firms' regulatory compliance. In a process called the "Own Risk and Solvency Assessment" insurers will be responsible for calculating their own SCR at least annually, monitoring it continuously and adjusting it whenever their risk profile

changes significantly. They will be required to focus on actively identifying, measuring and managing risks, including future developments such as new business plans and possible catastrophic events. The default method for calculating the SCR will be, as stated above, a standard formula but, with the permission of the regulator, insurers will be able instead to use their own internal models or a combination of the two. In the UK, such permission will likely take the form of a waiver granted under Section 148 FSMA 2000.

There will also be a supervisory system, called the "Supervisory Review Process", under which supervisors will monitor firms' SCR assessment processes. Supervisors will have the power to require insurers to hold additional capital (a "capital add-on") on top of their SCR as a precautionary measure where necessary. The SCR and the capital add-on together will form an "adjusted SCR". In determining whether or not to add to a firm's capital requirements the regulator will have regard to corporate governance and the adequacy of systems and controls as well as the financial risks associated with the firm's assets and liabilities.

Of relevance to the Pillar 2 reforms is the proposal, as part of Solvency II, to overhaul the application of solvency rules to multinational insurance groups. Supervision of such groups will mainly be carried out at group level. Each group company will be required to maintain its MCR individually, but if the proposal is implemented the adjusted SCR will be largely the responsibility of the group as a whole. The aim is to better allow diversified interests held in part of a group to be utilised for the benefit of the whole group for capital modelling purposes while also requiring the group to intervene and support a group member who becomes insolvent. The latter proposal may present an interesting legal dilemma in jurisdictions such as the UK that are traditionally reticent to "pierce the corporate veil", but it is intended to create a more level playing field as between branch and subsidiary-based group structures.

1.5.2.3 Pillar 3

The third pillar introduces enhanced requirements for public disclosure. Insurers will have to publish an annual report disclosing their solvency and financial position, including their MCR and adjusted SCR. This goes considerably further than current UK requirements

and has led to concerns among insurers that the market may be able to gauge a firm's regulatory problems by calculating its capital add-on and that, to protect their market reputation, firms will need to maintain a buffer of capital above the SCR to ensure it is never breached.

1.5.3 Adoption and implementation

As indicated below, Solvency II is being introduced using the "Lamfalussy" legislative process. This process has four levels. In level 1, a framework directive setting out the broad principles of the new regime is adopted. It is currently expected that the draft framework directive will be finalised and adopted by early 2009. Level 2 introduces more detailed technical implementing measures by way of further directives and/or regulations. In Level 3, national supervisors agree non-binding standards and guidance, and in Level 4 the European Commission (the "Commission") monitors compliance by Member States and steps in with enforcement measures where necessary. The new regime is expected to be operational by the end of 2012.

The FSA and HM Treasury strongly support Solvency II and the ISG regularly publishes the results of its work on the topic. Some of the reforms proposed by the Solvency II project have already been implemented in the UK under the FSA's relatively new prudential rules for insurers, which have modernised UK insurers' capital adequacy, risk management and governance standards as far as possible within the current EU rules, for example through the ICAS requirements.

1.6 How should the insurance industry respond to recent regulatory developments?

1.6.1 Response to principles-based regulation

For many firms, the principles-based regime necessitates a significant change in approach to compliance. Firms need to take a more holistic approach than in the past, deciding what business outcomes the high-level principles require and taking appropriate action to achieve them, rather than ensuring that documents and processes are simply consistent with detailed rules regarding form and content.

Senior management should implement this cultural shift throughout their organisations by educating staff at all levels of the business. Day-to-day oversight is likely to continue to be the responsibility of compliance officers, whom the FSA believes should be the "conscience" of the firm, providing strong signals as to appropriate conduct and proposing action to correct any breaches of the principles. However, senior management should be given greater insight into the compliance function to monitor whether the required outcomes are being achieved and compliance at a principles and outcomes level should take high priority on board agendas. The role of internal compliance and legal executives and external legal advisers in guiding senior management with regard to effective compliance with principles-based regulation will be key.

Firms should take a risk-based approach to compliance, focusing on preventing material breaches and informing the FSA of any that occur. Compliance officers may need to cultivate stronger relationships with their risk management colleagues and the senior business executives to ensure that they understand the impact of business decisions on the firm's compliance, risk and capital adequacy profile.

Firms need to keep track of the guidance, case studies and other documents that indicate FSA policy as to how the high-level principles should be applied. They will need to ensure that business decisions are consistent with the spirit of the principles, taking into account the FSA's current policy and guidance, and will need to document their decision-making processes to demonstrate that they have considered the relevant issues. They will also need to continue to comply with the remaining detailed rules in the Handbook, particularly where the rules have been tightened as a result of the FSA's concerns about particular products or practices.

Whilst principles-based regulation is generally welcomed by the insurance sector as it aligns regulatory compliance more closely with risk management and economic value considerations and provides management with greater flexibility in securing a particular compliance outcome, it is recognised that it also presents new challenges, including potentially a lack of certainty, consistency and transparency of FSA decisions, particularly with regard to enforcement.

1.6.2 Response to TCF

The repeated threat of enforcement action against senior management, as well as firms, who fail to apply TCF has undoubtedly focused industry attention on this area. Senior management must now fully commit to embedding the TCF culture throughout the firm, monitoring its implementation and taking corrective action where necessary.

1.6.2.1 Embedding culture
Through effective leadership, senior management should spread the TCF message and ensure that the firm's different departments utilise a joined-up approach that reflects TCF in each stage of the product lifecycle. TCF should form part of a firm's strategic and forward-looking planning and should influence the decision-making of individuals whose decisions impact on the TCF outcomes. Adequate controls should be implemented in order to ensure the delivery of TCF to consumers, detect risks and measure success (reliable management information is integral to this). Staff should be recruited, trained and evaluated with TCF in mind and reward structures should ensure that sales and performance targets do not take precedence over TCF or give rise to mis-selling.

An inevitable consequence of the shift from detailed rules is that firms must keep abreast of the increasing amount of guidance that the FSA issues to clarify, or expand upon, the TCF principle.

1.6.2.2 Management Information ("MI")
Management Information is a vital component of monitoring, measuring and demonstrating TCF. Without adequate MI, senior management will not be able to convince the FSA that the TCF outcomes are being achieved. Recognising that it is difficult for firms to develop MI processes to demonstrate adherence to a principle, the FSA has published guidance in this area. MI can be any form of information or evidence that is collected in the course of business (at any stage in the product lifecycle), including evidence of customer experience during or after the point of sale and staff opinion/commentary. It should enable management to make good decisions and should focus on delivery of the TCF outcomes rather than internal processes. Once produced, MI should be reported at the appropriate level, analysed and challenged. Where MI reveals potential risks or

shortcomings it should be acted upon and further MI should be generated to evidence resolution of the problem.

1.6.2.3 Examples of good practice

Examples of good practice that have been highlighted by the FSA include:

(a) appointing a very senior TCF champion, such as the CEO, and using sub-committees of senior managers covering the various business areas;
(b) reporting on the progress of implementation of TCF at regular monthly board meetings;
(c) creating TCF reporting lines to senior management in the various business areas and to the board;
(d) communicating a TCF vision to staff throughout the firm and including TCF in staff training and competence initiatives;
(e) building TCF into staff performance management arrangements;
(f) forming specialist teams to consider products against the TCF objectives;
(g) using employee surveys, sales information, complaints data and FOS decisions as MI in order to identify potential issues.

1.6.3 Response to Solvency II

1.6.3.1 Influencing the regulators

Insurance firms have already had opportunities to participate in public consultations on the Solvency II proposals (including, in particular, through the Quantitative Impact Studies), and further opportunities will arise prior to adoption. There has, in the past, been a tendency for the industry to react to regulatory developments *ex post facto* and the process of amending rules once they have taken effect has often been frustratingly slow. Solvency II presents an ideal opportunity to proactively influence regulators and legislators before the rules take full effect and in this context it will be particularly important to engage in relation to the Level 2 implementing legislation as that is where much of the detail of the new regime will be fleshed out. Opinions can be voiced through responses to consultation papers, dialogue with the FSA (including the ISG) and trade organisations, and the FSA is actively encouraging the industry to do so, particularly by responding to the Quantitative Impact Studies.

1.6.3.2 Preparing for the new regime

On the current timetable, full implementation of Solvency II will not happen until 2012 and the European Commission intends to have the new requirements in place at least 18 months before the implementation deadline to give firms time to prepare.

The ICAS regime has put UK firms in good stead for Solvency II. Nonetheless, the FSA recommends that firms begin now to consider what changes they will need to make to comply with the proposed new regime. For example, firms wishing to use their own internal models to calculate their capital requirements will need to plan ahead to develop those models and obtain the necessary regulatory approval from the FSA. Smaller firms without extensive data histories may need to undertake considerable work to develop adequate best estimates of their liabilities for use in calculating technical provisions. Where possible, firms should use the results of the ICA process as a decision-making and management tool, which will enable them to transition smoothly from ICAS to the use of internal models under Solvency II.