



July 2011

The Prudential Regulation Authority - an overview of the future of insurance supervision

In June 2010 the Government announced plans to abolish the current system of financial regulation, a tripartite system shared by the Treasury, the Bank of England and the Financial Services Authority (the FSA). This followed criticism of failures of the system during the recent/current financial crisis. The FSA in its current form will cease to exist and in its place the following three new regulatory bodies will be established:

- **The Prudential Regulation Authority (the PRA)**

The PRA will be a subsidiary of the Bank of England and will be responsible for the prudential supervision of insurers, deposit-takers and a small number of investment firms.

- **The Financial Conduct Authority (the FCA)**

The FSA will become the Financial Conduct Authority (the FCA) and will continue to be responsible for regulating the conduct of all firms, including those firms regulated by the PRA, as well as those that are not.

- **The Financial Policy Committee (the FPC)**

The FPC will sit within the Bank of England and will be responsible for macro-prudential regulation, effectively monitoring the combined effect of individual firms' actions.

On 16 June 2011 the Government published the draft legislation which will implement the changes. It is intended that the transfer of powers to the new regulatory bodies be completed by the end of 2012, with the new authorities becoming operational at the beginning of 2013.

The PRA's approach to supervision of insurers

The newly formed PRA will be responsible for the authorisation, prudential regulation and day-to-day supervision of all firms that are subject to significant prudential regulation, including banks, building societies, insurers and certain investment firms. As the FCA will act as the conduct regulator for these firms, they will be known as 'dual-regulated' firms.

The specific nature of insurance means that insurers are exposed to a different set of risks than banks, leading to a different impact on the stability of the financial system should an insurer fail. Recognising this and the fact that in practice it is difficult for policyholders to monitor the financial health of their insurer, the PRA's supervision of insurers is to be framed in a different way to that of banks.

On 20 June 2011, the FSA and Bank of England published a joint paper setting out how the PRA will approach the supervision of insurers. This briefing note will provide an overview of the PRA's approach and highlight a few of the issues that insurers may wish to consider.

The PRA's objectives

The PRA's general objective is to promote the safety and soundness of PRA authorised firms.

The PRA's insurance objective is twofold: to secure an appropriate degree of protection for policyholders whilst minimising the adverse impact that the failure of an insurer, or how it carries out its business, could have on the stability of the system.

It should be noted, however, that the PRA is not required to ensure that no PRA authorised person fails and an express statement declaring this will be included in the new legislation that will implement the changes.

Scope of regulation of insurers

Dual-regulated firms include the following insurance entities:

- insurers (including retail mutual insurers and friendly societies)
- reinsurers and
- Lloyd's of London's Society of Lloyd's and Lloyd's managing agents (although please note Lloyd's members' agents and advisers, as well as Lloyd's brokers will be regulated solely by the FCA).

(for the purposes of this briefing, collectively known as **Insurers**)

The PRA will treat UK subsidiaries of overseas firms in the same way as UK-headquartered firms, but will only have limited powers to supervise branches of EEA Insurers that have passported into the UK.

Overview of the PRA's regulation of Insurers

Authorisations

Applications for authorisation to be a regulated firm will be made to the PRA, who will administer the application and be responsible for granting authorisation. However, the FCA will have to give its approval before granting the permission and it is intended that it will be fully involved in the authorisation process. This is in line with the overwhelming majority of those who responded to the February 2011 consultation expressed a wish for applications to be made to a single regulator.

Permissions

An Insurer already authorised by the PRA would need to apply to the PRA in order to vary its

permissions to undertake additional authorised activities.

Approved persons

It is intended that the PRA and FCA will have a dual role in approving individuals, although the PRA will have primary responsibility. The PRA will lead the process for roles that have a bearing on the safety and soundness of the firm, such as 'Significant Influence Functions' and its assessment will cover the competence of individuals applying to perform controlled functions, as well as their probity and integrity. The FCA will be responsible for approving individuals to conduct-focused controlled functions.

Change of control

The PRA will consider change of control applications, but will be under a statutory duty to consult with the FCA. Should the FCA object to an application on the ground of the risks of money laundering or terrorist finance, the application must be refused or approved subject to specific requirements.

Where the target firm is regulated by the FCA, but is in a group which contains a dual-regulated firm, the PRA needs to be consulted. The PRA can then refuse an application on the grounds that following the change of control, either the firm will be unable to meet its prudential requirements or the regulator will be unable to supervise the firm.

Passporting

The PRA will be responsible for issuing relevant notices where an Insurer wishes to passport out of the UK by way of a branch office.

Rule waivers

If an application for a waiver or modification relates to an Insurer, both the PRA and FCA must consult the other before deciding on the application.

Part VII transfers

The PRA will be responsible for regulatory duties relating to applications under Part VII of the Financial Services and Markets Act 2000 (FSMA) for the transfer of insurance and banking business, although the FCA will need to satisfy itself that the transfer will not adversely affect customers of the firms involved in the transfer.

Each of the PRA and the FCA will be given powers equivalent to those available to the FSA under section 113 of FSMA, allowing them to apply to the court for an independent actuary's report after the transfer has been approved by the court.

Enforcement

The PRA, like the FCA, will be given a new power allowing it to publish the fact that it has issued a warning notice to a firm, together with a summary of that warning notice.

The PRA will not be obliged to publish this information, although it is to be expected. The PRA must consult the person to whom the notice will be given before any publication.

The PRA will not be permitted to publish a warning notice to Insurers if, in its opinion, it will be:

- unfair to the respective Insurer
- prejudicial to the safety and soundness of the Insurer or
- prejudicial to securing the appropriate degree of protection for policyholders.

The PRA must also publish that it has issued a notice of discontinuance, if it later decides to take no further action.

The PRA's Power of Veto

Recognising that the PRA should be the best equipped regulator to make assessments of financial stability risks, it will be given a limited power of veto over the FCA's actions. The PRA will only be able to exercise its veto if it considers that the FCA's proposed action would:

- threaten the stability of the UK financial system and/or
- result in the failure of a dual-regulated firm in a way that would adversely affect the UK financial system.

However, the PRA will not be able to use the veto to prevent the FCA from doing something that it is legally required to do, such as an action that is required by EU or international law.

Issues for insurers to consider

Co-ordination between the PRA and FCA

A key concern for Insurers is the dual-regulation by both the PRA and the FCA. Not only is there a danger of confusion, where Insurers are unsure which regulator they need to deal with, but there is also a concern that the duties of the PRA and FCA might overlap. This could have a cost impact on Insurers, with the potential for extra compliance costs for dealing with two regulators in respect of the same matter. It is difficult to predict how well in practice co-ordination between the PRA and FCA will work, but for it to be a success there needs to be well thought out and effective systems in place. The Government is aware of this and whilst the draft legislation does not go into detail how the PRA and FCA will co-ordinate their activities, there will be a statutory duty to co-ordinate.

This issue is particularly prevalent in respect of with-profits insurance (policies which contain both a defined and a discretionary benefit), where the line between prudential and conduct regulation has always been a little cloudy. The PRA is to have sole responsibility for matters relating to the interests of policyholders, which could affect the financial position of the firm and in respect of material issues, the PRA will consult with the FCA. The FSA is to shortly publish further details of how the PRA and FCA will co-ordinate.

Solvency II

The FSA has stated that much of the PRA's proposed approach to supervision will be achieved in practice through the application of Solvency II (the new European framework for insurance supervision). There is potential for some conflict here, however. The PRA's general objective is the safety and soundness of insurers and other regulated firms, with a view to promoting the stability of the UK's financial system, whereas its insurance objective is achieving appropriate protection for policyholders. The Government gives equal weight to both objectives, whereas compliance with Solvency II requires that the insurance objective has priority.

Enforcement

Enforcement is one of the most controversial elements of the proposed changes, because any publication of a warning notice would occur before an Insurer has had the opportunity to put its case to the relevant regulatory body. This could not only damage the Insurer's reputation, but also restrict its options when under investigation. For example, an Insurer may be more likely to contest proceedings if there has already been adverse publicity.

Relevant publications

- **26 July 2010**

HM Treasury's first consultation paper: 'A new approach to financial regulation: judgement focus and stability'. [Click here](#) to view.

- **24 November 2010**

HM Treasury's 'summary of consultation responses'. [Click here](#) to view.

- **17 February 2011**

HM Treasury's second consultation paper: 'A new approach to financial regulation: building a stronger system'. [Click here](#) to view.

- **16 June 2011**

HM Treasury's white paper on the reforms, which includes a draft version of the primary legislation which will bring the reforms into effect: 'a new approach to financial regulation: The blueprint for reform'. [Click here](#) to view.

- **20 June 2011**

The FSA and Bank of England published a joint paper on the PRA's prudential regulation of insurance companies: 'Our approach to insurance supervision'. [Click here](#) to view.

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