

## New UK financial services regulatory structure: An insurer's perspective

### Introduction

From 1 April 2013, the Financial Services Authority (the "FSA") will be abolished and replaced by the Prudential Regulation Authority (the "PRA") and the Financial Conduct Authority (the "FCA"). The Financial Policy Committee (the "FPC") will sit above these two regulators and monitor broader economic conditions.

The effective date of 1 April 2013 is referred to as the "legal cut-over" date ("LCO"). At a practical level, LCO will not be a "big bang" moment, as much of the new structure is already in place. The FSA divided itself into prudential and conduct business units in anticipation of the reforms last April and an interim FPC has been meeting for over two years.

The reforms are effected by the *Financial Services Act 2012* (the "FS Act"), which makes extensive amendments to existing legislation, such as to the *Financial Services and Markets Act 2000* ("FSMA"), the *Bank of England Act 1998* and the *Banking Act 2009*. The FS Act also contains stand-alone provisions. In addition to creating the new regulators, the FS Act gives new powers to the new regulators, such as the power to contract directly with Skilled Persons in respect of section 166 reports and the power to impose requirements on UK parent undertakings of UK insurers.

Following LCO, insurers will be dual-regulated by the PRA and the FCA. Overall, the centre of gravity for insurers (as with banks) will lie with the Bank of England (the "BoE"). This is evident from the fact that the PRA and FPC are both effectively parts of the Bank of England (the "BoE"), the PRA will be led by a BoE veteran and the PRA generally has veto rights over the FCA in areas of joint competence. Given that the BoE has not previously regulated insurers, there may be some period of learning and adjustment in relation to insurers.

### New Regulators and Approach

#### *Financial Policy Committee*

Like the Monetary Policy Committee (which sets interest rates), the FPC will be a sub-committee of the Court of Directors of the BoE.

### Contents

|                                   |   |
|-----------------------------------|---|
| Introduction .....                | 1 |
| New Regulators and Approach ..... | 1 |
| Transitional Arrangements ..      | 5 |
| Specific Rules .....              | 6 |
| FSA Handbook .....                | 9 |

The FPC has been established to address a perceived gap in the current system and its primary responsibility is for macro-prudential monitoring of the financial system to identify and correct systemic risks. Unlike the PRA and the FCA, it will not have direct regulatory responsibility for any particular types of firm. Instead, the FPC has the power to direct the PRA or the FCA to take macro-prudential measures to implement its decisions across relevant firms. For instance, the FPC will be responsible for decisions on the countercyclical capital buffer applied to banks, building societies and large investment firms and will have powers of direction over sectoral capital requirements. However, it is unclear how the FPC's powers in this regard would interact with maximum harmonising European directives (such as Solvency II).

An interim FPC was established in February 2011. Its members include: the Governor of the BoE, Sir Mervyn King (as Chairperson); the BoE Deputy Governor for financial stability, Paul Tucker; the BoE Deputy Governor for monetary policy, Charles Bean; the FSA Chairman, Lord Adair Turner; the Head of the FSA's Prudential Business Unit, Andrew Bailey; the BoE Executive Director for financial stability, Andy Haldane; the BoE Executive Director for markets, Paul Fisher; and four independent members. Since the establishment of the interim FPC, the discussions at its formal meetings have principally been centred on the regulation of banks, with insurers being mentioned only a handful of times.

### ***Prudential Regulation Authority***

The PRA is a subsidiary of the Bank of England and will be responsible for the micro-prudential regulation of banks, building societies, credit unions, insurers and major investment firms. It will be staffed by 1,200 people (mainly transferring from the FSA) and housed at 20 Moorgate in the former offices of J.P. Morgan Cazenove.

The PRA's approach to regulation may be summarised as follows:

- > the PRA will have two statutory objectives: (a) to promote the safety and soundness of regulated firms; and (b) in the case of insurers, to contribute to securing an appropriate degree of protection for policyholders;
- > the PRA will not operate a zero-failure regime. The PRA will, however, seek as far as possible – with resolution arrangements in place – to ensure that any firms that fail do so in a way that avoids significant disruption to the supply of critical financial services, including an acceptable degree of continuity of cover for policyholders; and
- > the PRA's approach to supervision will be clearly based on forward-looking judgement (taking into account a wide range of possible risks to the PRA's objectives), rather than being narrowly rules-based.

From LCO, the PRA will be headed by the current head of the FSA's Prudential Business Unit, Andrew Bailey (as Chief Executive Officer), who also sits on the FPC and will be a deputy governor of the BoE. Previously, Mr Bailey worked for the BoE in a number of roles for over 25 years, including

most recently as Executive Director for Banking Services and Chief Cashier (you will see his signature on many of the bank notes currently in circulation).

### **Financial Conduct Authority**

The FCA's strategic objective is to ensure that the relevant markets function well and is responsible for the conduct regulation of all financial services firms (including those that are prudentially regulated by the PRA, such as insurers). It will also be responsible for the prudential regulation of those financial services firms not supervised by the PRA, for example, most asset managers. The UK Listing Authority will be part of the FCA.

The FCA's strategic objective is supported by three operational objectives: securing an appropriate degree of protection for consumers; protecting and enhancing the integrity of the UK financial system; and promoting effective competition in the interests of consumers in the markets for financial services.

From LCO, the FCA will be led by Martin Wheatley, who previously served as the chief executive officer of the Hong Kong Securities and Futures Commission for five years. He will also become a member of the FPC.

The FCA will be staffed mainly by the remainder of the FSA's current workforce of 4,000 people. After the PRA-bound staff are removed, the FCA will be left with a workforce of approximately 2,800 people. The FCA will remain in the FSA's current headquarters in Canary Wharf.

### **General principles of co-operation between the regulators**

**Oversight by the FPC:** The FPC may formally recommend – on a “comply or explain” basis – that the PRA and FCA take specific regulatory actions towards all regulated persons or a class of regulated persons, where it believes such actions are required to protect financial stability. The FPC may also use one of its macro-prudential tools and direct the PRA or the FCA to implement its decisions across relevant firms.

**With-profits:** Both the PRA and the FCA will regulate with-profits business. The PRA will have responsibility for promoting the safety and soundness of firms and securing an appropriate degree of protection for policyholders, and the FCA will be concerned with ensuring fairness as between different classes and generations of policyholders and as between policyholders and shareholders. The PRA has ultimate responsibility in respect of decisions which have material consequences for both affordability and fairness (i.e., the PRA's views on affordability trump the FCA's views on fairness). Some examples of the role of each regulator in relation to with-profits insurers are as follows:

- > in respect of investment strategy, the PRA will consider the effect of the proposed strategies on the firm's overall solvency and liquidity position and the FCA will review the strategies for consistency with the firm's statements to policyholders and check that the firm has appropriate governance to support that strategy;

- > where an insurer proposes to make distributions to policyholders, the FCA will ensure that the proposed distributions are fair and the PRA will ensure that they are affordable; and
- > the FCA will operate rules on the fairness of charges that may be levied on policyholders and if the amount of charges is such that to meet them would compromise the firm's ability to meet its obligations to policyholders, the PRA may consider (together with the FCA and the firm) alternative ways to approach the issue and if necessary, may exercise its power of direction pursuant to the FS Act. Where the insurer's ability to meet its obligations to policyholders will not be materially affected, the PRA would not seek to intervene.

*Supervision of Lloyd's of London:* The PRA is the prudential regulator for the Society of Lloyd's, its members, and managing agents. The FCA will regulate the conduct of the Society of Lloyd's, managing agents and on a prudential and conduct basis, the members' agents and advisors, and Lloyd's brokers. The FCA and PRA both have powers of direction over the Society of Lloyd's and its members and will each consult with the other before using such power.

*Authorisation of firms and approval of individuals:* Both the PRA and the FCA have the power to authorise new firms within their respective jurisdictions, however the FCA will maintain a single register covering all FCA and PRA authorised firms and approved individuals. For insurers (and other dual-regulated firms), the PRA will seek the consent of the FCA to new authorisations and the FCA is required to consult the PRA before authorising a firm that is part of a group containing a dual-regulated firm. Where the PRA and FCA both have an interest in a 'significant-influence' role then both regulators will be required to consent to the appointment. Despite the creation of two authorising bodies (the PRA and FCA) with separate regulatory jurisdictions, the single "perimeter" operated by the FSA will remain largely intact. Accordingly, if a person with any Part 4A permission conducts a regulated activity without the necessary permission, this remains a breach of a requirement rather than an offence. By contrast, if a person without a Part 4A permission conducts the same regulated activity, this is an offence. The only exception to this is for credit-related activities. If such activities are conducted without permission, an offence is committed regardless of whether the firm has a Part 4A permission.

*Policy and rule-making:* Each regulator will make rules and policies in accordance with its respective mandate and the regulators will consult with each other in relation to policies and rules which may have a material effect on the other's objectives.

*Waivers:* Both regulators can only waive their own rules. Dual-regulated firms must therefore send applications for waivers and modifications to the relevant regulator responsible for the rules sought to be waived or modified.

*Information sharing:* Each regulator will share information which is relevant to the responsibilities of the other regulator where requested or will actively offer

information which it considers would be of material interest to the other regulator. Each regulator will also share certain information with the other on dual-regulated firms (such as insurers) and firms within dual-regulated groups.

**Enforcement.** The PRA and the FCA will meet on a regular basis to discuss potential and ongoing enforcement actions against relevant firms and will consult with each other before taking enforcement action. The FCA and PRA will co-ordinate with each other in advance of certain actions relating to dual-regulated firms and groups. In addition, in relation to a dual-regulated firm, the PRA may direct the FCA not to exercise a power or not to exercise it in a specified manner if the PRA believes that would threaten the stability of the UK financial system or result in the failure of a PRA authorised firm that would adversely affect the UK financial system. The FCA will be responsible for enforcing the combined regulator perimeter of the FCA and PRA (subject to the PRA's oversight in relation to unauthorised PRA-regulated activities).

## **Transitional Arrangements**

### ***General transitional arrangements***

Actions taken before LCO by firms or other persons to whom the rules apply will remain effective after the PRA and FCA Handbooks come into force. For example, if either Handbook requires a firm to submit a report that was submitted to the FSA before LCO, it will be treated as if it had been submitted to the new regulator. It is intended that the costs and disruption to firms of transitioning to the dual-regulatory structure should be minimised.

### ***Approved persons***

In respect of dual authorised firms:

- > The CF2 (non-executive director) function is the only function proposed to be split between the two regulators. All existing CF2s would be deemed to have been approved by the FCA.
- > All other significant influence functions will be transitioned according to the following principles: (a) each approved person will be deemed to have been given approval by the regulator that will in future specify that particular controlled function into rules; and (b) where there are changes between the old FSA framework of functions and the new PRA and FCA frameworks, firms will not be required to take action to switch existing people to the new framework of functions while they remain in their current role.
- > With-profits committee members will form part of the PRA's non-executive director function.

### ***Existing permissions and waivers***

Transitional arrangements for grandfathering existing provisions will be dependent on secondary legislation to be published. If a firm is already regulated by the FSA, its Part IV permission will automatically be transferred

over (to become a new Part 4A permission) and it will not have to submit a new application.

### ***New or varied permission and waivers***

Applications to the FSA that are made before LCO but not determined until after LCO will be transitioned to the appropriate regulator and made against the appropriate statutory tests. The statutory time limit on authorisations remains unchanged.

### ***Communications by firms***

Firms will be required to provide appropriate details about their regulatory status under the new regime (i.e. that they are FCA-authorized and PRA-authorized). The regulators intend to allow a transitional period of six months after LCO to make the necessary changes to their relevant business stationery and to any electronic equivalents.

### ***Individual guidance***

Individual Capital Guidance and guidance on the completion and submission of regulatory returns given by the FSA will automatically be transitioned to the PRA.

Firms should review all individual guidance and their associated behaviour in accordance with such guidance and assess the appropriateness of that behaviour in line with the PRA's statutory objectives. In the period ending 30 September 2013, firms may submit items of FSA individual guidance (not falling within the above categories) to the PRA for review together with their assessment of whether the behaviour or actions set out in the guidance would advance the PRA's objectives. Any guidance that is not referred to the PRA for review will cease to have any status as formal PRA individual guidance from 30 September 2013.

## **Specific Rules**

### ***Threshold conditions***

HM Treasury has published indicative threshold conditions for the PRA which are more specific than the previous rules and are closely related in substance to the objective of promoting the safety and soundness of firms and policyholder protection.

Dual regulated firms will need to meet two sets of conditions, one set from the PRA and one set from the FCA. For the PRA, there will be threshold conditions specific to insurers and threshold conditions for all other firms regulated by the PRA.

In summary, the key threshold conditions specific to insurers are:

- > Business to be conducted in a prudent manner: This provides that the firm must have appropriate financial and non-financial resources, having regard to the nature and scale of its business and its ability to destabilise the UK financial system. The condition also encompasses the existing close links condition.

- > **Effective Supervision:** This provides that the firm must be capable of being effectively supervised by the relevant regulator, having regard to the nature and complexity of its regulated activities, the complexity of its products and the way in which its business is organised.
- > **Suitability:** The firm itself must be fit and proper, meaning that those who manage its affairs must have adequate skill and experience and act with probity and the firm must comply appropriately with its obligations and requests made of it by the PRA.

The FCA's threshold conditions in relation to insurers are similar to the above, excepting that only non-financial resources will be considered by the FCA and additional conditions will be imposed concerning the suitability of the insurer's business model and the appointment of claims representatives throughout the EEA for motor vehicle insurers.

From LCO, the FCA and PRA will each be responsible for their own set of threshold conditions. When addressing a firm's application to vary its permission or impose or vary requirements on a firm, both regulators will need to ensure that the firm concerned will satisfy and continue to satisfy the threshold conditions for which that regulator is responsible.

### ***Approved Persons regime***

The two key proposed amendments to the current approved persons' regime are:

- > with the exception of the non-executive director function, the current list of controlled functions for dual-regulated firms will be divided between the regulators in order to minimise unnecessary duplication for dual regulated firms;
- > the Statements of Principle in the Statements of Principle and Code of Practice for Approved Persons (APER) are expanded to a wider set of activities, and their application to people approved by either regulator (meaning that both regulators will have the ability to discipline certain categories of approved person); and
- > the PRA will specify certain functions as being within its jurisdiction, including the roles of chairman, CEO, finance director, CRO, head of internal audit, actuarial function holder, key non-executives and the chairmen of the main board committees. The approval of such persons will be led by the PRA (subject to the FCA's consent). All other approved persons will be authorised by the FCA.

### ***Skilled Persons' report***

The key amendments proposed in respect of the section 166 regime are:

- > the regulators will be able to contract directly with the Skilled Person;
- > the costs of a Skilled Person shall be payable as a fee by the firm concerned; and

- > the regulators shall have the power to commission a Skilled Person to collate or keep up-to-date information, where a regulated firm has breached regulatory requirements to do so.

Skilled person reports have increased in popularity within the FSA since the financial crisis. Both new regulators have indicated that they will continue to make use of such reports and the FSA has been advertising on its website for applicants to a formal panel of skilled persons. This suggests that the new power to appoint such persons directly will indeed be used.

### ***Applications to vary and cancel Part IV permissions and requirements***

Part 4A of FSMA is the new provision detailing requirements for permissions to carry on regulated activities, and “Part 4A permission” will be the new term for a Part IV permission.

From LCO, insurers (and other dual-regulated firms) must apply to the PRA to vary or cancel their Part 4A permission.

In addition, FSMA will be amended to narrow the concept of ‘variation of permission’, such that the variation or cancellation of a requirement imposed on a firm will no longer form part of the ‘variation of permission’ procedure. The splitting out of “requirements” is to address the practice that had developed under the FSA of imposing ongoing requirements on firms through the mechanism of “conditions” on a variation of permission.

### ***Applications for the waiver or modification of rules***

Neither the FCA and PRA may give a direction waiving or modifying a rule unless it is satisfied that the direction would not adversely affect the advancement of the relevant regulator’s objectives.

The regulators will no longer consider whether the direction to waive or modify a rule would result in undue risk to persons whose interests the rules are intended to protect.

An additional criterion will be taken into account by both regulators when considering whether it is appropriate or necessary to publish a waiver – both regulators will be required to consider whether the publication of the waiver would be detrimental to the stability of the UK financial system.

### ***Controllers and close links***

A person who decides to acquire, increase control over, reduce or cease to have control over, a dual-regulated firm must notify the PRA. The PRA must then consult the FCA in assessing proposed acquisitions and increases of control.

### ***Transfers of business***

The PRA will lead the transfer of insurance business process. The applicants should discuss initial proposals with their usual supervisory contacts and provide initial information to the PRA, which will share it with the FCA. The PRA will consult with the FCA throughout the insurance business transfer process, including on the appointment of the Independent Expert and the form of the Independent Expert’s report, and prior to approving newspaper

notices and policyholder communications. Both regulators will have the right to be heard at the court hearings.

## ***New powers over parent companies of regulated firms***

Pursuant to the FS Act, the FCA, PRA and BoE will have new powers in respect of certain unregulated parent undertakings (“**qualifying parent undertakings**”) that control and exert influence over certain regulated firms (including insurers incorporated in the UK). This recognises that in most cases, it is the board of the ultimate parent undertaking that decides overall group strategy and policies and can therefore affect the regulated subsidiary’s ability to comply with its capital requirements.

These powers will allow the regulators to:

- make directions imposing requirements on qualifying parent undertakings (for example, to raise more capital, restrict dividends, move assets around the group, restructure, facilitate the removal of holding company directors, remove barriers to resolution, etc);
- take enforcement action (for example, fine or censure) against qualifying parent undertakings, where directions are breached; and
- gather information from qualifying parent undertakings.

## **FSA Handbook**

The existing FSA Handbook has been divided into two new Handbooks – one for each of the PRA and FCA. There is some shared content that is common to both PRA and FCA Handbooks. Copies of the new Handbooks are available online.

Over time, each new regulator will develop its own Handbook in accordance with its particular statutory objectives.

Author: Victoria Sander / Tim Scott / Jacinta Lim

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

© Linklaters LLP. All Rights reserved 2013

Linklaters LLP is a limited liability partnership registered in England and Wales with registered number OC326345. It is a law firm authorised and regulated by the Solicitors Regulation Authority. The term partner in relation to Linklaters LLP is used to refer to a member of Linklaters LLP or an employee or consultant of Linklaters LLP or any of its affiliated firms or entities with equivalent standing and qualifications. A list of the names of the members of Linklaters LLP together with a list of those non-members who are designated as partners and their professional qualifications is open to inspection at its registered office, One Silk Street, London EC2Y 8HQ or on [www.linklaters.com](http://www.linklaters.com) and such persons are either solicitors, registered foreign lawyers or European lawyers.

Please refer to [www.linklaters.com/regulation](http://www.linklaters.com/regulation) for important information on our regulatory position.

We currently hold your contact details, which we use to send you newsletters such as this and for other marketing and business communications.

We use your contact details for our own internal purposes only. This information is available to our offices worldwide and to those of our associated firms.

If any of your details are incorrect or have recently changed, or if you no longer wish to receive this newsletter or other marketing communications, please let us know by emailing us at [marketing.database@linklaters.com](mailto:marketing.database@linklaters.com).

## **Contacts**

For further information please contact:

### **Victoria Sander**

*Partner*

(+44) 20 7456 3395

[victoria.sander@linklaters.com](mailto:victoria.sander@linklaters.com)

### **Duncan Barber**

*Partner*

(+44) 20 7456 3356

[duncan.barber@linklaters.com](mailto:duncan.barber@linklaters.com)

### **Tim Scott**

*Counsel*

(+44) 20 7456 2457

[tim.scott@linklaters.com](mailto:tim.scott@linklaters.com)

One Silk Street  
London EC2Y 8HQ

Telephone (+44) 20 7456 2000  
Facsimile (+44) 20 7456 2222

[Linklaters.com](http://Linklaters.com)