



Insurance and reinsurance news

RULES ON CONDUCT OF BUSINESS AND GOVERNANCE

In this issue of *Insurance and reinsurance news* we focus on conduct of insurance business and governance rules. In particular, we consider how rules in one member state of the European Economic Area may be applied to firms from other member states.

The rules on right of establishment and freedom to provide services

The existing European insurance directives were adopted with a view to promoting the internal market. They supported the freedom of European people and businesses to provide services, and the right to establish branches of their businesses, anywhere in the Community.

So insurance companies authorised, and insurance intermediaries registered, in one member state may, with the approval of their home state supervisors, 'passport' into other member states subject to complying with notification requirements. Pure reinsurance companies authorised in the European Economic Area (EEA) operate throughout Europe without needing to comply with any notification requirements at all.

Host state conduct of business rules

Although in general the passporting firm need only comply with the prudential rules of its home state, it must usually comply with conduct of business requirements in the host state. Some of these requirements have now been harmonised under, for instance, the Directive on the Distance Marketing of Financial Services.

There is still scope, however, for host state supervisors to impose conduct of business requirements. This tends to happen particularly in relation to the more heavily regulated life products. Other host state rules, in the tax

and employment fields, for instance, may also generate compliance costs. The directives indicate that host state requirements should be imposed only 'in the general good'. There is scope, however, for differences of view over the meaning of this expression.

The interpretative communication

These local rules are not supposed to act as disguised barriers to entry into member state insurance markets. In an 'interpretative communication' published in 2000, the European Commission summarised the law applying to member state conduct of business rules. It also considered how these rules might restrict EU Treaty freedoms in the insurance sector. It stated (in line with previous European Court of Justice (ECJ) decisions) that such rules:

- must come within a field that has not been harmonised;
- must pursue an objective of the general good;
- must be non-discriminatory;
- must be objectively necessary; and
- must be proportionate to the objective pursued.

This test imposes quite stringent restrictions on host state regulators. Host state rules have accordingly from time to time been challenged by the Commission or the European Free Trade Association (EFTA) Surveillance Authority.

Recent judgments in the life sector

In Norway, for example, until 2006 costs incurred by a policyholder when taking out life assurance were required to be charged and paid at the latest at the same time as the first premium. It was claimed that this promoted competition. But for the rule, it was argued, a 'completion costs debt' would arise, which the policyholder would have to pay over the life of the contract or on earlier termination. This would discourage surrenders and transfers.

The EFTA Court considered, however, that that purpose could be achieved by less restrictive means – for instance, by requiring full information to be provided about costs spread over the life of the contract. It held, therefore, that the rules were incompatible with article 33 of the Life Directive and could not be applied to incoming firms.

A similar result was arrived at by the ECJ in 2002 in relation to Belgian life assurance rules. These provided that a life assurance proposal or policy must inform the policyholder that surrender of an existing life assurance contract for the purpose of subscribing to another life assurance policy is generally detrimental to the policyholder. The ECJ upheld the Commission's challenge to these rules.

Solvency II

The European Community rules on conduct of business requirements are mostly unaffected by the Solvency II Directive, which focuses on prudential regulation and governance. Unlike its predecessors, however, Solvency II identifies the protection of policyholders and beneficiaries as the main objective of supervision. Arguably this reflects a long-term trend in financial services regulation and the emerging strength of consumer interests.

Sometimes there may be a tension between the protection of consumers and the removal of barriers to trade. This is illustrated by a judgment last year in the ECJ.

Protecting consumers v removing barriers to trade

The case concerned the insurance of compulsory motor risks in Italy. The general policy in that country is to ensure that every motorist should be able to obtain insurance cover at premiums determined in accordance with the rules.

This applies however bad the risk may be, whether because the motorist is very young, has a record of drunken driving or lives in an area that generates a higher level of claims.

The Italian government justified the rules to the Commission on the basis that they were aimed at protecting victims of road accidents and reducing the burden on the insurance guarantee fund.

So all insurance companies insuring these risks in Italy, whether domestic or foreign, were required to provide cover to the entire market. They could not, for instance, specialise entirely in the better risks or limit themselves geographically to the more prosperous, northern, part of the country. This added considerably to start-up costs.

The advocate general, Ján Mazák, gave an opinion supporting the Commission's challenge to these rules. He did not consider that the rules were objectively necessary or proportionate to the objective pursued. Opinions given by an advocate general in the ECJ are usually followed by the full court. In this case, however, the Court took the opposite view to Mazák on all points.

The judgment commented:

'The fact that some member states have chosen to establish a system different from that introduced by the Italian Republic to ensure that every vehicle owner is able to take out third-party liability motor insurance for a premium that is not excessive does not indicate that the obligation to contract goes beyond what is necessary to attain the objectives pursued.'

The process of challenging state conduct of business rules is cumbersome and lengthy (sometimes taking as long as five years). The motor insurance case suggests that the outcome may now be more difficult to predict, not necessarily because the law has changed, but because of the trend towards protecting consumers, which leads to a different approach. So in future cases involving problems of this kind, the Commission may prefer to propose harmonising legislation rather than trying to find solutions on a case-by-case basis.

Governance requirements

A rather similar issue arises in relation to governance requirements affecting the (re)insurance sector. The current regime, Solvency I, is not very explicit on

governance issues. It focuses primarily on financial supervision and states:

‘The financial supervision of an insurance/assurance undertaking, including that of the business it carries on either through branches or under the freedom to provide services, shall be the sole responsibility of the home Member State.’

The current regime does, however, require home member states to ensure that insurers have sound administrative and accounting procedures and adequate internal control mechanisms.

By contrast, Solvency II is much more explicit on governance generally. The home member state will review governance arrangements under pillar two of the prudential regime. What is less clear is whether a firm operating outside its home state through a branch in another member state must also comply with local governance requirements and whether it will be the home or the host state authorities that take enforcement action when necessary. The better view is probably that host state supervisors should have no say on general governance requirements for passported branches. There may, nonetheless, be room under the strict ‘general good’ test for local governance requirements on client-facing activities or other rules imposed in the interest of the general good.

In many areas governance requirements are due to be harmonised under the Solvency II regime through ‘level two’ legislation. Even then, however, there may – unfortunately – be scope for different interpretations to be applied across the EEA, particularly if European governance requirements are implemented through directives. Regulations are directly effective across the EEA whereas directives need to be transposed and interpreted by member states.

This may not be a significant issue in all insurance groups that operate across Europe through a network of subsidiaries, because the subsidiaries will usually be incorporated locally and may not have cross-border operations. In groups with centralised risk management, some governance functions may be concentrated in the state where the group is supervised. The question then arises what expertise must be retained at local level. The Committee of European Insurance and Occupational Pensions (CEIOPS) has proposed, in relation to the

actuarial function, for instance, that ‘adequate actuarial skills have to be maintained at solo-level, as technical provisions and methodologies used are very closely linked to local market conditions’.

Increasingly, however, insurance groups are tending to consolidate into branch networks. These involve the same corporate entity operating throughout Europe. This may often be more efficient for capital-management purposes.

As mentioned above, Solvency II requires the home state supervisor to take responsibility for supervising all governance arrangements so that firms do not have to meet the expectations of 27 different insurance supervisors. In practice, it may be questionable whether a supervisor in western Europe, for instance, would have much enthusiasm for enforcing governance standards if the only problems arise in an eastern European member state. For example, the UK’s Financial Services Authority’s Enforcement Guide indicates that it ‘consciously uses the enforcement tool to deliver its overall strategic priorities’, which tend to be focused on the UK market.

This issue may be covered at a later date in Commission guidance within the Solvency II implementation process.

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