Insurance Quarterly Legal and Regulatory Update

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1 January to 31 March, 2010

DILLON EUSTACE

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INSURANCE QUARTERLY LEGAL AND REGULATORY UPDATE

Third Anti-Money Laundering Directive – 2005/60/EC

The draft legislation for the Criminal Justice (Money Laundering & Terrorist Financing) Bill 2009 ("the Bill"), which will give effect to Directive 2005/60/EC on the "Prevention of the use of the Financial System for the Purpose of Money Laundering and Terrorist Financing" (the "Third Anti-Money Laundering Directive") in Ireland, was presented to the Seanad for the Report Stage on the 23 March 2010 having concluded deliberations at both the Seanad Committee Stage on the 11 March 2010 and the Second Stage on the 2 March 2010.

While is it difficult to determine how long the Bill will take to progress through the Seanad it is hoped that the Bill will be passed into law in April 2010. However, until the legislation is passed, the Criminal Justice Act, 1994 (as amended) and the Criminal Justice (Terrorist Offences) Act, 2005 continue to apply.

On the 18 March 2010, the Financial Regulator invited public comment on the latest (March 2010) draft of the Industry Drafting Group's Core Guidance Notes on the prevention of the use of the financial system for money laundering or terrorist financing. Public comment on the draft guidance notes should be sent to both brendan.nagle@financialregulator.ie and brian.kelly@financialregulator.ie

The draft guidance notes are subject to further changes as the Bill nears the end of the legislative process.

If you would like further information on anti-money laundering requirements Dillon Eustace regularly advises on all aspects thereof and provides training sessions on this topic. Training can be held either at Dillon Eustace's office at 33 Sir John Rogerson's Quay, Dublin 2 or in house training can be provided at a venue of your choosing.

Solvency II Framework Directive - 2009/138/EC

On the 17 December 2009, the definitive text of the Solvency II Directive (2009/138/EC) was published in the Official Journal. The Council of the European Union ("the Council") adopted the Directive on 10 November 2009 and it was then signed by both the Council and the European Parliament on 25 November 2009.

The Directive aims to strengthen the supervision and prudential regulation of insurance and reinsurance companies, particularly through the imposition of new solvency and governance requirements. It also establishes a new framework for EU regulation through the recasting of 13 insurance directives into a single text.

The Directive comes into force 20 days after its publication in the Official Journal, however a number of the provisions (including the repeal of existing insurance directives set out in Article 310) only apply from 1 November 2012. Member States will have to implement the Directive by 31 October 2012.

On the 29 January 2010, the Financial Regulator published a document updating the industry on the response to its survey in August 2009. In August 2009 the Financial Regulator wrote to all Irish authorised insurance and reinsurance undertakings requesting the submission of certain information in relation to the use of internal models under Solvency II. The information was requested from 60 Life undertakings, 130 Non Life Insurance undertakings and 120 Reinsurance undertakings. Of the 310 institutions, 253 indicated that they intended using the Standard Model and 57 indicated that they intended to use an internal model. Of the 57 intending to use an internal model, only 16 will be using an internally-developed model, which will require to be approved by the Financial Regulator. The other 41 firms will be importing models developed at group level and authorised by regulators in other EU states.

Firms intending to use internal models are required to complete and return the second Questionnaire to the Financial Regulator by 31 March 2010.

On the 4 February 2010, the Financial Regulator published a letter addressed to the Society of Actuaries in Ireland providing feedback from its reviews of Financial Condition Reports and Statements of Actuarial Opinion. The Financial Regulator notes that in very many cases reports were not comprehensive enough. Actuaries should be documenting all considerations in their reports. The aim is to enable another actuary (in particular one working for the Financial Regulator) to understand the work undertaken. The Financial Regulator acknowledges that reports may be written for Directors who do not have actuarial experience, but notes that in the future and specifically with Solvency II in mind, greater technical knowledge will be demanded from Directors than has been the case in the past. This is an explicit signal from the Financial Regulator that it has high corporate governance expectations under Solvency II. While most work on Solvency II to date has concentrated on

the valuation models and techniques, Solvency II contains a sizeable body of corporate governance requirements which have not yet been as widely considered by firms.
The Financial Regulator notes that few actuaries gave much attention to Solvency II in their reports and have emphasised that it is very important that Boards receive advice on the expected impact of Solvency II.

Deloitte's External Study on the Impact Assessment of Solvency II

On the 20 January 2010, the Financial Regulator published on its website the consultation paper being undertaken by Deloitte on the potential impact of Solvency II technical (Level 2) measures. The European Commission appointed Deloitte to conduct this study, which will look at the impact of the proposed move from Solvency I to Solvency II on insurance balance sheets and business behaviour, on insurance products and markets and social and economic impacts.

The consultation paper sets out the preliminary conclusions of the likely impact of the move to Solvency II and the impact of the various policy options which are under consideration. Respondents are asked to comment (no later than the 19 February 2010) on these preliminary conclusions by providing business examples and highlighting possible exceptions to the general conclusions. The objective of this consultation is to ensure the maximum range of input is obtained from the industry. The information being gathered by Deloitte is additional to and independent of the consultation work being carried out by Committee of European Insurance and Occupational Pensions Supervisors' (CEIOPS) in relation to the implementation of Solvency II. The European Commission will produce and publish the Main Impact Assessment Report for the Solvency II level 2 measures based on contributions from Deloitte and other parties including CEIOPS.

Solvency II Level 2 Implementing Measures

In late 2009, CEIOPS established a Task Force to lead further work on the issue of the inclusion of a liquidity premium in the risk-free rate for discounting technical provisions as an additional input for Level 2 implementing measures. Having considered industry submissions, the Task Force issued its report on 1 March 2010, which deals with the issue of liquidity premium under the following headings:

- Methods of calculation of a liquidity premium for assets and liabilities;

- Recognition of a liquidity premium in the standard formula for the Solvency Capital Requirement (SCR);
- Split between interest rate risk and spread risk in the standard formula;
- Changes to the spread risk model to permit a liquidity premium;
- Adjustments to spread risk/other market risk correlation assumptions; and
- Overall impact of a liquidity premium on solvency of insurers.

The Comité Européen des Assurances (CEA) has published a set of "key messages" on Solvency II Level 2 implementing measures. Whilst fully supporting the Solvency II project, the CEA has criticised the advice given by CEIOPS to the European Commission on the inclusion of a liquidity premium (discussed above).

The CEA considers that CEIOPS' advice is in contradiction with the objectives underpinning the Solvency II Framework Directive in a number of respects - particularly in suggesting an increase of financial requirements beyond the level stated in the Directive.

CEA feels this will create serious obstacles to the sound functioning of insurance business and have unavoidable negative effects on consumers, without delivering significant incremental benefit in terms of policyholder protection.

Regulations on Accounts and Consolidated Accounts

On the 18 November 2009, the European Communities (Directive 2006/46/EC) Regulations (S.I. 450 of 2009), which implement Directive 2006/46/EC on Company Reporting in Ireland, were signed into law. On the 25 February 2010, an amending regulation to S.I. 450 of 2009 namely S.I. 83 of 2010 ("the Regulations") was published bringing clarity to the effective date of the Regulations.

The key changes are as follows:

- Irish incorporated companies (excluding investment companies) whose securities are admitted to trading on a regulated market or on a multi-lateral trading facility will be required to prepare and include a **Corporate Governance Statement** in the annual (directors') report <u>for financial year's ending on/after 18 November 2009 (S.I. 83)</u>;
- However, the requirement to include a description of the main features of the internal control and risk management systems of the company in relation to the financial reporting process <u>and</u> the auditor's opinion on same shall

only apply for financial year's beginning on/after 18 November 2009 (S.I. 83).

- Listed investment companies (i.e. listed fund companies), who are not already subject to annual reporting obligations in relation to a governance code by virtue of that listing, will have to produce a **Corporate Governance Statement** for financial year's beginning on/after 18 November 2009 (S.I. 83).
- Disclosure requirements for "off balance sheet arrangements" and "related party transactions" will apply to listed and unlisted companies in respect of financial years ending on/after 18 November 2009 (S.I. 83).
- Amendment to existing fair value rules whereby Regulation 3 extends the right of both public and private companies, which prepare annual accounts under the Companies Acts to use fair value accounting for a variety financial instruments in accordance with IAS 39 in both their individual and consolidated accounts.

It should be noted that a person who contravenes these Regulations is guilty of an offence and is liable on summary conviction to a fine of €5,000 or three months imprisonment or both and on indictment to a fine of €50,000 or imprisonment for a term not exceeding three years or both.

The Companies (Miscellaneous Provisions) Act, 2009

On the 23 December, 2009, the Companies (Miscellaneous Provisions) Act, 2009 (the "Act") was signed into law introducing a number of important changes to Irish company law.

Sections 1, 2 and 3 (a) – (h) and Section 4 of the Act have commenced relating to:

- The use of US GAAP by certain companies on a temporary basis therefore reducing the burden on those companies listed on the US Securities and Exchanges Commission, which want to relocate their head office to Ireland;
- The creation of a new type of purchase called an "overseas market purchase" to facilitate international companies re-domiciling to Ireland, which are not listed on the Irish Stock Exchange and that wish to avail of the market purchase regime when undertaking share buy-back programmes;
- The continuity of membership by directors of committees of enquiry established by the Irish Auditing and Accounting Supervisory Authority (IAASA) ensuring membership doesn't change during an enquiry, which could endanger fair procedure and process; and

- The limit of potential costs to the Exchequer of certain types of investigations into the affairs of the company, as the High Court may now require the applicant (e.g. such a director) calling for an investigation to give unlimited security for payment of costs of the investigation. Previously the security was limited to an amount up to IR£250,000.

Section 3(i) to (j) and Section 5 relating to migrating funds have not yet been commenced as the Financial Regulator is currently liaising with Cayman, Bermuda, Gibralter and the Channel Islands to agree reciprocal arrangements. This is likely to take another six months. When these sections are commenced, the Act will introduce a mechanism whereby certain collective investment undertakings can migrate their registered offices into and out of Ireland without firstly having to wind up in their current jurisdiction thus attracting investment funds business from third countries who are seeking to relocate to a well regulated jurisdiction.

Data Protection - New Standard Contractual Clauses

The European Commission has approved new standard contractual clauses on the transfer of data to data processors established in third countries. The new clauses will come into force from 15 May, 2010.

For further details please contact David Nolan in Dillon Eustace.

The link to the new clauses is set out below for convenience.

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:039:0005:0018:EN:PDF

Insurance Block Exemption

After a detailed review of the functioning of the current Block Exemption Regulation (BER) adopted in 2003 and which expires on the 31 March 2010, the Commission has adopted on the 24 March 2010 a new Regulation (Commission Regulation (EU) 267of 2010) that block exempts certain types of agreements in the insurance sector from the EU's general prohibition of practices restrictive of competition.

The new BER, which will come into force on the 1st of April 2010, renews two of the four categories of agreements currently exempted, namely joint compilations, tables and studies, and co(re)insurance pools, with some amendments. Certain information exchange can be justified in order to allow insurers to accurately assess risks. Pooling is also important in order to ensure that all risks can be covered. These two types of agreements justify a block exemption. Other types of cooperation may also be legal but it will be for insurers to self-assess that they comply with the general competition rules.

The new regulation will be valid until 31 March 2017.

Financial Services Ombudsman

On the 15 February 2010, it was announced that Bill Prasifka has been appointed as the new Financial Services Ombudsman and will take up office by the end of March 2010. Mr Prasifka succeeds Joe Meade who retired on 3 January 2010.

Mr Prasifka is currently Chairman of the Competition Authority, a role he has held since March 2006. Previously, Mr Prasifka has worked as the Irish Commissioner for Aviation Regulation.

The Financial Regulator

- Chief Executive – On the 4 January 2010, Matthew Elderfield took up the position as the new Chief Executive of the Financial Regulator taking over from Mary O'Dea. The roles of Chief Executive and Consumer Director will be combined. Matthew Elderfield will become the Head of Financial Regulation in the new restructured Central Bank, once legislation passes through the Oireachtas confirming the restructuring.

  Mary O'Dea will now take up the post of Assistant Director General, Financial Operations within the Central Bank.

  On the 12 January 2010, it was announced that Jonathan McMahon has been appointed as Assistant Director General with responsibility for Financial Institutions Supervision within the Central Bank, which will include oversight of the supervision of banks and insurance companies.

  The new Registrar of Credit Unions, when appointed, will report into Mr McMahon's division.

- Weaknesses in Sales Processes for Older Customers - The Financial Regulator, in February, published its findings following a four part examination conducted over 2009 of selected credit institutions, life insurance firms and investment and stockbroking firms in relation to the suitability of investment products sold to older customers.

The issues identified during the examination included the following-

- Firms should have a practical definition of an older customer with the Financial Regulator suggesting 60 as the appropriate benchmark;
- Firms are required to gather and record sufficient information including income and asset and liability detail from the customer to enable it to provide a suitable recommendation to the customer;
- Older customers should be offered the option of having a third party present at a sales meeting;
- Firms should advise older customers of the need for an emergency fund to cover medical or other long term care expenses; and
- Firms must prepare specific statements of suitability tailored to the consumer as distinct to issuing generic versions

The compliance issues identified during the inspection are already subject to separate engagement by the Financial Regulator with the individual firms concerned, however all firms are required to consider the issues identified in the findings and ensure that the appropriate amendments are made to procedures accordingly.

- General Charging Issues – On the 8 February, Matthew Elderfield, as the Head of Financial Regulation, announced that the Financial Regulator is conducting a review of its approach to how overcharging is dealt with under the Consumer Protection Code following recent cases where financial institutions continue to experience control failures that result in customers being overcharged. The Financial Regulator in conducting its review will focus on the timeliness of resolving overcharging in firms and the grounds for enforcement against such failures.

- Settlement Agreement – Following an initial themed inspection into the sale of Friends First ISTC Bonds and a subsequent inspection of the firm, the Financial Regulator has entered into a Settlement Agreement with effect from 17 February 2010 with Jim Mannion & Co (Insurances) Ltd, Strokestown, Co. Roscommon. The firm was found to have failed to inform one customer about the investment risks and guarantee limitations associated with the ISTC Creative Bond. In relation to the sale of other products, additional breaches were found relating to the failure to record certain customer information, failure to provide the customer with the firm's terms of business and failure to provide a statement of suitability.

The Financial Regulator reprimanded the firm and required it to pay a fine of €5,000. The firm has confirmed that it has adopted new procedures and controls to become compliant and prevent future non-compliance.

- Cash Funds – On the 22 February 2010, the Financial Regulator issued a letter to insurance firms requiring the submission of information relating to investment products which are marketed as being invested in cash or partially invested in cash. The Financial Regulator has requested insurance firms to identify the following information in their submission, which was due to be returned on 20 March 2010 namely:
  - The amount of each fund;
  - Whether the fund has a "no fall in value" assurance; and
  - Any difference between market value and face value.

  The Financial Regulator states that where such funds invest in variable instruments such as floating rate notes there may be issues "in regard to policyholders' reasonable expectations".

- Address to Leinster Society of Chartered Accountants – On the 11 March 2010 Mr Elderfield, as the Head of Financial Regulation, made his first public appearance since arriving in Ireland by addressing the Leinster Society of Chartered Accountants. Mr Elderfield discussed the need to overhaul our approach to financial regulation using a balanced and measured approach. He advised that he intended to implement a framework of assertive risk based regulation underpinned by a credible threat of enforcement whereby the riskiest firms manage themselves better and that firms and management are held more accountable for their actions.

- Frequently Asked Questions on the Prospectus Directive - On the 12 March 2010 the Financial Regulator published a list of the questions most frequently asked of the Financial Regulator regarding the Prospectus Directive 2003/71/EC. Queries regarding the Frequently Asked Questions should be addressed to markets@financialregulator.ie.

- Updated XML Reporting Schema for Life Insurance Companies – On the 26 March 2010 the Financial Regulator issued an updated version of the XML Schema for Life Insurance Reporting. This is available on the Financial Regulator's website under the Reporting Requirements page in the Life Insurance section.

- Address by Head of Financial Regulation to the European Insurance Forum – On the 29 March 2010, the Head of Financial Regulation, Matthew Elderfield, addressed the European Insurance Forum on the challenges posed by Solvency II to regulators in the context of taking a risk based approach to regulation and supervision. Instead of determining whether a rules based approach or a principles based approach to regulation is appropriate, Mr Elderfield said it is clear that a mixture of both is required so that the Regulator can assess the inherent risk and impact of a particular firm or sector. He went on to discuss the challenges posed by Solvency II to captive insurers, in terms of the obligation to prepare an Own Risk and Solvency Assessment (ORSA), given captives for the most part have a significantly different inherent risk profile to other insurers. He indicated that the Financial Regulator will take a common sense approach so long as captives take the time to put together a sensible assessment of the various Pillar II risks. He went on to confirm that the Financial Regulator is prepared to work with the Dublin International Insurance and Management Association (DIMA) to assess a handful of captive ORSAs on a pilot basis and use this for broader industry feedback thus providing DIMA members with a clearer picture of what is viewed as good practice by the Financial Regulator.

- Administrators appointed to Quinn Insurance – On the 30 March 2010, the High Court appointed two joint provisional administrators to Quinn Insurance Limited. The application was made under the Insurance Act, 1983 by lawyers acting on behalf of the Financial Regulator. The court was advised that the Financial Regulator has taken this action in the interest of the firm's policyholders.

  Following their appointment, the administrators will run the general insurance business as a going concern under different management in the interest of policyholders. The Financial Regulator has an onsite presence in the firm to oversee its actions and to work with the new management. At the same time the Financial Regulator has commenced an investigation into certain matters within Quinn Insurance Limited that have very recently come to light.

  In addition, the Financial Regulator has separately directed Quinn Insurance Limited to cease writing new business in the UK. Existing UK policyholders will not be affected by this decision as existing policies will remain valid. Customers can make claims in the normal way. The effect of this action is to prevent Quinn Insurance Limited suffering further financial losses from its currently unprofitable UK business.

  Quinn's life insurance business, which is a separate entity remains unaffected.

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This Insurance Quarterly Legal and Regulatory Update is for information purposes only and does not constitute, or purport to represent, legal advice. It has been prepared in respect of the current quarter and, accordingly, may not reflect changes that have occurred subsequent to the start of such period. If you have any queries or would like further information regarding any of the above matters, please refer to your usual contact in Dillon Eustace.

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