Examining the regulatory pipeline

23 November 2010

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Agenda

- **European regulatory developments**
  - **Packaged Retail Investment Products (PRIPs)**
  - **Gender Directive**
  - **Insurance Guarantee Schemes**
- **Irish regulatory developments**
  - **Corporate Governance Requirements (formerly CP41)**
  - **Variable Annuity requirements**
  - **Consumer Protection Code consultation**

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Not The Agenda

- **European regulatory developments**
  - **Solvency II**

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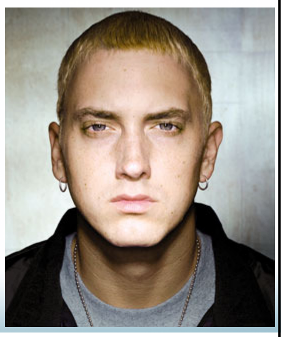
Packaged Retail Investment Products

- Individuals can invest directly in an asset – e.g. a share or basket of shares
- Alternatively, it may be possible to invest in something that gives exposure to the asset:
  - A unit-linked investment policy
  - A tracker bond
  - A UCIT or other fund
  - Maybe others
- Potentially very similar investments may be:
  - Produced by different entities,
  - Sold through different entities,
  - With different sales processes and
  - Different information disclosure requirements



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European Commission Paper

- April 2009 – EC issues a paper on PRIPs
- Proposal to move to a common framework for disclosure requirements and sales process of all PRIPs.
- EC Definition: A PRIP can take a variety of legal forms which provide broadly comparable functions for retail investors
  - Offer exposure to underlying assets, but in packaged form which modifies the exposure compared with direct holding
  - Primary function is capital accumulation (though some may provide capital protection)
  - Aimed at medium to long term retail market
  - Marketed directly to retail investors (though they may also be sold to more sophisticated investors)
- Terminology:
  - Firms producing PRIPs are **Manufacturers**
  - Firms selling PRIPs are **Distributors**
  - People buying PRIPs are **Investors** (regardless of the nature of the product)

3L3 set up a task force

- April 2009 – November 2009: CESR, CEBS, CEIOPS (three "Level 3" Committees covering securities, banking and insurance regulators) consider report
- Response is a 3L3 task force to study the key issues
- Three main areas of focus:
  - Scope
  - Disclosure requirements
  - Sales process
- Report of the 3L3 Task Force published in October 2010

3L3 task force recommendations

- Scope:
  - A PRIP is a product where the amount payable to the investor is exposed to a) fluctuation in the market value of assets or b) payouts from assets, through a combination of wrapping those assets, or other mechanisms than a direct holding.
  - Pensions and annuities out of scope for now – a lot more work to be done in this area
  - Protection products out of scope
  - Deposits out of scope (but Structured products are in scope)
  - Question mark about some products, including:
    - With Profits
    - Variable Annuities
    - Hybrid products (e.g. investment and protection combined)
  - Possible production of a non-exhaustive “white list” of PRIP products to complement the definition.
  - Direct investment in shares are out of scope – they are RIPs not PRIPs!

3L3 task force recommendations

- Disclosure Requirements:
  - Currently there are separate requirements for form and content of disclosures:
    - The Insurance Directives, The IMD, The Prospectus Directive, The UCITs Directive, MIFID
  - Key Investor Information document (KII) required for UCITs is the most useful starting point for common PRIP requirements
  - More work needed to ensure this is applicable to other PRIPs
  - Key principles relate to comparability of various types of PRIPs, and disclosure of key information around risks, costs, past / expected performance
  - Production will be the responsibility of the Manufacturer not the Distributor
  - Some open questions:
    - KII per fund? (e.g. life investment policy covering a range of funds)
    - What about a PRIP within a PRIP? (e.g. life policy wrapping a structured deposit)
  - Should investor specific information feed into a KII
    - Age of policyholder may affect benefits, what about commission levels etc.
    - 3L3 favour a standalone KII that does not contain information specific to the investor
    - Distributor gathers information and submits with application to the manufacturer
    - “Tailored” PRIP would require the standard KII with a supplemental document alongside
  - Majority of task force do not support pre-approval of KII by regulators

3L3 task force recommendations

- Sale Process:
  - MIFID Level 1 provisions are the benchmark, but must recognise other specific issues e.g. for insurance based PRIPs
  - Key MIFID principle: each firm must "act honestly, fairly and professionally in accordance with the best interests of its clients"
  - Conflicts of interest to be disclosed (in some cases this may not be enough, and conflicts will need to be avoided)
  - Requirements around suitability of advice for advised sales
  - Majority of task force members believe it should be possible to sell some PRIPs in non-advised sales - how will this interact with local requirements, e.g. re sales of insurance policies
  - Likely to be some particular requirements on "inducements"
    - Key principle of acting in the best interest of clients applies here – inducements should never impair compliance with this requirement.

Gender Directive

- "Gender Directive" – 2004/113/EC
- Designed to eliminate discrimination on the basis of gender
- Implications for insurance
  - Article 5 gives Member States an option to opt out in relation to insurance
  - Insurers can differentiate premium rates for men and women as long as:
    - Use of sex is a determining factor in the assessment of risk based on relevant and accurate actuarial and statistical data
    - Relevant data must be compiled and published regularly
  - Costs relating to pregnancy and maternity cannot be considered in differentiating premiums.

- Broadly speaking gender directive meant business as usual for Irish insurers… until now

Test Achats

- Test Achats is a Belgian consumer association – they have challenged the validity of the Article 5 opt-out at the European Court of Justice
- ECJ has not ruled yet, but the Advocate General recently opined against different rates for men and women
- IF ECJ follows this opinion (and has in the majority of cases) insurers would have to charge unisex rates
- Implications for pricing (obviously!), reserving, risk management…
- May result in higher premium levels overall (international experience suggests that this is the case)
- Wider implications?

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Rates differentiated by age

- Unisex rates would present challenges for certain markets – term assurances, annuities, motor insurance etc.
- Would expect industry to meet the challenges
- Potential for gender decision to have wider repercussions
- An equality directive (including age and disability) is currently being developed modelled on the gender directive – optional derogation for insurance
- Might the gender decision result in a prohibition from using age as a risk factor, maybe health information too
- Clearly there are very significant challenges for the insurance industry in this scenario

- Risk Equalisation for life insurers…?

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Insurance Guarantee Schemes

- EU Commission issued a White Paper in July
- Proposed policyholder protection scheme regime for life insurers
  - Minimum requirements to apply across Europe
  - Schemes to be set up in each Member State – home state rather than host state basis
  - Covering both life and non-life policyholders for amounts less than 100%
  - Schemes to be funded in advance rather than “after the event”
  - Commission suggests a fund of 1.2% of premiums to be built up after 10 years
  - Contribution from each insurer will depend on its risk profile
- Whatever the final form, EU Commission is committed to implementing a new regime
- Will mean greater costs for consumers but for greater security

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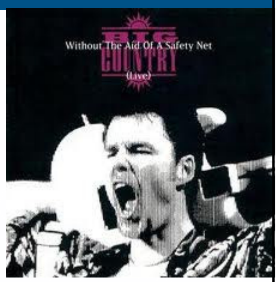
Key issues



- Enhance policyholder protection
- Increase harmonisation of EU insurance markets
- Challenge of moral hazard:
  - Safety net may encourage customers to choose riskier insurers
  - Safety net may reduce risk management incentives for insurers
  - Limits on benefits designed to mitigate the first point
  - Ex-ante funding designed to mitigate the second point
- Ex-ante funding will lead to additional costs
- Challenge of dealing equitably with people at the point of insurer insolvency
- Potential for the scheme to step in to avert insolvency
  - Additional challenges in terms of skills and resource
- For life insurance, focus on portfolio transfer of risks to another insurer
- For non-life – key protections around outstanding claims rather than premiums paid.

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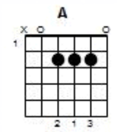
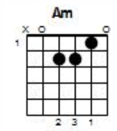
Corporate Governance Requirements

- CP41 issued by Central Bank (then FR) in April 2010, closing date for consultation was end June
- Follow up meetings with a small number of respondents
- Central Bank's largest ever response to a consultation paper - response described as very useful
- On 8 November, the CB published the revised code
  - Clarifying issues where respondents felt that further clarity was needed
  - Revising the code where the CB was "persuaded by the rationale put forward"
  - Retaining core requirements which will enhance effective corporate governance
- Governance code is one plank – new fitness and probity requirements due (Central Bank Reform Act) plus remuneration requirements

Major and Minor

- Many of the responses received related to proportionality
- The CB has now re-structured the code with a key change relating to the distinction between Major companies and Minor companies
- Basic requirements which apply to all companies.
- Additional requirements which apply to “Major” companies.
- Major companies will be informed that they are major soon
- Assessment based on criteria like:
  - Wholesale or retail business model
  - Number of contracts
  - Type of insurance provided
  - Risk (e.g. riskier products?)
  - Asset size, Technical provisions, Premium income, Capital position
  - Number of employees
  - Subsidiary / publicly traded / privately owned





Main requirements

Main requirements	Minor	Major
Minimum number on the board / INEDS	5 / 2	7 / 3
Minimum number of board meetings	Quarterly	11 – in 11 different months
Max no. directorships per director (financial services / other)	5 / 8	3 / 5
Audit Committee	Always	Always
Risk Committee	Always	Always
Nomination Committee	Not required	Always
Remuneration Committee	Not required	Always

- Majority of directors must be independent non-execs (except for subsids where non-exec majority can include group non-execs)
  - Non-exec – no executive responsibilities within the company but can have within the group
  - Independent – consider financial obligations, shareholdings, recent employment with the company, employment with the group, provisions of professional services, additional remuneration, close personal relationships

Main requirements contd.

- Board members shall attend each board meeting unless they are unable to because of circumstances beyond their control
  - Attend in person?
- Attendance and eligibility to vote must be evidenced
- Majority of directors reasonably available to Central Bank at short notice
- No significant conflicts of interest
- Board membership reviewed at least once every three years
  - Formally review any person who has been a board member for 9 years
- Requirements for chairman
  - Independent NED except subsidiaries – can be group NED
  - Elected annually
  - Can't be the CEO
  - Can't have been CEO, exec director or senior manager of institution in the previous 5 years
  - Can't be chairman or CEO of another credit institution or insurer

Role of the Board

- Effective, ethical, prudent oversight
- Business strategy
- Ensure proper management of risk and compliance
- Can delegate (but not abrogate) responsibility to sub-committees
- Understand Group functions / resources where these are relied on
- Be able to explain decisions to the Central Bank
- Appoint CEO, exec directors, senior managers
- Removal of heads of control functions (including internal audit, risk management, compliance, actuarial) subject to prior board approval
- Document risk appetite – understand risks to which the company is exposed

Variable Annuities

- CP42 – consultation paper on capital requirements for investment guarantees
- Issued in May 2009, responses by end June – now closed
- The Paper set out a series of requirements including:
  - Capital requirements
  - Risk management requirements
  - Modelling requirements
  - Reporting requirements
  - Independent oversight requirements

- Full regulatory response to the consultation process is awaited, but in the meantime the Regulator issued a letter to VA companies and their Appointed Actuaries / Signing Actuaries

Latest developments

- The letter sets out additional reporting requirements for end 2010

- AA needs to quantify, and report on a number of issues for year end – in line with normal reporting deadlines (by end April)

- From the Central Bank's perspective these will be issues that would normally have been considered and examined, but must now be documented and reported more formally

Main items to be considered:

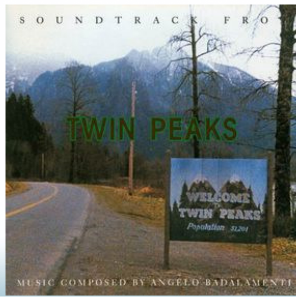
- Analysis and justification of offsets to reserves for dynamic hedging
- Analysis and justification of basis risk
- Numerical justification of sufficiency of model and modelling process
- Examination of the ESG
- Justification of all assumptions made
- Operational and model risk
- Liquidity risk
- Path dependency
- Demographic risk (especially longevity)
- Policyholder behaviour risk / lapses
- Counterparty risk

- This is going to be a lot of work

Solvency II comparison

- Appointed Actuaries and Signing Actuaries are asked to compare their VA reserving and capital with the Solvency II requirements (QIS5)

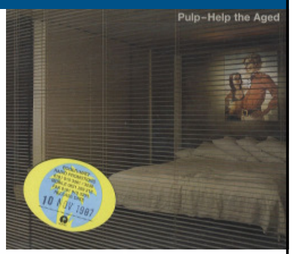
- Do companies need to hold the higher of current and Solvency II requirements?
  - Not Necessarily BUT…
  - If capital requirements under Solvency II are higher, then the AA / SA must understand why this is so
  - In particular if it is because the current methodology does not adequately allow for a risk that is captured under Solvency II, then the actuary would need to consider whether the current methodology is adequate.



Consumer Protection Code

- CP47 - open consultation on the CPC (closing date 10/01/2011)
- Proposed changes include changes relating to:
  - Vulnerable consumers
  - Suitability of mortgages
  - Additional product disclosures
  - Additional responsibilities for product producers
  - Recommendations from the review of the intermediary market (2008)
  - Error handling
  - Unsolicited contact
  - Arrears handling
  - Small print
  - Transparency of credit card statements
  - Statutory basis for IBF switching code

Insurance perspective:



- Vulnerable consumers
  - Issue emerged primarily from mystery shopping
  - “Mental or physical infirmity, age, circumstances or credulity”
    - Low level of educational attainment
    - Low income
    - High level of indebtedness
    - Poor credit history
    - English not a first language
    - Long term illness, disability, episodic illness
    - Diminished mental capacity
    - Near or over statutory retirement age, retired from occupation, or retiring soon
    - Recently bereaved
    - Those with substantial sums to invest and little or no investment experience
    - People who struggle to fill in the application form correctly
  - Regulated Entities have to assess suitability of products for consumers – this may be a challenge
  - Mostly an issue for distributors not manufacturers…but see the next slide

Insurance perspective:

- Additional product disclosures
  - Extension of Tracker Bond style key features document
  - Reference to KII document for UCITS (see PRIP discussion earlier)
  - Suggestion of traffic light system for disclosing investment risk
  - PRSA requirements to be incorporated into the revised Code
- Product Producer responsibilities
  - No appetite for advance product approval by the CB ("premature")
  - But more attention on monitoring product developments
  - Regular surveys of products, and broader powers for the CB to prohibit the sale of certain products that have been identified as "inappropriate"
  - Product producers must identify the types of consumer that the product would be suitable / unsuitable for
  - Product producers must provide distributors with detailed, clear, accurate, up to date information on design and risk features
  - Must review products annually to see if they continue to meet the general needs of the target market they were designed for.

Insurance perspective…

- Recommendations from review of the intermediary market include:
  - "broker" can be used by someone who offers consumers a "fair analysis of the market"
  - Terms of business must set out for each product type the level of service (fair or limited analysis)
  - Where limited - must disclose the names of companies whose products it distributes
  - Disclosures in relation to being tied agents (including disclosures in ads and product materials)
  - Limits on the use of the term "independent" (including fair analysis, option to pay by fee)
  - Remuneration disclosures for non-life intermediaries
  - Providers cannot terminate appointments based solely on new business volumes
  - Regulated entities must not knowingly create situations that may give rise to a conflict of interest

Insurance perspective…

- Error handling
  - Firms used to report “material” errors – open to interpretation
  - New requirement – Errors which cannot be resolved within 1 month
  - Errors that have or could result in customer detriment must be fixed within 6 months
  - Proactive testing and monitoring to prevent errors and detect early.
- Small Print
  - Key information must be included in the main body of an advertisement
  - Defined as any information which will influence a customer’s decision with regard to purchasing or not purchasing a product. Deemed to include:
    - Criteria for availing of the product
    - Exclusions
    - Max / Min investment amounts
    - Restrictions on withdrawals / access
    - Penalties / charges

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