



# Insurance and reinsurance news

RECENT AND FUTURE DEVELOPMENTS IN THE REGULATION OF LINKED LONG TERM INSURANCE PRODUCTS

In this edition of insurance and reinsurance news we discuss recent developments in the regulation of unit-linked products. We also consider some compliance issues and how the regulation of such products may change under the new Solvency II prudential regime.

## Introduction

Benefits under long term insurance products are often linked to the value of property such as a unit trust or other fund. They may also be linked to an index such as the FTSE.

Such products include annuities, mortgage endowment policies and single premium bonds.

## Recent reforms

The regulation of linked products was reformed from November 2007. The new rules in the Financial Services Authority's (FSA's) Conduct of Business Sourcebook (COBS) were aimed at:

- creating distinct regimes for:
  - on the one hand, retail products and,
  - on the other hand, products aimed at institutions such as pension funds;
- liberalising the rules as to what property, funds and indices may be linked to, within the limits imposed by the EU Life Assurance Directive;
- bringing the regime more closely (although not entirely) into line with equivalent rules applying to collective investment schemes; and
- articulating a set of high level principles mainly aimed at the design of linked products.

## Marketing and Treating Customers Fairly issues

The high-level principles applying specifically to linked products do not address marketing issues, although one

of the principles says that, 'A firm must notify its linked policyholders of the risk profile and investment strategy for the linked fund (1) at inception, and (2) before making any material changes.'

Financial promotions of linked products must be 'clear, fair and not misleading'. They should not, for instance, in any way understate the risk profile. These requirements are enforceable by the FSA. They may also be relied on by policyholders who are private individuals either in the courts or in claims to the financial ombudsman service.

Linked products are, of course, subject, in common with other products, to the requirement in Principle 6 of the main FSA Principles for Businesses. 'A firm must pay due regard to the interests of its customers and treat them fairly'. The FSA will interpret this under its 'Treating Customers Fairly (TCF)' project.

One specific provision in the FSA's guidance on the 'Responsibilities of Providers and Distributors for the Fair Treatment of Customers' (RPPD) may be worth noting in this context. The guidance says that a product provider should 'ensure that the information [provided to distributors] is sufficient, appropriate and comprehensible in substance and form, including considering whether it will enable distributors to understand it enough to give suitable advice (where advice is given) and to extract any relevant information and communicate it to the end customer.'

A breach of this duty might possibly result in enforcement action, including requirements that policyholders be compensated. In this context it is worth

noting that a recent report by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). It points out that 'during the crisis... some policyholders with unit-linked products have been affected by exposures to specific counterparties they had no clue were there'.

The requirement to treat customers fairly is not enforceable at the suit of policyholders themselves (as opposed to by the FSA on their behalf). The possibility, however, that the common law might evolve to accommodate claims of this kind cannot be ruled out.

## Territoriality

The territorial application of the new rules is limited. The effect is that an authorised independent financial adviser or its appointed representative may, through all its distribution channels, sell the linked products of, for instance, a Swiss insurer even if they do not fully comply with the permitted link rules. The customer will, however, still be protected by other FSA conduct of business and financial promotion rules.

## Solvency II

Under the existing Life Assurance Directive, representing part of the Solvency I framework, assets covering technical provisions must fall within the categories listed in article 23. This list was established in 1992 and has not since been updated.

The list is also interpreted by the FSA and most other European insurance regulators as requiring that the value of long term insurance products should only link to the same article 23 categories. This restricted the FSA's options when reforming its permitted link rules.

The list does not, however, necessarily prevent links being established to quite volatile property as the CEIOPS comment points out. The permitted links do not include, for instance, gold and mining and intellectual property rights.

When Solvency II is adopted and finally comes into force (the current target for implementation is 2012), the article 23 categories are due to be abolished in their entirety. They will be replaced by 'prudent person' rules, and, so far as linked products are concerned, conduct of business

rules (which are not subject to harmonisation under Solvency II). Conduct of business rules may, of course, apply more stringent requirements to insurance products that are linked to volatile property.

The latest version of article 131 of the draft directive, however, provides that member states may only restrict the types of assets or reference values to which policy benefits may be linked where the policyholder is a private individual. In that event, the requirements should be no more restrictive than those that apply under Directive 85/611/EEC relating to undertakings for collective investments in transferable securities.

Article 183 of the draft directive will also require insurers or their intermediaries to provide 'specific information ... to provide a proper understanding of the risks underlying the contract which are assumed by the policyholder'. In the case of the UK, this is already provided for in the FSA's Handbook.

The FSA has yet to indicate how the permitted links regime is likely to evolve in the longer term. Although the directive may provide that member states must implement by a date in 2012, this would not prevent specific provisions within the directive (such as the abolition of the article 23 categories) from being given effect well before that date.

The FSA's policy may, in any event, need to adjust to changes that are likely to be proposed by the Commission shortly. These will apply to all 'substitutable investment products' including those contained within an insurance wrapper. The Commission's proposals are expected to cover, among other things, the level and types of disclosure that will need to be made when such products are sold.

For further information please contact	James Smethurst Partner T +44 20 7832 7478 E james.smethurst@freshfields.com
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