SLAUGHTER AND MAY/

NEWSLETTER

June 2024

INSURANCE NEWSLETTER

Artificial intelligence and insurance

In our recent webinar we discussed the challenges and opportunities for the insurance sector of the use of artificial intelligence.

On 21 May the EU's AI Act was voted through by the European Parliament. It is expected to come into force in July or August, with a phased implementation of the Act's requirements to follow. The UK continues to follow a sector-based approach without specific legislation, as set out in the UK Government's "pro-innovation approach to AI regulation" document, and the PRA and FCA both confirmed in statements made in April that they consider existing powers are sufficient at present for the regulation of AI.

According to a survey by EIOPA published in April, in the EU 49% of non-life insurers and 24% of life insurers are already using AI, with large proportions expecting to take up use in the near future. There are a number of aspects of both the new AI Act and existing regulatory obligations which insurers need to be aware of in their use of AI systems, including those highlighted below. We discussed these and the wider interaction between AI and the insurance sector in our webinar.

Are you carrying out health or life insurance risk assessment or pricing in the EU using AI?	This may be classified as a high risk activity under the EU AI Act - specific risk management, data governance and other requirements will apply
Are you using AI systems which may give rise to transparency obligations under the EU AI Act?	Includes the use of "chatbots" to engage with customers - requirements under the EU AI Act include ensuring customers are aware that they are interacting with AI
Are you using an AI system based on a "General Purpose AI" model, e.g. Chat GPT, in the EU?	Additional obligations apply under the EU AI Act including documentation requirements
Are you using an AI algorithm to price retail insurance policies or to make decisions about whether to offer cover?	If the algorithm embeds or amplifies bias in a way which could lead to consumer harm, this will be a breach of the Consumer Duty (duty to act in good faith) Differential pricing needs to be justified and the algorithm therefore needs to be "interrogatable"
Does the AI algorithm potentially exploit behavioural biases (e.g. how likely certain customers are to shop around for better priced policies)?	This may be in breach of the Consumer Duty to avoid causing foreseeable harm

Where are we with Solvency II reform?

The full package of reforms to the onshored version of Solvency II, and transposition into a UK-specific regime, has now been published and we are into the implementation phase of the process. The timeline of recent and upcoming publications and deadlines is set out below.

Publication of PS2/24 - Review of Solvency II: Adapting to the UK insurance market and PS3/24 - Review of Solvency II: Reporting and disclosure phase 2	28/29 February 2024
Publication of CP5/24 - Review of Solvency II: Restatement of assimilated law	22 April 2024
Publication of PS10/24 - Review of Solvency II: Reform of the Matching Adjustment	6 June 2024
Matching adjustment reforms come into force (with the exception of attestation and notching requirements)	30 June 2024
Deadline for responses to CP5/24	22 July 2024
Expected policy statement to CP5/24	Q4 2024
Remainder of the Solvency II reforms, including MA attestation and notching requirements, expected to come into force	31 December 2024

Most policy issues were concluded with the publication of PS2/24 and PS10/24. CP5/24 is largely procedural, addressing the transposition of rules from the onshored regime into the PRA Rulebook. We discuss each of these publications in brief below.

PS2/24

PS2/24 sets out feedback to and final policy following the PRA's June 2023 consultation (CP12/23). We discussed the consultation proposals in our July briefing. The final policy is largely as originally consulted on and changes were mainly of a clarificatory or technical nature. More substantive changes were:

- a commitment by the PRA to make reasonable efforts to determine the outcome of a complete internal model application within six months
- the removal of the requirement for firms to disclose any Residual Model Limitation capital add-ons (in the context of internal models) separately in their SFCR
- the introduction of an option for capital add-ons to be "dynamic", allowing the amount to move if there are changes in the balance sheet of the insurer
- additional increases in the thresholds before the regime will apply, compared with those consulted on.

CP5/24

CP5/24 is mainly concerned with the mechanics of transposing the large parts of the Solvency II regime which are not subject to substantive change but which rely on onshored EU legislation – in particular, the Level 2 Delegated Regulation – into the PRA Rulebook and associated guidance.

As part of this process, some minor amendments have been made to the transposed material but in general no policy changes have been made. An exception to this is the introduction of a new time-limited transitional rule in the Own Funds Part of the Rulebook. This is intended to address a known issue in the market concerning outstanding preference shares containing dividend stopper features. Following the end of the own funds transitional period on 1 January 2026, the existence of these shares could create issues with the eligibility of a firm's ordinary shares to be treated as Tier 1 capital, by hampering the full flexibility of distributions on the ordinary shares and acting as a theoretical hindrance to recapitalisation. The transitional would allow the preference shares to continue to be disregarded in assessing the compliance of the ordinary shares with Tier 1 requirements for a period of 25 years.

PS10/24

We discussed the PRA's consultation on Reform of the Matching Adjustment in our October briefing. The PRA has made some changes to its policy proposals in the final rules and guidance.

Headline points are:

- the PRA has confirmed that firms are not expected to reclassify assets which are currently treated as fixed assets under PRA guidance as assets with highly predictable cashflows ("HP assets"), and made changes to the proposed guidance to reflect this
- the calibration of the two new matching tests for firms holding HP assets has been changed to increase the thresholds from 3% to 5%
- changes to liability eligibility rules have been made in order to include the in-payment part of group income protection policies and group death in service dependants annuities (GDAs)
- the amount of documentary evidence required to support an MA application has been reduced
- a transitional period for the MA attestation has been introduced, with the effect that no attestations will be required until after 31 December 2024
- the requirement to reflect "notching" in the technical provisions calculation will not take effect until 31 December 2024 (although it can be implemented earlier on a voluntary basis).

For a more in depth discussion of PS10/24, please see our detailed briefing.

The Consumer Duty - back books and board reports

The Consumer Duty has been with us for nearly a year now and should have been implemented fully by firms. There are, however, some upcoming deadlines which firms should have on their radar.

Closed products and services

The Consumer Duty will apply to closed products and services from 31 July 2024. In May the FCA wrote to firms setting out priority issues and action prompts for firms ahead of this deadline. Key areas identified

were: gaps in firms' customer data; fair value; treatment of customers with characteristics of vulnerability; gone-away or disengaged customers; and vested contractual rights.

Firms are reminded that although the Consumer Duty does not apply retrospectively, from 31 July firms will need to ensure closed products and services are compliant with the duty. This includes a requirement that there is a reasonable relationship between the price a customer pays and the benefits of the product or service.

Board reports

Under the Consumer Duty rules, the board must on an annual basis review and approve an assessment of compliance with the Consumer Duty, including whether the firm is delivering good outcomes for customers and any actions which the firm should take to address issues. This means that the first Consumer Duty board report must have been prepared and signed off by **31 July 2024**. The report should reflect the ongoing monitoring of outcomes which retail customers are experiencing, which should already be in place as required by the Consumer Duty regime.

FCA action

The FCA continues to focus on the Consumer Duty in its general supervision of firms. One of its earliest actions citing the duty was to write to guaranteed asset protection (GAP) insurers, in September 2023, informing them that it did not think the product was likely to be providing fair value to customers. Sales of GAP insurance were then paused in February 2024.

In May the FCA announced that four insurance firms have now been permitted to resume sales of GAP insurance, with materially lower levels of commission being paid. The FCA has stated that to restart sales firms must demonstrate that the products provide fair value.

Captive insurers

As noted in our Insurance Outlook, the Government announced last autumn an intention to put forward a new framework to encourage the establishment and growth of captive insurance companies in the UK. The consultation was earmarked for spring this year but did not emerge and will now depend on the plans of the future Government post-election.

In its London Matters 2024 report, the London Market Group continued to highlight the need for a regulatory environment that facilitates UK domiciled captives. It also noted developments in some European jurisdictions to encourage the use of captives, including France, as commented on further below.

European round-up

Spain - Uría Menéndez

The Spanish insurance market has experienced positive trends in the fields of insurance distribution (where the consolidation process of insurance brokers remains very strong), life savings businesses (with a significant rise in premiums and profitability), health insurance (which remains a very robust and attractive line of insurance) and motor insurance (where the main players are clearly recovering in 2024 from margin deterioration and poor combined ratios impacted by high inflation in the previous year). In the regulatory landscape, the most recent developments are driven by the transposition of EU Directive 2021/2118 into Spanish national law, through a Bill of Law which is currently being discussed at the Spanish Parliament. The primary objective of the proposed legislation is to enhance the protection and compensation afforded to victims of motor vehicle accidents, by providing a more precise and inclusive definition of vehicles which are subject to compulsory civil liability insurance. The Bill of Law also improves the framework for personal injury compensation assessment and fortifies the safety net for victims in the event of insurers' insolvency.

Finally, the proposed legislation includes amendments to the Spanish legislation on organization, supervision, and solvency of insurance entities aimed at (i) enhancing the supervisory powers to ensure compliance with fit and proper requirements of directors and officers of Spanish insurers and (ii) introducing preventive recovery plans as a tool for anticipation and proper crisis management of insurance companies.

Germany - Hengeler Mueller

The last months have shown a very active approach of German's financial regulator BaFin. As watchdog for the insurance industry, BaFin has set its prudential agenda confidently and is no longer shy to use its regulatory toolbox to enforce it where necessary. IT deficiencies identified in several German insurance undertakings has resulted in a number of capital add-ons and BaFin has increased the pressure on insurers to reduce costs embedded in their unit-linked life insurance products. Following concerns relating to private equity buyers after the resolution of Eurovita in Italy, BaFin blocked a back-book acquisition by Cinven, thereby creating uncertainty regarding the circumstances in which German insurers will be able to de-risk using external run-off providers in the future. However, Germany remains a core market for strategic and financial investment into the insurance sector and we expect increased M&A activity in 2024 H2.

France - Bredin Prat

France has seen an interesting increase in the number of reinsurance captives. Of the eleven new insurance companies authorised in 2023, five were reinsurance captives, with an additional seven projects currently under consideration for 2024. This trend, which continues from previous years, has been further encouraged by favourable tax measures included in the French 2023 Finance Act.

The French insurance regulator (ACPR) has noted this trend among both industrial and insurance groups. Some key points have already emerged in the licensing procedures for these captives. For example, when authorising captives, the ACPR pays particular attention to the companies' business plan, their management (which must have sufficient experience in the insurance sector, meaning that industrial groups cannot always rely on their existing internal resources) and their outsourcing arrangements. Thus, while these schemes offer many advantages, and despite the fact that they only provide services to their group, their structuring must be carefully considered, with particular attention to these regulatory aspects.

Netherlands - De Brauw Blackstone Westbroek

The insurance market in the Netherlands continues to be dominated by M&A activity and related transactions such as long-term asset management relationships. This is particularly the case for the large carriers. Achmea is currently looking at strategic options for its life and pensions business. In recent years, Aegon sold its entire Dutch business to a.s.r. (and a.s.r. subsequently agreed to sell Aegon Bank to BAWAG), NN sold NN Investment Partners to Goldman Sachs Asset Management, and Athora bought Vivat from Anbang and subsequently sold its asset manager ACTIAM to Cardano. Foreign private equity continues to be interested in the market, including in MGA and brokerage (similar to the trend across most of western Europe). Recent activity in that space includes BlackFin's acquisition of Aon's Dutch personal lines MGA and brokerage business, PE-backed Howden's acquisition of VLC, and a possible exit by Aquiline from Quintes.

Another significant recent development in the Dutch insurance market relates to the uncertainty around carriers' unit-linked portfolios. Insurers including Achmea, Allianz, a.s.r., NN and Reaal (part of Athora) have concluded settlement agreements with interest groups in relation to unit-linked insurance products sold in the Netherlands in the 1990s and early 2000s. The total settlement amounts to hundreds of millions of euros.

Italy - BonelliErede

Captive undertakings redomiciliation

In the past, the major Italian industrial groups established their captive insurance and captive reinsurance undertakings in other EU member states (most captives were established in Ireland, given its more favourable regulatory regime). In the last 2 years, however, those industrial groups have begun to redomicile their captives. The main reasons for this redomiciliation trend can be found in: (i) the need to ensure greater geographical coherence among entities in the captive's group, including as concerns the captive itself; (ii) the need to pursue greater efficiency in the captive's operational management; and (iii) the wish to centralise management of the insurance business in Italy, with consequent rationalisation and streamlining of processes and activities.

Under Italian regulatory provisions, captives are authorised by IVASS (Italy's supervisory authority) to insure and/or reinsure risks pertaining to companies which are part of the same group or pertaining to companies in which their parent company holds a shareholding of 20% or more.

Although the Italian regulator has changed its approach in respect of captive undertakings and appears to now be more favourable to their establishment in Italy, it has not yet adopted a specific regulatory framework applicable only to captives; therefore, captives are still subject to the regulatory provisions applicable to 'traditional' insurance undertakings (which assume risks on the general insurance market), despite the lower complexity of the activities performed and risks assumed.

There are two basic ways to implement redomiciliation: (i) a cross-border merger between an existing captive and an Italy-based newco; or (ii) a cross-border conversion, which is less complex in terms of corporate and regulatory requirements compared to a merger. That said, notwithstanding the implementation of the European Mobility Directive, IVASS still looks unfavourably on cross-border conversions, as it is unfamiliar with the related regulations. Indeed, unlike the Italian corporate law framework, the Italian insurance regulatory framework does not specifically envisage cross-border conversion.

Insurance policies – Natural disasters and catastrophic events

After years of debate, and in consideration of the damage caused by extreme weather events in Italy over the years, the Italian legislator included an obligation in the 2024 Budget Law (*Legge di Bilancio 2024*) for Italian business enterprises with a registered office in Italy or business enterprises based abroad with a permanent establishment in Italy (including not only companies, but also partnerships and individual businesses) to take out insurance policies covering damage caused by natural disasters and catastrophic events. Specifically, the insurance should cover damage caused to certain assets (land, buildings, installations, machinery, and other industrial and commercial equipment) by natural disasters and catastrophic events such as earthquakes, floods and landslides.

The 2024 Budget Law also imposes an obligation on insurers to assume these kinds of risks and thus to underwrite these types of policies. This obligation on insurers is undoubtedly one of the most innovative aspects of the 2024 Budget Law, and reflects the social function of these new types of coverage. The new obligations can be compared to the contracting obligation applicable to motor vehicle third-party liability insurance.

The 2024 Budget Law envisages particularly significant penalties for insurers that do not underwrite these policies, as they can be fined EUR 100,000–500,000 by the competent Italian supervisory authority. Conversely, Italian companies that do not take out insurance policies to cover damage caused by natural disasters and catastrophic events could find themselves ineligible for contributions, subsidies and other financial aid granted by the Italian public authorities.

Notwithstanding the above, the insurance-related provisions in the 2024 Budget Law generally lack clarity. Indeed, intervention by the competent ministries is desirable, if not necessary, to clarify the scope of the new regulations and ensure their full and effective implementation – not only by insurers but also by the companies required to take out such insurance by 31 December 2024.

Ireland - A&L Goodbody

Just as Irish insurers complete their preparations for Ireland's Senior Executive Accountability Regime going live on 1 July, attention and a degree of urgency is setting in on ensuring that they are compliant with the Digital Operational Resilience Act (DORA) that will apply from 17 January 2025. The purpose of DORA is to strengthen the IT security of financial entities, including insurance companies, to make sure that the financial sector in Europe is able to stay resilient in the event of a severe operational disruption. Many insurers have by now have done (or started) a DORA scoping exercise i.e. identified and prepared the necessary checklist of information, rights, requirements and obligations arising DORA. There are however vastly differing approaches being taken to contract analysis and to remediation of existing contracts. Some firms are finding it challenging to negotiate the necessary addenda with some of their material and/or high-risk vendors and we anticipate that the second half of 2024 will be a particularly busy period for DORA project teams to get this across the line in time.

Another significant development that we have been engaging with insurer clients on is the Central Bank of Ireland's consultation on its review of the Consumer Protection Code 2012 (Code). The purpose of the review of the Code is generally to modernise it to reflect a changing regulatory environment and to achieve a consumer-focussed mindset within the financial sector.

The consultation period closed on 7 June and insurers are beginning to scrutinise the draft Standards for Business Regulations and Conduct of Business Regulations (together, the Regulations) which will replace the Code once finalised. Insurers are digesting hundreds of pages of Regulations and related guidance and considering themes like what "securing customers' interests" will involve in practice. Groups that have already analysed the UK's Consumer Duty are asking what the differences in expectation and approach are likely to be.

While there will be a lead in period, with the Regulations currently anticipated to be effective from 1 January 2026, we are still a few months away from the Central Bank confirming their final form. However with major changes not anticipated, now seems a good time for compliance mapping to start.

CONTACT

JONATHAN MARKS
PARTNER
T: 020 7090 3056
E: jonathan.marks@slaughterandmay.com

BETH DOBSON
PSL COUNSEL
T:020 7090 3070
E: beth.dobson@slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

Published to provide general information and not as legal advice. © Slaughter and May, 2023.
For further information, please speak to your usual Slaughter and May contact.

www.slaughterandmay.com