EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (REGULATED ACTIVITIES) (AMENDMENT) ORDER 2007

2007 No. 1339

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 The instrument is a regulatory simplification measure. It removes a distinction under which life insurance policies are subject to different regulatory regimes depending on a policyholder's age or the term of a policy.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Background

4.1 This Order amends the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544) (RAO) to narrow the definition of a qualifying contract of insurance.

4.2 Under the Financial Services and Markets Act 2000 (FMSA), only exempted persons or persons authorised by the Financial Services Authority (FSA) are allowed to carry on a regulated activity. In order for an activity to be regulated under FSMA, it must be carried on by way of business and both the activity and the investment in relation to which it is carried out must be specified in the RAO.

4.3 "Qualifying contracts of insurance" are one class of specified investments, and are defined in article 3 of the RAO. This Order amends the RAO to amend, from 6 June 2007, the definition of a qualifying contract of insurance.

5. Territorial Extent and Application

5.1 The instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 The main policy focus is deregulation and simplification by removing age and term criteria for determining which schemes of regulation apply to different insurance products. Policy has been informed by consultation and discussion with industry.

7.2 Life insurance sales are subject to different regulatory regimes under FSA rules depending on whether a policy is deemed to have an element of investment. The sale of policies classed as investments is subject to tighter regulation than the sale of protection policies. The two sorts of policy are differentiated by the definition of "qualifying contract of insurance". A non-qualifying contract must meet all the following criteria:

- the benefits under the contract are payable only on death or in respect of incapacity;
- the policy has no surrender value or the surrender value does not exceed the amount of a single premium;
- the term of a policy must be ten years or less, or the policy must only pay out if the policy holder dies before a specified age not exceeding 70

7.3 Policies exceeding ten years, and paying out after the policyholder is aged 70 (qualifying contracts of insurance), are treated as investments. They are subject to the FSA's general Conduct of Business rules (COB). Non-qualifying policies for less than 10 years or paying out where the policyholder dies before age 70 come under the FSA's Insurance Conduct of Business rules (ICOB).

7.4 As a result, the sale of a 25-year term assurance policy to a 45-year-old customer is subject to a different set of rules to the sale of the same policy to a 46-year-old. Similar anomalies occur depending on whether the term of a policy is more or less than ten years. These criteria produce a system which is in practice inconsistent and difficult for industry to accommodate. Since many advisers are not qualified to work under both regimes, there is a risk that the current system may prevent some consumers from being offered the most appropriate product for their needs.

7.5 There is no non-legislative option available. Following representations from industry, the FSA consulted on two options in its Quarterly Consultation No.9 (CP 06/13) in July 2006: option 1 to extend the age limit from 70 to 80, and option 2 to remove the age and term conditions. Option 2 received widespread support from respondents. Of 37 responses, three were in favour of maintaining the status quo; two were in favour of option one; 26 were in favour of option two. Six responses suggested a different approach which proved unviable after consideration.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

9. Contact

Brian Garcia at HM Treasury Tel: 020 7270 5890 or e-mail: brian.garcia@hm-treasury.x.gsi.gov.uk can answer any queries regarding the instrument.

Regulatory Impact Assessment
Amendment to the Statutory Definition of Qualifying contracts of insurance

Purpose and intended effect

Objective: to simplify the rules under which life insurance policies are subject to different regulatory treatment depending on a policyholder's age or the term of a policy.

Background: The regulation of long term insurance sales depends on whether a policy is deemed to have an element of investment. Article 3(1) of the Regulated Activities Order 2001, No.544 defines a "qualifying contract of insurance" by reference to the following criteria:

- whether benefits under the contract are payable only on death or in respect of incapacity;
- whether a policy has a surrender value or the surrender value does not exceed the amount of a single premium;
- the term of a policy and the age of the policy-holder

The effect is that policies exceeding ten years, and paying out after a policyholder is aged 70, are 'qualifying contracts of insurance' and are treated as investments. They are subject to FSA conduct of business rules (COB). Non-qualifying policies that do not meet these criteria come under less stringent insurance conduct of business rules (ICOB).

Rationale for Government Intervention: Tighter COB requirements are more costly to firms than ICOB regulated sales because the ICOB regime is generally lighter touch. Although more stringent regulation of investment business is, in general, justified on the basis of the more complex and risky nature of some investment products, this does not apply to pure protection products like term assurance.

The application of different rules has an impact on how life insurance can be offered to customers, since advisers need to know a customer's circumstances before a sale can begin. A decision on which rules apply must be made early on since advisers need to determine whether they possess the right (investment or insurance) authorisation. The COB and ICOB rules set out detailed requirements, while an adviser authorised for both investment and insurance business also needs to provide certain combined disclosure documents. There are additional costs for insurance companies who must ensure that they transact only with appropriately authorised advisers. In addition, the rules are not aligned with pensions legislation under which it is possible to offer term assurance up to age 75.

Firms say that the rules are confusing for staff and customers. Some firms may choose not to offer certain policies. For example, some insurers design term assurance policies to cease before the 70th birthday of the assured in order to avoid a complex sales process. Some firms have said that they will often try to keep a sale in the ICOB regime by offering a shorter term, if they discover the customer has a protection need beyond age 70, instead of passing the sale to an adviser operating under COB. Customers may therefore be sold a less appropriate product for their needs.

Meanwhile, there is a greater need for protection to cover older ages. Longevity is increasing, people are increasingly working after retirement age, and are taking out mortgages later in life or for longer terms, and having children later in life. Employers who offer life benefits must offer them to employees who are working beyond the normal retirement age.

Consultation

Feedback during the two-year review of the Financial Services and Markets Act identified the 70-year age limit as an example of over-regulation. The Government said that it might be worth exploring this and agreed with the FSA that they should consult on it in July 2006[1].

Following representations from industry, the FSA consulted on two options in its Quarterly Consultation No.9 (CP 06/13) in July 2006: Option 1 to extend the age limit from 70 to 80, and option 2 to remove the age and term conditions. Of 37 responses, three were in favour of maintaining the status quo; two were in favour of option one; 26 were in favour of option two. Six responses supported a different approach that proved unviable after consideration.

<u>Option 1 – Increase the age condition</u>

Age 80 was suggested in order to create a buffer for future improvements in mortality: the actuarial evidence suggests age 70 in 1986 (when the limit was set) is equivalent to at least age 75 today. This limit would probably cover most of the demand for term assurance and other protection products. Firms would still face the potential difficulty of operating dual regulatory regimes for term assurance depending on the age of the life assured, but given that most protection business would be covered by the increased age condition, instances of this happening should be rare.

<u>Option 2 – Remove the age condition and ten-year term condition</u>

This would be a permanent solution. Firms would no longer face dual regulatory regimes and there would be no regulatory deterrent to selling term assurance to those aged over 70.

This option will affect the sale of whole of life policies without a surrender value. Sales of whole of life investment and protection policies would, as now, continue to be split between the COB and ICOB regimes. However, these

[1] FSA quarterly Consultation No.9 (CP 06/13) July 2006

products are very different in nature. They are not substitutes for each other and this approach is not therefore thought to be problematic.

Costs and benefits

Common issues

The proposed change in definition will affect an estimated 1% of all term assurance sales under both options. The number of affected contracts is expected to grow because of the socio-economic changes outlined above and may also increase because of the way firms might react to the change in the definition.

Both options will reduce compliance costs per sale since the ICOB regime (including associated rules such as training and competence) is lighter touch than the COB regime. Because this change is deregulatory, we have not estimated the reduction in compliance costs. There may be some small one-off costs in changing systems and staff training but we expect these to be of minimal significance. We expect that firms will only choose to incur these one-off costs if they expect to make savings elsewhere.

To the extent that both options lead to an increase in insurers and distributors underwriting and selling protection insurance to consumers that have a protection need beyond age 70, the proposed change will result in benefits to those consumers.

The average annual sales of term assurance policies between 2001 and 2005 was 1.82 million. One reinsurer’s estimate is that less than 1 per cent of these policies may have been sold under the more stringent COB rules (18,222 policies). The average annual sales of whole of life assurance policies during the same period was 226,936, of which 185,376 were non unit-linked. We exclude investment type policies with a surrender value (41,560 on average) because they are ineligible for the ICOB regime. We also exclude guaranteed acceptance sales by mail (execution only sales) where the potential savings are lower. These form around 75% of whole of life policy sales. The average number of eligible whole of life policies is therefore estimated to be 26,000.

The maximum number of policies that might therefore migrate from the COB to ICOB regime, based on average sales between 2001 and 2005 data, is estimated to be:

Term assurance sales	18,000
Whole of life protection sales	26,000
Total	44,000

There is an estimated potential saving of one hour of adviser time and associated administrative costs if these sales are able to be made through the ICOB regime.

Assuming the cost of adviser time and administrative support is £90 per hour, a conservative estimate, then 44,000 x £90 = £3,960,000.

Additional administrative savings through simpler documentation requirements for execution–only sales can be expected to take the total savings figure past £4 million. There may be some further savings, since firms will no longer need to know a client's age and desired policy term before beginning the sales process.

	COB	**ICOB**
Adviser training	Exam requirement	No exam, competency
Suitability assessment	Most suitable	Suitable
Sales time	Up to 2 hours	Up to 1 hour
Commission disclosure	Required	Not required
Documentation	Key features (KFD) Growth projections Projection rates Suitability letter	Policy summary or KFD Statement of needs (similar to suitability letter)

Total estimated potential savings: £4,000,000 per year

Comparison between Options 1 and 2

Option 2 is more deregulatory than Option 1 and is likely to involve a greater reduction in compliance costs for firms. Option 2 has the advantage that firms are not required to determine a client's age and desired policy term before beginning the sales process. It has the advantage of a more permanent solution. However, it has not been possible to quantify the difference in cost savings between the two options: there were no responses to a question about this in the FSA's consultation.

Option 1

Sales where the policy term extends beyond age 80 of the assured are few. However, this option would generate some limited compliance costs through firms monitoring term assurance sales to ensure that policies were sold under the correct regulatory regime.

Although the ICOB regime is lighter touch than the COB regime, it is unlikely to reduce consumer protection for policies with a term extending beyond 70 years. This is because the risk profile of these policies is the same as those policies that can already be sold under the ICOB regime.

Option 2

Under this option firms would be able to operate under a single regime for the sale of term assurance. Compliance costs associated with monitoring sales to ensure that they are made under the correct regulatory regime would no longer arise. In addition, there would be a reduction in compliance costs for firms selling whole-of life policies without surrender values because they could sell them under the lighter ICOB regime compared to the COB regime.

There was a concern that permitting sales of whole-of-life policies under ICOB could involve some costs to customers, particularly a fear that that insurers might restructure certain products in order to sell them under the ICOB regime (by removing the surrender value from whole of life policies). However, an analysis of whole of life policies currently available on the market has failed to identify a policy that has an investment characteristic but no surrender value. The FSA is satisfied that the risk is either unfounded or adequately mitigated by their existing rules.

Equity and fairness

This measure does not raise equity or fairness issues. Consumers will benefit from having access to a wider range of protection products.

Small firms impact

The FSA will introduce, through their rules, a facility to allow firms to continue to sell these products in accordance with COB rules if they choose to do. This will greatly minimise the costs of implementing this rule change.

There are some 1700 firms that have a life policy permission (COB) without a corresponding non-investment insurance permission (ICOB). The FSA's consultation drew attention to this and invited firms' views on a potential narrowing of permissions. The FSA have also liaised with trade bodies and, in a general insurance letter to small firms, asked firms to contact the FSA if they thought their permissions might be affected. There have been no responses relating to this point, which seems to be largely theoretical. Should a firm need to vary the scope of their permission as a result of this measure the FSA propose to deal with it free of charge.

Competition assessment

The measure will enhance competition by removing regulatory barriers to firms undertaking certain categories of life insurance business depending on the age of a policyholder or the terms of a policy. This may affect sales of up up to 1% of term assurance policies and a small number of whole-of-life policies.

Enforcement, sanctions and monitoring

Implementation: the new rules will come into effect on 6 June 2007.

Post implementation: the FSA will monitor product developments and sales processes. It is undertaking a review of ICOB with a view to submitting low risk products to a lighter regulatory approach. The likely intended outcome for the sale of protection products will be improved effectiveness regarding product, price and service disclosures.

Summary and recommendation

Option 2 has received widespread support from respondents. Our analysis concludes that the products which would move across from COB to ICOB do not have an investment element and so can be sold under the ICOB regime without risk of consumer detriment.

This will generate likely savings of around £4 million per year.

Declaration and publication

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs

Signed …Ed Balls………………………

Date   4th April 2007

Economic Secretary to the Treasury
HM Treasury

Contact point

Brian Garcia
HM Treasury
Tel: 020 7270 5890
e-mail: brian.garcia@hm-treasury.x.gsi.gov.uk