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EU Insurance Briefing - May 2009

Overview of the EU's response to the financial crisis: the insurance regulatory perspective

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1. INTRODUCTION

This briefing reports – in summary form and with a focus on the insurance sector – on recent European initiatives to respond to the financial crisis. In this and the following sections we set out the background to these initiatives, including the causes of the crisis (section 2). Sections 3 to 6 describe the proposed measures to repair the European supervisory and regulatory framework, with commentary on the content and final adoption of the Solvency II Framework Directive. Section 7 summarises the results of the 14 March G20 meeting. Section 8 highlights the UK's Turner Review and related discussion paper for regulatory reform. Section 9 provides an overview of the London Summit of heads of state ("Leaders") held on 2-3 April and the G20's "Global Plan for Recovery and Reform". Section 10 reports on the latest Solvency II developments and we conclude with some general remarks in section 11.

The EU's response to the economic and financial crisis comprises:

- a European Economic Recovery Plan, e.g. fiscal stimulus, promoting open trade and a low carbon economy, and tackling rising unemployment; and
- proposals to establish a new financial supervisory system.

In addition, last autumn the Commission appointed The High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière (former Managing Director of the IMF and Governor of the Bank of France).

This high-level group – supported by a secretariat drawn from the European Commission – issued its report on 25 February (the "Report")¹. The Report distinguishes between regulation and supervision (this briefing reflects the same approach for the insurance aspects) and includes 31 recommendations for a new regulatory agenda with stronger coordinated supervision. It contains two sets of measures:

- regulatory repair; and
- supervisory repair.

On 4 March, the European Commission promptly followed up on the Report with a "Communication for the Spring European Council – Driving European Recovery" (the "Communication")².

EU Insurance Briefing – May 2009

The Communication has two objectives:

- show Member States that there is an EU response to the crisis and that the Commission is active; and
- ensure that within the G20 the EU continues its leadership role in establishing principles among the G20 participants.

The Communication supports most of the Report's recommendations - not surprisingly, as the Commission was closely involved in the drafting of the Report. In essence, the Communication asks EU leaders to support the Report's recommendation for a core set of regulatory standards throughout the EU and to adopt a legislative package of measures (many of them already in the EU pipeline, e.g. regulating hedge funds, private equity and remuneration/compensation). Others will be the subject of proposals for adoption by the European Council in June 2009. It also endorses the key principles set out in the Report, especially stronger oversight and supervision at the EU level, i.e. the European System of Financial Supervision, while maintaining a clear role for national supervisors, and the establishment of a macro-prudential, early-warning body to identify and address systemic risks, i.e. the European Systemic Risk Council under the auspices of the European Central Bank ("ECB").

The Communication is non-binding and addressed to the Council. The Commission hopes to receive an invitation from the Council to start working on a regulatory agenda - which, depending on the nature of the proposed measures, means drafting specific legislation for adoption by Council and Parliament. The proposed regulatory agenda will be presented in June 2009.

Finally, the Commission recently launched a public consultation on the Report, its Communication and its intention to put forward to the June European Council a detailed plan for revising the European supervisory architecture based on the Report³. The Commission will make legislative proposals in the autumn (see below) in the hope that these will become effective in the course of 2010 or even earlier. The deadline for submissions on the consultation was 10 April and a related conference "Towards a new supervisory architecture in Europe" was held in Brussels on 7 May.

2. **DIAGNOSING THE CAUSES OF THE FINANCIAL CRISIS (DE LAROSIÈRE REPORT)**

In summary:

- **Macro economic causes:** ample liquidity, low interest rates, loose monetary policy, large global trade imbalances, mis-pricing of risk, large increases in leverage;
- **Inadequate risk management:** by firms, supervisors and regulators and a lack of transparency, build-up of a shadow banking system (hedge funds,

EU Insurance Briefing – May 2009

private equity), misunderstood complexity, etc.;

- **Credit rating agencies:** failed to rate structured products properly and operated with major conflicts of interest;
- **Corporate governance:** weak shareholders and management, misguided remuneration schemes;
- **Regulatory/supervisory:** excessive focus on micro supervision rather than macro supervision, lack of regulation of derivatives markets; and
- **Global and European institutional weakness:** IMF, FSF, G20 and lack of coordination.

3. REGULATORY REPAIR: GENERAL

The Commission's four general policy objectives for European financial market regulation flowing from the Report comprise:

3.1. *Filling gaps where European or national regulation is insufficient or incomplete*

- regulatory standards for hedge funds and private equity (April 2009);
- tools for early intervention in the event of a crisis (June 2009);
- proposals to increase the quality and quantity of prudential supervision;
- legislation on prudential capital: trading book activities; and
- legislation on credit rating agencies.

3.2. *Ensuring European investors and small and medium-sized companies can be confident about their savings and their rights as investors in financial products*

- a communication on retail investment products to strengthen marketing safeguards; and
- measures to reinforce bank depositor, investor and policyholder protection.

3.3. *Improving risk management in financial firms and aligning pay incentives with sustainable performance*

- a communication on remuneration of directors followed by legislative proposals (April 2009); and

EU Insurance Briefing – May 2009

- a communication on remuneration in the financial services sector (April 2009).

3.4. *Ensuring more effective sanctions against market wrongdoing*

- review of the Market Abuse Directive; and
- proposals for strengthening sanctions (autumn 2009).

All these ambitious measures are the subject of a regulatory agenda which promises intense activity in 2009. With Parliamentary elections and a change in the Commission scheduled for later this year, the intended pace for these reforms seems optimistic. Please also refer to the timetable and overview of financial services-related regulatory initiatives, recently updated by the European Commission, found in the Annex.

4. REGULATORY REPAIR: INSURANCE

The Report notes that, although the crisis originated in the banking sector, it also affects the insurance sector. The key message is that Solvency II's regulatory and supervisory measures should be adopted without delay but that a number of further regulatory initiatives will be needed.

It confirms that Solvency II (designed before the crisis) was initially progressing in the right direction. The Report clearly favours group support as a component in a European solvency regime. Specifically:

- Group support is a subset of group supervision which allows a subsidiary in a European group to hold less than its required solo solvency capital on the basis that it has received a binding declaration of financial support from its parent;
- Critics of group support – mostly smaller Member States without head offices of European groups – have pointed out that there would be many legal and regulatory obstacles for the smooth operation of the group support regime, let alone problems of enforcement of the group support declaration; and
- These Member States endorsed the 2008 French compromise (which excluded group support), and it was on this basis that the Czech Presidency was able to announce on 26 March that the three EU institutions (Parliament, Commission and Council) had reached agreement on the text (see 10 below).

Beyond Solvency II, the Report makes a certain number of observations illustrating the shortcomings in achieving a single market in insurance, in particular:

- a lack of a consistent set of rules;
- too much regulatory diversity between the Member States;

EU Insurance Briefing – May 2009

- too much diversity in the enforcement of EU directives;
- too much regulatory arbitrage; and
- too many national options left for implementation, e.g. the Insurance Mediation Directive.

The Report recommends more recourse to EU legislation in the form of regulations (directly applicable in the Member States), rather than directives (for which Member States enjoy a choice of form and method for their implementation). It also suggests an additional layer of regulation for the insurance industry, i.e. the adoption of harmonised rules for insurance guarantee schemes (“IGS”).

Currently, Solvency II does not address IGS. The Commission resisted including IGS in its original proposal, though it did mandate a study which demonstrated the patchwork of existing schemes in the EU. Some schemes operate on the basis that a Member State provides a guarantee to the insurer it supervises (the “home state” model used in France and Germany), while other Member States impose membership of a scheme on any domestic or foreign insurer underwriting risks situated in the Member State (the “host state” model used in the UK). A proposal is expected in the autumn of 2009.

Finally, the Report identifies the lack of an adequate framework for retail investment products (which includes savings-type life insurance products). It calls for improved pre-contractual information, clarification of the responsibility of intermediaries and control over depositaries and custodians.

5. SUPERVISORY REPAIR: GENERAL

The Report makes a distinction between macro- and micro-prudential supervision.

5.1. *Macro-supervision*

Macro-supervision has been virtually inexistent and the Report highlights too much emphasis on the supervision of individual firms and too little on the macro-prudential side. There is no adequate structure at EU level to identify macro-prudential risks, and even less to take any EU action.

The first major proposal is therefore to provide the EU with a supervisory framework that detects potential risks early, deals with them effectively before they have an impact, and meets the challenge of complex, international financial markets. It was initially suggested that the ECB could play this role but this idea was abandoned in favour of the creation of an *ad hoc* organisation, the European Systemic Risk Council (“ESRC”), to be chaired by the President of the ECB, members of the Board of the ECB and chairpersons of the level 3 committees⁴.

EU Insurance Briefing – May 2009

The ESRC will decide on macro-prudential policy, provide early risk warning to EU supervisors, compare observations on macro-economic and prudential developments and give direction on these issues. There will also be an exchange of information between ESRC and the micro-prudential supervisors.

5.2. *Micro-supervision*

The Report takes the view that the existing level 3 committees for banks, investment services and insurance companies are weak and were inefficient during the crisis. They cannot make urgent and legally binding decisions. In the words of the Report, evidence shows that the crisis prevention function of supervisors in the EU was not performed well and is not “fit for purpose”. The Report therefore calls for a European System of Financial Supervision (“ESFS”).

The ESFS would convert the existing level 3 committees into fully-fledged European authorities:

- European Banking Authority;
- European Securities Authority; and
- European Insurance Authority.

In addition to their existing competencies as level 3 committees, these new European Authorities would have the following key competencies:

- legally binding mediation between national supervisors;
- the adoption of binding supervisory standards;
- the adoption of binding technical decisions applicable to individual institutions;
- the oversight and coordination of colleges of supervisors;
- the licensing and supervision of specific EU-wide institutions (e.g., credit rating agencies and post-trading infrastructures);
- binding cooperation with the ESRC to ensure adequate macro-prudential supervision; and
- a strong coordinating role in crisis situations.

6. **SUPERVISORY REPAIR: INSURANCE**

The proposals for supervisory repair should be considered in the context of existing EU

EU Insurance Briefing – May 2009

legislation and the Solvency II regulatory framework. Although Solvency II already addresses many of the supervisory reforms called for by the Report and the Commission in the Communication, there are, however, additional issues not addressed in Solvency II. These reforms are considered below.

6.1. Solvency II's proposals for supervisory repair

The Report points out that micro-supervision has been the norm in the insurance industry. Supervisory practices have not adapted to address groups with subsidiaries in the EU. Pending the adoption of Solvency II, cooperation between supervisory authorities has been largely inexistent – despite the Insurance Groups Directive (“IGD”). There has been no real group or lead supervisor or effective cooperation between supervisors. Although the IGD contemplated the creation of a college of supervisors, these have hardly met in practice and, even when they have, their operation has been based on self-regulation, without a clear division of tasks and responsibilities. Large groups operating on a branch or cross-border basis throughout the EU have also lacked genuine group supervision. There has been excessive reliance on home country supervisors and limited powers granted to the host authorities.

Insurance has its own level 3 committee. The Committee of European Insurance and Occupational Pensions Supervisors (“CEIOPS”) has been providing technical advice to the Commission on the Solvency II Directive and has also been active in preparing the implementing measures which will be needed before 2013. The Report notes that CEIOPS can only provide non-binding advice. So far, it has focused on future legislation and supervisory standards to the detriment of crisis management. We comment further on CEIOPS at 10 below.

Solvency II already contemplates the close cooperation between supervisory authorities recommended in the Report and the Communication. Group and solo supervisors are required to cooperate on the basis of clear rules. Colleges of supervisors comprising the group supervisor and the solo supervisors will need to be set up. They will be bound to share information regarding, e.g., the financial situation of the group, solvency and risk concentration and the group’s governance systems. Supervisors will need to consult each other before decisions are made which affect the group structure or before sanctions or financial measures are taken.

There may be disagreement within a college of supervisors. Solvency II already recognises that solo and group supervisors within colleges of supervisors may disagree and provides that, in the absence of a joint decision mechanism, the group supervisor will ultimately decide. Solvency II provides no more than a mediation role to CEIOPS to resolve differences.

6.2. The Report's proposals for additional supervisory repair measures

Macro-prudential supervision has been lacking in the insurance industry. There has been excessive reliance on micro-supervision. The Communication endorses

EU Insurance Briefing – May 2009

the Report's proposal to create the ESRC (described in more detail above) which would work at the macro-level with the ECB and CEIOPS. The presence of a sufficiently large number of international insurance groups in the EU, representing systemic risks, means they would be subject to closer macro-prudential scrutiny.

The Report also calls for upgrading the quality of supervision by national supervisors in terms of status, degree of independence, appropriate funding, and employment policy.

It proposes to strengthen CEIOPS. A recent Commission decision already strengthens CEIOPS providing it with a clearer mandate and better decision-making procedures. Similarly, existing colleges of supervisors need to be strengthened, with the participation of the CEIOPS Secretariat.

CEIOPS should be endowed with ultimate decision-making powers in the college of supervisors for cross-border groups. This is a sensitive issue because it means that national supervisors (those in the country where the parent is domiciled) will give up some of their authority.

Finally, **CEIOPS should be developed into a European Insurance Authority.** This transformation falls short of making it a European insurance supervisor. The European Insurance Authority would perform the same role as CEIOPS:

- advising the Commission on regulatory issues;
- defining convergence of supervisory standards; and
- oversight of colleges;

and would carry out a number of new functions, including:

- a legally binding mediation role in order to solve disputes between national regulators (withdrawal of license, capital add-on, approval of internal risk models); and
- prudential assessment of pan-EU mergers and acquisitions.

The Commission appears to support all of these proposed insurance-specific measures, but they will not be part of the Solvency II package (that would reopen already difficult negotiations). However, the Commission has announced that they should be operational in the course of 2010.

7. GROUP OF TWENTY (G20) MEETING OF FINANCE MINISTERS AND CENTRAL BANK GOVERNORS, 14 MARCH

The Finance Ministers and Central Bank Governors of the G20⁵ met on 14 March to

EU Insurance Briefing – May 2009

prepare for the G20 Leaders’ Summit, held on 2 – 3 April in London. They agreed further action to restore global growth, support lending and reforms to strengthen the global financial system. They also reported progress on the work remitted to them after the Leaders’ initial meeting on 15 November, 2008 in Washington DC.

Following the 15 November summit, the International Association of Insurance Supervisors (“IAIS”) issued three papers:

- Issues Paper on Group-Wide Solvency Assessment and Supervision (67 pages)⁶;
- Follow-up Response to the G20 Washington Action Plan (13 pages)⁷; and
- Follow-up Response to the G20 Washington Action Plan and FSF Recommendations (14 pages)⁸.

The Follow-up Responses include the “Strategic response of the IAIS to address lessons from the financial crisis specific to the insurance sector”. Although the banking and securities sectors have tended to attract most attention, we can expect the IAIS input also to be taken into account – not least when the Commission tackles its regulatory agenda set out above.

8. THE TURNER REVIEW: A UK DE LAROSIÈRE REPORT?

On 18 March the UK’s Financial Services Authority (“FSA”) published the “Turner Review - A regulatory response to the global banking crisis”⁹. Lord Turner, chairman of the FSA, was asked by the UK’s Chancellor of the Exchequer to review the events that led to the financial crisis and to recommend reforms. Along with Lord Turner’s Review, the FSA has also published a lengthy discussion paper setting out, in greater detail, specific policy proposals¹⁰. Although the current crisis arose in the banking, investment banking and shadow banking sectors and most proposals focus on these sectors, the Review’s implications for insurance are identified.

From an EU perspective the Turner Review recommendations represent further support for the de Larosière Report’s recommendations, as endorsed by the European Commission.

9. G20 LEADERS’ SUMMIT, 2-3 APRIL, LONDON

This summit’s objective was to reach international agreement among leaders of the world’s major economies and global economic institutions on reviving the world economy. The Leaders were invited to make three commitments:

- “to take whatever action is necessary to stabilise financial markets and enable families and businesses to get through the recession”, e.g. to “...strengthen the financial sector and mitigate the decline in investment and the risks of financial isolationism, as foreign-owned banks withdraw lending or return it to their

EU Insurance Briefing – May 2009

home markets”;

- “to reform and strengthen the global financial and economic system to restore confidence and trust”.

In addition, world leaders would review whether further steps were needed to marry better the objectives of financial and macroeconomic stability “...to put the global economy on track for sustainable growth”¹¹.

Intriguingly, the insurance sector was barely mentioned.

The Leaders issued a communiqué entitled, “The Global Plan for Recovery and Reform” (9 pages)¹². The communiqué makes good on the pre-summit commitments but contains no specific reference to insurance. However, in the section of the communiqué on “Strengthening financial supervision and regulation”, elements of Solvency II, e.g. cooperation between national regulators, are evident.

10. LATEST SOLVENCY II DEVELOPMENTS

On 26 March the Committee of Permanent Representatives (“COREPER”) ¹³ unanimously reached informal agreement on the text of the Solvency II Framework Directive; formal endorsement by COREPER followed promptly thereafter.

Group support and the treatment of equity risk were the principal contentious issues. The agreement removes group support, but not group supervision. It includes a clause providing for future review of group support. As for the treatment of equity risk, the “duration approach” is to be used only after being transposed into Member State legislation and for clearly defined life insurance products.

The insurance industry has welcomed this compromise agreement¹⁴.

CEIOPS was also pleased that a political compromise was reached to allow Solvency II to proceed. Composed of high-level representatives from the insurance and occupational pension funds supervisory authorities of EEA Member States, CEIOPS, as noted above, is – within the Lamfalussy process – the level 3 committee for these sectors. It also provides advice to the Commission in its preparation of draft implementing measures for insurance and reinsurance (including Solvency II). In doing so, it contributes to the consistent implementation of Community legislation in the Member States and promotes co-operation among supervisory authorities, including the exchange of information on supervised institutions.

In the autumn of last year, CEIOPS established working groups to examine the implications of the financial crisis and analyse the aspects particular to the insurance sector. Their main findings and possible conclusions as to Solvency II levels 2 and 3 advice and measures are reflected in their Report on “Lessons learned from the crisis – (Solvency II and beyond)”, released on 27 March¹⁵.

EU Insurance Briefing – May 2009

CEIOPS concludes that current events demonstrate that Solvency II is urgently needed, so it too welcomed political agreement allowing final adoption.

On 22 April the European Parliament voted to approve the Solvency II Framework Directive. The Parliament and the Council of Ministers had already reached an agreement on a common text; this means the legislative procedure ends with the Parliament's vote and subsequent formal adoption of the text by the Council¹⁶.

Commission President José Manuel Barroso was particularly pleased with the parliamentary vote,

“By approving the Commission’s proposal, the European Parliament has contributed to lasting economic recovery. An integrated and competitive insurance sector, supervised consistently across borders, is essential for every consumer and every business in Europe. Solvency II will help protect policy holders from bad practice. It will help shield our economies against a repeat of the disastrous excessive risk-taking by financial institutions, including certain insurance operators, that has contributed to the global crisis. It will be good for insurers and reinsurers themselves, by giving them new opportunities and helping restore confidence.”¹⁷

As for final adoption by the Council, this has been delayed because of the time necessary to finalise the text in all (23) official languages. The Council now expects the text to be formally adopted under the Swedish Presidency (from 1 July).

11. CONCLUSION

The insurance sector’s existing regulatory architecture, together with the proposals recently agreed in Solvency II, appear appropriate and prescient. Generally, insurers have been able to withstand the crisis better than other financial institutions. For example, from an overview of EU cases of state aid for the financial sector (as of 7 May), only one major case relates exclusively to an insurer with the vast majority of cases involving banks¹⁸.

As summarised in this briefing, Europe has proposed a number of regulatory reform initiatives. It is therefore within the context of a comprehensive reform of financial services regulation that Solvency II will operate and be influenced. In other words, following final adoption of Solvency II by the Council, insurers will face a two-fold challenge: they must focus on levels 2 and 3 measures under Solvency II; in addition, they will need to monitor how the other reform initiatives may affect their operations.

In conclusion, it has been said that Solvency II was a regulatory response in search of a crisis. Most industry observers do agree that, even with the deletion of the group support regime, Solvency II still contains the blueprint for a modern and robust regulatory system that will respond to financial crises both current and future.

EU Insurance Briefing – May 2009

- 1 http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf
- 2 http://ec.europa.eu/commission_barroso/president/pdf/press_20090304_en.pdf and Annexes – http://ec.europa.eu/commission_barroso/president/pdf/press_20090304_annx_en.pdf
- 3 Full details at: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/373&format=HTML&aged=0&language=EN&guiLanguage=fr> and http://ec.europa.eu/internal_market/finances/committees/index_en.htm
- 4 i.e., per Lamfalussy process, the chair persons of CEIOPS, CEBS and CESR (each of these committees being composed of the national supervisors of each Member State).
- 5 The Group of Twenty (G20) Finance Ministers and Central Bank Governors, established in 1999, brings together systemically important industrialised and developing economies to discuss key issues in the global economy.
- 6 http://www.iaisweb.org/__temp/Issues_paper_on_group_wide_solvency_assessment_and_supervision.pdf
- 7 http://www.iaisweb.org/__temp/IAIS_follow-up_response_to_G20_February_2009.pdf
- 8 http://www.iaisweb.org/__temp/IAIS_follow-up_response_to_FSF_February_2009.pdf
- 9 The full 126 page Turner Review: http://www.fsa.gov.uk/pubs/other/turner_review.pdf
The Press Release, <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/037.shtml>
- 10 The full “Discussion Paper -A regulatory response to the global banking crisis”, (219 pages): http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf
FSA newsletter summarising the Discussion Paper DP09/2, (5 pages): http://www.fsa.gov.uk/pubs/discussion/dp09_02_newsletter.pdf
- 11 Full details at: <http://www.londonsummit.gov.uk/en/>
- 12 <http://www.londonsummit.gov.uk/resources/en/PDF/final-communicue> Explanatory document, “London Summit Outcomes” (9 pages): <http://www.londonsummit.gov.uk/resources/en/PDF/london-summit-outcomes-020409>
- 13 The Permanent Representatives Committee or “Coreper” (Article 207 of the Treaty establishing the European Community) is responsible for preparing the work of the Council of the European Union. It consists of the Member States’ ambassadors to the European Union (“Permanent Representatives”) and is chaired by the Member State which holds the Council Presidency (currently the Czech Republic). http://europa.eu/scadplus/glossary/coreper_en.htm
- 14 <http://www.cea.eu/uploads/Articles/documents/090326%20Solvency%20II.pdf>
- 15 Press release: <http://www.ceiops.eu/media/files/pressreleases/20090327-press-release-lessons-to-be-learned-SII-and-beyond.pdf>
Full Report: <http://www.ceiops.eu/media/files/publications/reports/CEIOPS-SEC-107-08-Lessons-learned-from-the-crisis-SII-and-beyond.pdf>
- 16 http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressdata/EN/mainact/107367.pdf
- 17 <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/621&format=HTML&aged=0&language=EN&guiLanguage=en>
- 18 <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/111&format=HTML&aged=0&language=EN&guiLanguage=en>

EU Insurance Briefing – May 2009

Annex

Timetable and overview of financial services-related regulatory initiatives announced by the European Commission (as at 8 May)

Initiative	Adoption Status	Remarks
Financial supervision package	May 13	New supervisory arrangements to be running in the course of 2010
Directive on alternative investment fund managers (AIFM)	April 29	
White paper: Tools for early intervention	June 24	
Derivatives: Communication re increased transparency, stability	June 24	
Legislation on prudential capital: trading book activities & securitization	June 17	
Legislation on prudential capital: re. liquidity risks & excessive leverage	Autumn 2009	
Rolling action program on supervisory rules	2009 launch	
Communication on retail investment products	April 29	
Reinforce protection for bank depositor, investor, & insurance policyholder	Autumn 2009	
Responsible lending	Autumn 2009	
Recommendation on directors' remuneration	April 29	
Recommendation on remuneration in financial services sector	April 29	
Review Market Abuse Directive	Autumn 2009	
Proposal on strengthened sanctions	Autumn 2009	

(Original) Source: Communication for the European Council, 4 March, 2009

EU Insurance Briefing – May 2009

If you have any questions concerning this briefing, please contact Guy Soussan (gsoussan@steptoe.com) or Philip Woolfson (pwoolfson@steptoe.com). For more information about our EU Insurance Practice please [click here](#).

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