Linklaters

Insurance Update.

Espírito Santo Financial Group SA issue of €500 million fixed rate notes

Espírito Santo Financial Group SA is the Luxembourg holding company for the Espírito Santo group, whose main banking, securities and insurance operations are in Portugal. The group is also represented in Switzerland, Spain and Brazil. The insurance members of the group are Companhia de Seguros Tranquilidade SA and Companhia de Seguros Tranquilidade-Vida SA.

Espírito Santo Financial Group SA has issued €500 million fixed rate step-up notes due 2025 together with 10,000 warrants for ordinary shares of the holding company. Linklaters, through its London and Lisbon offices, acted for the sole manager to the issue, Lehman Brothers International (Europe). Linklaters Loesch advised the issuer as to Luxembourg law.

This is the first Luxembourg listing of notes with warrants since the implementation of the EU Prospectus Directive and the first issue of notes with warrants by a European issuer since 2001. It was also the largest non-mandatory equity-linked deal yet in 2005.

FSA consultation on insurance securitisations

This month, the Financial Services Authority started consulting with the insurance industry on financial reinsurance and other forms of monetisations for life insurers. The purpose of the meeting, held at the Association of British Insurers, was to outline the FSA's likely approach to such transactions, and to prepare the ground for a possible consultation during 2006.

Paul Sharma of the FSA recognised that there had been increased demand for monetisation products by life insurers. There needed to be a consistent approach to regulation of such transactions across different sectors. The FSA intends to adopt a "principles based" approach. These products are developing rapidly and are becoming increasing sophisticated. Rules would not be flexible enough. At the core of the FSA's proposed approach would be the economic substance of the transaction, rather than its form.

Risk transfer is the key. Where a transaction will not transfer all risks associated with the relevant business, the FSA will expect the insurer to identify the capital associated with the non-transferred risks. It will not give such risks capital relief.

It remains to be seen how insurers will be able to satisfy the FSA about excluded risks. The individual capital adequacy calculations will potentially provide a starting point.

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In addition, the FSA also referred to a possibility of an alternative and less burdensome authorisation process for special purpose vehicle reinsurers once the new reinsurance framework is introduced in December 2007. The time which it currently takes to go through a full authorisation process for a UK reinsurer in a typical SPV structure can influence whether insurers decide to go ahead.

Assured Guaranty (UK)'s first financial guarantee

Assured Guaranty (UK) Limited is a monoline insurer first authorised in the UK in 2004. It is a member of the Assured Guaranty group.

Linklaters advised Assured Guaranty (UK) on its first financial guarantee of listed bonds. Assured Guaranty (UK) wrapped Euro 150,000,000 Class A1 Senior Floating Rate Notes due 2035. The notes were issued by Dekania Europe CDO 1 plc. They were backed by a portfolio of securities issued by companies that:

- are, or are holding companies for, a bank, life insurer, health insurer, non-life insurer, property and casualty insurer, reinsurer covering various types of risk, Lloyd's managing agency or Lloyd's corporate capital member
- have insurance company and/or bank subsidiaries with net worth, determined on a statutory or GAAP basis, in excess of €10,000,000 as of the most recent fiscal period for the most recent reports available and
- satisfy various ratings criteria.

Solvency II progress

Considerable progress has been achieved over the last year in the consultations aimed at the adoption in 2010 of a new Directive covering the prudential regulation of insurers, reinsurers and insurance groups. The Solvency II Directive will replace all existing directives including the Reinsurance Directive, which has just appeared in the Official Journal and is due for implementation by December 2007.

Group issues

Key issues in Solvency II include how responsibility should be allocated for the supervision of cross-national groups and how such groups should be provide for diversification benefits in capital modelling. No final decision has been taken on these issues yet. The views, however, expressed by the Committee of European Insurance and Occupational Pensions Supervisors, in their second Solvency II consultation paper seem already to have influenced current policy making by the Financial Services Authority. An example of this is the material on benefits of diversification in the FSA's insurance sector briefing "ICAS - one year on".

Capital tiering

A key issue discussed in CEIOPS' latest consultation paper, which appeared earlier this month, is as to the eligible elements of capital to cover both solo

and group capital adequacy requirements. Capital tiering is to follow the model applying in the banking sector. Indeed the FSA to some extent anticipated this development in its capital adequacy rules which came into force at the end of 2004. The intention now is that the European rules on the use of hybrid capital should be relaxed.

CEIOPS is also consulting on a French proposal that deeply subordinated debt should be allowed up to 15% of the required solvency margin and considered separately from perpetual subordinated debt. The latter debt should not exceed the current limit of 50% of the solvency margin. The question here is whether this proposal should be implemented in advance of Solvency II by amendment to the existing directives.

The Solvency Capital requirement

Under Solvency II both general and long term insurers will be required to calculate and adhere to a solvency capital requirement based either on a standard formula or using internal models. John Tiner, chief executive of the FSA has expressed views on how the SCR should be calculated and claims that these have broad support.

Problems with "writing against reinsurance"

A witness in the case *Bonner v Cox*, decided in the Court of Appeal earlier this month, stated:

> "Writing against a reinsurer, I would suggest, is where you analyse the risk, work out that you probably would not write it, but with the benefit of reinsurance, you would write it anyway. I think you would not be doing your underwriting on a normal basis because you had reinsurance to protect you."

Mr Justice Thomas in *Sphere Drake v Euro International Underwriting Ltd* described the practice as "gross loss-making business". An intention to write against reinsurance would, he considered, need to be declared to the reinsurer if it arose before the reinsurance was put in place. Where the intention arises later, writing against reinsurance may give the reinsurer a right to avoid if the conduct is fraudulent and material to his interests.

The Court of Appeal in *Bonner* was not prepared to find that a treaty of non-proportional reinsurance was subject to an implied term that the cedant should not write against reinsurance. Lord Justice Waller observed:

> "Dishonesty", "wilful misconduct" or "recklessness" might provide a basis on which a reinsurer could refuse to accept a risk, for example, if the underwriter exercises no underwriting judgment at all in accepting a risk, not caring whether it was good or bad, or deliberately took a risk knowing of a loss which would only fall on his reinsurers, or took a bribe to write the risk, a remedy might well be available. But if this is to be so we would think it likely to be on the basis that on the proper construction of the policy such a risk would not be covered at all.

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In other words, perhaps, writing against reinsurance should be expressly provided for, or as the case may be, against, in reinsurance documentation.

VAT exemption for insurance related services?

The Government has considered responses to its consultation concerning Value Added Tax and insurance related services following the judgment of the European Court of Justice in *Arthur Andersen & Co Accountants.* This judgment was discussed in our March 2005 issue.

The Government has noted that the VAT treatment of financial services and insurance will soon be subject to review by the European Commission, and has decided to delay its decision regarding implementation of this ECJ judgment. The Government will monitor the progress of the review in deciding when to make the necessary changes to UK law and will provide the industry with sufficient notice in advance of implementation.

It is unusual for the UK Government to defer compliance with European rules in this way. It remains to be seen whether it is supported by the Commission.

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