Linklaters

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Insurance Update.

Foreign Investment in the UAE insurance sector

The insurance market in the United Arab Emirates (UAE) and the wider Gulf Co-operation Council (GCC) region has expanded considerably in recent years, largely due to the rapid rate of economic development, bringing with it an increased volume of risk to be insured (please also see the Insurance Update article entitled "Insurance in the Gulf Co-operation Council" www.linklaters.com/Publications/Publication1386Newsletter/20100128/Pages/InsuranceGulf.aspx.

Investment in the UAE, including Abu Dhabi and Dubai, by foreign insurance companies however remains restricted both in relation to the ownership of subsidiaries and the setting up of branch operations. An exception to this is the Dubai International Financial Centre (DIFC) which is a federal financial free zone in Dubai operating outside the federal civil and commercial laws of the UAE, which permits 100% foreign ownership and:

> in respect of DIFC and non-UAE based risks, global insurance companies may establish insurers and offer direct insurance;

> in respect of UAE based risks, DIFC insurers may only offer reinsurance; and

> any DIFC based insurance company will need to understand and comply with the local regulatory requirements in any jurisdiction to which it would like to offer its products.

Further information is set out below.

United Arab Emirates (on-shore)

Legal restrictions on foreign ownership

Foreign ownership of UAE insurance companies is restricted:

> UAE insurance companies are required to have not less than 75% of their share capital owned by UAE or GCC nationals. In addition, we understand that the UAE Insurance Authority's (the UAE insurance regulator) present position is that it will not approve the establishment of any new UAE insurance company unless it is wholly owned (100%) by UAE government entities.

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> In relation to branch operations, we understand that the UAE Insurance Authority will not currently approve the establishment of branches of a foreign insurance company which is not already present and licensed to operate in the UAE. In any event, consent for establishing such a branch must be obtained from the UAE Insurance Authority and requires, in particular, the foreign company to demonstrate that it offers new insurance products not offered by existing insurance companies or offers existing coverage needed by the insurance market. Foreign insurance companies wishing to establish a UAE branch, will also need to engage a local “sponsor”.

> Therefore, the only apparent route currently available for a foreign investor to access the insurance market in the UAE is through acquiring stakes of not more than 25% in existing UAE insurance companies.

> UAE insurance companies are also required to be established as a public joint stock company and listed on either the Abu Dhabi Securities Exchange or the Dubai Financial Market. The corporate governance requirements that apply to listed entities may further impair the ability of a foreign investor to control a UAE insurance company. These include that the chairman and the majority of the board of directors must be UAE nationals; and the majority of the board must also be comprised of non-executive directors and at least one-third must be independent directors; and, given the listing requirement, acquiring more than 20% of a UAE insurance company will require the approval of the Emirates Securities and Commodities Authority.

Structuring options

There are a number of bespoke measures used in practice to mitigate the effect of the foreign ownership rules and allow alternative means of control. These measures effectively allow the minority foreign shareholder to have certain benefits in practice that full or significant ownership of the UAE company would offer.

These can be achieved by agreeing certain consent rights in the shareholders’ agreement (i.e. negative control), or entering into a nominee arrangement or management agreement with the UAE national investor (as opposed to the articles which are broadly speaking in a standard form). It may also be possible to agree certain director appointment rights, although these rights would be subject to the corporate governance requirements set out above.

However, these measures are limited and may not achieve the desired commercial objectives for the foreign investor, for example, accounting consolidation, management control or economic return. Also, these options are not without risk, and to the extent that such measures allow the foreign shareholder to practice a commercial activity in the UAE that is not otherwise open to it, they may fall foul of the UAE Federal law regarding commercial concealment.

New developments

The UAE Government has announced that a new set of regulations will be coming into force governing the insurance sector. It is hoped that these regulations will clarify and liberalise the position on foreign establishment and/or ownership, but at the time of going to press, these regulations are yet to be published. We will provide an update when published.

DIFC (off-shore free zone)

The DIFC is a financial free zone in Dubai operating outside the federal civil and commercial laws of the UAE. Therefore, the UAE Commercial Companies Law and relevant insurance laws and regulations referred to above do not apply to entities established in the DIFC. Accordingly, the DIFC has a separate set of laws and regulations, which allow 100% foreign ownership of companies within the free zone. Any insurance business carried out in or from the DIFC will be regulated by the Dubai Financial Services Authority.

The DIFC has attracted a number of foreign insurance entities that are able to provide underwriting capacity to local direct insurers through reinsurance arrangements.

However, foreign insurance companies who set up in the DIFC are limited in the type of insurance that can be offered. In particular, the DIFC is a largely wholesale rather than retail market place for insurance and DIFC-based insurance businesses do not deal directly with retail customers in the UAE. DIFC insurers must operate on a reinsurance basis for risks within the UAE, but this allows access to the UAE and the region as a whole as there are few restrictions on reinsurance arrangements with local direct insurers (frequently ceding up to 100% of the risk) in the UAE or the other GCC countries. Since 2009, risk carriers are now able to issue direct insurance contracts in respect of risks situated within the DIFC and outside the UAE. However, it is important to note that other jurisdictions in the region will have specific regulatory requirements. Any DIFC based insurance company will need to understand and comply with the local regulatory requirements in any jurisdiction to which it would like to offer its products.

The insurance companies in the DIFC are not treated as UAE insurance companies for so long as they do not satisfy the applicable local ownership requirements in the UAE. Therefore acquiring a DIFC insurance company which is subject to the more relaxed ownership rules will not necessarily afford foreign investors the ability to acquire local insurance operators or access certain lines of business.

Linklaters LLP launched its Abu Dhabi office in September 2011.

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A study on co-(re)insurance pools - more competition attention for pools and ad hoc agreements?

The European Commission has highlighted concerns that:

> in relation to insurance pools, many insurers were incorrectly using the old competition block exemption as a “blanket” exemption, without carrying out the required careful legal assessment of a pool’s compliance with the “conditions” required by that block exemption; and

> ad hoc co-(re)insurance agreements on the subscriptions market (broadly a coinsurance market) may have never been covered by the old or new block exemption and that an alignment of pricing (between co-(re)insurers through ad-hoc co-(re)insurance agreements), could fall within the scope of the prohibition of anti competitive agreements/practices under Article 101(1) of the Treaty on the Functioning of the European Union, although they may be eligible for exemption under Article 101(3) - this should be assessed for competition law compliance on a case by case basis. This concern was raised in the Commission’s Final Report on the Business Insurance Sector.

In September 2011, the European Commission announced a tender for a study to be undertaken of co-insurance and co-reinsurance pools and of ad hoc insurance agreements in the subscription market to follow up on these concerns.

This invitation to tender refers to the principles adopted by the European Federation of Insurance Intermediaries (BIPAR), and endorsed by the European Insurance Associations (CEA), designed to guide members on how to comply with competition law in relation to subscription business.

The Commission notes that implementation of these principles and any other ways of tackling the issues raised in the Sector Inquiry need to be monitored in order to determine if positive changes in the market have taken place since the Sector Inquiry.

The successful tenderer will be organising interviews with insurers, brokers and insurance clients, and other market participants, in order to report to the Commission with a clear picture on insurance pools and insurance agreements and how they operate across the European Union.

The Commission intends to monitor pools and their compliance with Article 101 of the Treaty on the Functioning of the European Union and the block exemption regulations with the help of national competition authorities (within the framework of the European Competition Network).

Hence insurers and reinsurers can expect more attention on these issues, arising from the Sector Inquiry and the renewed BER, during the course of 2012 and should also note the potential for follow-up enforcement action.

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FIO Seeks Comment on Improving Regulation of Insurance Industry

On October 17, the U.S. Federal Insurance Office (FIO) requested public comment on ways to improve insurance regulation in the United States. The FIO, which was created by the Dodd-Frank Act, lacks the ability to regulate insurers, but it may recommend that an insurance company be deemed a systemically important financial institution (SIFI) by the U.S. Financial Stability Oversight Council, which could subject that company to prudential regulation by the Federal Reserve. It is also charged with analyzing the regulation of insurance in the United States, identifying gaps in industry oversight, and preparing a report for Congress about how to modernize the current insurance regulatory regime. In requesting public comment, the FIO sought input on, among other things, the state-to-state uniformity of insurance regulation and the potential costs and benefits if insurance were regulated by the federal government rather than the states.

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Solvency II Update

FSA Consultation Paper 11/22: Transposition of Solvency II – Part 1

Transposition: consultation papers

In order to transpose the Solvency II directive (the "**Directive**") into law, changes are required to primary legislation (on which HM Treasury is consulting - please see below for further details) and also to the FSA Handbook.

The FSA's proposal for transposing the Directive into the Handbook involves the introduction of a new prudentially focused sourcebook - SOLPRU - which will apply to in-scope firms together with a number of changes to other existing parts of the Handbook.

In preparation for transposition, the FSA has published the first of two planned FSA consultation papers on the rules to transpose the Directive ("**CP1**"). The FSA decided to commence consultation at this stage as they believe that the policy set out in the Directive is stable and Omnibus II is not expected to affect the core principles of the Solvency II framework. The second proposed consultation paper will be published once agreement has been reached on Omnibus II and on the level 2 legislation and will address any required changes arising out of finalised legislation together with topics such as Lloyds, reporting requirements and templates and proposals around with-profits ("**CP2**"). The FSA expects to publish CP2 in Q2/Q3 2012.

Transposition Approach

The approach which the FSA takes to transposition is "intelligent copy-out" which means that the words of the Directive are followed as closely as possible with departures from copy-out only taking place in circumstance where it is necessary to provide greater clarity or where the Directive requires a discretionary decision to be made. As the Directive sets out the standards below or beyond which Member States cannot go, the FSA has limited opportunity for discretion in transposing the Directive. In addition, if as anticipated, level 2 is implemented as an EU regulation (which will apply directly to firms and supervisory authorities without the need for any other implementing measures), there will be no consultation process in relation to level 2 provisions.

Content

CP1 covers:

> the European context, the FSA's approach to transposition and transposition in the context of regulatory reform flowing from the establishment of the Financial Conduct Authority and the Prudential Regulation Authority;

> the draft text for SOLPRU together with an explanation of the draft rules and guidance;

> proposed amendments to other sourcebooks as part of the transposition process; and

> a cost benefit analysis for the introduction of Solvency II.

Timing

The consultation period for CP1 closes on 15 February 2012 after which the FSA intends to publish a Feedback and Policy Statement in the second quarter of 2012.

HM Treasury Consultation on Solvency II

HM Treasury's consultation paper on amendments to primary legislation notes that most of the requirements of the Directive can be achieved using powers provided by the Financial Services and Markets Act 2000 ("FSMA") and the FSA's Handbook. Accordingly, the number of changes that are required to primary legislation is relatively small when compared to the number of Directive provisions.

It is proposed to transpose the Directive at a primary legislation level by means of a statutory instrument containing provisions amending FSMA (following its amendment by the forthcoming Financial Services Bill). The consultation paper includes the draft text for The Financial Services and Markets Act 2000 (Solvency 2) Regulations 2012 (the "Statutory Instrument").

The consultation paper addresses the following broad categories as contained in the Statutory Instrument:

> amendments necessary to specify the authorisation and de-authorisation of undertakings to carry out insurance and reinsurance business;

> new bespoke powers of approval for the Prudential Regulatory Authority ("PRA"), which relate to the approval of matters such as ancillary own funds and classification of own funds into tiers. The powers are outlined in the Statutory Instrument;

> new duties for the PRA relating to their participation in the new supervisory framework; and

> amendments to align terms and definitions with the terminology of the Directive.

The consultation period is the same as that allowed for CP1 and closes on 15 February 2012.

Third Country Equivalence Up-date

Solvency II has three different equivalence tests:

> Article 172: reinsurance by third country entities;

> Article 227: group solvency for EEA insurance groups with a third country subsidiary; and

> Article 260: group supervision for third country insurance groups.

In August 2010, EIOPA issued equivalence assessment consultation papers in respect of Bermuda, Japan and Switzerland and in October 2011 final reports were published on each of these countries. A summary of EIOPA's findings for each county is set out below.

Bermuda

EIOPA found that Bermuda met the criteria for equivalence under each of the articles but with caveats. Under the Bermudan supervisory system, insurers are categorised into classes. EIOPA found that insurers falling within classes which are essentially commercial classes met the criteria with a few caveats while other classes did not. Areas attracting EIOPA comment included:

> a partial equivalence with regard to authorisations;

> the possibility of carrying out both insurance and non-insurance business in a single company was identified as a potential risk for reinsurance cedants and is a significant difference from Solvency II provisions;

> a requirement to strengthen areas of governance and public disclosure;

> no equivalence with regard to requirements around changes in business, management and qualifying holdings; and

> partial equivalence with regard to co-operation and exchange of information with other supervisory authorities.

EIOPA was unable to reach a conclusion on the current valuation framework as there was a variety of different valuation standards available or on the proposed valuation standards, given the material uncertainties which remain around the economic balance sheet framework which is being developed.

Japan

Japan was assessed for equivalence under Article 172 only. It was found to meet the criteria for equivalence, but with a number of caveats. Specifically, the Japanese solvency regime was found to be only partly equivalent for reinsurers. New entrants and those expanding their business rapidly will not be subject to the same level of prudence in relation to reserving requirements. Currently technical provisions are not calculated using market consistent valuation. However, EIOPA has said that it expects this to become largely equivalent once the anticipated move in Japan to market consistent valuations of liabilities is finalised.

Switzerland

EIOPA found that the Swiss Financial market Supervisory Agency ("FINMA") fully met the criteria for equivalence under Article 227. Equivalence was also found under Articles 172 and 260, albeit with certain caveats. EIOPA's main finding was that FINMA's governance and public disclosure requirements are not as extensive as those under Solvency II. FINMA are in the process of reviewing this and EIOPA recommended that the equivalence of the public disclosure regime be revisited. EIOPA also noted that in order to achieve equivalence with Solvency II standards all insurers would be required to have a compliance function comparable to that of Solvency II and an internal audit function.

The FSA's Consultation Paper on the Transposition of Solvency II – Part 1 ("CP1") and Equivalence

Member States have discretion to allow the group solvency calculation to take account of the SCR and own funds requirements as laid down in a third country - "local rules". These local rules can only be used if the third country has received a positive equivalence decision as found in Article 227 of the Directive. The FSA proposes to exercise this Member State discretion by allowing the use of local rules, where equivalent. The FSA's proposal to exercise the option is one of the issues which is being consulted on as part of CP1.

FSA to help insurers avoid extra costs from Solvency II delay

The FSA has announced they will work with UK insurers to explore possible ways to avoid extra costs from the expected delay to the introduction of the Solvency II regime. Rather than come into force in 2013 as originally planned, the FSA has revised its implementation assumptions and its planning assumption is for the Directive to be transposed into UK law by 1 January 2013 when certain responsibilities will be switched on for supervisory authorities and EIOPA and with new standards to come into force for UK firms on 1 January 2014.

Julian Adams, head of insurance at the FSA, said at an industry briefing on 3 November 2011 that while it was very likely that some form of Solvency II reporting will be required during 2013, it was unclear what this would amount to. To address the industry's concerns of the additional costs from having to run old capital requirement models alongside the new models developed for the incoming Solvency II regime in 2013, the FSA supervisors looking at internal model applications will "explore with firms possible ways of avoiding the costs associated with the dual running of an ICAS and Solvency II model, while continuing to secure a degree of policyholder protection". He went on to elaborate that "this could include investigating whether, where we are minded to approve a firm's model, such a model could be used to demonstrate satisfaction of some or all of a firm's ICAS requirements". He also added that the FSA would not go further than this to waive or alter the current Solvency I requirements until the new standards come into force in 2014.

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Recent Deals

Our recent deal experience in the sector (details of which we are able to disclose) include:

> advising on the £166.27 million recommended partial cash offer by Jardine Matheson Holdings Limited for 21,734,665 ordinary shares of Jardine Lloyd Thompson Group plc (the offer document published on 23 September 2011 was the first offer document to be published under the new UK Takeover Code rules which came into effect on 19 September 2011);

> advising Legal & General in respect of the provision of a bespoke bulk annuity insurance contract in relation to the T & N Retirement Benefits Scheme, the largest bulk annuity contract involving all members of a pension scheme ever to be signed in the UK;

> advising on the sale of all the shares in Fidea NV, the second Belgian insurance network of KBC Group, to J.C. Flowers & Co. (the sale was required by the European Commission as a result of the state aid received by the KBC Group in 2008);

> advising Evercore Partners International LLP in relation to the cash confirmation exercise in connection with the recommended cash offer by AmWINS Group Inc. (by one of its subsidiaries) for THB Group plc; and

> advising the trustees to the Rolls-Royce Pension Fund on a £3 billion longevity swap entered into with Deutsche Bank.

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This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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