Linklaters

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Insurance Update.

European Legal Entity Consolidation and Societas Europaea

Reducing the number of European legal entities within a group would mitigate the increased prudential and administrative requirements which will arise as a consequence of the implementation of Solvency II. A reduction in the number of legal entities is likely to:

> lead to lower capital requirements as a result of achieving diversification benefits;

> allow fungibility of capital; and

> reduce regulatory infrastructure and expense – for example, by requiring fewer computer models (or capital calculations using the standard formula) and annual ORSAs (own risk and solvency assessments) and SFCRs (solvency and financial condition reports).

Consolidating European legal entities might be aimed at establishing single pan-European entities for each of the life and non-life components of an insurance group's business with branches in relevant EEA states, using the passporting regime under the directives. That "hub" entity could also be a European SE (Societas Europaea) established in the hub jurisdiction and such a hub would then have the advantage of being portable between EEA jurisdictions. An SE is a company established in one EEA state which may change its jurisdiction of establishment to another EEA state. The SE can be an authorised insurer which is able to operate on a pan-European basis using passports to set up branches in each jurisdiction where previously there was a separate legal entity writing business.

The question of whether or not an SE is a viable entity to be established as the hub for the European business will revolve around a number of factors, including:

From a tax perspective, a European SE tends to be unattractive for US groups because an SE cannot be a "check the box" company for US tax purposes. Otherwise, the attractiveness of the portability of the SE might be undermined by the fact that an SE may be liable to pay exit charges when it transfers to another member state. Whether or not an SE is used as the hub, a branch structure would mean a greater risk of triggering capital gains tax on

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disposals leading to less flexibility for future M&A. Whatever the status of the hub, a more general observation is that consolidations make future M&A more difficult as it would by necessity involve asset (rather than share) deals – and asset deals are much more difficult to execute.

From an employment perspective, issues will be much more significant if an SE, which is to have employees, is used. This is because an SE has, at its heart, employee involvement rights which are often of significant concern to companies.

The portability of an SE, once established, may be somewhat more theoretical than real. Previous experience suggests that changing jurisdiction is a rather bureaucratic process in which regulatory approvals are required. For example, if an SE is transferring from the UK, a certificate is required from the relevant government minister confirming that the formalities have been complied with and that creditors' and minority shareholders' interests have been protected. A solvency statement must be sent to UK Companies House (carrying potential criminal sanctions) along with further forms providing supporting information. The minister and the UK regulator (where the transferring company is regulated by it) then have two months to object to the transfer (the UK regulator can object on "public policy grounds"). These rules are very closely based on the European Company Regulation so other EEA states' rules are likely to be similar.

Creditors have the right to object to the transfer of an SE from one EEA state to another – they must be informed of the proposals as part of the process.

If an SE is not used, then it is simply necessary to incorporate and authorise a new operating insurance company in the destination jurisdiction (with branches in other relevant jurisdictions) and to transfer the relevant shares or business to that entity, in the usual way.

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Indian Guidelines on Outsourcing of Activities by Insurers

The Indian Insurance Regulatory and Development Authority has issued final guidelines on outsourcing by insurance companies. These categorise the activities of insurers as follows:

> core activities (such as underwriting, administration, complying with know your customer/anti-money laundering requirements, administering policyholder complaints, bank reconciliation etc) - broadly speaking, insurers are prohibited from outsourcing these activities, although there are certain exceptions: for example, clerical activities related to bank reconciliation maybe outsourced although the insurer must retain sole responsibility for reconciling various bank accounts; and

> non-core activities (such as facility management, website development and management, pay roll management, HR services, etc.) and

supporting activities (which are specified activities which support core activities and include activities such as data collection of prospects, data entry, etc.) - insurers are permitted to outsource these activities provided that they undertake proper risk assessment and due diligence of the proposed service provider and also comply with various risk management principles and reporting requirements.

An insurer is required to consult the Authority where there is any ambiguity over whether an activity comprises a core activity or a non-core activity.

The guidelines specify a list of **risk management principles** (set out below) with which an insurer must comply when outsourcing any activity, which include:

- establishing a comprehensive outsourcing policy which sets out matters such as criteria for selecting both the activities to be outsourced and proposed services providers and scope of delegation of authority (which should depend on risks, materiality and systems to monitor and review the outsourced activities);
- reviewing service provider performance;
- implementing an outsourcing risk management programme, which includes materiality thresholds relating to specified factors, including the financial, reputational and operational impact on the insurer due to a service provider's failure to perform;
- establishing contingency plans and ensuring that the service provider establishes contingency plans;
- ensuring confidentiality of information is maintained; and
- ensuring that outsourcing relationships are governed by written contracts and that termination payments are reasonable.

Outsourcing to a group entity: the guidelines provide that all arrangements with a service provider which is a group entity of the insurer or which has a common director with the insurer must be disclosed as soon as the arrangements are entered into (or within a specified time period where a service provider becomes a group entity).

All existing outsourcing contracts which do not comply with the guidelines must be terminated by 30 June 2011 (although the Authority has discretion to extend this date by up to three months on a case to case basis).

This article has been provided by Talwar Thakore & Associates. TT&A is a "best-friend" of Linklaters.

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EU Insurance industry digests landmark ECJ ruling on gender-based pricing

On 1 March 2010, the European Court of Justice published its much-anticipated decision in the case of "Test-Achats" signalling an end to the use of gender as a factor in pricing insurance. The decision invalidates a provision of EU law which enables insurers to charge differential premiums or provide differing benefits depending on the sex of the policyholder and is based upon a broad prohibition in the Treaty on European Union on discrimination on the grounds of sex.

The ruling impacts in areas such as car and medical insurance where, for example, young male drivers are often charged higher premiums than their female counterparts because they are statistically more likely to cause accidents. The costs of purchasing annuities from an insurance company and insuring death benefits for members may also be affected. Currently, annuities are generally more expensive to secure for women (because they tend to live longer), while death benefits are more expensive for men (because they tend to die earlier).

The ruling has attracted criticism from within the industry, although there had been fears that it would be given immediate – or even retrospective – effect. However, the Court's judgment will, in fact, apply from 21 December 2012, allowing companies some time to update their pricing policies and systems.

The Commission will now review the ruling and it will be subject to local implementation in each EEA jurisdiction so there is scope for some further change in this area.

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Creation of the UK FCA

In March 2011, Hector Sants, the CEO designate of the UK Prudential Regulation Authority, gave a speech about the creation of the Financial Conduct Authority, the body which will focus on consumer protection and the markets in place of the UK Financial Services Authority.

The speech described how the FCA would be different from the FSA. The fundamental difference will be that, where the FSA was generally passive and reactive, the FCA strategy will be based on a proactive and intensive approach comprising four key elements:

> addressing structural deficiencies in sectors and the marketplace which limit or impair consumer choice and experience;

> delivering intensive supervision of firms to ensure they are treating customers fairly;

> making proactive product-based interventions; and

> ensuring the appropriate level of redress and compensation.

In order to fulfil this new role, the FCA will need stronger powers of intervention than those currently enjoyed by the FSA. Mr Sants spoke strongly in favour of powers to ban specific products and refer firms to the competition authority. He also suggested that the FCA would shift towards rules, rather than principles, and towards more detailed prescription.

In addition, the speech made clear that the FCA must deliver credible deterrence by taking action against firms and individuals. In an effort to suggest that this strategy has already taken shape, the upsurge in FSA activity in relation to market abuse was highlighted, together with the change in the FSA's fining regime which enabled the FSA to link fines more closely to income. It is clear that the new FCA will aim to deliver more intensive, consumer focused regulation.

However, there was recognition that this new approach and the powers that will come with it will require trust and confidence from both consumers and the industry. This will need to be underpinned by a commitment to transparency and accountability. To achieve this, Mr Sants advocated a new model of interacting with consumers which will need to have a robust and effective mechanism for understanding consumer needs and ensuring they feel that their views are listened to and taken into account in decision making.

The speech also emphasised that the FCA would not be a "no failure" institution that would seek to remove all risk taking from consumers. Mr Sants highlighted that an informed investor, equipped with full disclosure of risks, is entitled to make mistakes and that this premise is central to effective wholesale markets and the operation of stock markets for retail investors.

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China to Launch Insurance Exchange in Shanghai

The Chairman of the insurance regulator in China, the China Insurance Regulatory Commission, recently commented to the press that an insurance exchange will be set up in Shanghai as part of the central government's plan for Shanghai to become an international financial centre. Whilst no specific details were given, there was a press report in February 2011 that the relevant government authorities are currently reviewing a proposal from the Shanghai government to the State Council to set up an insurance exchange. According to the press report, the proposed insurance exchange would initially provide a centralised trading platform for reinsurance, property insurance, liabilities insurance and group life insurance products with risk securitization products, such as catastrophe bonds and insurance derivatives being provided at a later date.

In addition, the insurance exchange may provide information relating to insurance brokers, insurance assessors and other insurance intermediaries. It is thought that participants in the exchange will include life insurers, property and casualty insurers, reinsurance companies and insurance intermediaries.

However, it remains unclear as to whether foreign insurers will be allowed to trade on the insurance exchange.

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Administration for Insurers Consultation

The Government has continued with its programme to ensure effective insolvency regimes are available across the financial services industry by consolidating a number of pieces of legislation applying to insurers into one instrument: the Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010. The administration process for insurers is now set out in this single order. It remains the case that out-of-court administration - available to companies generally - is not available to insurers.

In addition to consolidating various legislative instruments, the 2010 Order also modifies the purpose of an administration of an insurer. The main aim of insurer administration should be to provide assistance to the Financial Services Compensation Scheme to enable it to administer the compensation scheme and secure continuity of insurance contracts and to require an administrator of an insurer to continue the business of the insurer and make payments under any policies. Consequential changes are also made to ensure that, for example, the FSCS is added as a party entitled to be represented at the hearing of an administration application in relation to an insurer and receive various creditor notifications.

The consolidation exercise for insurers follows on from the consultation carried out in 2010 on strengthening the administration regime for insurers and implements a number of its proposals. Other areas of the financial services sector to have also seen insolvency reform include banks in 2009 and, most recently, investment banks, with the introduction of new special insolvency and administration regimes.

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US pensions and derivatives regulatory initiatives - implications for insurers doing business with US pension funds

There have been two recent regulatory developments in the US that may impact insurers doing business with US pension funds.

Department of Labor Proposes Expanded Definition of “Fiduciary”

The US Department of Labor (DOL) has recently proposed regulations which significantly expand the circumstances in which an individual or an entity may become a fiduciary under the US Employee Retirement Income Security Act of 1974 (ERISA) as a result of having provided investment advice with

respect to a pension fund, which exposes these individuals or entities to the risk of liability for fiduciary breaches and prohibited transactions under that Act.

While the proposed regulations contain an exemption for parties which are engaged in purchases or sales of securities or other property with a pension fund, this “seller’s exemption” is generally viewed as too narrow to cover many of the products and services offered to pension funds on an arms-length basis by financial institutions, investment funds and insurance companies (such as an insurance policy under which an insurer pays a pension fund amounts that the fund is due to pay to its annuitants). Various industry groups, including the American Council of Life Insurers and the Committee of Annuity Insurers, have urged the DOL to clarify the seller’s exemption so that it is clear that it covers the full scope of ordinary course selling and distribution activity.

The DOL intends to finalise the fiduciary regulations by the end of this year.

Commodity Futures Trading Commission Proposes Business Conduct Standards for Swaps

Even if the DOL clarifies the exemption referred to above, there is an additional challenge for longevity products documented as swaps. The US Commodity Futures Trading Commission has proposed regulations implementing aspects of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. These impose business conduct standards on the swap providers which enter into swap transactions with certain counterparties (including pension funds) which are widely viewed as resulting in ERISA fiduciary status under the proposed DOL regulations described above and potentially current law. Hence, these swap transactions with pension funds may well be limited or prohibited unless an exemption or other relief becomes applicable. Commentators have noted that this result appears to be contrary to congressional intent as, before Dodd-Frank was passed, Congress had removed provisions which would have imposed a fiduciary duty on providers of swaps to pension funds.

The Commission intends to finalise the proposed business conduct standards regulations by July of this year.

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Proposed amendments to the Singapore Insurance Act

Towards the end of last year, the Monetary Authority of Singapore conducted a consultation on proposed changes to the Insurance Act. The proposed changes include:

> giving the MAS greater flexibility to disclose information it obtained through inspections;

> giving the MAS the explicit powers to inspect the branches and subsidiaries of locally incorporated insurers;

> imposing confidentiality requirements on the recipients of MAS' inspection reports;

> requiring foreign regulators to seek MAS' approval prior to conducting inspections on registered insurers in Singapore, and to allow MAS to impose conditions on the foreign regulators in relation to these inspections; and

> further regulating the ownership and control of insurers incorporated in Singapore.

Although the MAS has issued feedback last month on responses to the proposed changes (which clarified certain issues raised by the respondents but did not introduce any major changes to the original proposals), the MAS has not yet stated whether the proposed changes are final or what the next steps will be.

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UK consultation paper: protecting with profits policyholders

The FSA has published a consultation paper on with profits policyholders and is asking for feedback on the proposals made by 24 May 2011. At a high level, the proposals include:

> setting guidance to ensure that firms are clear that the FSA sees the fair treatment of with profit policyholders applies to the fund as a whole (and are not restricted to notional asset shares), and turning the current elements of guidance relating to conflicts (which explicitly recognise that conflicts may arise between the interests of shareholders and with profit policyholders) into a rule and expanding this so that it covers conflicts between types of policyholder (as well as between policyholder and shareholder);

> making proposals in relation to applying market value reductions to avoid potential detriment to the remaining policyholders that would arise if a payment is higher than the underlying assets, and rules in relation to reductions in writing new business (including requiring all firms (not just those which have been closed to new business since 2005) to have run-off plans) as it can bring with it changes in the way business is managed, which need to be recognised in advance and planned for

> requiring that new businesses that are written, and strategic investments that are made or retained be restricted to new businesses and strategic investments which are likely to have no adverse effect on the policyholders' interests;

> making it clear that the prohibition to firms charging their with profits funds for costs that are more than the costs they have incurred in operating the fund applies to in-house services companies;

> requiring that excess surplus may not be reattributed but must be distributed and to change the reattribution process (including so that any identified excess surplus must be distributed first); and

> making proposals in response to criticisms that with profit committees (where established) are not sufficiently independent including requiring with profit committees to be established in all cases, except for smaller firms with other proposals to enable independent judgment, and proposals relating to the constitution of the committees, defining independence, publishing terms of reference, recording decisions, advice given to the committees and on liaising with the with profits actuary.

Solvency II Update

EIOPA Report on the [fifth Quantitative Impact Study (QIS5) for Solvency II] http://www.fsa.gov.uk/pubs/cp/cp11_05.pdf was published on 14 March. Set out below are some of the technical provisions issues highlighted by EIOPA:

> There were different interpretations of the definition of “contract boundaries” which had lead to inconsistencies between undertakings and possibly also an incorrect calculation of technical provisions.

> Net provisions had decreased materially as against Solvency I with gross provisions decreasing by some 24.9%. The main explanation for this was the discounting of future cash flows for non-life business (not applicable under Solvency I) and the exclusion of safety margins (now offset by the explicit risk margin). Different segmentation principles apply as between the two regimes which would account for some of the difference.

> The application of the buckets relating to illiquidity premium across these product types does not appear to have been applied consistently between undertakings, and many supervisors have requested detailed guidance on which products attract the illiquidity premium and which bucket should apply.

> Many undertakings did not use the full calculation approach for the valuation of the risk margin as this was felt to be too complex and time consuming. Largely speaking, undertakings have used the proposed simplifications, supported by supervisory authorities often on the grounds that the risk margin is relatively immaterial and hence does not justify the difficulty of the full calculations.

> Application of data for segmentation purposes was often not consistent. Undertakings indicated that their systems were not sufficiently capable of accurately segmenting business in accordance with the QIS 5 specifications. Most countries report that guidance on segmentation was not sufficiently clear and that there has been a lack of consistency.

> In relation to the potential impact of transitional measures on technical provisions, whilst most respondents did not think they were material in

their market, two countries saw them as vital, particularly in respect of long term liabilities. The most common product type to which transitionals were applied was annuities, including bulk annuities (a summary of the transitional provisions set out in the Omnibus II directive (as mentioned in January's edition) is below:

http://www.linklaters.com/Publications/Publication1386Newsletter/20110131/Pages/New_EU_Financial_Supervision_Authorities_Begin_Work.aspx

Summary of transitional provisions

The Omnibus II directive specifies transitional provisions for the implementation of Solvency II. Although it sets out maximum periods for the transitional period, the actual time period selected by local European regulators may be for a shorter period. The transitional requirements are required to be at least equivalent to the existing framework on insurance and reinsurance directives and should not result in more favourable treatment for insurance or reinsurance undertakings, or lower protection for policyholders than currently exists.

A summary of the transitional provisions is set out below.

Solvency II Article Number	Issue	Transitional Period
35(5)	To have appropriate systems and structures in place to provide information for supervisory purposes	5 years (although this is unclear due to a reference to 3 years in Article 308b(a))
37(1)(a) and (2)	Requirement for a capital add-on where a supervisory authority concludes that the risk profile of the undertaking deviates significantly from the Solvency Capital Requirement and consequential requirement relating to the way in which the capital add-on is to be calculated	10 years (The assumptions underlying the transitional Solvency Capital Requirement referred to below must be taken into account)
41(1) and (3)	To have in place an effective system of governance which provides for sound and prudent management of the business and to have in place and implement written policies in relation to at	3 years

Solvency II Article Number	Issue	Transitional Period
	least risk management, internal control, internal audit and, where relevant, outsourcing	
51(1)	To disclose publicly, on an annual basis, a report on its solvency and financial condition	3 years (A report containing a high level summary of the information listed in Article 51(1) will be required)
75(1)	Method of valuing assets and liabilities	10 years (Must comply at least with the local law applicable on 31 December 2012)
76(2), (3) and (5)	Rules relating to technical provisions (general provisions)	10 years
94	Main criteria for the classification of own fund items into tiers	10 years
100, 101(3), 102, 104	To hold eligible own funds covering the Solvency Capital Requirement and other provisions	10 years (Must comply with a transitional Solvency Capital Requirement that is no higher than the Solvency Capital Requirement and no lower than the sum of the Minimum Capital Requirement and fifty per cent of the difference between the Solvency Capital Requirement and Minimum Capital Requirement)

Solvency II Article Number	Issue	Transitional Period
218(2) and (3)	To ensure that eligible own funds are available in the group which are always at least equal to the group Solvency Capital Requirement	10 years (Eligible own funds must be available in the group which are calculated by reference to the calculation method of the transitional Solvency Capital Requirement)
172(3), 134(1), 227(1) and 261(1)	Third country equivalence	5 years (The supervisory authorities must give commitments in relation to the convergence to an equivalent regime over a set period of time, the existing or intended content of the regime, and matters of cooperation, exchange of information and professional secrecy obligations).

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Recent Deals

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

> advising JP Morgan as documentation agent, The Royal Bank of Scotland Plc as facility agent and the mandated lead arrangers on a $650,000,000 letter of credit facility for the Catlin Group Limited and several of its subsidiaries;

> advising ALLIANZ on the [issue] of EUR 2,000,000,000 5.75 per cent. guaranteed subordinated fixed to floating rate notes with scheduled maturity in 2041 which comply with requirements for own funds of an insurer under Solvency I and are also structured to comply with the requirements for own funds in tier 2 for insurance companies as set out in the draft implementation regulation for the new Solvency II regime; and

> advising New York Life Insurance Company on the sale of its interest in its Thai life insurance joint venture to its partner Siam Commercial Bank Public Company Limited.

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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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