Linklaters

March 2012

Insurance Update.

Eurozone

The ongoing Eurozone crisis is a hot topic for everyone including those in the insurance sector.

Despite the current period of relative calm, it is impossible to predict how the situation will develop. Politicians across Europe are focused on a political solution which still appears the most likely outcome, however, regulators are rightly expecting financial institutions, including insurance companies, to consider their exposures. At least one regulator has said that good risk management means planning for the unlikely but severe consequences of a range of scenarios, such as the departure of some countries from the Eurozone.

What should insurers be thinking about? We have been discussing this with many of our clients in the insurance sector in the UK and across the globe.

Attached is a link to the Eurozone developments page on our website. http://www.linklaters.com/Publications/Eurozone-developments/Pages/Eurozone-developments-video.aspx

If you and your team would like to "brainstorm" with our insurance sector experts, please feel free to contact us.

Our webcast is available for you to register and view. Running times are correct and the whole webcast is exactly 39 minutes. Please click on the attached link to take you to the webcast.

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Linklaters launches Longevity Solutions Initiative

Linklaters has launched a new cross practice initiative to support pension schemes and pension solution providers on their longevity solutions. The Longevity Solutions Initiative brings together legal expertise in pensions, insurance, derivatives and other areas.

With people living longer, pension providers are facing the issue of paying pensions for longer than they had originally expected. Linklaters' pensions,

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insurance and derivatives teams have been at the forefront of devising and advising on innovative solutions to hedge this longevity risk.

The firm has been advising both pension trustees on hedging this risk, for example advising the trustees to the Rolls-Royce Pension Fund on a £3bn longevity swap entered into with Deutsche Bank. Linklaters also advises banks who take on this risk by way of both insurance and derivatives, for example Credit Suisse on the £1.7bn ITV Pension Scheme. These two deals are the largest longevity risk transfer swaps to date.

Related to this, Linklaters advises on bulk purchase annuities. This is where companies running final salary pension schemes buy annuities from an insurance company to provide an income for those who retire which could ultimately lead to the insurer issuing annuities to the pension scheme members itself. Linklaters' longevity team recently advised Legal & General in relation to the T&N pension scheme and, separately, the Uniq plc pension scheme trustees on their bulk annuity policy issued by Rothesay Life. A novel feature of the Uniq transaction was that the pension scheme was in the Pension Protection Fund (PPF) assessment period and secured a guaranteed level of benefits.

Please see attached link to our contribution to the "Clear Path Analysis" on "Pension de-risking: Longevity Hedging & Buying Out 2012".

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Advantages/disadvantages of using title transfer and security collateral arrangements

Collateral is a hot topic when considering transactions, primarily as parties are dependent upon their counterparties' strength of covenant to pay premiums and/or claims. There are many different structures and permutations which may be used. However, set out below is a high level overview of the advantages and disadvantages of:

(a) providing collateral by way of title transfer (in essence, where the legal and beneficial interest in the assets is transferred outright to the recipient as owner (subject to a contractual obligation on the recipient's part to re-transfer equivalent assets)); and

(b) using a security arrangement as a means of collateralisation (in essence, where the assets are appropriated towards payment of a particular debt and available to the secured party upon the occurrence of contractually defined enforcement events).

Issue	Title Transfer	Security Arrangement
Use of collateral assets	**Advantage**: the recipient, as owner, can deal with the assets freely.	**Disadvantage**: unless expressly provided for, use is often restricted.

Issue	Title Transfer	Security Arrangement
		The recipient, as secured party, may not deal with the assets until an enforcement event has occurred.
Negative pledge – where the provider is prohibited from creating security over any of its assets.	**Advantage**: unlikely to be an issue unless negative pledge is broadly drafted.	**Disadvantage**: generally incompatible with negative pledges.
Formalities – additional requirements in order to be enforceable against third parties.	**Advantage**: much simpler, as recipient is owner.	**Disadvantage**: more complex, with possible registration requirements, unless it constitutes a "financial collateral arrangement".
Limits on enforcement of security	**Advantage**: not applicable	**Disadvantage**: restrictions may be applicable, although reduced for "financial collateral arrangements".
Realisation of collateral	**Advantage**: the recipient is not required to take any steps to realise the collateral, as it already owns it following transfer.	**Disadvantage**: more complex and contractual arrangements will generally provide for how the assets may be dealt with.
Over-collateralisation (note under-collateralisation may also arise depending on frequency of	**Disadvantage:** the provider has credit exposure against the recipient if the value of transferred collateral exceeds that of its secured liabilities.	**Advantage:** the provider retains property rights with respect to the secured assets. The secured assets should not normally form part of

Issue	Title Transfer	Security Arrangement
valuation.)		the insolvent estate of the secured party.
Tax	**Disadvantage:** potential capital gains tax or stamp duty charges.	**Advantage:** issues are unlikely to arise.
Regulatory issues	**Disadvantage:** may sometimes give rise to regulatory obligations, such as disclosure requirements.	**Advantage:** issues are unlikely to arise.
Who is entitled to the investment return?	**Neutral:** it is usual for the documentation to provide for an equivalent return to be payable to the provider, which will reflect the return accruing on the transferred assets	**Neutral:** the return on the assets will accrue for the benefit of the provider, although it may not be able to deal freely with such return whilst the secured obligations remain outstanding.
Be able to count as regulatory capital	Depends on jurisdiction and which entity is posting, but regulatory treatment likely to follow accounting treatment.	Depends on jurisdiction and which entity is posting, but regulatory treatment likely to follow accounting treatment.

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Foreign Account Tax Compliance Act

Certain provisions of the Foreign Account Tax Compliance Act ("**FATCA**") were brought into force by the Hiring Incentives to Restore Employment Act to combat the use of offshore accounts by US taxpayers. The reporting and withholding provisions of FATCA seek to encourage **foreign financial institutions** ("**FFIs**"), which include non-US insurance companies, to provide certain information to the US Internal Revenue Service ("**IRS**") by imposing a 30 per cent. withholding tax on certain payments made to an FFI unless the FFI enters into an agreement with the IRS ("**FFI Agreement**").

Under the FFI Agreement the FFI must:

> undertake to report to the IRS information about its **US policyholders**; and

> agree to withhold on certain payments to **policyholders** who do not provide proof of their US or non-US status, and to FFIs that have yet to enter into FFI Agreements.

The proposed regulations take a number of important steps toward addressing some of the concerns raised by the insurance industry in connection with prior guidance issued under FATCA. However, there remain many areas of uncertainty, in particular, in relation to the passthru payment regime (see below under "Application to Insurance Companies") whereby the IRS is considering further alternatives to relieve the potential burden of this withholding on FFIs. Accordingly, insurance companies may be required to sign up to FFI Agreements without the full scope of the passthru payment regime being clear.

The proposed final form regulations are only proposals and may change before they are issued in final form. The final regulations are expected to be issued in late 2012 and FFIs must start entering into FFI Agreements starting in 2013 to ensure that they will not be subject to FATCA withholding on US source payments made to them beginning in 2014. Withholding under FATCA on gross proceeds from the sale of assets that generate US source interest and dividends will not begin until 1 January 2016 and withholding on "foreign passthru payments" will begin with effect from 1 January 2017 (at the earliest).

Application to Insurance Companies

To avoid FATCA withholding, a non-US insurance company that is an FFI will have to enter into an FFI Agreement pursuant to which it undertakes to report information to the IRS regarding any US persons who are direct or indirect owners of "financial accounts" with the insurance company. The proposed regulations specifically include any insurance company (or the holding company of an insurance company) that issues or is obligated to make payments with respect to a "financial account" within the definition of an FFI. Such definition of "financial account" includes only cash value (essentially investment life and pensions) insurance contracts and annuity contracts issued or maintained by financial institution, and excludes protection insurance contracts, such as term life insurance contracts.

FATCA requires FFIs to undertake significant due diligence and reporting obligations. The extent of these obligations depends on the identity of the policyholder (i.e. whether the policy is held by an individual or an entity). To the extent that a non-US insurance company falls within the scope of FATCA, such company would have to establish procedures by which it can identify US "account holders" (i.e. policyholders for insurers). The proposed regulations contain detailed rules on the information required to be collected from each type of policyholder and certain presumption rules that apply in determining the type of policyholder.

Importantly, the proposed regulations provide that due diligence is only required for certain in-force policies (exceeding a certain value) in order to determine whether they are held by US persons (including for this purpose, certain US owned entities). For new policies issued after the effective date of an insurance company's FFI Agreement, it will be required to review the information provided at the inception of the policy, including identification and any documentation collected under AML/KYC rules.

An insurer FFI that identifies an policy as a US policy must report certain information about the policy to the IRS.

The FFI Agreement will also require a non-US insurance company to agree to act as withholding agent and withhold 30 per cent. of any "passthru payment" it makes to a "recalcitrant account holder" (being an account holder that does not provide the necessary information to the insurance company or does not provide a waiver of any local law that would prohibit disclosure of the information to the IRS) or a non-compliant FFI (being an FFI that does not enter into and comply with an FFI Agreement) or in certain circumstances to terminate those policies.

Data Privacy Concerns

The disclosure, withholding and policy termination requirements of FATCA raise significant issues under local data protection rules and other regulatory regimes and contract laws. Thus, it may not be possible for an insurance company to comply with the obligations of signing up to an FFI Agreement. Acknowledging this concern, the IRS announced the intergovernmental approach discussed below under "**Joint Statement**".

In addition, because FATCA applies on a group-wide basis, the proposed regulations permit group members that are established in jurisdictions that prohibit disclosure to be "limited FFIs" for a transitional period. The existence of these limited FFIs in an otherwise compliant group will not prevent other FFIs in the group from being considered compliant. While an insurer which is a limited FFI is not required to disclose information to the IRS that it is prohibited by law from disclosing, it must agree to certain minimum due diligence, disclosure and document retention requirements, including identifying itself to withholding agents as a non-participating FFI (meaning that it will be subject to FATCA withholding on US source payments and passthru payments it receives).

Intergovernmental approach: joint statement

Contemporaneously with the release of the proposed regulations, the US Treasury issued a joint statement with the governments of France, Germany, Italy, Spain and the UK outlining a possible intergovernmental approach to implementing FATCA and automatic information exchange between partner countries. Under this approach, the information required by FATCA will be reported to the partner country which would in turn share the information with the IRS. This approach may avoid the risk of FFIs in those jurisdictions breaching local data protection and other legal restrictions.

Under this approach, any agreements entered into with a partner country would identify categories of FFIs that would be treated, consistent with IRS guidance (such as the proposed regulations), as deemed compliant or presenting a low risk of tax evasion. Although this intergovernmental approach may make compliance less burdensome to insurance companies established in FATCA partner jurisdictions, it is not clear how, if at all, this approach would apply to subsidiaries or business units of insurance companies organized or operating outside those jurisdictions.

Grandfathering

The proposed regulations extended the grandfathering rules in the statute so that no FATCA withholding will apply to "obligations" outstanding on 1 January 2013. The proposed regulations confirm the prior guidance on the definition of obligation, which is defined as any legal agreement that produces or could produce a passthru payment, but excluding any legal agreement or instrument that is treated as equity for US tax purposes or any legal agreement that lacks a stated expiration or term, such as a savings deposit or demand deposit. The proposed regulations specifically mention "life insurance contracts payable upon the earlier of attaining a stated age or death" and "term certain annuity contracts" as grandfathered obligations. Therefore, these types of contracts issued before 1 January 2013 will not be subject to FATCA withholding, but may be subject to the due diligence and reporting requirements mentioned above.

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UK FSA Final Guidance on Liquidity Swaps

The FSA has published its final guidance on "liquidity swaps". The previous draft guidance was published in Autumn 2011. The final guidance has been expanded from the earlier draft, to apply to the wider term of "collateral upgrade transactions" - which include liquidity swaps. The definition of collateral upgrade transaction is broad - it is defined as a transaction where there is a material difference in the quality of assets exchanged for a period of more than one year. The FSA clarifies that these transactions may take a number of forms, including by way of repo, reverse repo, and stock lending and borrowing.

Banks have increasingly been entering into these transactions with insurers to improve their liquidity – this enables the bank to access the insurer's high quality liquid assets and shifts to the insurer lower quality less liquid assets.

The guidance issued by the FSA requires firms to address a number of key detailed risks (including legal risks) as well as, in certain cases, requiring firms to pre-notify the FSA of the transaction. There are also some specific requirements that apply to insurers.

Attached is a link to our summary of the guidance and key issues.

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UK Retail Distribution Review

The FSA's Retail Distribution Review (RDR) is due to be implemented in the UK at the end of 2012. The RDR is focused on how investments are distributed to retail consumers in the UK and aims to address the root causes of "insufficient consumer trust and confidence in the products and services supplied by the market".

The RDR proposals are designed to: (a) improve the clarity with which firms describe their services to consumers; (b) ensure that independent advice is really independent and reflects investors' needs; (c) remove commission bias from the system of recommendations made by advisers; (d) ensure that investors know up-front how much advice is going to cost and how they will pay for it; and (e) increase the professional standards of investment advisers.

It will have a significant impact on the way most advisors, investment managers and product providers operate in the retail investment market. For example, insurers will need to consider whether their distribution agreements are complaint given the ban on commission. It could also have a significant impact on the product which certain firms choose to continue to offer – for example, pure protection products fall outside the scope of the RDR and can still be sold on a commission basis.

Firms are expected to comply with the requirements by the end of 2012 and the requirements will apply to all advisers in the retail investment market, regardless of the type of firm they work for.

Attached is a link to our fact sheet which provides a general overview of the review.

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China's compulsory transport accident insurance market opens to foreign insurers

On 14 February 2012, China and the US jointly released a fact sheet on strengthening US-China economic relations which provided that China is set to open up its large compulsory transport accident insurance (CTAI) market to foreign insurers. This reported development follows several years of discussions between Chinese and US government representatives and it is understood that relevant regulations will be forthcoming, even though no concrete timetable has been set yet.

Car insurance premiums, according to Bloomberg, account for approximately 70% of total premiums in the Chinese insurance market. The current prohibition on foreign insurers providing CTAI in China has enabled Chinese domestic insurers to dominate the Chinese car insurance market as customers tend to use the same insurer for both their compulsory and optional coverage policies (the latter is non-restrictive to foreign insurers). According to press reports, Chinese CTAI policy providers have been consistently loss-making in the CTAI sector in recent years and a purpose of liberalisation is to change the market condition.

At present, some foreign insurers in China have entered into arrangements whereby the foreign insurer provides optional insurance policies while the domestic insurer provides compulsory insurance policies.

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FSA Policy Statement: Protecting with-profits policyholders

The FSA has published a Policy Statement (PS12/4) confirming its new rules on protecting with-profits policyholders, following on from the Consultation Paper (CP11/5) published in February 2011. Key points from the policy statement are set out below:

> **Conflicts of interest**: In accordance with the Consultation Paper, the FSA has converted current elements of its guidance relating to conflicts of interests into mandatory requirements. In particular, the new rules provide that firms must take reasonable care to ensure that all aspects of their operating practices are fair to the interests of their with-profits policyholders and must be able to demonstrate to the FSA that they have taken such reasonable care.

> **Terms of New Business**: In a bid to strengthen the rules and guidance on the terms of new business written into a with-profits fund, the FSA's new rules permit new business to be written only if the firm's governing body is satisfied, so far as it reasonably can be, and can demonstrate, that the terms on which the new business is to be effected are likely to have no adverse effect on with-profits policyholders' interests.

> **Charges to with-profit funds**: In light of the concerns raised following the Consultation Paper, the FSA has parked its proposed amendment of the rules to prevent intra-group service companies from charging to their with-profits funds costs that are more than the costs such companies have incurred in operating the fund. Nevertheless, the FSA has stated that this area will continue to receive scrutiny under the existing governance regime and firms should consider this topic in connection with their compliance under the new rules surrounding conflicts of interest.

> **Strategic investments**: In accordance with the Consultation Paper, the FSA has introduced a new rule for a firm's governing body to demonstrate that the purchase or retention of strategic investments is likely to have no adverse effect on the interests of with-profits policyholders.

> **Reattribution of inherited estates**: The FSA have clarified that they would expect firms to distribute any excess surplus before they undertake any reattribution exercise. The process set out in the Consultation Paper for a firm intending to undertake a reattribution exercise has largely been adopted.

> **Corporate Governance**: Due to the lack of consensus in the responses received, the FSA has dropped its proposal to require all with-profits funds (save for small funds) to have with-profits committees (WPCs). The FSA has also adapted its proposal with regard to the composition of WPCs, and permits in its new rules internal appointments to WPCs, subject to the WPC having an independent majority (and potentially an independent person chairing the committee). The FSA has largely retained the Consultation Paper's proposal for a firm's WPC's terms of reference to be published on the firm's website and the proposed requirements for a clearer separation of the WPC's recommendations and the governing body's decisions. The proposal in the Consultation Paper that the WPC must work closely with the with-profits actuary and obtain his opinion or input as appropriate has been moved from a rule to guidance and the various proposed requirements in respect of reporting lines and the assessment of the performance of the with-profits actuary have been largely retained.

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Solvency II Developments

General

Key recent developments in relation to the Solvency II Directive are:

> the Economic and Monetary Affairs Committee of the European Parliament (ECON) has approved the European Parliament's proposed compromise amendments to the Omnibus II Directive; and

> the plenary vote on Omnibus II in the European Parliament has been rescheduled for 2 July 2012 in order to allow enough time for negotiations between the Parliament, the Commission and the Council of Ministers to take place. EIOPA does not anticipate there to be any material change to the current implementation timetable and the FSA has confirmed that the new date will not change its work plan.

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Remuneration Update

Although the remuneration requirements under Solvency II will not be implemented until 2014, we are talking to some of our clients about the likely requirements now – especially since some EU jurisdictions have already extended the banking sector remuneration requirements to the insurance sector (see our previous alert here).

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Recent Deals

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

> advising AXA on the acquisition of HSBC's P&C businesses in Hong Kong, Singapore and Mexico and on the 10-year exclusive P&C bancassurance distribution agreement between AXA and HSBC in Hong Kong, Singapore, Mexico, India, Indonesia and China, for a combined upfront consideration of US$494 million;

> advising AXA Belgium SA in relation to the sale of its Belgian funeral protection insurance portfolio and related commercial assets to Dela Enterprises NV.;

> advising the Joint Global Co-ordinators on the US$6 billion strategic sell-down by AIG of its shareholding in AIA Group Limited by way of a block trade / placing; and

> advising ageas SA/NV and ageas N.V in relation to a cash tender offer on CASHES (Convertible And Subordinated Hybrid Equity-linked Securities). As part of the deal, the related Relative Performance Note between Ageas and Fortis Bank was cancelled proportionally and Fortis Bank undertook to call the Tier 1 instruments it issued in 2001 and which are 95% held by Ageas.

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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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