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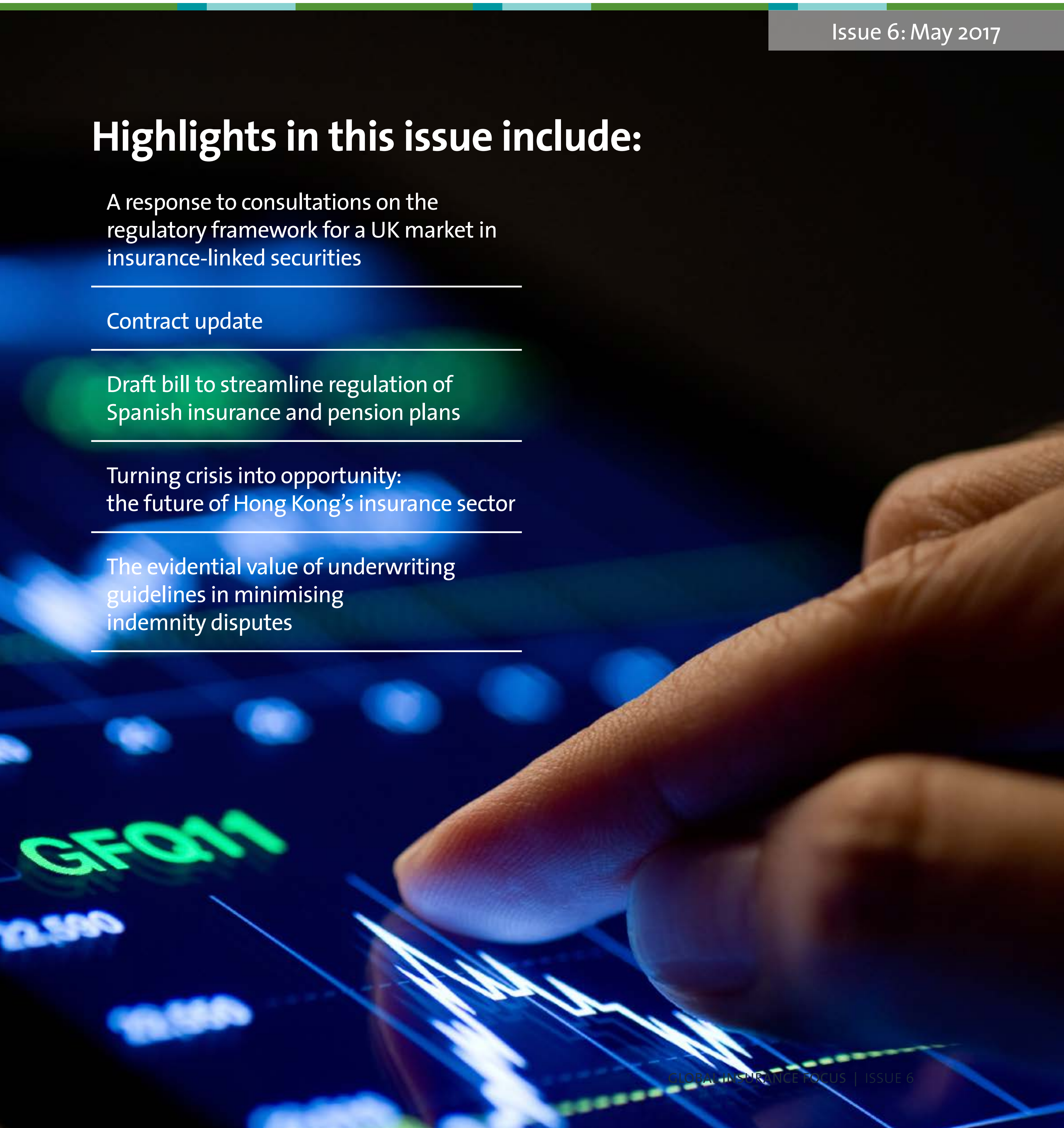
Global Insurance Focus

An overview of the latest developments in the global insurance and reinsurance industries

Issue 6: May 2017

Highlights in this issue include:

- A response to consultations on the regulatory framework for a UK market in insurance-linked securities
- Contract update
- Draft bill to streamline regulation of Spanish insurance and pension plans
- Turning crisis into opportunity: the future of Hong Kong's insurance sector
- The evidential value of underwriting guidelines in minimising indemnity disputes



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UK

A response to consultations on the regulatory framework for a UK market in insurance-linked securities

By Adam Levitt, Alex Biles and Caroline Johansen, UK

Introduction

As we reported in the November 2016 edition of our Global Insurance Focus, HM Treasury ("HMT") has been working with the ILS Taskforce, established by the London Market Group, to develop a legal, tax and regulatory framework for a UK market in insurance-linked securities ("ILS"). HMT, the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA") have recently completed consultations on the proposed framework. Some of our responses to the consultations are discussed in this article. A more detailed analysis can be found at https://www.ashurst.com/en/news-and-insights/legal-updates/insurance-linked-securities---a-closer-look-at-the-proposals-for-a-new-uk-regime/

It had initially been hoped that the regulations would return to Parliament and a final version be published in advance of Easter. However, that date was missed and until after the forthcoming general election, Parliament will not consider the regulations after the vote.

The "fully funded" requirement

Consultation

Under the "fully funded" requirement, the insurance special purpose vehicle (**"ISPV"**) must "at all times" have assets the value of which is equal to or exceeds its aggregate maximum risk exposure and be able to pay its liabilities as they fall due. In contrast to the approach taken by regulators in a number of existing ILS jurisdictions, the PRA considers limited recourse clauses "irrelevant to an initial assessment of whether the ISPV is fully funded" and such clauses cannot therefore be "imprudently relied upon in place of a sound risk management or conservative investment strategy".

Our response

In the context of the low or negative yield environment for UK and EU government securities, we believe that the PRA should take a proportionate interpretation of what is meant by "at all times" and should not use this requirement as a hair-trigger for regulatory non-compliance. In addition, the PRA should clarify how limited recourse provisions could undermine an effective risk transfer from a cedant (re-)insurer.

The "fit and proper" investor requirement

Consultation

ISPVs are expected to be able to assess the fitness and propriety of shareholders and investors that are qualifying holders (i.e. holders of 10 per cent or more of the capital or voting rights of the ISPV or holders with significant influence over management).

Our response

We would welcome further clarification from the PRA on its intended application of the fit and proper investor requirement, particularly in relation to debt investors. In our view, debt investors should be excluded from the requirement on the basis that: (a) they are not generally considered to be members of a company incorporated under English law; and (b) ISPVs are unlikely to be able to identify holders of bonds settled and traded through the clearing systems.

Reporting

Consultation

Protected Cell Companies (**"PCCs"**) must prepare audited financial statements on an annual basis as a whole (i.e. separate accounts are not required for individual cells).

Our response

While the requirement for PCCs to produce audited accounts as a whole brings the accounting and reporting regime for PCCs into line with comparable requirements applicable to single transaction ISPVs (e.g. under Part 15 of the Companies Act 2006 for limited liability companies), investors may consider audited accounts of PCCs as a whole of limited value in assessing the performance of transactions on a cell-by-cell basis. Therefore, we expect that investors in a PCC will contractually impose reporting obligations for individual cell transactions.

Protected cell companies

Consultation

The proposed framework contains various provisions to ensure that the core and cells of a PCC are "insolvency-remote" from one another and that the assets and liabilities of one particular "part" of the PCC are segregated.

Our response

Under the proposed UK framework, insolvency procedures apply only to the PCC's respective parts. This reduces the risk of a creditor of a single cell subjecting the other cells to a general moratorium. However, we would welcome further clarification on whether the liquidation of the core of a PCC could impact the viability of the other cells in a PCC.

Securities offering restrictions

Consultation

ILS are suitable for professional investors only and may not be "offered to the public".

Our response

While we agree that ILS are suitable only for sophisticated investors, we consider that the public offer restriction may be unworkable, particularly for ILS issued via public markets. We would prefer to see a regime similar to the FCA's restriction on the sale and marketing of "contingent convertible securities" (or "cocos") issued by banks, which in our view would be more workable and effective.

Other points

Transfers of business: We would welcome clarification on whether the insurance business transfer regime in Part VII of the Financial Services and Markets Act 2000 would apply to an ISPV, i.e. whether all or part of the business of a cell could be transferred by way of a Part VII transfer.

Tax: The proposed tax regime for ISPVs includes bespoke corporation tax and interest withholding tax exemptions for the ISPV. These tax exemptions will be lost if certain stringent conditions are breached. There are also specific provisions restricting the use of tax losses made by an ISPV.

Final thoughts

There is a clear demand for a UK market for ILS and we believe that the proposals in the consultation are a good step in the right direction. Market participants will inevitably benchmark the competitiveness of a UK regime against established markets.

While we acknowledge that any onshore UK regime will need to comply with the overriding requirements of the Solvency 2 regime (at least until Brexit), there are still some aspects of the proposals that could be improved or refined. In particular, the PRA's proposed interpretation of the fully funded requirement will be vital in ensuring that the UK market is regarded as competitive. Finally, we believe that the proposed public offer restriction should be refined.

UK

Contract update

Contractual interpretation and commercial context

In *Wood (Respondent) -v- Capita Insurance Services (Appellant) (2017)*, the Supreme Court held that an indemnity in a share purchase agreement (**"SPA"**) did not cover the costs of a remediation scheme agreed between the purchaser of a company and the Financial Services Authority (the precursor to the Financial Conduct Authority) to compensate customers who had been identified as potentially affected by the Company's misselling of insurance products before the completion date.

In reaching its decision, the Supreme Court examined the rules of contractual interpretation and confirmed that the exercise remains an iterative one by which conflicting interpretations are checked against the provisions of the contract and its commercial context.

In this particular instance, an indemnity provision formed part of an overall risk allocation regime within the SPA and therefore had to be read in conjunction with the extensive warranties in the document. This prevailed over a detailed analysis of the syntax of the clause in question.

Enforceability of a reasonable endeavours clause

The dispute in *Astor Management AG and another -v- Atalaya Mining Plc and others (2017)* centred upon the payment of deferred consideration under an agreement between the parties relating to the ownership and exploitation of a copper mine in southern Spain.

After holding that the obligation to pay deferred consideration had not been triggered because the specified source of funding had not been obtained, Leggatt J dealt with ancillary issues of reasonable endeavours and good faith. In particular, he held that the obligation to use reasonable endeavours to enter into an agreement with a third party for funding was sufficiently certain to be enforceable and, as a general principle, unenforceability was very much a "last resort" of the court in such cases.

However, whether the obligation to use reasonable endeavours had been satisfied depended heavily on commercial factors and the economic viability of the project as a whole. The court confirmed that an obligation to use all reasonable endeavours to achieve an end does not require unlimited expenditure, which means that costs are a highly relevant factor in deciding what, if any, further steps are reasonable – and ultimately when to stop. Applying this to the facts in the case, the agreement with a third party for funding had to be commercially viable. On the evidence, only one lender was prepared to make available such a facility, and that was on terms which did not make economic sense. Accordingly, the defendant was not in breach of the obligation to use reasonable endeavours.

SPAIN

Draft bill to streamline regulation of Spanish insurance and pension plans

By Francisco de León, María José Menéndez and Rafael Fernández, Spain

The Spanish Government aims to improve the economic and functional governance of the entities in charge of the supervision of the banking, capital markets and insurance sectors in Spain.

The early stages of development of the legislation (the **"Bill"**) within the Spanish enactment process finished in March of this year. These stages include a time period for preliminary consultation of the public, which provides an opportunity for interested parties to make comments on issues that should be covered, or raise any points to be taken into consideration even before the drafting has commenced. At this point in time, a first draft of the Bill does not yet exist; however, the Bill is a promising initiative by the Spanish Government to implement international standards into the Spanish legal system.

Some of the main measures proposed are: (i) the setting up of a number of Independent Administrative Authorities (*Autoridades Administrativas Independientes*, hereinafter **"AAIs"**) in areas such as competition, market supervision, regulation and insurance and pension funds; (ii) the establishment of an AAI to unify and simplify claim procedures in banking, capital markets and insurance; and (iii) the implementation of a new system for senior management appointments by the Government, including the establishment of a panel of independent experts that will assess the suitability of candidates.

The legal concept of AAIs is provided for in Act 40/2015, of 1 October 2015, on the Legal Regime of the Public Sector, which defines AAIs as public entities, having their own legal personality, allowed to carry out functions with appropriate independent standards. AAIs are supposed to be sustainable on a broadly stand-alone basis from a financial point of view.

As regards the insurance sector, the Bill intends to implement an AAI for Insurance and Pension Plans (*Autoridad Administrativa Independiente de Seguros y Planes de Pensiones*) which could ultimately imply, as stated by the Minister of Economy, Industry and Competitiveness Mr Luis de Guindos, the division of the Directorate General

for Insurance and Pension Plans (*Dirección General de Seguros y Fondos de Pensiones*, hereinafter the **"DGSFP"**) into two different areas, one focused on supervision and the other on regulatory work.

If the Bill is passed and its scope confirmed, the current functions of the DGSFP would most probably be split between two new AAIs:

- The Independent Administrative Authority for Insurance and Pension Plans (*Autoridad Administrativa Independiente de Seguros y Planes de Pensiones*), which would carry out supervision and regulatory functions in respect of insurance and pension funds, with a scope of activity similar to that of the UK Prudential Regulation Authority as regards insurance.

- The Independent Administrative Authority for Financial Services Users' and Financial Investors' Protection (*Autoridad Administrativa Independiente de los Usuarios de Servicios Financieros y de los Inversores Financieros*), which would undertake the role of the three existing Complaint Services (*Servicios de Reclamaciones*) that currently sit within the DGSFP (insurance and pension plans), the National Stock Market Commission – CNMV (stock market and financial services) and Bank of Spain (banking products), with a scope of functions comparable to that of the UK Financial Conduct Authority.

After completion of the preliminary public consultation phase, the Bill will move to the drafting stage, and it is expected that a preliminary draft will be published during the coming months.

ASIA

Turning crisis into opportunity: the future of Hong Kong's insurance sector

By Ben Hammond, Asia

The crisis

There has been a degree of soul-searching within Hong Kong's insurance industry of late. As Laura Cha, Chairman of Hong Kong's Financial Services Development Council (**"FSDC"**), explained in a report released on 3 March:*

"The recent departure and downsizing of the Hong Kong offices of various international insurance and reinsurance companies highlights the need for Hong Kong to further develop our insurance and reinsurance industry. Further departures are likely in the near future if action is not taken."

Hong Kong continues to keenly feel competition from Singapore. Hong Kong insurers were hit by the decision of the Chinese State Administration of Foreign Exchange in 2016 to cap the purchase of overseas insurance product purchases using UnionPay at US$5,000. Regulation and technological innovation have also suffered a degree of inertia pending the formal launch of operations by the new Insurance Authority (scheduled for 2017), which is due to replace the Office of the Commissioner of Insurance (**"OCI"**) as Hong Kong's insurance regulator. The OCI has traditionally been conservative in its approach to licensing and regulation.

The opportunity?

In its report, the FSDC identifies a number of proposed changes, including:

1. China: The FSDC recommends that the Government look to agree with the China Insurance Regulatory Commission to apply a "Special Administrative Region" (**"SAR"**) status to Hong Kong under Mainland China's solvency framework, the "China Risk Oriented Solvency System" (**"C-ROSS"**). Hong Kong is currently categorised as "offshore" alongside all other non-Chinese jurisdictions. Granting a differentiated status to Hong Kong-registered insurers on C-ROSS for writing risks in Mainland China would open up global trade activities for China as a whole.

2. Regulation: In addition to recommending speeding up implementation of the proposed new risk-based capital regime for insurers, the report regards insurance-linked securities (i.e. instruments whose values are driven by insurance loss events), and captive insurance as areas of particular opportunity for the Hong Kong market. In the latter case, the FSDC sets the goal of licensing over 5-10 captives per year with a total of 50 captives by 2025.

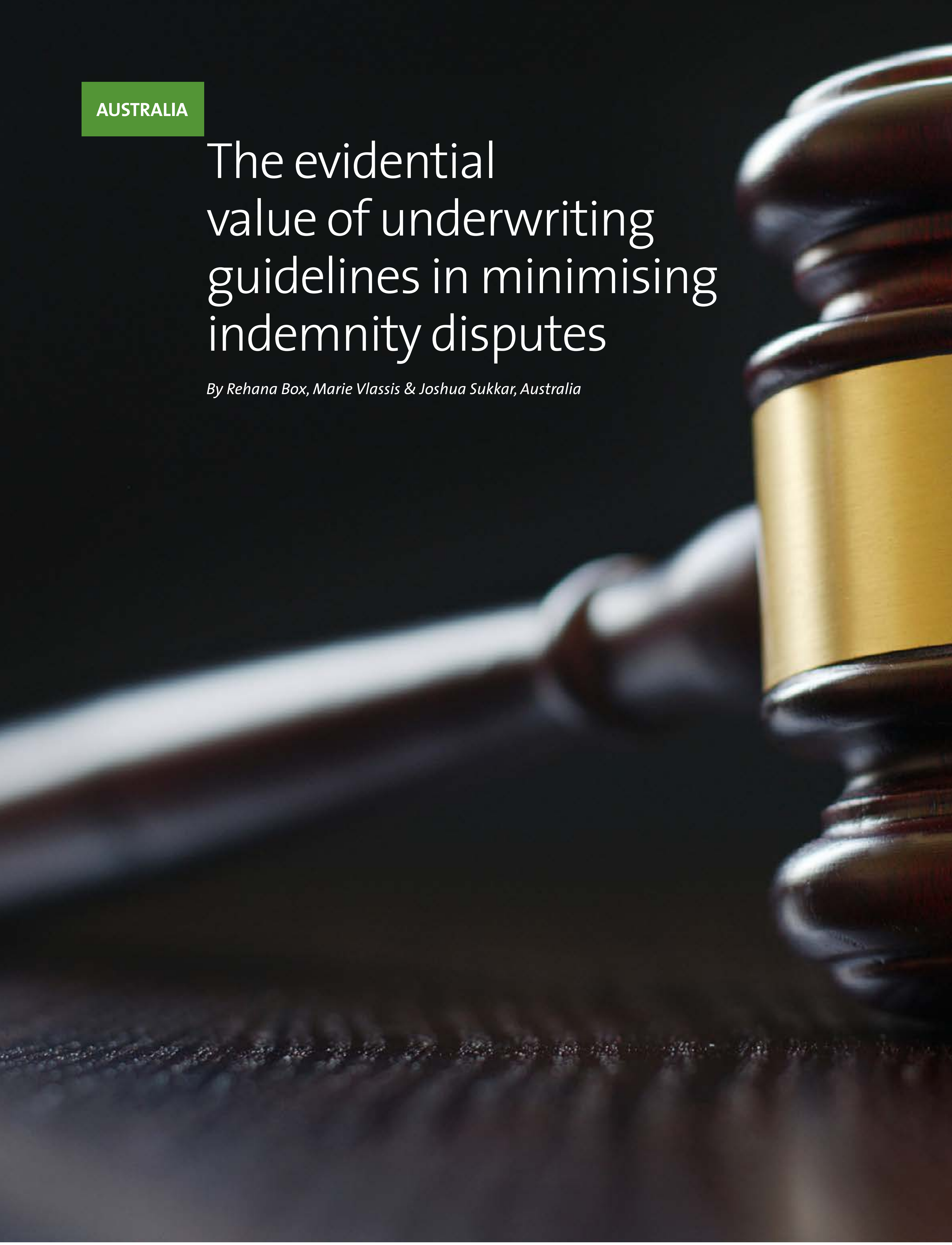
3. Tax: Alongside recommendations for tax incentives focused on marine risks, and the expansion of Hong Kong's double tax treaty network, the report recommends the extension of a 50 per cent profits tax break (currently for reinsurers only) to offshore non-life business assumed by direct insurers, as well as tax incentives for brokers placing insurance and reinsurance businesses in Hong Kong, and for Hong Kong insurers placing business with Hong Kong-registered reinsurers.

The future

Hong Kong has ground to make up. In contrast to other financial sectors, and compared with other jurisdictions, areas such as FinTech which have the potential to disrupt the insurance industry just as much as other areas of the global economy remain relatively undeveloped.

However, lack of development also denotes opportunity and the Hong Kong insurance industry is poised for a period of change: a new regulator in 2017, the development of the new risk-based capital framework moving into its final stages and increasing public debate. Watch this space.

* The FSDC was established in January 2013 to engage the industry to formulate proposals to promote the further development of Hong Kong's financial services industry, and to advise the Government. The FSDC's report (Paper No. 27) was published in March 2017: "Turning Crisis into Opportunities: Hong Kong as an Insurance Hub with Development Focuses on Reinsurance, Marine and Captive" available at http://www.fsdc.org.hk/sites/default/files/FSDC%20Paper%2027%20-%20Reinsurance%2C%20Marine%20and%20Captive%28e%29_1.pdf



AUSTRALIA

The evidential value of underwriting guidelines in minimising indemnity disputes

By Rehana Box, Marie Vlassis & Joshua Sukkar, Australia

Introduction

The Insurance Contracts Act 1984 ("ICA") has been in operation in Australia for over three decades, and its application by Australian courts has been varied.

Recent decisions concerning section 28 of the ICA (which section is mirrored in England in the *Consumer Insurance (Disclosure and Representations) Act 2012* and the *Insurance Act 2015)* show that insurers can rely on conservative underwriting practices to deny an insured's claim where an insured has misrepresented or failed to disclose a matter that would have materially affected the insurer's decision to enter into the insurance contract, cover loss under the insurance contract once incepted, or avoid the insurance contract.

Insurers' reliance on conservative underwriting practices

A survey of recent decisions in Australian courts demonstrates that insurers involved in claims litigation regarding section 28 often benefit from evidence of conservative underwriting practices.

An insurer who disputes a claim under the relevant policy will usually do so for one of the following reasons:

- there may be doubt whether the policy responds to the loss claimed; or
- it may be thought that the insured is responsible for the loss because the policy was procured by a misrepresentation, or involved a non-disclosure on the part of the insured.

Where an insurer apprehends a misrepresentation or non-disclosure by the insured, section 28 of the ICA provides two options to remedy the breach by the insured.

Firstly, if the insured's misrepresentation or non-disclosure is fraudulent, the insurer may avoid the contract, recovering all monies advanced to the insured and retaining the premium paid (the **"Fraudulent Limb"**).

Secondly, if the insured's misrepresentation or non-disclosure is innocent, the insurer may only reduce its liability to the extent that it has been prejudiced by the misrepresentation or non-disclosure (the **"Innocent Limb"**).

Similar provisions in respect of pre-contractual misrepresentation and non-disclosure exist in England under the *Consumer Insurance (Disclosure and Representations) Act 2012* for consumer contracts[1] and the *Insurance Act 2015* for non-consumer contracts[2]. Both

1 Consumer Insurance (Disclosure and Representations) Act 2012 s 2, s 5, Schedule 1 Part 1.
2 Insurance Act 2015 Part 2 s 3, Schedule 1 Part 1.

English acts make the same distinction as the Australian ICA, entitling the insurer to avoid the contract and keep the premium for fraudulent misrepresentation or non-disclosure, and to seek damages proportionate to the insurer's loss for innocent misrepresentation or non-disclosure.

Misrepresentation or non-disclosure: proving the extent of the insurer's prejudice

Although insurance fraud is widely thought to be a continuing and major encumbrance on underwriters, the burden of proof for proving fraud is incredibly high, and many Australian decisions show that insurers have difficulty proving the Fraudulent Limb to a court because the concept of fraud suggests a subjective dishonesty which is difficult to demonstrate through circumstantial evidence. For this reason, insurers will often argue the Innocent Limb.

In order to satisfy the Innocent Limb, an insurer must prove that the insured's misrepresentation or non-disclosure materially prejudiced the insurer, such that if the insurer was aware of the misrepresentation or non-disclosure, it would have either charged a higher premium, imposed different terms, or not issued the policy at all. However, in this respect, Australian courts are aware of the insurer's benefit of hindsight and tendency to adduce self-serving evidence.

Relevance of underwriting guidelines

Recent cases show that an insurer will be in a better position to prove material prejudice if it can point to internal guidelines that suggest that the insurer holds a conservative attitude towards underwriting risk.

In the 2016 Victorian Supreme Court decision of *Bergman -v- CGU Insurance Ltd*,[3] Mr Bergman (the **"Insured"**) was issued landlord's insurance from CGU Insurance Ltd (the **"Insurer"**) whereby the Insured's property, which he intended to demolish, was insured for a total of $800,000. Approximately three years later, the property became vacant for a period of two days whilst preparations were made for demolishing the buildings on the property, and during these two days, the buildings on the property were substantially damaged by a fire.

The Insured made a claim under the policy which was rejected by the Insurer on the basis that the Insured had specifically answered "no" when asked in the proposal form whether the property was under construction or to be demolished. The court held that the Insured had made a misrepresentation by falsely representing a matter relevant to the Insurer's decision whether to accept the risk.

3 Bergman -v- CGU Insurance Ltd [2016] VSC 81.

The court was ultimately satisfied that if the Insured had disclosed his intention to demolish the insured property, the Insurer would not have issued the policy. On this basis, the Insurer argued it was entitled to reduce its liability to nil. Central to this conclusion were underwriting guidelines tendered by the Insurer that advised its underwriters to deny all insurance proposals that involved property subject to demolition plans. In finding for the Insurer, the court confirmed the guidelines demonstrated that *"any demolition plans or statutory orders are blanket unacceptable risks to the defendant"*.

Some months later, in the New South Wales Supreme Court case of *Beslic -v- MLC Ltd*,[4] the court was required to weigh the evidential value of an internal underwriting policy, this time in the context of MLC's guideline that its underwriters reject all life insurance proposals involving persons suffering from severe symptoms of mental illness. Similarly to *Bergman v CGU Limited*, the court placed significance on these guidelines and accepted that they were evidence of the standard practice of MLC's underwriters.

4 Beslic -v- MLC Ltd (No 2) [2016] NSWSC 746.

The recent decisions show the superior courts in Australia accepting evidence of internal guidelines to determine the individual insurer's actual underwriting practice, rather than self-serving oral evidence tendered after indemnity has been denied. In theory, underwriting guidelines should provide an objective yardstick for measuring the extent that an insured's misrepresentation or non-disclosure has prejudiced an insurer.

A lesson for insurers

Australian insurers can capitalise on the courts' favourable interpretation of underwriting guidelines by adopting conservative and prescriptive underwriting guidelines. In this way, an insurer will be able to put its best foot forward when aiming to prove that an insured's misrepresentation or non-disclosure materially affected the insurer's position.

Although underwriting guidelines remain non-binding, the courts' approach suggests that insurers should be cognisant of the guidelines when writing risk as, in the event of an indemnity dispute, such guidelines may be called upon to determine the application of section 28 of the ICA.

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"They are a great team who provide an individual service which was tailored to our needs. They were able to give advice when we needed it and challenge where required - despite a number of competing stakeholder requirements. With their help, we were able to deliver to tight timescales."

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"The team is very driven and responsive to clients' needs"

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