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Contents

	Page
Europe - Solvency II Update	1
UK - FSA speech on the new approach to insurance regulation and the implementation of Solvency II	1
UK - FSA sanctions in team move cases	2
UK - UK's 'controlled foreign company' rules	3
UK - Budget 2012	4
US - Force-placed insurance public hearing	5
US - Updates on legislation to amend credit for reinsurance provisions	6
Global – Efforts underway to identify too-big-to-fail insurers	9
See Also	9

Europe – Solvency II Update

On 21 May 2012, in anticipation that the Omnibus II directive will not be published on schedule, the European Commission published its proposal to amend the transposition and application dates of Solvency II to 30 June 2013 and 1 January 2014 respectively. The Omnibus II directive is critical in providing a guideline to a smooth transition from Solvency I to Solvency II and so the European Commission believes it would be beneficial to postpone the current transposition and application dates to avoid bringing about any uncertainties should the Omnibus II directive fail to be published in time for the transposition.

UK – FSA speech on the new approach to insurance regulation and the implementation of Solvency II

On 19 April 2012, Julian Adams (Director of Insurance Supervision, Prudential Business Unit, the FSA) gave a speech at the City & Financial Conference in London, in which he discussed the role of the Prudential Regulation Authority (the **"PRA"**) and noted some trends the FSA is seeing as part of the internal model process.

The role of the PRA

Mr. Adams explained that the statutory objectives of the PRA were two-fold, namely a general objective of safety and soundness of firms, and a more specific insurance objective of contributing to the securing of an appropriate degree of protection for policyholders. He commented that he saw the benefits of the new arrangements as putting the regulator in a much better position to understand and deal with the nature and extent of cross-sectoral risk transfer, and to ensure consistency of treatment between the insurance and banking sectors.

The PRA is not intending to implement a zero failure regime, but it will aim to minimize the probability of firm failure as well as bring about a situation where the impact of a failure (both on policyholders and on the financial system) is minimised.

There will be a new framework to replace the FSA's current ARROW framework. The first stage of this will be an assessment of the vulnerability of a firm's business model. Then the PRA will consider whether there is a reasonable resolution approach which could be adopted in the event of a firm failure. Thirdly, a detailed analysis will be carried out of the firm's financial strength. Finally, the quality of the firm's risk management and governance arrangements will be considered. The approach taken will vary from firm to firm, with the greatest effort being put into dealing with those firms that pose the greatest risk to the PRA's objectives.

Mr. Adams noted that the practicalities of the new arrangements will be set out in more detail at industry briefing events June 2012.

UK – FSA sanctions in team move cases

On 16 May 2012 the FSA banned Mr Anthony Verrier, former COO of Tullet Prebon Plc, from ever again working in a regulated activity in the financial services industry. This decision follows on from the High Court's March 2010 ruling in *Tullett Prebon PLC v BGC Brokers LP* where the court took a dim view of BGC's conduct in poaching a team of brokers from Tullett. The Court of Appeal subsequently upheld the High Court's findings and, in April 2011, a private settlement was reached between the parties for an undisclosed sum. The FSA based its decision not on its own investigation, but on the High Court's March 2010 findings. The FSA took the view that the High Court's ruling confirmed that Mr Verrier was not a fit and proper person due to concerns over his honesty, integrity and reputation.

The FSA's decision is notable because it is only the second time in its history that it has used the outcome of a previous court case as the basis for imposing a ban on an individual. In addition, it is the first time that the FSA has taken action over a team move case. It should be noted however that Mr Verrier is contesting the ruling and it has been referred to the Upper Tribunal, an independent judicial body. The Tribunal may uphold, vary or cancel the FSA's decision.

Our view is that it was the exceptional circumstances of Mr Verrier both lying under oath and constructing a false constructive dismissal argument that led the FSA to take the steps it did. Mr Verrier's behaviour as disclosed in the High Court's judgment was at the particularly egregious end of the kinds of behaviour we see in team moves. We doubt that the FSA would seek to ban or fine individuals simply on the basis of being involved in a team move that came about without deliberate lies being told to the team's employer as this alone would not be sufficient to call the individual's honesty and integrity into question. Indeed, it may not even be sufficient for an individual to lie to their employer; it may have been the lying in court and the elaborate constructive dismissal argument that were the distinguishing factors in Mr Verrier's case.

Having said that, we do believe that the FSA's decision is illustrative of their hardening stance against wrongdoing in the City. The decision could provide a new weapon in the armoury of employers looking to defend against team defections. Alerting the FSA to an employee's conduct in orchestrating a team move is no doubt something that regulated employers will be considering with increased frequency and the potential sanctions are quite possibly a greater deterrent than threats of damages or injunctions. Nevertheless, this should, of course, only be considered in particularly serious cases and with the benefit of legal advice.

For further details, our full article can be found here.

UK – UK's 'controlled foreign company' rules

The UK's 'controlled foreign company' ("**CFC**") rules are directed at companies which artificially divert UK profits to low tax territories or other favourable overseas tax regimes so as to reduce their UK tax liabilities. Broadly, under the current rules, a UK company with a 25% or more interest in a company controlled from the UK and resident in a country with a tax rate on income profits at least 75% lower than the UK's rate can be taxed on a proportion of that company's profits.

The UK's CFC rules have been the subject of scrutiny in recent years, with many arguing that they have contributed to the trend that has seen a growing number of multinational corporate groups – including within the insurance industry - 're-domicile' offshore (especially to Bermuda in the case of insurers).

Reform of the UK's CFC legislation has been a central feature of the current Coalition Government's plan to make the UK's corporate tax rules more competitive and more territorial. Proposals for reforms to the UK's CFC rules were tabled in November 2010 as part of the Coalition Government's 'Corporate Tax Road Map'. An interim programme of reform was implemented by the Finance Act 2011. In June 2011, the Coalition Government published a consultation document setting out detailed proposals for full CFC reform to be introduced in the Finance Bill 2012. Draft legislation was published in December 2011, with further updates and revisions to the draft legislation made subsequently. The Finance Bill 2012 (published on 29 March 2012 and still awaiting Royal Assent) contains legislation to repeal the current CFC legislation and replace it with a new CFC regime.

Many in the insurance industry have been following the changes to the UK's CFC provisions with extreme interest. The key elements of the new CFC rules can be summarised as follows:

- In very broad terms, it is proposed that a CFC charge will arise only if a foreign company is (i) controlled from the UK, (ii) the CFC has chargeable profits as defined by the so-called "gateway", and (iii) none of a number of "safe harbours" or (iv) exemptions apply. This approach effectively reorders the current rules, which start from the position of charging all of a CFC's profits unless an exemption applies.
- A company can be controlled by reference to legal or economic control or by reference to accounting standards. Furthermore, the so-called "control TAAR" means that a company that would not otherwise be a CFC may be treated as a CFC if it is reasonable to suppose that it would be a CFC but for arrangements (one of) the main purpose(s) of which is securing that it is not a CFC.
- The business profits of a foreign subsidiary will generally be outside the scope of the new CFC regime if they meet the specified conditions set out in the "gateway". The gateway identifies those profits (if any) that are artificially diverted from the UK and which, therefore, pass through the gateway and become subject to the CFC charge. If there are no chargeable profits following application of the gateway, no CFC charge will arise.

- "Safe harbours" for the gateway conditions are provided covering general commercial business, incidental finance income and some sector specific rules. A foreign subsidiary can rely on these safe harbours to show that some or all of its profits are outside the scope of the CFC regime.
- As an alternative to the gateway and safe harbours, the new regime will also provide exemptions for CFCs. The exemptions will apply to the CFC as a whole and include an excluded territory exemption and a low profits exemption. The lower level of tax test which currently forms part of the definition of a CFC will function as an exemption in the new regime.
- The regime includes rules for finance companies which will generally result in an effective tax rate on intra group finance income of one-quarter of the main corporation tax rate. The regime will also provide for full exemption in certain circumstances.

The new CFC rules will be effective for CFCs with accounting periods beginning on or after 1 January 2013.

UK – Budget 2012

New Corporate Tax Regime for Life Insurance Companies

Following an announcement in the 2011 Budget and a consultation paper published in April 2011, the Finance Bill 2012 contains legislation to establish a new corporation tax regime for UK life insurance companies and friendly societies, to take effect on 1 January 2013. The legislation will also apply to overseas life insurance companies operating in the UK through a permanent establishment.

The new regime will alter both the basis on which life insurance companies' taxable profits are computed and the detailed rules by which those profits are taxed. The new regime is also intended to deal with essential adjustments arising from the Solvency II Directive (*2009/138/EC*).

In very broad terms, the taxation of life insurance companies under the new rules will move from its current reliance on regulatory returns made to the Financial Services Authority to a system where the starting point for calculating trade profits for tax purposes will be the profit reported in statutory accounts.

The new legislation includes a targeted anti-avoidance rule to address cases where companies enter into arrangements with a main purpose of securing a tax advantage in connection with the transitional rules. This anti-avoidance rule has effect from 21 March 2012 and may be triggered by transactions and arrangements entered into from that date.

General Insurance: Claims Equalisation Reserves

There is currently a regulatory requirement for general insurance companies (but not Lloyd's members) to maintain claims equalisation reserves ("**CERs**") in respect of certain lines of business. From 1996, general insurers were allowed to treat amounts transferred into CERs as tax deductible (and amounts transferred out were treated as taxable receipts). In 2009, rules were introduced to allow equivalent deductions for Lloyd's corporate and partnership members. The relief currently available is dependent on the regulatory requirement for general insurance companies to maintain CERs. However, under Solvency II, that requirement will be withdrawn.

As announced in the 2011 Budget and following consultation, the Finance Bill 2012 contains legislation to repeal the tax rules relating to CERs from the date that the Solvency II capital requirements come into force. Built-up reserves will be taxed in equal amounts over a six year period commencing from this date, although insurers can elect to tax the remaining balance in any year during the transitional period.

Lloyd's: Stop Loss Reinsurance

The Finance Bill 2012 contains legislation to amend the time at which tax deductions may be taken into account for premiums payable by corporate members of Lloyd's in respect of member-level stop-loss insurance (where taken out on or after 6 December 2011). The legislation is designed to align the timing of tax deductions for premiums with the recognition of the profits to which they relate. This measure follows on from an informal consultation announced in the 2011 Budget, and the publication on 6 December 2011 of draft legislation and a HMRC technical note.

US – Force-placed insurance public hearing

On 17 May 2012, the New York Department of Financial Services ("**DFS**") held three days of public hearings to pursue an ongoing investigation to assist homeowners facing force-placed insurance in New York and examine the highly profitable working relationships between the insurance companies, servicers, and lenders writing these policies. Two weeks after the hearings ended, New York Assemblywoman Barbara Clark introduced a bill on 29 May 2012 that would prevent mortgage servicers from splitting or sharing referral fees with lenders and insurers. Furthermore, the bill proposes to ban working relationships between affiliated entities issuing force-placed insurance. The insurers would be required to provide homeowners plenty of notice before force placing coverage. The three-day public hearing at DFS, followed by the proposed legislation, look to be merely the beginning of a likely extensive investigation that may result in regulatory scrutiny of the parties involved and possible implementation of additional regulation.

In New York state, mortgage servicers typically issue force-placed insurance through an insurance company of their choice when a homeowner defaults on his voluntary insurance policy. Force-placed insurance companies in New York have allegedly overcharged homeowners $500 million since 2004. Two insurers, in particular, write 90% of all force-placed insurance policies in New York. These insurers share up to 75% of all collected premiums (amounting to several millions of dollars annually) with two lenders, in connection with their relationship agreements. These agreements, therefore, result in significant profit. New York regulators are considering whether these insurers are exploiting homeowners and earning significant profits at the borrower's expense. The discussions regarding force-placed insurance have subsequently taken a political turn as minority and working class homeowners allege they feel targeted by the servicers, insurers, and lenders issuing these policies.

Consumer advocates testified at the hearing that the alleged predatory practices behind force-placed insurance are damaging homeowner equity, and therefore negatively affecting the New York housing market. Homeowners testified that banks, servicers and insurance companies never notified them of their force-placed insurance and it was a long and grueling process to change the policy back to their

original coverage. These homeowners noted that once they received force-placed insurance, their premiums increased by 3 to 10 times that of their previous voluntary insurance and brought them deeper into debt.

At the DFS hearings, several experts and housing advocates suggested the following possible solutions to prevent servicers and insurance companies from profiting at the expense of struggling homeowners paying for force-placed insurance:

- NY should require servicers to continue paying already existing policy payments.
- Servicers should be not allowed to force place over-coverage. This policy means that insurers cannot issue force-place insurance that exceeds the minimum required coverage.
- NY Regulators should implement a minimum loss ratio in the range of 20 to 25% and require companies to file their rates frequently with the department. (Some companies have allegedly not re-filed rates with DFS since 1988.)
- NY should entirely ban beneficiary relationships between affiliated lenders, insurance companies, and servicers to promote healthy competition in the market.
- Servicers should return unused premiums to borrowers within 45 days.

Assemblywoman Clark has already taken the initiative and introduced a bill in line with some of these recommendations, while DFS regulators continue to consider other possible solutions. Superintendent Benjamin Lawsky and Executive Deputy Superintendent Joy Feigenbaum appear to be seriously considering the possibility of banning relationship agreements and implementing a minimum loss ratio. Comments from the DFS regulators indicate that they struggle to understand what services force-placed insurers offer that voluntary insurers do not in order to justify their much higher rates and high loss ratios. The alleged lack of transparency in the working relationships and high commissions from collected premiums attract the regulators' attention. The DFS regulators will certainly continue investigating these practices, and at the very least, they seem likely to require insurers to file frequent and detailed rate-filings with the department.

US – Updates on legislation to amend credit for reinsurance provisions

Georgia's reinsurance reform bill has been signed by the Governor and becomes law. Meanwhile, legislation has been introduced in Delaware proposing similar amendments to the existing credit for reinsurance laws of that state. As we have previously reported, the following states have already adopted reduced collateral requirements:

- Florida (property and casualty only)
- Indiana (life, property and casualty)
- New Jersey (life, property and casualty)
- New York (life, property and casualty)
- Virginia (life, property and casualty)

Georgia

On 2 May 2012, Georgia Governor Nathan Deal signed Georgia Senate Bill 385, making Georgia the latest state where a bill has been enacted that amends existing credit for reinsurance laws to conform to the November 2011 changes to the National Association of Insurance Commissioners ("**NAIC**") model law. For more information on the Georgia legislation, please see our article from the February 2012 Mayer Brown Global Corporate Insurance & Regulatory Bulletin, *Additional states introduce credit for reinsurance reform legislation; New Jersey proposes new credit for reinsurance regulations*. For more information on the amendments to the NAIC model law and regulation, please see our article from the October 2011 Mayer Brown Global Corporate Insurance & Regulatory Bulletin, *NAIC Fall 2011 Meeting Notes*, as well as the February 2012 article noted above. For background on the progression of reinsurance collateral requirements reform in the US, please see our article, *US reinsurance collateral reform picks up pace*, which can be found here.

Delaware

The recently introduced Delaware House Bill 346 contains provisions that track the amended NAIC model law and would make a significant change to the statutory provisions governing credit for reinsurance in that state by potentially allowing full credit to insurers that cede risk to unauthorized reinsurers that post less than 100% collateral. Under the newly proposed legislation, credit will be allowed to a domestic insurer when risk is ceded to an assuming insurer that has been "certified" as a reinsurer by the Delaware Insurance Commissioner and that secures its obligations in accordance with the requirements of the Delaware Insurance Code. In order to be eligible for certification, an assuming insurer must meet certain requirements, including being domiciled and licensed in a "qualified jurisdiction" as determined by the Delaware Insurance Commissioner, maintaining specified financial strength ratings, maintaining minimum capital and surplus, submitting to the jurisdiction of Delaware, meeting filing requirements and satisfying any other requirements of the Delaware Insurance Commissioner. A rating will be assigned to each certified reinsurer, giving consideration to the financial strength ratings of the certified reinsurer. Most significantly, the proposed legislation provides that a certified reinsurer must secure its obligations at a level consistent with its ratings, as specified in rules to be adopted by the Delaware Insurance Commissioner, opening the door for the possibility of risk-based collateral requirements under which a certified reinsurer will be able to post less than 100% collateral, with the ceding insurer still receiving credit for the ceded insurance.

The Delaware bill also contains provisions requiring ceding insurers to manage their concentration risk, following amendments to the NAIC model law that were added in the wake of similar provisions added to New York's Regulation 20, Credit for Reinsurance from Unauthorized Insurers. Under the proposed legislation, a ceding insurer would have to take steps to manage its reinsurance recoverable proportionate to its own book of business. A domestic ceding insurer would have to notify the Delaware Insurance Commissioner within 30 days after reinsurance recoverable from any single assuming reinsurer, or group of affiliated assuming reinsurers, exceeds 50% of the domestic ceding insurer's last reported surplus to policyholders, or after it is determined that reinsurance recoverables are likely to exceed this limit. The proposed legislation would also require a ceding insurer to take steps to diversify

its reinsurance program and notify the Delaware Insurance Commissioner within 30 days after ceding to any single reinsurer, or group of affiliated assuming reinsurers, more than 20% of the ceding insurer's gross written premium in the prior calendar year, or after it is determined that the reinsurance ceded is likely to exceed this limit. In both situations, the notification to the Delaware Insurance Commissioner is intended to demonstrate that the exposure is being safely managed by the domestic ceding insurer.

Other states

Similar legislation has already been introduced in other states to amend the existing credit for reinsurance laws of those states to conform with the revised NAIC models. For more information on the legislation introduced in Illinois, please see our article from the January 2012 Mayer Brown Global Corporate Insurance & Regulatory Bulletin, *Illinois continues to pursue credit for reinsurance reform*. For information on legislation introduced in Connecticut, Louisiana and Missouri, please see our article from the March 2012 Mayer Brown Global Corporate Insurance & Regulatory Bulletin, *Legislation to amend credit for reinsurance provisions introduced in additional states*.

We expect a number of other states to consider similar legislation this year to amend their laws and regulations to bring them into line with the amendments to the NAIC Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786) that were adopted at the NAIC's 2011 Fall Meeting. Although NAIC model laws and regulations do not become effective in any given state unless and until they are enacted by the legislature or promulgated by the insurance regulatory authority of that state, the NAIC model law and regulation generally have an influence on state laws and regulations to the extent that certain aspects of the amended models become accreditation standards of the NAIC. States strive to maintain their NAIC accreditation so that other states will defer to them as the primary regulatory authority for insurers domiciled in their states. Inclusion of the amended versions of the model law and model regulation in the NAIC accreditation standards will create a strong incentive for states to adopt them.

During 2012, the NAIC's Reinsurance (E) Task Force (the "**Task Force**") has been conducting discussions to determine which aspects of the amendments to the models should become accreditation standards. At the NAIC 2012 Spring Meeting, the Task Force released for comment proposed revisions to the key elements of the standards for reinsurance ceded within the Financial Regulation Standards and Accreditation Program. The proposed revisions are being developed by the Task Force for the purpose of submitting recommendations to the Financial Regulation Standards and Accreditation (F) Committee as a result of the revisions to the credit for reinsurance model law and regulation. If the proposed revisions are adopted, states would not need to change their existing credit for reinsurance rules in order to remain accredited, but any state wishing to establish a framework allowing for reduced collateral would have to follow the revised models.

Global – Efforts underway to identify too-big-to-fail insurers

On 31 May 2012 the International Association of Insurance Supervisors (the **"IAIS"**) began soliciting public comments on a proposed assessment methodology for designating insurance companies as global systemically important insurers (**"G-SIIs"**). Under the new proposals, an insurer's possible designation as a G-SII – which could trigger enhanced regulatory scrutiny and heightened capital requirements – would depend on five factors: size, global activity, interconnectedness, non-traditional and non-insurance activities, and substitutability. These five categories of analysis, which are comprised of eighteen specific indicators, aim to reveal an insurer's actual systemic importance to the global financial system.

Acknowledging that traditional insurance activities do little to create or exacerbate systemic risk, the IAIS has emphasised that the extent to which insurance firms are interconnected and the extent to which they engage in activities unrelated or tangential to insurance should be given the highest weightings when determining G-SII designations. The IAIS has also proposed implementing more intuitive analyses to act as a backstop to the above calculation-driven approach in the hope of both capturing systemically important institutions that might fall through the cracks of a solely indicator-based approach and of excluding institutions that meet the indicator approach, but which do not warrant enhanced scrutiny. The IAIS is accepting comments on the proposed methodology until 31 July 2012 and the Financial Stability Board, which coordinates at the international level the work of national financial authorities and international standard setting bodies, is expected to release an initial list of G-SIIs in the first half of 2013.

For further details, see the IAIS's press release and proposal here.

See Also

You may be interested in a recent Legal Update from our Derivatives & Structured Products and Financial Services Regulatory & Enforcement practices: The New CFTC and SEC Swap "Entity" Definitions - Highlights.

If you have any query in connection with anything in this Bulletin, please do not hesitate to get in touch with your usual Mayer Brown contact or one of the contacts referred to below.

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