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Europe – IMD2 update

ECON PUBLISHES DRAFT REPORT ON IMD2

On 11 January 2013, the European Parliament's Committee on Economic and Monetary Affairs (**"ECON"**) published a draft report (dated 14 December 2012) on the European Commission's proposal to introduce a revised Insurance Mediation Directive (**"IMD2"**). The draft report contains a draft European Parliament legislative resolution which sets out a number of suggested amendments to the Commission's original proposal (which was published in July 2012). It also includes an explanatory statement by the rapporteur, Werner Langen, in which he sets out his views on, and explains the proposed amendments to, the following key areas covered by IMD2:

- scope – the Commission is seeking to expand the scope of the directive to encompass sales of insurance contracts by insurance and reinsurance undertakings without the intervention of an insurance intermediary, claims management and insurance policies sold along with other services, but ECON considers that claims management by insurance undertakings or by third parties under insurance outsourcing contracts is already covered by Solvency II and therefore does not need to be included in IMD2;
- registration and simplified declaration procedure – ECON supports the propositions that (i) although they are now within the scope of the directive, insurance undertakings and their employees will not need to register again, and (ii) tied intermediaries may be registered by registered intermediaries; however, ECON considers that the Commission's proposal for a simplified registration procedure for the provision of ancillary insurance mediation and claims management services should be deleted to ensure a level playing field for all intermediaries;
- professional and organisational requirements – ECON welcomes the Commission's recommendation that insurance intermediaries be required to update their knowledge and ability through continuing professional development, but it considers that the form, substance and authentication requirements thereof should be left up to the Member States (subject to minimum requirements regarding knowledge and abilities);
- conflicts of interest and transparency – ECON acknowledges that conflicts of interest and transparency are one of the major areas of change under the revised directive, but expresses concern that compulsory disclosure of commissions and variable remuneration would lead to spiralling competition rather than greater consumer protection; however, given existing disparities in the EU insurance market, ECON considers that Member States should be free to introduce disclosure requirements over and above those of the directive;
- cross-selling – ECON expresses concern that the Commission's proposal in this regard (namely that, where insurance services or products are offered as a package, they must also be offered separately) could result in consumers no longer being offered advantageous package deals, so ECON suggests amending the draft directive to provide that consumers should simply be informed if parts of a package may also be purchased separately;

- insurance investment products – ECON has indicated that it considers it necessary to take account of the distinction between insurance and pure investment products; in addition, ECON is opposed to the proposed ban on commission-based advisory services, as this could seriously detract from the supply of insurance products in certain markets, and suggests that harmonisation in this area should be kept to a minimum; ECON also suggests that, with regard to the disclosure of remuneration, Member States should have freedom to adopt divergent provisions in accordance with their perceived market requirements; and
- delegated acts and levels of harmonisation – ECON is opposed to the Commission's proposal for a number of delegated acts in major areas of the directive, suggesting instead that detailed arrangements should be determined by the Member States themselves or through a co-decision procedure in Council and Parliament in cases where a real need for harmonisation is shown to exist.

Annexed to the draft report is a letter to ECON from the European Parliament's Committee on Legal Affairs (**"JURI"**) enclosing the 11 September 2012 opinion of the Consultative Working Committee of the Legal Services of the Parliament, the Council and the Commission.

The final version of the ECON report will be considered by the European Parliament during its plenary session on IMD2, which is currently scheduled to be held in early July 2013 (see *IMD2 – anticipated timetable* below).

DRAFT JURI OPINION ON IMD2

On 21 January 2013, JURI published its draft opinion (dated 18 January 2013) on IMD2. In the draft opinion, JURI calls on ECON to incorporate a number of amendments to the European Commission's original IMD2 proposal into ECON's report on IMD2 (see *ECON publishes draft report on IMD2* above).

UK TRANSPOSITION AND IMPLEMENTATION OF IMD2

On 15 January 2013, the UK Government announced, by way of a written ministerial statement, its decision to opt in to IMD2. The statement explains that the European Commission's proposal for IMD2 includes provisions on alternative dispute resolution which impose requirements on the UK's civil justice system, in terms of the operation of limitation periods and the availability of interim remedies. On this basis, the Government considers that the Justice and Home Affairs opt-in protocol (under which the UK has the right to decide whether or not to participate in new EU legislation) applies. The statement explains that the Government has opted in as it believes that, in view of the wider significance of the IMD2 proposals, it is in the UK's interests to participate.

IMD2 – ANTICIPATED TIMETABLE

The European Parliament has updated its procedure file on IMD2, indicating that it will consider the legislative proposal during its plenary session to be held from 1 to 4 July 2013.

The European Commission and the European Insurance and Occupational Pensions Authority are expected to work on level 2 measures during 2013/2014, with the new regime expected to come into force in 2015.

Europe – EIOPA update

One of the principal recent developments from the European Insurance and Occupational Pensions Authority (**"EIOPA"**) is the launch of the long-term guarantee assessment for Solvency II (see our article *Europe – Solvency II update* below). In addition to this, EIOPA has recently published key documents relating to strategy for colleges of supervisors and EIOPA's activities in general.

2013 ACTION PLAN FOR COLLEGES OF SUPERVISORS

On 29 January 2013, EIOPA published its 2013 action plan for colleges of supervisors (the **"Action Plan"**). The main objective of the Action Plan is "*to make further progress in improving effectiveness by enhancing the risk analysis and efficiency of the supervision of cross-border insurance groups and their undertakings and, thus, to support crisis prevention and financial stability in the EEA under the current regulatory regimes as envisaged under the EIOPA regulation*". The Action Plan is divided into four key areas, each with separate objectives:

- risk analysis in colleges
  - Objective (i): to develop a common understanding of risks and structured analytical approach (to be complied with by 31 December 2013).
  - Objective (ii): to reach a common understanding on a final assessment of the risk exposure of the group and its major solo entities (to be complied with by 1 July 2014).
- internal model related tasks (applicable only to colleges for groups applying for internal model use)
  - Objective: to review existing work plans for the pre-application and application process under consideration of the implementation of interim guidelines for the period leading up to Solvency II (ongoing task – no deadline for compliance).
- review and alignment of the college work to the interim guidelines for the period leading up to Solvency II
  - Objective (i): to update the college work plan under consideration of the implications of interim guidelines for the period until the implementation of Solvency II (to be complied with by 30 June 2013).
  - Objective (ii): to assess the conclusion of a co-ordination arrangement for the interim period leading up to Solvency II (to be complied with by 31 December 2013).
- self-assessment on college guidelines
  - Objective: to discuss the results of the self-assessment made as part of the 2012 action plan in the college and identify measures allowing closing the gaps.

EIOPA has also published a report on the 2012 action plan, which sets out a summary of the activities of the colleges in 2012 and the accomplishments of the 2012 action plan.

MULTI-ANNUAL WORK PROGRAMME FOR 2012-2014

On 18 January 2013, EIOPA published its multi-annual work programme for the period 2012-2014, which sets out a general overview of EIOPA activities in 2012 and its plans for the next two years in the following eight areas: regulatory tasks; supervisory tasks; consumer protection and financial innovation; common supervisory culture; financial stability; crisis prevention, management and resolution; external relations; and EIOPA internal organisation.

Key strategic directions in each area are as follows:

- regulatory tasks
  - completion of the standards and guidelines required for Solvency II and the monitoring of their implementation
  - establishment of the operational tasks required of EIOPA under Solvency II
  - enhancement of convergence in supervision by greater use of tools such as the supervisory review process
  - assessment of impact of Solvency II framework on consumers
- supervisory tasks
  - participating in college meetings
  - facilitating information exchange
  - enhancing the functioning of colleges by collecting, defining and disseminating best practices
  - developing a Q&A procedure and developing a supervisory handbook addressing best practices
- consumer protection and financial innovation
  - developing common methodologies to assess the effect of product characteristics and distribution processes on consumer protection and on the financial position of institutions
  - promoting transparency, simplicity and fairness for consumer financial products or services across the internal market
  - developing training standards for the industry
  - co-ordinating regulatory and supervisory treatment of new or innovative financial activities
  - adopting guidelines and recommendations with a view to promote safety and soundness of financial markets and convergence of regulatory practice
- common supervisory culture
  - establishing and conducting sectoral and cross-sectoral training programmes for European insurance supervisors to enhance convergence in supervisory practices
  - facilitating personnel exchanges and secondments between competent national authorities
  - conducting regular thematic peer reviews across all national competent authorities to strengthen the consistency and quality of supervisory practices

- financial stability
  - monitoring and assessing financial markets and following up identified risks
  - stress tests of the insurance sector
  - issuing financial stability reports and reporting outcomes of financial stability and vulnerability analyses to the European Systemic Risk Board, the European Commission, the European Parliament and the Council of the European Union
- crisis prevention, management and resolution
  - promoting vigilance on the part of insurance supervisory authorities in EEA Member States to anticipate and prevent financial crises, and raising awareness and improving preparedness of national competent authorities to deal with financial crises
  - playing a key role in the development of resolution policy in Europe
- external relations
  - providing a platform to: (i) facilitate mutual understanding, know-how exchange and mutual learning from experience in different jurisdictions on an on-going basis; and (ii) address topics of overarching international relevance
  - supporting, co-ordinating and facilitating work in the area of third country equivalence
  - co-ordinating and supporting the functioning and the work of the two EIOPA stakeholder groups, liaising and co-operating with the European System of Financial Supervision, and liaising with EU Institutions and other stakeholders on subjects of relevance to EIOPA
- EIOPA internal organisation
  - ensuring EIOPA has the required competent and motivated staff, including promoting the secondment of national experts to EIOPA
  - enhancing EIOPA's processes and supporting IT solutions to achieve a high level of compliance, transparency, efficiency and effectiveness
  - ensuring sufficient budgetary, financial and internal control arrangements
  - ensuring suitable contingency planning is in place
  - taking full corporate and social responsibility, by reducing EIOPA's carbon footprint, setting up robust working processes of communication with the media and public and offering opportunities for trainees and students

Europe – European Commission establishes expert group on European insurance contract law

On 17 January 2013, the European Commission issued a decision establishing an expert group on European insurance contract law. This group has been established to assist the Commission in examining whether differences in contract law between different jurisdictions represent a barrier to cross-border trade in insurance products and, in the event that the group concludes that differences in contract law may hinder such cross-border trade, it is charged with identifying the insurance areas that are most likely to be affected.

The group is to be composed of up to 20 members, including representatives of stakeholders (including the insurance industry, the main users of insurance products and practitioners with experience in drafting insurance contracts) and experts acting in their personal capacity (such as academics with specific expertise in the field).

The group is to present a report on its findings to the Commission by the end of 2013.

Europe – Solvency II update

TIMING

The EU is sticking to its target date of January 2014 for implementation of Solvency II, but insurance regulators and market participators across Europe are continuing to express doubt that this target is achievable, with some commentators suggesting that a "Solvency 1½" scenario may be in place from January 2014 and others suggesting that implementation will simply be delayed again (with suggested start dates ranging from January 2015 to January 2017).

The European Insurance and Occupational Pensions Authority (**"EIOPA"**) has indicated that it is still aiming for an implementation date of 1 January 2014 but has suggested that a gradual implementation, taking into account proportionality, may be appropriate to allow supervisors and undertakings to be better prepared for the new regulatory framework. With the European Parliament not scheduled to vote on Omnibus II until June 2013 at the earliest (see *EIOPA launches long-term guarantee assessment* below), EIOPA will not be able to release its draft technical standards and guidelines for consultation until the second half of 2013 and it is therefore unlikely that this consultation phase will be completed by January 2014. However, EIOPA has indicated that it would like to see most of Pillar 2 (requirements for the governance, risk management and supervision of insurers) and some of Pillar 3 (disclosure and transparency requirements) in force from January 2014.

EIOPA LAUNCHES LONG-TERM GUARANTEE ASSESSMENT

One of the reasons for delay in finalising the Omnibus II directive is the decision of the EU trilogue parties to require an impact study on the long-term guarantees package under Solvency II. This long-term guarantee assessment (**"LTGA"**) was launched by EIOPA on 28 January 2013 in co-operation with national supervisory authorities so is now underway.

The LTGA aims at testing various approaches towards those Solvency II measures that are related to long-term guarantees provided by life insurers and, to the extent relevant, non-life insurers, in order to assess the effects that the implementation of such measures may have on policyholders and beneficiaries, insurance and reinsurance undertakings, supervisory authorities and the financial system as a whole. Participation is not mandatory for all insurers, but wide participation has been encouraged.

The assessment will focus on the evaluation of the following key features, both individually and in combination:

- adapted relevant risk-free interest rate term structure ("Counter-cyclical Premium");
- extrapolation;

- matching adjustment ("Classic" and "Extended");
- transitional measures; and
- extension of the "Recovery Period".

In providing quantitative data for the purposes of the LTGA, insurance undertakings are requested to follow the Technical Specifications published by EIOPA.

Insurance undertakings have until 31 March 2013 (a period of nine weeks) to carry out their estimation of the impact of the measures covered in the LTGA. During April and May 2013, the data submitted by insurance undertakings will be validated by the national competent authorities and then analysed by EIOPA at an EU level. EIOPA then intends to publish a report on the LTGA in the second half of June 2013.

In light of this timetable, it appears likely that the European Parliament vote on Omnibus II, which is currently scheduled for the first half of June 2013, will be delayed further in order that the results of the LTGA can be taken into consideration.

OTHER

For UK specific news relating to Solvency II, please see our article *UK – FSA update* below.

UK – FSA update

SOLVENCY II UPDATES

FSA updates firms in internal model approval process

On 29 January 2013, the FSA sent a letter to firms in the FSA's internal model approval process (**"IMAP"**) for Solvency II, setting out the FSA's approach to allowing firms to use their Solvency II work to meet the current regulatory requirements under the Individual Capital Adequacy Standards (**"ICAS"**).

In this letter, the FSA indicates that it has developed a practical approach (described as ICAS+) to the challenge of using Solvency II work to meet ICAS requirements, which is intended to allow firms to continue to make progress towards Solvency II.

The key elements of ICAS+ are as follows:

- current ICAS rules will continue to apply, including the requirement to carry out an Individual Capital Assessment (**"ICA"**) and set individual capital guidance (**"ICG"**);
- the scope of the ICAS review will seek to leverage IMAP work already conducted, i.e. where an ICAS+ submission is of sufficiently high quality, the FSA will seek to provide as much detailed feedback on IMAP progress as possible;
- the FSA intends to combine ICAS+ and IMAP processes and governance – an ICAS+ review will result in (i) a review of the firms ICA and ICG, (ii) feedback on the development of the Solvency II internal model, and (iii) an updated work plan for the Solvency II model review; and
- the current supervisory approach will continue for groups, i.e. the focus will be on UK solo firms, with group risks taken into account.

The letter confirms that IMAP firms are not required to adopt this new approach and indicates that Solvency II reporting will not be brought in any sooner than is required by the European Insurance and Occupations Pensions Authority.

For firms that choose to adopt the ICAS+ approach, initial details of the information required are set out in the appendix to the letter. The letter states that the FSA is currently working through the next level of detail to implement the ICAS+ approach and that further information on what will be required will be provided to firms in the second quarter of 2013.

FSA postpones general insurance stress testing exercise

The FSA announced on 31 January 2013 that its next general insurance stress test exercise, originally scheduled for late 2012 and already postponed, is now expected to take place in the second half of 2013. This change has been announced in order to co-ordinate the exercise with other FSA initiatives, including FSA consideration of analytical tools and information requests to firms that could inform views on the strength of balance sheets and adequacy of capital.

FSA announces timing of Solvency II policy statement

On 31 January 2013, the FSA also announced that, due to continuing delays to Omnibus II, it expects to publish a policy statement on Solvency II in the second half of 2013. This policy statement will collate feedback from various FSA consultation papers on Solvency II.

INSURANCE CONDUCT SUPERVISION NEWSLETTER

On 31 January 2013, the FSA published the first edition of its insurance conduct supervision newsletter (the **"Newsletter"**), which is intended to update all retail life and general insurers and the London market on: (i) the work of the FSA's supervision departments; (ii) some of the key cross-sectoral regulatory initiatives that affect insurers; and (iii) relevant policy developments.

The Newsletter includes articles on the following topics:

- the insurance intelligence programme (this is an initiative started by the FSA in August 2012, which involves a series of meetings or visits with insurers, brokers, consumer bodies and other stakeholders in the insurance sector to discuss trends and emerging risks);
- thematic reviews of:
  - motor legal expenses insurance;
  - annuities;
  - compliance with the Retail Distribution Review; and
  - government-linked funds;
- how the Prudential Regulation Authority and the Financial Conduct Authority will work together to protect the interests of with-profits policyholders; and
- a study into general insurance "add-ons".

The Newsletter also provides details of recent consultation papers and FSA finalised guidance, any EU/international developments, and recent speeches given in relation to conduct regulation.

UK – Order made for transitional arrangements relating to the new regulatory regime

On 29 January 2013, the Financial Services Act 2012 (Transitional Provisions) (Rules and Miscellaneous Provisions) Order 2013 (the **"Order"**) was made to provide for transitional arrangements relating to the switch from the FSA to the new twin peaks regulatory structure on 1 April 2013.

The Order, which will come into force on 20 February 2013, provides for the following:

- the Prudential Regulation Authority (**"PRA"**), the Financial Conduct Authority (**"FCA"**) and the Bank of England to designate existing FSA rules to become part of their own rulebooks under the new regime – any FSA rules that are not designated via this process before 1 April 2013 will cease to have effect;
- the exercise of functions by the FCA prior to it receiving its full statutory powers on 1 April 2013 – the Order permits persons to be appointed to act on behalf of the FCA as if they were its governing body prior to1 April 2013;
- directions and waivers in respect of rules made by the FSA; and
- amendments to the Bank of England Act 1998 such that the Bank of England's Non-Executive Directors' Committee will be able to perform certain functions in relation to the PRA and the Financial Policy Committee until 1 April 2013 – from 1 April 2013, these functions will be performed by the Bank of England's new Oversight Committee.

The full text of the Order can be found here.

UK – Lloyd's to conduct sanctions market review

In light of increased focus from legislators and regulatory bodies in the EU and the US on (re)insurance and broking transactions as a subject of sanctions and export control legislation, Lloyd's has announced that it will be undertaking a sanctions market review (the **"Review"**) during 2013.

In recent times, increased (re)insurance and broking prohibitions under EU and extra-territorial US sanctions have been directed at EU (re)insurance and broking companies, preventing them from broking or providing (re)insurance for a number of transactions, including to key industry sectors like oil, petrochemicals and gas within jurisdictions such as Iran and Syria.

This has led to increased regulatory scrutiny of (re)insurers' and brokers' compliance with international sanctions, an approach which is expected to continue under the auspices of the Financial Conduct Authority when it takes over from the FSA on 1 April 2013, so Lloyd's has announced the Review in order to ensure that its managing agents are reacting to these market challenges appropriately and that risks are being managed effectively.

The Review will be piloted in the first quarter of 2013 with three managing agencies, with the Review being rolled out to all managing agencies in the last three quarters of 2013.

US – NAIC Separate Account Risk Working Group issues proposed recommendations

In 2010, the Financial Condition (E) Committee of the National Association of Insurance Commissioners (**"NAIC"**) established a Separate Account Risk (E) Working Group (the **"Working Group"**), chaired by Blaine Shepherd of the Minnesota Insurance Division, to study life insurers' use of separate accounts for non-variable products, and particularly the use of separate account products that increase the risks to an insurer's general account. The Working Group devoted the greater part of 2012 to closed-door study sessions, in order to gain a better understanding of the types and characteristics of non-variable separate account products. In December 2012, the NAIC staff compiled the results of those study sessions into a draft document called "Non-Variable, Insulated Products/Product Characteristics with Proposed Recommendations" (available here). At a public meeting held by teleconference on 9 January 2013, the Working Group voted to expose that draft for a 45-day comment period ending on 25 February 2013.

The Working Group's draft classifies separate account products into six broad categories and analyzes each category by describing the product characteristics, comparing the products to general account products, discussing certain factors affecting whether the products should be covered by state guaranty funds, and ultimately offering a recommendation as to whether the products should be insulated from general account claims. The working assumption of the draft seems to be that if a separate account product strongly resembles a general account product, then the separate account product should not be insulated from general account claims.

On the 9 January 2013 conference call, Rhode Island Insurance Superintendent Joseph Torti, who chairs the NAIC Financial Condition (E) Committee (the "parent" committee of the Working Group), cautioned that the exposure of this document does not mean that separate account insulation for non-variable products is coming to an end, but it does mean that the Working Group wants proponents of those products to explain the market need for these products and what differentiates these products from comparable general account products that justifies allowing them to enjoy an insulation that general account products do not enjoy. Mr. Torti said that it will not be sufficient for commenters to assert that disallowing insulation would be disruptive to the marketplace; rather the Working Group wants to make sure that insulation is being used for a legitimate purpose, and not to avoid reserve requirements or non-forfeiture requirements or otherwise evade regulatory protections.

Also speaking on the conference call were representatives of the American Council of Life Insurers and the Committee of Annuity Insurers, each of whom questioned the premises and approach of the Working Group's draft document and indicated that they would be submitting comment letters in response to it.

It is important to bear in mind that, even if the Working Group were to adopt its exposure draft as a definitive recommendation, the document would still need to be approved "up the chain" within the NAIC. And while the NAIC generally has the authority to define statutory accounting principles for insurance companies, separate account insulation provisions are currently embedded in the state insurance laws

that govern separate accounts – laws that can only be changed by the action of individual state legislatures. Not only would any proposed changes to those laws be quite controversial in legislatures of the states where major life insurers are domiciled, but also it does not appear that this issue has been identified as a priority by the National Conference of Insurance Legislators. It is therefore possible, even if the Working Group's recommendations are adopted substantially as proposed and are incorporated into statutory accounting principles, that a conflict could emerge between the NAIC statutory accounting regime and the state statutory framework governing separate accounts.

US – Former US Senator Ben Nelson from Nebraska appointed NAIC Chief Executive Officer

The NAIC has appointed former Nebraska Senator Ben Nelson as its Chief Executive Officer. Nelson replaces NAIC's acting CEO, Andrew Beal, who took over the position left by Therese Vaughn, a former NAIC President and Iowa Insurance Commissioner. Nelson's responsibilities will include working with federal and international governmental agencies as well as insurance industry representatives and consumers. As a former state insurance regulator and Governor, as well as industry executive (Nelson previously served as CEO of the Central National Insurance Group), he has been praised by NAIC President and Louisiana Commissioner Jim Donelon as an effective advocate "for the preservation of our state-based system of regulation", in an era when federal oversight of state insurance regulation may be increasing. The Federal Insurance Office was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act to monitor (though not regulate) all aspects of the insurance industry, including international regulatory issues, and identify gaps in the state insurance regulatory system that could contribute to a systemic crisis in the insurance industry or the United States financial system.

US – Connecticut Insurance Commissioner Tom Leonardi named lead representative for the NAIC on international issues

Connecticut Insurance Commissioner Tom Leonardi was appointed in January 2013 to chair the International Committee of the NAIC and has also recently been appointed to be a member of the Executive Committee of the International Association of Insurance Supervisors (**"IAIS"**). Leonardi is taking the IAIS Executive Committee post previously held by former NAIC CEO Therese Vaughn, who recently stepped down from that role (see separate article herein regarding appointment of Ben Nelson as NAIC CEO). The IAIS represents insurance regulators and supervisors from more than 200 jurisdictions in nearly 140 countries. Alongside the NAIC and new CEO Nelson, Leonardi is assisting the IAIS in tackling policies regarding international regulation and oversight. EU regulators generally favor global capital standards and oversight for insurers, while Commissioner Leonardi, along with other US regulators, firmly opposes this "one size fits all" approach and warns that "to have a lead regulator that has ultra-powers would be detrimental." He adds, however, that US and EU regulators have now "reached a deeper

understanding" on reinsurance collateral issues and general financial stability issues that could encourage greater cooperation. The IAIS members are in the process of negotiating the Common Framework for the Supervision of Internationally Active Insurance Groups (**"ComFrame"**) for regulatory oversight of large international insurers. Stateside, the NAIC is developing its own supervision requirement of Solvency II with the proposed Own Risk and Solvency Assessment requirement for insurers and insurance holding company systems. Assuming the NAIC and individual US states adopt this proposal, it will not be effective until January 2014. The negotiations for ComFrame are due to conclude mid 2013.

US – Validus challenges "cascading" federal excise tax

Validus Reinsurance Limited, Hamilton, Bermuda (**"Validus"**), filed suit on 25 January 2013 challenging the US government's position that the federal excise tax (**"FET"**) on insurance premiums paid to foreign insurance companies applies on a "cascading" basis. This is the first lawsuit challenging the "cascading" approach to the tax since the US government announced that approach nearly five years ago.

In early 2008, the Internal Revenue Service (**"IRS"**) issued Revenue Ruling 2008-15 which ruled, for the first time, that the FET on insurance is due every time a US risk is insured, reinsured, retroceded or otherwise transferred to a foreign reinsurer, even if the risk transfer is from one foreign reinsurer to another. Although the FET on insurance or reinsurance premiums paid to foreign insurance companies had been part of the law for nearly a century, the IRS had not attempted to impose the tax on a transfer of a US risk from a foreign insurer to a foreign retrocedant.

Certainly most foreign reinsurers had not, prior to 2008, paid the FET when they ceded US risks to another foreign reinsurer. Many in the reinsurance industry criticized the government's apparent change of its long-held position. The industry questioned whether the US has the authority to impose a tax on a transaction between two foreign insurers with no connection to the US. The industry also questioned whether the US government would be able to collect that tax from a foreign party.

Despite the criticism from the industry, the IRS commenced audits of foreign reinsurers and has collected the FET from many of them.

The only way to mount a legal challenge to the IRS's application of the FET on a "cascading" basis is to pay the tax and sue for a refund. That is what Validus did.

According to Validus' complaint, the IRS audited Validus for 10 calendar quarters from 2006 through 2010. The complaint states that at the completion of the audit the IRS requested that Validus consent to an assessment of tax and interest "relating to second leg reinsurance (cascading) premiums paid to taxable (non-exempt) foreign insurance companies." Interestingly, the IRS did not assert that Validus was liable for penalties since Validus had "reasonable cause for its position of non-taxability."

The complaint states that Validus paid the tax demanded by the IRS in February 2012 and, in July 2012, Validus filed a claim for refund of the taxes paid. After the IRS took no action on Validus' refund claim for six months, Validus filed suit for refund in the United States District Court for the District of Columbia.

We expect this case to be closely followed by the offshore insurance industry. We understand many other market participants who have been audited have paid the tax and also filed requests for refund. We understand many of those who have filed claims are waiting to see if Validus prevails before they press their claims to a suit for refund.

US – Dodd-Frank corner

For a discussion of cross-border jurisdictional issues relating to the US Commodity Futures Trading Commission's regulation of swaps under Dodd-Frank, please see our recent legal update here.

For a discussion of proposed Federal Reserve regulations that would require non-US banks to hold all US subsidiaries, including insurance company subsidiaries, under an intermediate holding company, please see our recent legal update here.

China – CIRC ponders new reinsurance rules in China

A draft version of *Notice on Issues regarding Reinsurance Transactions between Foreign-invested Insurance Companies and their Affiliated Companies* (the **"Draft Notice"**) was released by the China Insurance Regulatory Commission (the **"CIRC"**) for public comment on 14 December 2012. The Draft Notice would, if adopted, impose more stringent requirements on foreign-invested insurers wishing to use affiliated reinsurers.

These would include the requirement that an affiliate must have posted a net profit for a prior three-year period. The cash flow of the affiliate must also be stable without any "abnormal fluctuation" (although the Draft Notice does not define what is meant by "abnormal fluctuation"). The Draft Notice also requires the foreign-invested insurer to post the relevant reports/forms in relation to its affiliated reinsurance arrangements on its official website for at least five years, and the insurer must have no record of any major violation of law in the previous three years (previously, this period was two years).

In addition, the Draft Notice would also require that the underwriting profits and net profits of the insurer in question must not be significantly reduced due to the reinsurance arrangements with its affiliates.

It is clear from the release of the Draft Notice that the CIRC is keen to enhance the security of the reinsurance business while also looking to ensure that foreign-invested entities do not transfer underwriting profits in this way.

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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