

The latest legal news on

Insurance and Reinsurance



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Newsletter

LG
the angle



A spiral by any other name

There is a growing school of thought in the London insurance market that we have seen sub-prime before, or at least something remarkably like it. Mention the word 'opacity' and those of an age are more likely to remember the LMX spiral problems of the late 1980s than to complain about a cloudy pint of Courage Best.

It is fair to say that there are some parallels that seem to be emerging between the problems being encountered in the world's financial markets and the underwriting of LMX reinsurance business. The most obvious one of these is what is called 'opacity', or rather what Sir David Walker, in his 1992 report of an inquiry into the LMX spiral at Lloyd's, referred to in similar terms:

"...the transparency of risk was eroded in the LMX spiral as successive reinsurers became more remote from the original insurance assessment and contract. The transfer of risk within the market meant that transparency virtually disappeared beyond the initial levels of the spiral.."

Just as successive reinsuring underwriters of LMX business became unable to assess their exposure to underlying losses, so too have many purchasers of bonds in the debt market been unable to value their assets with any degree of certainty if they contain an element of sub-prime assets. The financial press has been riddled in recent months with stories of bond holders, with income stream and assets linked in part to the US sub-prime, being unable to work out their exposures. Many

banks have already announced huge third-quarter write downs, and some commentators do not see it ending there. Those who hold bonds which themselves are derived from other bonds, which in turn may contain an element of sub-prime asset, are in the realms of 'opacity', unable to work out exactly what they have in their debt portfolio because they are, in some cases, too far away from the original transaction.

One can draw some other parallels between sub-prime and the LMX spiral, like the fact that in the spiral those left with the biggest exposures were those at the end of the spiral because they were left holding liabilities which they could not pass on. In sub-prime, when the credit crunch hit, those investors left holding the sub-prime investments, unable to borrow further or to securitise and pass on the risk, were left with the biggest potential losses.

One very obvious parallel between the LMX spiral and the current crisis of liquidity is the solution. For the LMX market it was the creation by Lloyd's of the reinsurance company, Equitas, into which all Lloyd's syndicates' liabilities for 1992 and prior years were compulsorily reinsured, allowing the market to move forward with a relatively clean sheet of paper. Compare this with the fact that some of the biggest banks in the world including Citigroup, Bank of America and JPMorgan Chase have, in principal at least, recently agreed to create what they call a 'Super SIV' (structured investment vehicle) capitalised with funds of \$80 billion, the primary purpose of which is to create liquidity in the debt market by providing short-term credit to finance high-risk investments in the sub-prime market.

However, we should not get too carried away by drawing parallels between the insurance market of the late 1980s and the banking markets of today unless, of course, the history helps to predict what might come out of it.

The insurance and reinsurance markets today, more than 15 years on from the LMX spiral, are the subject of much tighter financial and regulatory controls. Underwriting practices are subject to greater peer and investor scrutiny. Loss modelling is more sophisticated.

If there were to be any pointers from the aftermath of the LMX spiral which might repeat themselves following sub-prime and the global financial markets slowdown, a rise in regulatory and management control (internally and externally) for trading certain debt instruments might be one of them.

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Broker's covering fax gives reinsurer right to avoid



In *Limit No 2 v Axa Versicherung AG* (17 October 2007), the defendant, Albingia (now part of the Axa Group), entered into a series of reinsurance treaties from 1996-98 which the Commercial Court held were void for misrepresentation and non-disclosure of material facts.

On 4 July 1996 brokers faxed Albingia with a proposal to protect the energy accounts of two syndicates at Lloyd's for 12 months effective from 1 July 2006. Attached to the fax was a slip and statistical information. The fax cover sheet stated "As a matter of principle they [the syndicates] maintain high standards and would not normally write construction risks unless the original deductibles were at least £500,000 and preferably £1,000,000".

Following negotiations Albingia entered into the treaty which was later extended by endorsement to 31 January 1998, and again to a second, 12 month treaty, effective from

1 February 1998. Following deteriorating losses and an inspection, it was found that the syndicates had not been following a policy of underwriting risks with deductibles of at least £500,000, let alone £1,000,000.

Sitting as a Deputy Judge of the Commercial Court, Jonathan Hirst QC held that the 1996 treaty was void for innocent misrepresentation. Whilst the package of documents sent by the broker to Albingia should have been read as a whole, there was no reason to treat the fax cover sheet with any less importance than the rest of the information. The statement could not be read as a statement of past practice or of broker opinion, but was to be taken as a statement of current practice. As the treaty was a first loss fac/oblig treaty, the level of deductible was a material factor for a prudent reinsurer.

The 1997 endorsement was found to be an amendment to the 1996 treaty and therefore could not survive the avoidance of the 1996 treaty. Albingia were also entitled to avoid the 1998 treaty due to continuing misrepresentation and non-disclosure.

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Court of Appeal upholds decision on 'threat' to keyholder

In *Anders & Kern UK Ltd v CGU Insurance Plc*, 28 November 2007, Anders & Kern was the wholesaler of audio-visual presentation equipment and home cinema systems. Anders & Kern had a retail and wholesale policy with Norwich Union, which included clauses stipulating that the warehouse would either have a set and functioning alarm or a keyholder would be present at all times. However, the policy also stated that the condition would not apply where a theft or attempted theft had included violence or the threat of violence.

On 16 April 2004 there was a fault with the alarm and so Mr Kuziw, the managing director of Anders & Kern attended the premises. However, he felt unsafe and so left to go home. There was subsequently a break-in causing damage and plasma screens were stolen. Anders & Kern presented an insurance claim under the policy to Norwich Union. Norwich Union refused the claim stating that the premises had been left unattended and no intruder alarm was set or working.

Anders & Kern commenced proceedings, relying on the exception to the conditions and/or that the policy was subject to an implied term that the keyholder was not required to remain at the premises if there was a threat of violence.

The Court of Appeal held that the first instance judge had to decide, on the facts, whether the actual theft had involved violence or the threat of violence. The Court considered that it would have required a considerable stretching of language to say that the theft in this case had involved violence or the threat of violence to Mr Kuziw. Further, the clauses in the contract required the premises not to be left unattended. Whatever risk Mr Kuziw found himself facing whilst at the premises at the relevant time, a term that the insurer should have provided cover after the point at which he had left the premises, could not be implied into the policy. The first instance judge had correctly applied the law.

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Reinsurance Directive

The deadline of 10 December 2007 for implementation of the Reinsurance Directive (the 'Directive') by EEA member states has now passed.



This Directive is intended to establish a legal framework for the regulation and prudential supervision by a 'home' member state regulator of pure reinsurers which have their head office in one of the 28 EEA countries.

Of course, reinsurance has been regulated in the UK for a number of years now. However, the Directive will permit reinsurers to carry on business anywhere in the EEA, either by setting up an establishment in another EEA member state or by 'passporting' their services cross-border into another member state.

What is potentially of more interest is that the Directive also allows member states to establish their own rules for ISPVs.

ISPVs

The UK's FSA has defined an ISPV to be a special purpose vehicle which assumes risks from insurance undertakings or reinsurance undertakings.

The FSA has required that an ISPV fully funds its exposure to such risks through receipt of the actual proceeds of a debt issuance or some other financing mechanism where the repayment rights of the providers of such debt or other financing mechanism are fully subordinated to the undertaking's reinsurance obligations.

The FSA has also required that the ISPV must ensure that at all times its assets are equal to or greater than its liabilities. No additional capital or solvency margin is required.

The FSA introduced rules regulating ISPVs at the end of 2006. The FSA's ISPV regime is a lighter-touch one when compared to its regime for insurers and reinsurers as the FSA has taken the view that this is a proportionate response to the risks posed by ISPVs.

The FSA intends to monitor the ISPVs through supervision of the cedant re/insurer.

Tax regime

HM Revenue & Customs is currently consulting on a special tax regime for ISPVs. If such a regime were friendly to UK ISPVs, then this is likely to make the setting up of such ISPVs in the UK much more attractive.

The HMRC's new regime proposes that, provided an ISPV falls into one of five categories of ISPV, then the ISPV's profits for corporation tax purposes will be calculated on the basis of its retained profit. Retained profit is defined as being the amount required to be retained pursuant to the relevant ISPV arrangement, or in the event of insufficient funds to meet such required profit, the amount of actual profit.

HMRC is to meet with the Association of British Insurers to canvass the ABI's views on its proposals.

It is possible that the new regime could become effective before the end of 2007, but the beginning of 2008 would appear to be a more realistic time-frame.

Final thoughts

There is a battle for capital. Bermuda has been very successful in recent years in attracting capital, an increasing amount of which in recent times has backed local special purpose vehicles.

It is hoped that the FSA's regime and the new tax regime to be introduced by HMRC will together provide a conducive environment for ISPVs and provide some real competition to other jurisdictions.

A UK 'side-car' could prove very attractive not only to cedant re/insurers (which may be able to obtain full solvency credit in its regulatory balance sheet subject to obtaining a specific waiver from the FSA) but also to capital market players which will have an alternative jurisdiction in which to invest their cash.

Legal & General has very recently become the first company to set up an ISPV in the UK. There may well be others in the near future.

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Conduct of business



On 1st November, the Markets in Financial Instruments Directive (MiFID) was implemented in the UK by means of substantial revisions to the FSA's Conduct of Business rules.

MiFID is part of the legislative programme designed to impose uniform standards on member states to facilitate a single market in financial services across the EU. MiFID is concerned principally with fund management and does not extend to the regulation of contracts of insurance. However, the need to amend the existing conduct of business rules, in relation to investment services, to comply with MiFID has led the FSA to draft its Conduct of Business Sourcebook ('COBS') in a manner which applies the MiFID requirements to all retail investment firms with the exception of financial advisers giving advice to UK residents. These are covered by an opt out.

COBS is the first major product of the FSA's move away from highly prescriptive conduct rules towards its goal of a principles-based regulatory environment. Providers have struggled with the need to shoehorn product documentation into uniform formats and the ability to produce meaningful material matched to the product will be welcomed. However, there remain a number of mandatory requirements and the downside of principles, even when extensive guidance is available, is that they increase the uncertainty as to whether a provider can ever be confident that it has complied with the requirements, if challenged at some stage in the future.

In the words of the FSA, regulation is now focusing on "high level outcomes rather than detailed rules." For providers and distributors of insurance products, this implies an increasing reliance on formulating and maintaining appropriate policies, processes and audit trails to demonstrate compliance.

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Claims management

The Ministry of Justice has finalised its post-consultation report on the imposition of mandatory professional indemnity ('PI') insurance for claims management companies.

The regulators of many professions require practitioners to take out a minimum level of professional indemnity insurance to protect clients of those professions in the event that they bring negligence actions. Such cover also protects the practitioner's business and, it is claimed, that requiring the business to comply with conditions imposed by the PI insurer, imposes an additional layer of 'regulation'.

One area of activity which has, to date, escaped any such imposition is that of claims management.

The report recognises that the management services available cover a range of claims. Obtaining cover will increase costs but does not confer significant benefits upon all customers to the same extent. Where the claim is straightforward and of low value, PI cover is likely to be of less relevance to the client than in cases where higher levels of

compensation are likely to be awarded and the potential financial consequences of negligence are greater.

The report states that some insurers are, in principle, willing to consider providing PI cover for claims management companies although the well-publicised problems experienced by some high volume companies in the past may temper their enthusiasm.

The Ministry has, therefore, concluded that with effect from July 2008, claims management businesses that represent clients in the personal injury sector should be required to obtain a minimum level of PI cover.

The terms of the mandatory cover will be a minimum level of indemnity for a single claim of £250,000 and, in aggregate, £500,000. Any excess cannot exceed £10,000. There must be appropriate cover in respect of legal defence costs and continuous cover in respect of claims arising from work carried out from the effective date.

If claims management is being carried out by an insurance intermediary which holds PI cover that meets the requirements of the FSA for its mediation activities, it will be deemed to satisfy any claims management requirement.

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The global village

The results of two recent surveys were quite illuminating.

The first survey was conducted by Booz Allen Hamilton in conjunction with the World Economic Forum. This ranked regulatory bodies/processes as the second most important enabler to the development of an insurance market after legal framework and ahead of competition, skills and training.



The second survey was conducted by the Centre for the Study of Financial Innovation and PwC. This ranked regulatory overkill as the biggest threat to the insurance market ahead of natural catastrophes, quality of management and climate change.

Clearly, striking the right balance in terms of insurance regulation is critical and no mean feat.

Too much regulation can strangle the industry, erode profitability and create barriers to innovation and competition. However, too little regulation can result in anti-competitive practices, predatory sales practices and potential harm to customers and the local economy.

This article takes a snapshot look at some of the general trends in insurance regulation around the world today.

Regulatory trends: emerging markets

The emerging markets comprise parts of Asia, Latin America, Eastern Europe, Africa and the Middle East.

These regions comprise 86% of the world's population yet are also characterised by low levels of insurance penetration.

General trends include the following:

- regulation appearing to drive development – for instance, by encouraging new distribution channels to help tap potential growth;
- increased liberalisation and removal of barriers to entry (particularly in Latin America and Eastern Europe) – this will result in an increased presence of foreign players who will, no doubt, win market share from the local players but who will also introduce competition, new skills and expertise to the local market –

liberalisation could also result in increased consolidation of the market and privatisation of state insurance companies;

- reduced micro-management of business practices by regulators; and
- the emergence of some micro-insurance (that is, insurance for low-income people such as crop insurance).

Regulatory trends: rest of the world

In respect of the rest of the world and the more mature markets, general trends include the following:

- the growth of super-regulators – for example, the UK's Financial Services Authority which is responsible for supervising not only insurance underwriters and brokers, but also, amongst others, banks and building societies;
- a move away from a 'tick-box' approach (and compliance with a number of prescriptive, 'black letter' rules) and towards a more principles-based regime;
- some regulatory arbitrage (as evidenced by, for example, the flight of start-up capital to Bermuda in the wake of hurricanes Katrina and Rita); and
- the growth in market-led initiatives – a good example of this was the market-led initiative in the UK for there to be a certain prescribed percentage of written contracts in place following inception of risk within a specified period of time (the so-called 'contract certainty' initiative).

Convergence

It may be a trite comment but the world is fast becoming a smaller place.

What is particularly interesting and noteworthy is the evidence of some alignment of local regulations, particularly in some of the emerging markets, with international best practice (for example in respect of solvency and corporate governance).

This is probably borne out of an increasing realisation that, in the long-term, a sound and proportionate regulatory regime is more likely to be able to better protect customers, engender confidence in the market and make a more sustainable contribution to the relevant local economy.

More can be done, however, in terms of convergence, in particular in respect of reinsurance, which is essentially a global business. The works of a number of organisations and committees, such as the International Association of Insurance Supervisors, will be valuable in this respect.

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Syndicate 2004

Part VII to Admiral



Court approval was obtained on 21 November 2007 for the transfer of business under Part VII of FSMA 2000 of the business of Syndicate 2004 to Admiral Insurance Company Ltd.

Syndicate 2004 underwrote a share of the business retained by the Admiral group between 2000 and 2002. From 2003 the group underwrote UK motor business through Admiral Insurance Company Ltd and Admiral Insurance (Gibraltar).

Under the Part VII, the remaining liabilities of Syndicate 2004 will now be transferred to Admiral Insurance Company Ltd.

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First transfer of German run-off business to UK under Reinsurance Directive

The first transfer of run-off business from a German entity to a UK entity under the EU Reinsurance Directive has now taken place.

Deutsche Rückversicherung AG ('Deutsche Rück') has transferred all of its third party run-off business to its UK-based subsidiary, Deutsche Rück UK Reinsurance Company Ltd, using the provisions of Section 121f para.1 of the new German Insurance Supervisory Act VAG which came into force on 2 June 2007 and which are part of Germany's implementation of the EU Reinsurance Directive. The provisions allow reinsurance portfolio transfers similar to those which are permitted under Part VII of the UK's Financial Services and Markets Act 2000. Chilington International will manage the Deutsche Rück UK business.

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Season's greetings to all of our clients and contacts and we very much look forward to working with you again in 2008!

This year LG will be making a donation to the children's charity, the Unicorn Theatre, rather than sending personal Christmas cards. We wish all our clients and contacts best wishes over the festive season and a happy New Year.

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LG opens in Dubai



We are pleased to announce the opening of LG's office in Dubai, in the heart of the DIFC. The new office will serve as a base from which LG will continue servicing its clients across the Gulf region and beyond, including those in India and South-East Asia.

James Foster is the first resident partner. He will be supported by other partners and lawyers across the firm's Insurance and Reinsurance, Corporate and Finance, Private Capital and Construction and Projects groups, who will continue working across the region.

For further details of our services to the Gulf and Asia insurance and reinsurance markets, contact Martin Mankabady on martin.mankabady@lg-legal.com

Look out

- For LG's Martin Mankabady who will be speaking at the Complinet conference on 6 and 7 February 2008 on broker remuneration and conflicts of interest. Martin will also be speaking on *Managing legal risk* at the 9th Annual Capital Management in the Re/Insurance Industry Conference, to be held in central London on 6 and 7 March 2008.
- For a bill to be put before the Scottish Parliament reversing the recent House of Lords decision in *Johnston v NEI International Combustion* on the non-recoverability of damages for pleural plaques.

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