

*Willkie Insurance Industry Review*

## Corporate and Risk Transactions, Regulation and Tax Developments

*March 2019*

# Willkie Insurance Industry Review

March 21, 2019

To Our Clients and Friends:

We are pleased to present the Willkie Insurance Industry Review of recent developments in corporate transactions, insurance risk transfers, regulation and tax in the insurance sector. This includes a discussion of mergers and acquisitions, corporate governance and shareholder activism, insurance-linked securities, excess reserve financings, longevity and de-risking transactions, traditional capital markets transactions and the regulation and taxation of insurance companies, covering the U.S., the E.U., and the U.K.'s insurance company and Lloyd's markets.

We hope that you find this Willkie Insurance Industry Review informative. Please contact us if you would like further information about any of the topics covered in this report.

Sincerely,

Insurance Transactional and Regulatory Practice  
Willkie Farr & Gallagher LLP

## #1 Legal Adviser in Insurance M&A

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*SNL Financial/S&P Global Market Intelligence*  
2014-2018, based on the aggregate number of deals in the U.S./Canada/Bermuda

## #1 Issuer's Counsel for U.S. Insurance Capital Markets Offerings

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*Thomson Reuters*  
2018, 2017, 2016, 2015 and 2014, based on market share

## Band 1 for Insurance – Transactional and Regulatory

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*Chambers USA*  
Nationwide and New York | 2018, 2017, 2016, 2015 and 2014

## Described as the “preeminent transactional practice” with “standout experience”

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*Chambers USA 2018*

## “Pragmatic, very straightforward, responsive and really on top of everything”

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Client Quote in *Chambers UK 2019*

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## I. REVIEW OF M&A ACTIVITY

### A. U.S. and Bermuda

The year 2018 saw a significant increase in announced M&A deal volume in the United States and Bermuda when compared to 2017. Aggregate disclosed volume increased to \$44.58 billion in 2018 from \$19.29 billion in 2017.<sup>1</sup> The increase was concentrated in the property/casualty sector, which featured several large transactions involving Bermuda insurance/reinsurance companies. In contrast, the life sector saw only two significant legal entity transactions in 2018. Most of the M&A activity in this sector involved the sale of blocks of business effected through reinsurance transactions. (Unfortunately, publicly available M&A databases do not count reinsurance transactions as “M&A,” making it difficult to compile a complete list of deals and therefore provide a comprehensive picture of these transactions.) Finally, M&A activity involving insurance brokers and agents continued to set records in 2018 with more than 600 announced transactions, many involving private-equity-sponsored roll-ups.

#### i. Property/Casualty Transactions

Property/casualty deal volume in 2018 was fueled by acquisitions of Bermuda-based insurers/reinsurers. The largest of these transactions, and the largest insurance transaction of 2018, was AXA’s \$15.39 billion acquisition of XL Group Ltd. This transformative transaction, coupled with AXA’s initial public offering of its U.S. life and annuity business, AXA Equitable Holdings, resulted in a decisive shift of AXA’s business away from life-related risks to commercial lines property-casualty insurance.

There were three other significant Bermuda transactions in 2018: American International Group’s (“AIG”) acquisition of Validus Holdings (\$5.6 billion); the acquisition of Aspen Insurance Holdings by funds managed by Apollo (\$2.6 billion); and RenaissanceRe Holdings’ (“RenRe”) acquisition of Tokio-Millennium (\$1.5 billion). The AIG/

Validus announcement followed only four months after AIG’s Systemically Important Financial Institution (“SIFI”) designation was revoked by Federal regulators, and the transaction was AIG’s first acquisition since the 2008 financial crisis. AIG later returned to the M&A market in September 2018 with the acquisition of Glatfelter Insurance Group, a prominent specialty insurance broker and program manager. The Aspen transaction, together with Apollo’s 2018 acquisition of a majority stake in Bermuda run-off specialist Catalina Holdings, significantly expands Apollo’s holdings in the property/casualty sector. More recently, Apollo had focused on acquisitions in the life and annuity sector through its affiliate, Athene.

A property/casualty transaction that received considerable attention in 2018 was the acquisition of AmTrust by Evergreen Parent, L.P., an entity formed by private equity funds managed by Stone Point Capital LLC, together with Barry D. Zyskind, Chairman and CEO of AmTrust, George Karfunkel and Leah Karfunkel, to take the company private. In the transaction, Evergreen Parent acquired the approximately 45% of the company’s issued and outstanding common shares that the Karfunkel-Zyskind family and certain of its affiliates and related parties did not already own or control. Pursuant to the original merger agreement, executed in March 2018, the public stockholders were to receive merger consideration of \$13.50 per share in cash. Following the acquisition of over 9% of AmTrust’s outstanding shares by affiliates of Carl Icahn and Icahn’s public opposition to the transaction, in June 2018 the merger agreement was amended to increase the merger consideration to \$14.75 per share in cash, representing an increase of \$1.25 per share over the previously agreed-upon price. In connection with the amended merger agreement, AmTrust and Evergreen Parent entered into a settlement and support agreement with affiliates of Carl Icahn, pursuant to which the Icahn Group agreed to support the transaction and waive appraisal rights and other claims with respect to the transaction.

Another notable 2018 transaction was The Doctors Company’s acquisition of Hospital Insurance Company for \$650 million. Hospital Insurance Company is a New York-domiciled medical malpractice carrier owned by

<sup>1</sup> Transaction statistics from S&P Global Market Intelligence.

# I. Review of M&A Activity

three large New York hospitals. The deal represents the second significant acquisition of a New York medical malpractice carrier in recent years. Only one month before the HIC transaction was announced, Berkshire Hathaway completed its \$2.5 billion acquisition of MLMIC Insurance Company, the state's largest medical malpractice insurer, after a two-year demutualization process.

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## ii. Specialty Carriers

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Specialty carriers have long been popular targets in property/casualty M&A. The year 2018 provided two more prominent examples: Hartford's acquisition of Navigators (\$2.1 billion) and Kemper's acquisition of Infinity (\$1.6 billion).

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## iii. Life and Annuity Transactions

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There were no "blockbuster" transactions in the life and annuity sector in 2018. In fact, only two legal entity transactions were announced last year that exceeded \$1.0 billion in deal value: Liberty Mutual's sale of Liberty Life Insurance, a subsidiary of Dai-ichi Company, to Lincoln Financial, and its individual life and annuity business to Protective Life (\$3.3 billion in the aggregate); and Nestlé's sale of Gerber Life Insurance Company to Western & Southern Financial, (\$1.5 billion). In the Liberty transaction Lincoln retained the legal entity, Liberty Life, and its group benefits business and reinsured its individual life and annuity business to Protective Life. The transaction significantly expanded Lincoln's benefits operations. For Protective, which has been an active accumulator of blocks of life insurance and annuity business, the transaction was its largest acquisition to date. Similarly, the Gerber transaction was the largest in Western & Southern's history.

Notwithstanding the shortage of legal entity transactions in the life and annuity space, the market for blocks of business was active in 2018, and should remain so in 2019 and beyond. Increasingly, these types of transactions are at the core of M&A activity in the life sector. Various factors are responsible for this development. Among them is the pressure on insurers from rating agencies, equity analysts

and investors to optimize their liability portfolios and exit businesses that are seen as non-core, volatile (like variable annuities) or problematic (like long-term care). In addition, the scale bar is rising constantly, causing companies to regularly reevaluate these operations. A long-term, low interest rate environment has also been a significant factor encouraging exits from certain lines of business.

There is a growing roster of buyers of blocks of insurance businesses including: industry consolidators such as Protective, Wilton Re and RGA; platforms owned by private equity firms such as Apollo, Carlyle and Blackstone; as well as some of the larger mutuals. These buyers typically bring significant expertise, discipline and experience to the table. As a result, deals that in prior years might have been difficult to accomplish are getting done. An example includes Wilton Re's reinsurance of \$2.7 billion of a block of long-term care reserves from a subsidiary of CNO Financial. This transaction could point the way to other LTC transactions in coming years.

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## iv. Private Equity and Insurance M&A

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The continued and increasing involvement of private equity groups in insurance-related transactions is a trend of note. Recent estimates put the amount of dry powder available to PE funds worldwide in excess of \$1 trillion and in their search for attractive assets, insurers and reinsurers have become an asset class that is increasingly of interest to such investors. In particular, larger PE groups with their significant asset management capabilities across asset classes have shown an interest in insurance targets. These include transactions in the life insurance area as well as the more established practice of investing in P&C businesses. Recently announced transactions include, among others, Carlyle's investment alongside AIG in DSA Re; an investment of \$6 billion of DSA Re and AIG assets into Carlyle-managed strategies; the purchase of FGL Life by CF Corp with backing from the Blackstone funds; the purchase of Voya Financial's variable and fixed annuity business by a consortium led by Apollo; Elliott's acquisition of Prosperity; and the acquisition of The Hartford's remaining life operations by a consortium led by Cornell Capital and Atlas Merchant. Some of these transactions would have

# I. Review of M&A Activity

been harder to execute with only traditional M&A trade bidders but the capital and expertise which PE funds are able to deploy have clearly expanded these possibilities.

As PE-backed transactions become more commonplace the associated regulatory approval process is becoming easier to navigate, both for the regulators and the PE fund managers. In the U.S., the insurance laws of each state require an acquirer of “control” of an insurer domiciled in that state to obtain the regulator’s prior approval, which involves a process of scrutiny designed to ensure that policyholders are protected following the closing of the transaction. The business plans which need to be submitted in order to support this process may look quite different for a PE-backed transaction compared to that of a more traditional trade buyer, which may include presenting a structure incorporating more leverage and/or having some of the key individuals exercising control sitting within the financial sponsor. As more PE transactions come to market regulators across the U.S. are becoming more familiar with these aspects. Similarly, PE funds are becoming more familiar with the level of disclosure and other diligence that they need to provide in order to complete the regulatory process as smoothly as possible.

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## v. Other Developments

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Two new public company participants could also have an impact on the M&A marketplace in 2019 and beyond. BrightHouse and AXA Equitable were created by MetLife and AXA, respectively, as publicly traded vehicles to house their large individual life and fixed and variable annuity operations. While these companies have not yet announced M&A transactions, we expect that they could become important players in life M&A in coming years. Time will tell.

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## B. Europe and the U.K.

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Whilst there have been some substantial European, U.K. and Lloyd’s of London (“Lloyd’s”) elements to many of the significant international insurance transactions we discuss above, various research shows that activity focused

specifically within the European market itself has generally lagged behind the U.S., both in terms of volume and size.

Many had predicted that, once the dust had properly settled following the long-awaited coming into force of Solvency II on January 1, 2016, European insurers would return to focusing on M&A with renewed vigor. While the extent to which these regulations will prove to be a wider driver of deal activity in the longer term remains unclear, there are some transactions for which the change in solvency rules can be identified as an underlying feature, particularly in the life assurance sector.

Beyond this, the fact that the significant loss events of both 2017 and 2018 have only led to a relatively modest hardening of rates in the commercial insurance and reinsurance markets, together with the on-going uncertainty in the U.K. market arising from Brexit, have limited the levels of deal volume in Europe during 2018 into early 2019. (See *below*, Section VII.B.i “Principal Regulatory Developments Affecting Insurance Companies—European and U.K. Regulatory Developments—Brexit.”)

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### i. Focus on Asset Management

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In last year’s edition we noted two large transactions driven by insurers seeking to identify synergies with their asset management businesses. This trend continued in 2018 with further transactions. In February Standard Life Aberdeen, which had only been created in August 2017 via an insurer/asset manager merger, announced the sale of the whole of its life assurance business to Phoenix Group in a deal worth £2.28 billion in cash plus a 19.99% stake in the purchaser. Perhaps the most significant feature of this transaction was the consequent break of the seller from the insurance business: Standard Life’s insurance roots date back to the early 19th century and once represented the largest mutual insurance business in Europe, but the new entity is now focused exclusively on asset management.

Standard Life Aberdeen was not alone in this trend. In March it was followed by U.K. Prudential plc, which announced a sale of part of its U.K. life insurance business. This deal concerned its £12 billion annuity portfolio, which

## I. Review of M&A Activity

was acquired by Rothesay Life, a specialist annuity insurer. Alongside this disposal, Prudential plc announced plans to de-merge its savings and asset management business, M&G Prudential, and list it separately on the London Stock Exchange. The remaining life assurance of Prudential plc business will be primarily focused on its growing operations in the U.S. and Asia and represents a group with a significantly different business profile compared with the pre-transaction group.

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### ii. Distribution Consolidation Continues

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Consolidation amongst insurance brokers and intermediaries has continued apace in 2018. The most notable transaction was Marsh & McLennan's \$5.7 billion deal to buy U.K.-headquartered Jardine Lloyd Thompson ("**JLT**"). This public takeover deal, at a premium of 33.7% over JLT's pre-announcement share price, represents the latest in a long line of expansion and consolidation amongst the largest broking groups. However, there has been M&A activity amongst intermediaries throughout the deal size spectrum, with Arthur J. Gallagher including several European transactions among its extensive list of acquisitions. Examples of transactions announced by this group include U.K. insurance services provider HMG-PCMS Limited and U.K. retail broker Blenheim Limited.

London market specialist brokers have been the subject of international acquisition interest, particularly from U.S. buyers. Lloyd's broker Tysers was acquired by U.S. broking group Integro Inc., specialist broker B&W Brokers Limited was acquired by AssuredPartners and Beach & Associates was acquired by Acrisure LLC from its previous shareholders, which included Aquiline Capital Partners. In another notable private equity move in this sector, funds managed by J.C. Flowers acquired two London insurance broking operations - SSL Insurance Group and Endeavour Insurance Services - combining them as part of a buy and build strategy in this area. A similar approach was seen in another PE-backed broker group with the merger of U.K. brokers PIB and Lorica, a venture backed by Carlyle.

There were a number of notable distribution focused deals in the personal lines sector with Covea selling U.K. retail

broker Swinton to The Ardonagh Group and Qatar Re acquiring U.K. motor insurer Markerstudy.

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### iii. Insurtech Attracting Investment

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As well as the continuing trend for consolidation in insurance distribution, there was continued interest in insurtech transactions, including from private equity funds. One deal showing elements of both of these was Bain Capital's £1.2 billion bid for on-line insurer esure.com, which cited the target's use of technology as a key driver. Interest in fintech and insurtech by both funds and insurance carriers continues to be strong and varied, whether through acquisitions, venture investments, partnerships, start-ups or hiring executives with the relevant experience to act as disrupters of the status quo.

Zurich Insurance Group ("**Zurich**") also invested in this area during 2018. Its activity included deals to fund Digital Insurance Group, a next generation technology partner focusing on assisting insurers on delivering digital strategies and acquiring a stake in CoverWallet, a digital platform aimed at providing insurance to SMEs in Europe.

Another notable Insurtech initiative was the development of the "Lloyd's Lab", a platform aimed at assisting the nurture of innovative businesses, particularly those with a technology focus. Initiatives arising from its first cohort of participants have included the development of apps and software to assist collaboration between and assessment of risk, and a second cohort of opportunities is due to be selected in early 2019.

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### iv. Asia Continues to Engage

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Following some significant investments from Asia-based insurance groups in 2017, including MS&AD and Sampo, there were also some notable transactions funded by capital from Asia during 2018. One such deal was China Re's acquisition of Lloyd's insurer Chaucer from Hanover Insurance Group, a transaction valued at \$865 million.

# I. Review of M&A Activity

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## v. Lloyd's in the Spotlight

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After syndicates sustained large aggregated market losses in 2017, the spotlight was on how the Corporation of Lloyd's would react. One key initiative has been a review of business lines for 2019 prior to the annual coming-into-line process, with the aim of improving underwriting performance, particularly in the lowest-performing syndicates. This has seen the Lloyd's Performance Directorate scrutinizing syndicate business plans with underwriting performance in mind and has resulted in several syndicates announcing that they are withdrawing from, or significantly downsizing, premium targets for several lines of business for the 2019 underwriting year.

In addition to the China Re acquisition of Chaucer, Enstar announced that it had retained investment bank Evercore to assist in evaluating market interest regarding the potential sales of each of Atrium and StarStone, the company's active underwriting businesses at Lloyd's, although no transactions have been announced as of the date of this Review.

The spark igniting Lloyd's M&A came from Liberty Mutual in 2019 when it concluded its strategic review of its Pembroke Managing Agency and Dublin-based Ironshore Europe DAC businesses by announcing an agreement to sell them to Hamilton Insurance Group. Liberty Specialty Markets will continue to serve the Lloyd's market through its Syndicate 4472. Earlier in 2018, Munich Re similarly sought to simplify its operations at Lloyd's, announcing the sale of its Beaufort Underwriting Agency to Cincinnati Financial Corporation and concentrating its ongoing interests in the market under the Munich Re brand.

Lloyd's has been devoting a significant amount of effort to the establishment of a Belgium subsidiary that will enable it to continue to operate seamlessly following the U.K.'s withdrawal from the E.U. The new entity, Lloyd's Insurance Company S.A., opened on November 13, 2018, although whether this will prove to be a catalyst for further M&A activity for insurers wishing to get a foothold in this market, together with the broader licensing advantages of Lloyd's, remains to be seen. (For further discussion of Lloyd's, see

*below* Section VII.B.i, "Principal Regulatory Developments Affecting Insurance Companies—European and U.K. Regulatory Developments—Brexit.").

The impact of these trends on M&A activity in the Lloyd's market should become clearer as 2019 progresses. Although the initiative to focus on underperforming lines may have delayed sales processes that commenced in 2018, activity has picked up in 2019 and those managing agencies and syndicates with above-average underwriting results will no doubt attract the usual suitors. As the half-dozen completed deals over the past 18 months suggests, Lloyd's specialty carriers remain attractive to both strategic buyers and financial investors.

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## vi. Legacy Consolidation Continues

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European insurers continue to be engaged in transactions aimed at managing legacy exposures. One notable example was Zurich's announcement in December that it had agreed to transfer its pre-2007 U.K. legacy employers' liability policies to Bermuda-based run-off specialist Catalina in a \$2 billion deal. This follows a deal between the pair announced in November 2017 for the transfer of German medical malpractice liabilities for approximately \$450 million.

At the start of 2018, Catalina announced that it had received investments from RenRe Ventures and Apollo in order to assist with its growth in the legacy sector. Other specialist run-off groups also continued to be active during the year, with Enstar completing a reinsurance to close transactions in respect of Lloyd's syndicates of both Neon and Novae in deals which involved reserves of \$456 million and \$811 million, respectively.

Further run-off consolidators that were also active included R&Q, which announced further deals involving its Malta-based consolidation vehicle, including the acquisition of Irish company Western Captive Insurance DAC, and Darag, which announced deals to acquire the Quodos insurance liabilities and the IKANO insurance company of Sweden.



## II. Developments in Corporate Governance and Shareholder Activism

### II. DEVELOPMENTS IN CORPORATE GOVERNANCE AND SHAREHOLDER ACTIVISM

We start our governance and activism review with a description of 2018 proxy fights involving U.S. insurance holding companies. We then review the latest trends in corporate governance, shareholder activism and shareholder proposals generally, with a focus on how they may affect insurance groups. Finally we discuss some of these same trends and other new developments in the U.K. and Europe.

#### A. U.S. Corporate Governance

##### i. Proxy Contests

As our readers know, proxy contests involving insurers can bring into play unique issues and defenses under the holding company acts of U.S. states. Insurance holding company laws require persons who are presumed to have “control” of an insurer to file change of control approval filings or to effectively “disclaim” control before acquiring the rights that create a presumption of control. Although whether control actually exists is a question of facts and circumstances, having a representative on the board of directors of an insurance holding company is a significant fact for many insurance regulators. Further, in some states merely holding proxies covering more than 10% of the outstanding shares of an insurance holding company creates a presumption of control.

While there were no proxy contests in 2018 in which an outsider sought representation on the board of directors of a public U.S. insurance holding company, there were two notable proxy contests in connection with M&A deals involving U.S. insurers. In both, the principal antagonist was Carl Icahn, who took on AIG a few years earlier. In May 2018, Icahn-controlled interests filed a proxy statement urging shareholders of AmTrust Financial Services, Inc. to vote against the proposed take-private deal with affiliates of the company’s founders. Icahn, who owned almost 10% of the outstanding shares, claimed that the \$13.50 price per

share proposed to be paid was too low and that the special committee process used in the transaction was tainted by the alleged conflicts of the committee’s financial adviser. His tactics were successful; the merger agreement required that the merger be approved by a majority of the non-controlling shareholders, and as of the planned meeting date, AmTrust was forced to announce that it did not have the required votes for approval. It then moved quickly to meet with Icahn, who had previously stated that the true value of the target was at least \$20 per share, and perhaps as high as \$35. When the dust settled a few days later, the founders had agreed to increase their offer to \$14.75, and Icahn had agreed to vote in favor. Public sources speculated that Icahn made \$30 million on a \$240 million investment; if true, that is not bad for a few months’ work.

In the second proxy fight, Mr. Icahn again took on an insurer in an M&A deal, when in August 2018 he filed a proxy statement seeking votes against the proposed acquisition of Express Scripts by Cigna. (Although Express Scripts is principally known as a pharmacy benefit manager, it owned insurance subsidiaries as well.) This time Icahn was not successful. After the influential proxy advisory firms ISS and Glass-Lewis announced their recommendations that shareholders vote in favor of the deal, Icahn withdrew his proxy fight.

It is unknown whether the parties to either of these mergers considered asserting that Icahn would be an unapproved (and presumably unacceptable) “controlling person” under state insurance laws, if he were to succeed in obtaining control of enough proxies to block these deals (in addition to his own shares). It is at a minimum an avenue that the targets of his unwanted attention might have considered pursuing. However, it may be hard for a public company board to go public with that sort of defense to an unwanted objection to a deal, rather than fighting it on the merits.

##### ii. Proxy Access

Proxy access refers to the ability of shareholders to include their own candidates for election to the board in the issuer’s annual proxy statement. Proxy access does not mean that insurgent candidates will necessarily be elected; rather, it

## II. Developments in Corporate Governance and Shareholder Activism

is intended to reduce the costs of running a proxy fight by allowing proponents of board candidates to avoid the costs of printing and distributing their own proxy statements. In 2011, the Securities and Exchange Commission's ("SEC") proposed proxy access regulations were vacated by a U.S. federal court. The SEC's proposed rule would have permitted holders of more than 3% of the company's stock, who had held such stock for at least three years, to elect up to 25% of the company's board (a "3/3%/25%" formula). However, in the wake of that proposal, shareholder activists began to seek so-called "private ordering" solutions to proxy access, in which issuers would adopt their own rules allowing access to the issuer's proxy statement, generally through a bylaw amendment. Although activist interest in this topic was initially limited, in 2015 and 2016 proxy access proposals boomed. According to Georgeson Inc., there were approximately 200 such proposals presented to Standard & Poor's ("S&P") 1500 companies in 2016, although a smaller number actually came to a vote.

The number of proxy access proposals has declined over the past few years. This decrease is attributable to the fact that many large companies have by now adopted a form of proxy access. The New York City Comptroller's Office in particular is slowing the pace of its shareholder proposals on the topic. According to Georgeson, only seven companies in the S&P 1500 presented shareholder proposals to enact proxy access in 2018, compared to 26 in the prior year and 61 in 2016. However, 30 companies presented proposals from shareholders seeking changes to a previously adopted proxy access measure in 2018, compared to only two in 2016. These so-called "fix-it" proposals generally seek changes in some of the core features of proxy access, such as the percentage of the board that can be elected through proxy access (with proponents often seeking 25% of the board, rather than the 20% of the board that has become the standard for boards to adopt under issuer-sponsored proposals) and the number of holders whose shares can be aggregated to reach the 3% ownership threshold included in many companies' bylaws. (On the latter point, most bylaws of U.S. domestic issuers limit the number of holders that can be aggregated to 20, while activist shareholders generally ask that this number be increased to 40 or 50, or

that there be no such limit at all.) The good news, from the standpoint of issuers, is that fix-it proposals do not seem to attract much support. None of the 30 proposals voted on in 2018 received a majority of the shares voted. The average vote in favor was 27.5% of all shares voted.

For insurance holding companies, proxy access raises additional issues not present for many other types of issuers, as described above. Insurers implementing proxy access would be well advised to require any nominee to have obtained all necessary regulatory approvals for board service, and to build such a requirement into their relevant bylaw. Of course, issuers should also require that to be eligible to use proxy access, the shareholder should have acquired its shares without the intent to change or influence control of the company, and that the holder not presently have such intent. This requirement is common in company-adopted proxy access provisions, and is based on a provision included in the SEC's abandoned proxy access rule.

To date, it appears that despite the wide support among investors for the adoption of proxy access (as opposed to the lack of such support for changes in a previously adopted bylaw), only two companies have received a request for inclusion of a director candidate in the issuer's proxy statement. In late 2016, GAMCO Asset Management, an entity affiliated with activist investor Mario Gabelli, proposed a candidate for election at the annual meeting of National Fuel Gas Company, a New York Stock Exchange-listed diversified natural gas company. NFG quickly rejected the bid to include the candidate in its proxy statement, on the basis that GAMCO had been pushing for the break-up of the company, a move consistent with a control intent as defined under the Exchange Act. GAMCO then withdrew its proposal. More recently, in late December 2018 a holder of shares in The Joint Corp. (for those of you eager to know, *not* a recreational marijuana business) filed a Schedule 14N nominating an activist investor who also holds shares in the issuer as a director candidate. It is not immediately clear that there is any fundamental flaw with this nomination (as there was in GAMCO's quest), although more details may emerge with time.

## II. Developments in Corporate Governance and Shareholder Activism

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### iii. U.S. Say on Pay; Pay Ratios

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As in the five prior years, in 2018 shareholders once again overwhelmingly voted in favor of executive compensation in U.S. companies' annual "say-on-pay" votes. According to Georgeson, only 11 companies in the S&P 500 received less than majority support for their executive compensation. Adverse recommendations by Institutional Shareholder Services and Glass, Lewis & Co., the two biggest proxy advisory firms, once again greatly outnumbered failed votes. An additional 4% of S&P 500 issuers received favorable votes that were in the danger zone of from 50-70% in favor. For the experiences the U.K. has had on these issues, see *below*, Section II.B.i, "U.K. Corporate Governance—U.K. Say on Pay".

In the U.S., pay ratio disclosure was first required to be disclosed in the 2018 proxy statement. This disclosure compared the total annual compensation of the company's CEO to that of the "median company employee," as determined under SEC guidance. These disclosures unsurprisingly showed a wide gulf between CEO pay and median employee pay. It remains to be seen what sorts of shareholder proposals or impacts on say-on-pay votes these disclosures may generate.

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### iv. Other Corporate Governance Shareholder Proposals

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The number of corporate governance shareholder proposals in the 2018 proxy season (not including proxy access) was higher than in 2017, reversing an overall multiyear trend. According to information compiled by Georgeson, the number of such proposals voted on increased dramatically to 229 proposals in 2018 from only 172 proposals in 2017.

The 2018 increase was largely fueled by proposals to permit shareholders to call a special meeting (57 proposals voted on in 2018 vs. 24 in 2017) and to vote by written consent (36 in 2018, up from 14 in 2017). While these two types of proposals typically do not pass, as in past years they averaged in the neighborhood of 40% votes in favor, as a percentage of shares voted. Another common proposal asked companies to have a board chairman independent from the chief executive officer, with 46 proposals coming

to a vote in 2018, compared to 39 proposals in 2017. Average support for these proposals was approximately 32%, not enough to bring about change but continuing to show the importance of this issue to a range of institutional investors. As in prior years, shareholder proposals to eliminate classified boards, adopt majority voting for directors and eliminate supermajority voting provisions were more successful. These are the only types of proposals that routinely receive a majority of votes cast. However, the number of such proposals remained low, reflecting the extent to which these governance changes have already been adopted by the S&P 500.

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### v. Environmental and Social Proposals

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Environmental and social stockholder proposals continue to garner increasing press attention. Most prominent among these are initiatives to address diversity, both among the employees and the directors of public companies; gender pay gaps; political contributions by corporations; and the topics of sustainability and environmental issues, including greenhouse gas emissions. However, companies have shown an inclination to negotiate with the makers of such proposals to avoid the negative PR associated with running them in the proxy statement. Many CEOs want to do the right thing on these topics, while others do not want to see their companies mentioned in an unfavorable light with respect to issues such as diversity. In addition, board and employment diversity (in particular) has grown very important to institutional investors, particularly over the last two years. Large institutional investors have announced their support for board diversity, including BlackRock, State Street and Vanguard. BlackRock CEO Larry Fink made headlines in January 2018 with his letter to CEOs, in which he called on corporations to "serve a social purpose," or else risk losing their license to operate from key stakeholders. Additionally, the NYC Comptroller's Office has been very active in engaging with issuers on the topic of diversity. The average vote in favor of these proposals increased from 24.5% in 2017 to 36.6% in 2018, according to Georgeson and Proxy Insight. According to executive recruiters Spencer Stuart, on average female directors constituted 24% of the board members of Fortune 500 companies in

## II. Developments in Corporate Governance and Shareholder Activism

2018, up from 22% in 2017. In addition, 87% of such boards have two or more women directors, up from 80% last year and 56% a decade ago. Those companies with no female directors can expect stockholders to ask questions about this topic with frequency in the future. Further, it is not clear that minority representation on boards is increasing as fast. Given the relative lack of diversity of executives at the top level of the insurance industry, those companies should be prepared to hear from shareholders over the next few years, unless things change organically.

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### vi. Other U.S. Governance Developments

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In 2018, the SEC has shown a renewed interest in revising the regulation of the proxy process. Chairman Jay Clayton has among other things suggested that proxy advisors should be subject to additional regulation (at present, they are lightly regulated). One such step would be to require them to provide additional information about how they reached particular recommendations, which many issuers would agree can be frustratingly unclear and seemingly arbitrary at times. In addition, the SEC will consider raising the threshold for the making of a shareholder proposal, as well as making it harder to submit the same proposal repeatedly at a company when it has failed to gain much support.

The SEC has so far not shown interest in tightening the regulation of exempt solicitations, although business and legal groups have called for it to be examined. These solicitations, which appear on the SEC's filing system EDGAR as SEC Form PX14A6G filings, give shareholders the ability to communicate with each other without soliciting a proxy or making a formal shareholder proposal. In the past year, they have begun to be used by certain activists to encourage other shareholders to vote against a management proposal for a governance change, where the activist believes that the proposal does not go far enough. Business groups have questioned whether there should be more recourse for misleading PX14A6G filings, and whether corporate issuers should really be subject to having to respond to them (or risk ignoring them) all year long. These objections seem unlikely, however, to get a sympathetic ear at the SEC.

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## B. U.K. Corporate Governance

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### i. U.K. Say on Pay

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Companies incorporated in the U.K. and with a London Stock Exchange listing are required to produce a directors' remuneration report containing a directors' remuneration policy, which is subject to a binding vote at least every three years, and an annual report on remuneration in the financial year being reported on, which is subject to an annual advisory vote. In 2018 there was a continuing trend toward significant shareholder dissent over executive remuneration, as reflected in these votes. The Investment Association found that 61 FTSE All Share companies had either their directors' remuneration policy or the report itself voted against by more than 20% of shareholders. One company had its remuneration policy defeated by a 52.01% majority, and five companies had their reports defeated by majorities ranging from 58% to 72%.

Although this figure declined from 68 in 2017, the discontent over remuneration appears to be focused on FTSE 100 companies which saw a jump in defeats of their remuneration policies and reports combined from nine to 18. Chris Cummings, the chief executive of the Investment Association, encouraged FTSE 100 companies to do more to ensure that management's pay packets align with company performance and remain at levels that shareholders find acceptable, or risk facing another backlash in 2019.

In another executive pay development, the U.K. government introduced in July the Companies (Miscellaneous Reporting) Regulations 2018, which came into force on January 1, 2019, and requires pay ratio disclosure for all listed PLCs that have over 250 employees within the group. Furthermore, the Investment Association now maintains a register of companies that face opposition to their pay policies from more than 20% of their shareholders.

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### ii. The U.K. Corporate Governance Code

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On July 16, 2018, the United Kingdom's Financial Reporting Council (the "FRC") published a revised Corporate Governance Code applicable to issuers whose securities have a premium listing on the London Stock Exchange (the

## II. Developments in Corporate Governance and Shareholder Activism

“Code”). Broadly, the revised Code made changes to three areas of corporate governance which we discuss below – (1) director remuneration, (2) the function and composition of the board of directors and (3) issuers’ relationships with their stakeholders.

The Code has long been considered a ‘gold’ standard for the corporate governance of listed groups. However, a comprehensive review of and consultation on the Code took place in 2017 against the backdrop of declining trust in big business and increased public scrutiny around corporate governance conduct. With this in mind, the U.K. government, in its response document to a Green Paper Consultation on U.K. corporate governance reform, asked the FRC to update the Code to ensure that it continues to be fit for purpose. Under the LSE listing rules, an issuer must, as always, provide (1) a statement of how it has applied the Code’s principles and (2) a statement that it has complied with all relevant provisions of the Code or, if not, an explanation as to why (“comply or explain”). As a result, the Code remains flexible if a particular issuer chooses to explain its non-compliance.

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### a. Remuneration

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The area of director remuneration, as noted above, has received the most attention from the press and public generally, and so it is unsurprising that this part of the revised Code has seen some significant changes.

The main change to director remuneration under the Code is that executive share awards are now required to have a minimum vesting of five years (rather than three) from their date of grant. The total vesting and holding period of five-plus years would not include deferred elements of annual bonuses, which typically vest over a shorter period. Additionally, another change coming out of the revised Code with respect to remuneration schemes and policies is that formulaic calculations of performance-related pay should be rejected and instead discretion should be capable of being applied when the resulting outcome is not justified.

Another important change is that the chair of the remuneration committee should now have at least 12

months’ experience on a remuneration committee. This acknowledges the complexities of executive and senior management compensation. The revised Code also clarifies expectations with respect to pensions of executive directors, explaining that they should be in line with those available to the workforce.

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### b. Director Responsibilities

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Acknowledging the significant commitments required from board members, the revised Code also requires directors to disclose other significant commitments unrelated to the company, together with an indication of the time involved for each matter. Additional external appointments should not be undertaken without the board’s prior approval, with any permissions given explained in the annual report. The revised Code also notes that full-time executive directors should not take on more than one non-executive directorship in a FTSE 100 company or other such significant appointment.

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### c. Composition, Succession and Evolution

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The Code amendments to board composition reflect a continuing focus on promoting diversity. A principle of the revised Code is to ensure that appointments and successions should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths. The changes include requiring the remuneration committee to report in the annual report on how it is achieving a diverse pipeline of senior managers, the gender balance of senior managers and how diversity supports the issuer more generally.

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### d. Leadership and Purpose

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The revised Code requires boards to “understand the views of the company’s other key stakeholders.” Boards should establish a method for gathering the views of the workforce and the FRC suggests three options for doing so: appointing (1) a director from the workforce; (2) a formal workplace advisory panel; or (3) a designated workforce non-executive director. Issuers will need to consider which of these options, or such other alternative way of promoting

## II. Developments in Corporate Governance and Shareholder Activism

dialogue between the workforce and the board, should be implemented after January 1, 2019.

Issuers must also now explain what actions they intend to take to consult with shareholders to understand the reasons behind any vote where more than 20% of shareholders dissent. Issuers are required to provide updates six months after the dissenting vote as well as in the next annual report.

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### e. Practical Implications of the Code Amendments

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It will be important for issuers, including members of their board, general counsels and company secretaries, to familiarize themselves with the revised Code to ensure compliance and to consider how the disclosure requirements will be satisfied in the annual report for the 2019 fiscal year.

In the sphere of management remuneration, equity compensation plans may need to be revised, or deviations explained, in light of the new minimum vesting provisions and also to introduce discretion, where it does not already exist, for boards to override “formulaic outcomes.”

When liaising with stakeholders and particularly with their workforces, issuers should consider what approach best suits these relationships. Issuers should consider which of the three workforce engagement options would be most effective, or whether a bespoke engagement mechanism would be more appropriate.

In relation to the revised independence criteria, it may be necessary to plan for, and make, difficult decisions related to, the new rules and the tenure of many chairs. Issuers should ensure that they have procedures to pre-clear and gather current information on directorships with other companies to avoid ‘over-boarding’ (i.e., whereby non-executive directors hold multiple directorships).

Issuers should consider whether committees require any further training or support given their increased remit under the revised Code. Committees may also require greater access to human resources departments and department heads to properly address the requirements of their roles related to succession.

A copy of our client alert on the U.K. Corporate Governance Code is available at [https://www.willkie.com/-/media/Files/Publications/2018/07/Financial\\_Reporting\\_Council\\_Publishes\\_Updated\\_UK\\_Corporate\\_Governance\\_Code.pdf](https://www.willkie.com/-/media/Files/Publications/2018/07/Financial_Reporting_Council_Publishes_Updated_UK_Corporate_Governance_Code.pdf).

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### iii. Corporate Governance Principles for Large Private Companies

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In parallel to the revised Code for premium listed companies, the FRC has also recently published the final version of the six Corporate Governance Principles for Large Private Companies (the “**Principles**”), in response to the need for improved transparency and accountability in the corporate governance of large private companies. The Principles, which exist as a complement to the directors’ duties enshrined in section 172 of the Companies Act 2006, and which are designed to help companies comply with new corporate governance disclosure requirements introduced in June under the Companies (Miscellaneous Reporting) Regulations 2018, apply for accounting periods starting on or after January 1, 2019 to all U.K.-incorporated companies which are not listed on the premium segment of the London Stock Exchange with more than 2,000 employees, or a turnover of more than £200 million and a balance sheet of over £2 billion, assessed for the individual company rather than on a consolidated basis.

The six Principles are centered around (1) purpose and leadership — an effective board develops and promotes the purpose of a company and ensures that its values, strategy and culture align with that purpose, (2) board composition — effective board composition requires an effective chair and a balance of skills, backgrounds, experience and knowledge, with individual directors having sufficient capacity to make a valuable contribution, and the size of a board being guided by the scale and complexity of the company, (3) board responsibilities — the board and individual directors should have a clear understanding of their accountability and responsibilities and the board’s policies and procedures should support effective decision-making and independent challenge, (4) opportunity and risk — a board should promote the long-term sustainable success of the company by identifying opportunities to create and preserve value

## II. Developments in Corporate Governance and Shareholder Activism

and establishing oversight for the identification and mitigation of risks, (5) remuneration — a board should promote executive remuneration structures aligned to the long-term sustainable success of a company, taking into account pay and conditions elsewhere in the company and (6) stakeholder relationships and engagement — directors should foster effective stakeholder relationships aligned to the company's purpose with the board being responsible for overseeing meaningful engagement with stakeholders, including the workforce, and having regard to their views when taking decisions.

Companies adopting the Principles should follow them using an 'apply and explain' approach in a way that is most appropriate for their particular organization. This provides flexibility similar to the Code's 'comply or explain' approach for premium listed companies, which permits explanations of non-compliance. As this is the first attempt at drafting a corporate governance code fit for adoption by unlisted, private companies, it remains to be seen whether the Principles will come to represent a defining moment for the corporate governance of large, private U.K. insurance companies or whether it will require additional disclosures in the preparation of the annual report filed with U.K. Companies House.

### III. INSURANCE-LINKED SECURITIES

#### A. Return to Normalcy?

Insurance-Linked Securities (“**ILS**”) is the name given to a broad group of risk-transfer products through which insurance and reinsurance risk is ceded to the capital markets. This group of products is continually evolving to meet market and investor demand, and includes catastrophe bonds, sidecars, industry loss warranties, collateralized reinsurance and insurance-based asset management vehicles.

Drawn by low-correlated asset returns, particularly in a historically low interest rate environment, the amount of capital supporting the ILS market has grown considerably over the last several years as international pension funds, endowments, family offices and other large pools of capital have increased their investment allocation to ILS-dedicated asset managers.

Once a niche alternative to traditional reinsurance, ILS has developed into a mainstream component of insurance risk-taking capacity, often competing directly in or alongside traditional reinsurance catastrophe programs, in addition to more liquid securities products, such as cat bonds.

A confluence of natural catastrophes and other market events during 2018 has brought the ILS asset class to its most pivotal moment to date. On the heels of Hurricanes Harvey-Irma-Maria (HIM) in 2017, 2018 again saw significant losses, but this time from California wildfires (the Camp and Woolsey fires), Hurricanes Michael and Florence, Typhoon Jebi, as well as continuing loss reserve deterioration from Hurricane Irma. Unlike prior year catastrophes, losses in 2018 stemmed mostly from peripheral perils that had previously not drawn much attention from reinsurers and ILS funds and, arguably, were not underwritten with adequate premium rates.

In addition, although the market was hopeful that the three major hurricanes of 2017 would produce an increase in reinsurance and ILS rates, those increases failed to

materialize. Many ILS fund managers were signaling to the market for several years that they had underlying investors that would enter the market or increase their allocations following a bad catastrophe year. This available capital created a self-defeating prophecy for rate increases, as there was ample supply to dampen the post-event opportunity. The lack of rate increases in 2018 only exacerbated the impact of the California wildfires and natural catastrophe events.

The overall poor performance of the asset class for two consecutive years, particularly from unexpected catastrophe events in 2018, triggered significant redemptions at some of the largest ILS funds.

Some of the market indicators around January 1, 2019 renewals are that the major catastrophe losses of the last two years have taken their toll to temper investor appetite for certain reinsurance structures, such as sidecars. The emerging industry view seems to be that investors are beginning to exercise a greater degree of discipline and patience about where to commit their available capital. Is this a return to normalcy? Namely, does increased investor discipline signal a return to a more normalized investor and sponsor dynamic? While we do not believe that we will see a significant hardening of the market overall, there may be geographies or cedants where this is not the case, and there will likely be an evolutionary sorting of “winners and losers” among ILS sponsor and capacity providers.

While these market dynamics will continue to play out in 2019, we would like to highlight several important considerations below:

- Sidecars remained a popular issuance vehicle in 2018, with many established sidecars continuing to access the market, such as Swiss Re’s Sector Re, Munich Re’s Eden Re and Leo Re, Liberty Mutual’s Limestone Re, PartnerRe’s Lorenz Re, Argo Re’s Harambee Re, MS Amlin’s Viribus Re, among others. In addition, new entrants included AXIS Insurance with dual insurance and reinsurance sidecar structures, Peak Re’s Lion’s Rock Re. Although the total number of transactions remained high, market conditions were particularly choppy in the fourth quarter, with the



### III. Insurance-Linked Securities

size of transactions challenged by tight market conditions. This was the first time in recent memory that market capacity for insurance securitization vehicles disappointed sponsors.

- An important test for 2019 will be whether recent conditions in the sidecar market impact more traditional catastrophe bond structures. Sidecars are still a relatively small part of the insurance securitization market, and provide a different risk profile and investment case than catastrophe bonds (in very basic terms, sidecars perform more like equities and cat bonds more like fixed income securities). 2018 was an historic year in terms of primary cat bond issuance volume, with approximately \$13.85 billion in new issuances and total outstanding volume reaching approximately \$37.8 billion at year end (based on data published by [www.artemis.bm](http://www.artemis.bm)). While it is our view that the market dynamics affecting sidecars will not necessarily impact the overall cat bond market, we believe that recent experience will cause sponsors to focus more on price and capacity during the first half of 2019 rather than continuing to push on terms and expanded coverage. These questions will begin to be answered in the first half of 2019 as the bulk of cat bond deals are brought to market ahead of June 1 renewals.
- Although ILS fund redemptions have been an important story during 2018, the reduction of capital has certainly not been universal across platforms. Instead, the market may see a much-needed differentiation of asset and reinsurance managers based on underwriting performance and whether the manager adds value across the risk transfer chain. We believe this differentiation is ultimately in the best interests of the industry. For instance, in December, RenRe announced that it had launched Vermeer Reinsurance Ltd., a new A.M. Best rated property catastrophe reinsurer backed by PGGM, a Dutch pension fund service provider with €215 billion of assets under management. Vermeer will be initially capitalized with \$600 million of equity from PGGM, with up to a further \$400 million available to pursue growth opportunities in 2019, for a total of \$1 billion of capital. The company received an “A” financial strength rating from A.M. Best.
- An important footnote to the 2018 events is the issue of “trapped” capital in collateralized reinsurance, sidecars and cat bonds. In many of these collateral structures, the reinsurer is required to maintain capital at a multiple that decreases over time pursuant to a “buffer loss factor table.” These buffers could result in investor capital being tied up in a reinsurance trust for a considerable period of time, even though actual losses are expected at lower levels under the applicable reinsurance contract. While such buffers are common and agreed at the time of inception to account for reserve deterioration, this trapped capital has the potential to impact the overall capital in the overall market, lower ILS fund returns, and put added pressure on the terms of collateral release mechanisms. In addition, the long process of subrogation claims against California utility PG&E for wildfire losses, including its bankruptcy process, may further complicate the commutation of contracts and the release of trapped capital.
- 2018 witnessed significant M&A activity for ILS fund managers, which is a healthy sign for the maturation of the industry. In November, Nephila Holdings Limited announced the completion of its \$975 million sale to the Markel Corporation. Nephila is one of the largest ILS fund managers, with assets under management of approximately \$12.3 billion as of July 31, 2018, and has been managing institutional assets in this space since it was founded in 1998. Also in November, Neuberger Berman broadened its alternative investment platform through the acquisition of Cartesian Re, which with its affiliate Iris Re, manages more than \$1 billion in assets under management, focusing primarily on industry loss warranties. On December 6, 2018, Markel Corporation issued a press release announcing that it had been contacted by U.S. and Bermuda authorities with respect to inquiries into loss reserves recorded in late 2017 and early 2018 at Markel CATCo Investment Management Ltd and its subsidiaries. It is too early to tell what the outcome of such inquiries will be, or if it brings about increased regulatory scrutiny for ILS funds generally. However, Willkie is monitoring events very closely and updating our fund clients about broader regulatory implications to the industry.

### III. Insurance-Linked Securities

- 2018 was a significant year of growth for the mortgage insurance linked-note market, which provides excess of loss reinsurance protection to mortgage insurers. Primary issuances in 2018 were approximately \$3 billion in notes, with over \$4 billion issued since the launch of the first transaction in 2015. Willkie helped pioneer the technology for this market and has since represented four of the five issuers in all but one transaction, including Arch MI, Essent, NMI and Radian in multiple Rule 144A offerings. These innovative transactions combine diverse structural features from both the catastrophe bond and RMBS markets. Unlike a traditional catastrophe bond that provides coverage for natural catastrophes, such as hurricanes and earthquakes, investors in mortgage insurance-linked notes are exposed to the risk of defaults on a fixed, but amortizing pool of insured residential mortgage loans. The mortgage insurance-linked note market helps to demonstrate the power of ILS technology to transform other lines of insurance business, such as mortgage insurance. We expect this innovation to continue in 2019.

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#### B. U.K. ILS Framework

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As we previously reported, the new U.K. [ILS regulatory and tax framework](#) was passed into law by the U.K. government towards the end of 2017, after a significant amount of work between the regulators, industry, and the government itself, as well as consultative contributions from relevant professional services firms including Willkie. Several sponsors have incorporated new protected cell companies and others have taken advantage of the full U.K. ILS framework, with its regulatory and tax advantages. See our client alert on the new framework: [https://www.willkie.com/-/media/Files/Publications/2017/11/UK\\_ILS\\_Regime\\_Proposed\\_Final\\_Draft\\_of\\_the\\_Risk\\_Transformation\\_Regulations.pdf](https://www.willkie.com/-/media/Files/Publications/2017/11/UK_ILS_Regime_Proposed_Final_Draft_of_the_Risk_Transformation_Regulations.pdf).

In January 2018, Neon raised third party capital to support the U.K.'s first ILS transaction by U.K.-domiciled protected cell company, NCM Re (U.K. PCC) Ltd. The inaugural U.K. ILS transaction by Neon launched on January 1, 2018 as a \$72 million collateralized quota share reinsurance transaction,

underwriting a portion of Neon Syndicate 2468's property treaty reinsurance and direct and facultative portfolios.

In May 2018, SCOR availed of the U.K. ILS regime to launch the French reinsurance firm's first catastrophe bond since 2016, issuing \$300 million of Series 2018 ISPV 1 notes issued by Atlas Capital U.K. 2018 plc. The Atlas Capital catastrophe bond is the first cat bond issuance under the U.K. ILS regime, a milestone that places the U.K. now ahead of some domiciles where only collateralized reinsurance has been transacted so far.

In November 2018, Brit received approval from the U.K. Prudential Regulation Authority ("**PRA**") to establish the first multi-arrangement ISPV ("**MISPV**") under the U.K. ILS regime, meaning Brit's MISPV, Sussex Capital U.K. PCC (funded by Brit's Sussex Capital unit, which features an open-ended ILS fund and underwrites collateralized reinsurance through Bermuda special purpose insurance vehicle Sussex Re), will be able to write collateralized reinsurance deals for multiple cedants, as opposed to the single-cedant structures contemplated by the two prior U.K. ILS vehicles. The addition of a U.K. domiciled collateralized reinsurance underwriting vehicle means Brit can now more easily offer protection options to clients that might prefer their transaction located within the U.K., which may be attractive to some Lloyd's syndicates.

The PRA, backed by the U.K. Government, continues to note the importance of ILS to the U.K.'s competitiveness. As part of this ongoing initiative, the London Stock Exchange, on December 17, 2018, has launched a consultation process in connection with the proposed amendments to the International Securities Market Rulebook to accommodate the listing of U.K. ILS instruments (Market Notice 16/18). Willkie has worked in consultation with the London Stock Exchange in the development phase prior to the publication of Market Notice 16/18 and responded formally to the official consultation.

With a track record now being established, first through the NCM Re sidecar, then by the issuance of the Atlas Capital catastrophe bond, followed most recently by the Brit MISPV, these efforts are beginning to yield results in the

### III. Insurance-Linked Securities

initiative to turn the U.K. into a competitive ILS domicile. While Brexit has been said to be a potential deterrent for some sponsors of U.K. ILS deals, it's clearly not stopping all potential sponsors from testing the new regulations, with a number of ILS fund managers and reinsurer sponsors testing the appropriateness of having a U.K. domiciled reinsurance transformer vehicle established.

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#### **C. Other ILS Regulatory Developments - Guernsey**

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In December, the Guernsey regulators agreed to formally allow cells of regulated protected cell companies in Guernsey a 30-day grace period for the application of collateral at their inception and when deals within the structures are renewed. The issue of collateral rollover, in particular at the renewal of a transaction, has long been highlighted as a potential concern for the ILS market. ILS fund managers, (re)insurance sponsor cedants and investors have sought to strike the right balance between having sufficient cover in place for the cedant in the event of early-occurring losses, before collateral has rolled from the expiring prior year's cell, and on the other hand, being adequately responsive to investor concerns around the cost of trapped capital year-on-year.

Reasoning this is a commercial decision for the ILS sector to take with the full knowledge and acceptance of the cedants involved, the Guernsey International Insurance Association agreed to accommodate this 30-day provision, where an ILS cell would not be considered to breach its fully-funded requirements if the collateral was not in place yet. At time of writing, neither Bermuda nor the U.K. have an equivalent 'collateral grace period' concept.

## IV. Excess Reserve Financings

### IV. EXCESS RESERVE FINANCINGS

#### A. Summary of Deal Activity

2018 continued the optimistic trend started in 2016 as the number of new excess reserve financing transactions remained consistent with 2017.

Prior to 2016, the number of excess reserve financing transactions was impacted by an abundance of caution from both regulators and insurance companies in the life insurance reserve financing market. This was in large part a result of the National Association of Insurance Commissioners<sup>2</sup> (“NAIC”) Captives and Special Purpose Vehicle Use (E) Subgroup activities, and in particular the adoption by the NAIC of Actuarial Guideline 48 (“AG 48”) in late 2014 (as further described in subsection C. of this section below), which applies to all policies issued after December 31, 2014 which fall under regulation XXX or AXXX.

In 2017 and 2018, new excess reserve financing transactions picked up due to an increased level of certainty as to what will be permitted by regulators in present and future financings. In addition to an increase in new transactions, companies continued the trend of restructuring existing transactions to take advantage of lower lending rates and the continued interest by reinsurance companies in acting as financing providers. In addition, some companies were interested in financing XXX and AXXX without the use of a captive by adding admitted assets to the balance sheet of the insurer. Most insurers that have a history of excess reserve financing transactions completed the process of addressing the complexities of AG 48 issues in late 2016 or early 2017, with many closing new transactions involving AG 48 covered policies, or adding a block of AG 48 policies to an existing transaction, in 2018.

<sup>2</sup> The organization composed of the chief insurance regulatory executives in each state and other U.S. territories.

#### i. AXXX Market Remains Open

As was the case in 2017, several recent transactions were designed to provide reserve financing for universal life policies subject to Regulation AXXX. In 2018, the expansion of lenders willing to provide financing to fund AXXX reserves continued the trend that started in 2012. In most transactions in both the XXX and AXXX markets, commitments were for 10-25 years, although it is still common to see shorter terms intended to act as a financing bridge until other expected sources of funding become available.

#### ii. Non-Recourse Transactions Remain the Structure of Choice

In 2014, prior to the effective date of AG 48, the vast majority of deals were secured by non-recourse letters of credit, contingent notes or collateral notes, as those transactions had essentially replaced traditional letters of credit among lenders and reinsurance companies active in the AXXX/XXX market. In 2015, we saw a return to, or at least a heightened interest in, traditional letters of credit. In 2016 and 2017, we saw a return to the non-recourse contingent note structure, which remained by far the structure of choice in 2018. In the past, the obligation to reimburse the bank for any draw on the letter of credit was guaranteed by a parent holding company, thus being known as a “recourse” transaction. In a non-recourse transaction, no such guaranty is required. Rather, the ability to draw on the letter of credit or contingent note is subject to certain conditions precedent. These conditions typically include, among others, the reduction of the funds backing economic reserves to zero and a reduction in a prescribed amount of the captive’s capital, and a draw limited to an amount necessary for the captive to pay claims then due. Because of these conditions, lenders and other funding sources became more comfortable assuming the risk of relying for repayment on the long term cash flows from a block of universal life policies. With the advent of AG 48, some regulators initially had approached a non-recourse transaction with added caution, where the proposed “Other Security” is a conditional draw letter of credit or a

## IV. Excess Reserve Financings

contingent draw note. 2018 continued to show that many regulators recognized that this approach is not expressly forbidden by the new rules, and that these bespoke sources of contingent funding are acceptable in the age of AG 48. Collateral notes (demand notes backed by pools of assets) may, but typically do not, contain these contingent features and therefore should remain acceptable for financing under AG 48, at least as "Other Security."

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### iii. Choice of Domicile for Captives and Limited Purpose Subsidiaries

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Vermont and Delaware remained the preferred domiciliary jurisdictions for captive life insurers in 2018. Several states have adopted captive insurer laws or have amended and expanded existing captive insurer laws over the past few years to facilitate reserve funding transactions. Similar to 2018, additional states, including Arizona, Nebraska and Iowa, were being utilized as captive insurer domiciliary jurisdictions. As has been the case for the last few years, the use of "Limited Purpose Subsidiary" statutes in several states have cooled off and may not currently be the captive of choice, at least for new AG 48 transactions. The exception would appear to be Iowa, where we have seen Iowa-domiciled insurers continuing to utilize the Limited Purpose Subsidiary law. The Limited Purpose Subsidiary ("LPS") statutes permit a ceding company to form a captive insurer in the same domiciliary state as the ceding insurer, which has proven to provide for a more streamlined regulatory approval process for a transaction.

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## B. Utilized Structures

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### i. Limited Purpose Subsidiaries

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We are not aware of any new transactions that closed in 2018 and that employed the use of an LPS law in a reserve financing transaction. Georgia, Indiana, Iowa and Texas have each promulgated an LPS statute. The advantage of an LPS over a captive insurer is that an LPS, once licensed, may provide its ceding company parent with full credit for reinsurance without posting any security in the form of a letter of credit or a credit for reinsurance trust. Under the LPS statutes, an LPS is permitted to take statutory financial statement credit for the face amount of letters of credit as

well as parental guaranties by statutory authority; the LPS need not seek regulatory approval for a permitted practice or other dispensation to use this accounting treatment. Although this was a major development in the ability to finance Regulation XXX/AXXX reserves, we have not seen the use of the LPS statutes take off as expected, likely as a result of the generally lackluster market activity in the past few years brought on by general caution on the part of insurers and regulators alike.

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### ii. Credit-Linked Notes and Collateral Notes vs. Letters of Credit

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As mentioned above, recent activity in the marketplace implies that the use of contingent credit-linked notes in a role that may be analogous to a "synthetic letter of credit" will continue, along with collateral notes, to be the structure of choice for excess reserve financing transactions. In the typical credit-linked note transactions, an SPV issues a puttable note to a captive insurer. The captive insurer's right to "put" a portion of the note back to the SPV in exchange for cash is contingent on the same types of conditions that would otherwise apply in a non-recourse contingent letter of credit transaction. The use of these notes, rather than letters of credit, has provided a means for reinsurance companies, which contractually agree to provide the funds to the SPV to satisfy the put, to enter a market that was once only available to banks. In collateral note transactions, demand notes backed by pools of assets are issued by an SPV to a credit for reinsurance trust on behalf of the captive. Collateral notes are typically rated and qualify as admitted assets. The assets that back the collateral notes can be provided by banks, reinsurance companies or other providers of collateral.

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### iii. Use of Excess of Loss Reinsurance as a Financing Source

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The use of excess of loss reinsurance agreements as a reserve financing source, although utilized in the market for several years now, saw a continued resurgence in 2018, with several financing transactions choosing an XOL policy over a credit-linked note format. In an XOL transaction, the captive reinsurer and the XOL provider, usually a

## IV. Excess Reserve Financings

professional reinsurer or reinsurance affiliate of a financial guaranty insurance company familiar with credit-linked note transactions and reserve financings generally, enter into an XOL agreement whereby the captive reinsures mortality risk and the XOL provider assumes the captive's collection risk. The XOL provider pays claims in excess of the economic reserve, or for a financing of policies under AG 48, the amount of "Other Security." The advantages to an XOL transaction over a credit-linked note transaction are the relative simplicity of the transaction structure and corresponding agreements, as well as a more familiar format to present to regulators. Because many of the same financing providers that participate in the credit-linked note market also offer XOL agreements as an alternative structure, we would not be surprised to see continued growth in XOL transactions in the future.

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### iv. Funding Sources Beyond Banks

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As outlined above, the market for funding sources in XXX and AXXX transactions has expanded beyond banks in recent years through the use of contingent credit-linked notes, collateral notes and XOL agreements. Large reinsurance companies have shown a keen interest in participating in these transactions through support of the SPVs that issue the contingent notes and collateral notes and through the use of XOL agreements. With the expansion of the group of potential funding sources for these transactions, life insurance companies can seek more competitive pricing and terms. Although the past few years have shown a trend of reinsurance companies surpassing banks as the primary "risk taker" in these transactions, we would note that in 2018 the market witnessed at least one bank actively and successfully enter this market as well as at least one financial guaranty insurer, which may portend the beginning of a resurgence by these companies in this market.

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### C. Regulatory Environment

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We noted above the importance of the NAIC's adoption of AG 48, which was part of the NAIC action plan to develop further regulatory requirements with respect to XXX and AXXX transactions. The adoption of AG 48 in 2014 was

followed by the NAIC adopting the Term and Universal Life Insurance Reserve Financing Model Regulation and an amended version of AG 48 in December 2016. Importantly, the Model Regulation and AG 48 aim to set standards applicable to XXX and AXXX transactions, instead of restricting them outright.

For most states, the adoption of the Model Regulation will replace AG 48. According to the NAIC, as of November 2018, four states (*i.e.*, California, Iowa, Virginia and Wyoming) had adopted the Model Regulation.

Prior to 2018, the NAIC engaged in discussions to determine whether the Model Regulation should be adopted as a Part A Accreditation Standard (which would have the substantive effect of requiring all U.S. states to adopt the Model Regulation within the next few years). At that time, this accreditation decision was deferred until the finalization of the changes that will need to be made to the Credit for Reinsurance Model Law (which authorizes state insurance departments to promulgate the Model Regulation) as part of the NAIC's response to the Covered Agreement between the United States and the European Union. The NAIC is expected to finalize these changes to the Credit for Reinsurance Model Law in early 2019, and it is possible that discussions as to whether the Model Regulation should be adopted as a Part A Accreditation Standard will resume shortly thereafter.

## V. Longevity, Pension Close-outs and De-risking Transactions

### V. LONGEVITY, PENSION CLOSE-OUTS AND DE-RISKING TRANSACTIONS

2018 was a relatively quiet year for longevity transactions in Europe. The most encouraging European geographical expansion was seen in the Dutch market, which historically was dominated by index-linked longevity transactions. We previously reported that NN Life (part of the Nationale-Nederlanden Group) entered into an index-based longevity derivative with reinsurer Hannover Re that protects NN Life against the longevity risk associated with approximately €3 billion of its liabilities. We had hoped this would mark the resurgence of index-linked longevity transactions following the regulatory scrutiny which negatively impacted the market during 2015 and 2016; however, despite the fact that there is certainly a great deal of interest and debate surrounding this market, no further index-linked transactions were announced publicly during 2018. While market participants continue to seek solutions to reduce basis risk originating from index-linked longevity transactions, it appears as if indemnity solutions will continue to dominate the longevity market.

The U.K. bulk annuities market demonstrated one of its best years, with buy-in and buy-out transactions set to exceed £20 billion, an increase of 50% compared to the previous record of £13.2 billion set in 2014. There have been several “jumbo” bulk annuities of more than £1 billion during 2018.

The number of active insurers in the U.K. bulk annuities market has remain unchanged over the course of the year and there are currently eight insurers quoting in the market. Both Prudential plc and Standard Life disposed of significant individual and bulk annuity portfolios during 2018. Prudential plc transferred £12 billion of annuity liabilities to Rotheray Life pursuant to an interim reinsurance followed by a Part VII transfer<sup>3</sup> and Phoenix Life acquired £5 billion of annuity liabilities from Standard Life. Encouragingly, as demonstrated by the high deal volume of buy-in and buy-

out transactions in 2018, it does not appear as if these substantial transfers have dampened insurer appetite for bulk annuities.

Following a robust year for bulk annuities, demand for longevity reinsurance capacity continues to be strong. The trend we have witnessed in previous years whereby insurers and reinsurers develop close working relationships and, in some instances, develop preferred terms, by (for example) establishing facility arrangements or putting in place master collateral and/or payment netting arrangements across the business relationship, has continued. This is a hugely positive development for the market and we are witnessing a drastic reduction in the time it takes to get relatively complex longevity-only reinsurance transactions from pricing to execution. New reinsurance relationships have been established during 2018. In February, Prudential Financial (“**Prudential Financial**”) announced that it had completed a \$1.8 billion longevity reinsurance arrangement for Scottish Widows Limited, a subsidiary of Lloyds Banking Group plc. The direct longevity risk transfer and reinsurance arrangement saw Prudential Financial assume the longevity risk on approximately \$1.8 billion (£1.3 billion) of annuity liabilities held by Scottish Widows within its life and annuities book. In the first transaction between the pair, Prudential Financial closed a major longevity reinsurance transaction with Aviva Life & Pensions U.K. Limited in August 2018, which covered \$1.4 billion of longevity liabilities in respect of the pension scheme of a FTSE 100 company. Pension Insurance Corporation (“**PIC**”) also announced a £725 million longevity reinsurance transaction with Bermuda-based reinsurer Partner Re in respect of the Dockworkers Pension Fund. Prudential Financial and PIC have also had a busy year – the parties have established flow reinsurance terms, whereby Prudential offers advance commitment of capital and known reinsurance capacity pricing to PIC. The facility allows PIC to roll up multiple smaller pension risk transfer transactions into a single closing, and consequently, PIC is able to offer more efficient risk transfer solutions that meet the needs of small pension schemes. Prudential Financial and PIC also announced their sixth longevity reinsurance arrangement, a \$1.2 billion deal covering around 7,500 pensioners in May 2018 and further

<sup>3</sup> See below Section VII.B.v, “Principal Regulatory Developments Affecting Insurance Companies—European and U.K. Regulatory Developments—Updates in Relation to Part VII Transfers” for recent developments.

## V. Longevity, Pension Close-outs and De-risking Transactions

transactions between the pair remain undisclosed at the time of publication. PIC has also transacted with French reinsurer, SCOR, by completing a £1.2 billion longevity reinsurance transaction, covering the longevity risk of around 8,000 beneficiaries.

Zurich has, in the past, insured the smaller side of the longevity-only market through their “streamlined structure”, which was designed to provide small schemes with access to the reinsurance market. However, in 2018, Zurich completed its largest ever longevity swap arrangement, an intermediated arrangement that covers more than £2 billion of pension liabilities for the U.K.’s National Grid Electricity Group of the Electricity Supply Pension Scheme. We understand that a significant proportion of the longevity risk assumed has been transferred by Zurich through a longevity reinsurance transaction with Canada Life Reinsurance. During 2018, we also saw Legal & General (“L&G”) insure on the smaller side of the longevity-only market by intermediating the transfer of £300 million of longevity liabilities from a mid-sized U.K. pension scheme to the reinsurance market (in this case, SCOR). Despite being a dominant transaction structure during 2017, we have not witnessed any significant offshore captive intermediated transactions in 2018; however, we believe it likely that similar transaction structures will re-appear during 2019.

Following the first example of a conversion of a longevity swap written by Phoenix Life in favor of the Phoenix Group’s own pension scheme, the PGL Pension Scheme, into a £1.2 billion buy-in, L&G converted a longevity swap it already had already entered into with a pension scheme of British Airways into a \$4.4 billion pensioner buy-in, the largest bulk annuity transaction to-date.

Despite the uncertainty surrounding Brexit, deal volume during 2018 was not negatively impacted. We previously noted the dissatisfaction of both the U.K. insurance industry and the PRA with the risk margin calculation under Solvency II as clearly an area to keep an eye on during 2018. The House of Commons Treasury Committee (“Committee”) called for the PRA to provide a report detailing, among other things, a solution to the risk margin to improve calibration and in June 2018 the PRA responded.

Although the PRA acknowledged that the risk margin is too sensitive to interest rates, prompting insurers to reinsure a substantial proportion of longevity risk offshore, they have no concerns with respect to the way in which such reinsurance business is being conducted. In light of ongoing uncertainty about the U.K.’s future with the European Union in relation to financial services, the PRA responded that it does not see a durable way to implement a change at this stage. They promised to keep the position under review and will be updating the Committee when there is a clearer way forward on the state of the Brexit plans. The issue with the risk margin therefore remains one to watch but we do not anticipate any interruption to longevity reinsurance as a result of Brexit or the risk margin in 2019.

2018 also saw further strides taken towards the expansion of the longevity risk transfer market through the use of capital markets solutions and transactions that allow insurers to transfer both market risk as well as longevity risk. The market is in its infancy and much of the activity has involved proof of concept transactions and/or the establishment of strategic partnerships between sponsoring reinsurers and offshore reinsurance sidecars, who may, for example, be interested in taking exposure to market risk. We believe that reinsurance sidecars have the potential to provide much needed additional capital to the market, in a form that is not subject to a requirement to hold a regulatory solvency capital buffer, thereby enabling sponsoring reinsurers to offer keener pricing to insurers. As a result, an E.U.-based insurer could gain considerable capital benefits by reinsuring longevity risk, market risk, or both to a reinsurance sidecar. We expect to see more activity in this space in 2019.

Similar steps were taken in the U.S. market, where early 2018 saw the announcement of Langhorne Re, a closed-end Bermudan reinsurance vehicle established by U.S. life and health insurer Reinsurance Group of America (“RGA”) and Bermuda (re)/insurer RenRe. It was reported that Langhorne intends to acquire closed in-force life and annuity blocks and has approximately U.S.\$780 million in equity, shared by the two sponsors and other third-party pension fund and life insurer commitments, to support such acquisitions. RenRe will assume primary asset and



## V. Longevity, Pension Close-outs and De-risking Transactions

investment management responsibilities for the vehicle, RGA will originate and administer the relevant policies, and the two will share management fees equally. Langhorne has indicated that it is ultimately seeking to manage \$5-6 billion in assets, which suggests that it will aggressively pursue acquisitions and investments. The first such acquisition, which saw Langhorne acquire Arizona-based Zale Life Insurance Company, was announced in July.

Turning to the U.S. market more broadly, we noted previously that commentators expected the U.S. market to reach between \$18 and \$20 billion in total volume by year end as a result of the highest third quarter sales volume since the late 1980s. These predictions proved to be too modest as the market's final tally reached \$23 billion. That total represented a 68% increase over 2016 and made 2017 the busiest year since 2012. The 2017 mark is all the more impressive given that two transactions (the \$25 billion and \$7.5 billion "jumbo" deals between Prudential Financial and General Motors and Verizon, respectively) accounted for the bulk of 2017's total volume. 2017, in contrast, saw a proliferating variety of smaller and medium sized deals, mixed with a trend away from jumbo deals, as we noted previously.

2018 saw the U.S. market continue its focus on small to medium sized deals, while surpassing its impressive 2017 performance. By the end of the third quarter of 2018, reported buy-out transactions had already surpassed 2017 in both deal volume (22 deals to 19) and asset volume (\$31.7 billion to \$20.2 billion). The number of insurance companies offering pension risk transfer services in 2018 remained steady at 15, which is nearly double the number of participants from just a few years ago. Indeed, market watchers have noted that these insurers have invested in the additional staff and administrative infrastructure needed to support pension risk transfers, which has helped the market to grow.

The high volume of sales in the U.S. market in 2018 appears to have been spurred by the same factors as in the prior year. As was the case in 2017, commentators pointed to the significantly increased premiums payable to the Pension Benefit Guaranty Corporation ("**PBGC**") as a key

factor in motivating plan sponsors to de-risk. As we noted in our 2017 Year In Review, the 2012 Moving Ahead for Progress in the 21st Century mandated regular increases to the fixed and variable rate premiums charged by the PGBC, and as a result, the fixed rate premium rose to \$74 per plan participant in 2018 (more than double the 2012 rate of \$35), while the variable rate premium reached \$38 per plan participant (more than 4 times the 2012 rate of \$9). As industry professionals have pointed out, these increases have created a strategic need for plans to reduce the number of participants with lower monthly benefits, since the premium for those participants, assessed per head, is disproportionately expensive.

In addition, market-watchers have also noted that changes in corporate tax rates (ushered in by the December 2017 Tax Cut and Jobs Act—see *below* Section VIII.A, "Tax Trends and Developments Affecting Insurance Companies—U.S. Tax Developments" for more information), increasing interest rates (which can improve pension funding ratios) and market volatility could spur activity in the pension and longevity risk transfer markets. The impact of the Tax Cut and Jobs Act should be limited, as most sponsors operating on a calendar tax year had until mid-September to make plan contributions that would be deductible at the higher rates in effect prior to the Act's passage. Interest rates and market volatility could have a greater effect over the longer term, though it remains to be seen whether these factors contributed to the market's strong performance in 2018 or whether they may have an impact in the future.

Commentators have also noted that interest among plan sponsors and insurers remains high. Such interest was underscored by Alcoa's announcement in January that it plans to purchase \$300 million in annuities to cover the pension liabilities for approximately 9,000 retirees and beneficiaries. Although it did not provide a specific timeline for these purchases, Alcoa stated that it plans to freeze its defined benefit plans and discontinue the subsidy it currently offers to certain U.S. retirees who do not qualify for Medicare in 2021.

Interest was also high among insurers. In May, AIG announced its intention to grow its presence in the pension

## V. Longevity, Pension Close-outs and De-risking Transactions

risk transfer market by building on two plan termination transactions concluded in 2017. These transactions transferred approximately \$1.5 billion in liabilities to AIG. Similarly, U.K.-based insurer L&G announced in June that it intends to expand its pension risk transfer business to become a “major player” in the U.S. market. L&G reported that it has assumed an aggregate of nearly \$2 billion in pension liabilities for 28 clients in less than three years.

Other noteworthy deals and developments in 2018 included the announcement in May that MetLife (“**MetLife**”) and FedEx reached an agreement on a “jumbo” transaction that saw FedEx transfer to MetLife approximately \$6 billion in pension liabilities for around 41,000 retirees and beneficiaries. This deal was the largest deal announced in the U.S. market since Prudential Financial’s 2012 deals with General Motors and Verizon (which, as noted above, transferred approximately \$25 billion and \$7.5 billion in liabilities, respectively).

Prudential Financial was also busy in 2018. In July, Prudential Financial announced the sale of a \$923 million group annuity contract to Raytheon Company, the Massachusetts-based defense contractor. The deal transferred pension obligations for approximately 13,000 retirees and beneficiaries to Prudential Financial. In October, Prudential Financial announced a \$1.6 billion transaction with International Paper, which purchased a group annuity contract covering 23,000 retirees and beneficiaries. The deal is International Paper’s second with Prudential Financial in the space of one year. The two parties completed the transfer of \$1.3 billion in liabilities, covering 45,000 International Paper retirees and beneficiaries. As of October, Prudential Financial anticipated the closing of 18 or 19 transactions in total by year end, up from 13 in 2017.

In December, Athene announced a “first-of-its kind” full plan termination transaction to date with Bristol-Myers Squibb covering approximately 4,800 active employees, 1,400 retirees and their beneficiaries currently receiving benefits and 18,000 former employees who have not yet begun to receive benefits. It is anticipated that the transaction will cover \$3.8 billion in benefits when it closes in the third quarter of 2019. According to Bristol-

Myers Squibb, the “transaction provides a special election window for active Bristol-Myers Squibb employees who are participants in the Plan, during which they may elect to commence their pension benefits while remaining actively employed with Bristol-Myers Squibb. The Plan will terminate on February 1, 2019,” and participants who do not elect to receive a lump sum will be covered by the transaction. This transaction is likely to be at the forefront of a trend, identified by commentators, of expanding the pension risk transfer market beyond traditional retirees to those who still work for the relevant employer, but have not yet retired (i.e. “deferred” participants) and to those who have moved to other employment while retaining pension benefits.

Like the U.S., the Canadian pension risk transfer market maintained a high level of activity in 2018. By the end of the third quarter 2018, the market saw C\$2.9 billion (\$2.1 billion) in reported transfers—making it already the second busiest year on record, and positioning it to top last year’s total of C\$3.7 billion (\$2.7 billion). If that mark is exceeded, as commentators expect, the Canadian market will have grown for six successive years.

Industry professionals believe that a mix of factors has contributed to this growth, including solvency funded ratios, which reached an 18-year high in 2018, a stabilized pool of insurers, and legislative changes in British Columbia, Ontario and Quebec that permit plan sponsors to fully transfer responsibility to insurers without retaining any residual risk. Part of the market’s success has been attributed to the willingness and ability of plan sponsors and insurers to develop innovative, customized solutions to plan needs, including longevity risk transfer.

While Canada has rarely seen billion-dollar “jumbo” deals such as are relatively common in the U.K. and the U.S., three insurers (Sun Life, Desjardins Financial Security and Industrial Alliance) completed a C\$750 million (\$552 million) pension risk transfer from U.S.-based Alcoa in the first quarter. The transaction was part of a larger restructuring of Alcoa’s pension plans in the U.S. and Canada that saw the plan sponsor contribute \$95 million to its Canadian pension fund (and a further \$200 million to its

## V. Longevity, Pension Close-outs and De-risking Transactions

U.S. fund) that further reduced the plan's liabilities. The deal was the second largest in Canada to date, following only last year's C\$900 million (\$662 million) transfer between Sun Life, Canada Life, RBC Insurance and an undisclosed company.

Indications point to continued robust risk transfer markets in 2019 in the U.K. and North America. In the U.K., generally low costs for longevity risk transfers with reinsurance should assist market activity, while there is also expected to be regrowth in captive-structured "jumbo" transactions. De-risking in the U.S. is expected to continue in 2018 in response to continually rising PBGC premiums and increased interest rates, while stock market volatility adds a further incentive to that mix. In Canada, the generally high solvency of plans at the end of 2018 should help to sustain market development.

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### VI. CAPITAL MARKETS

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#### A. U.S. Capital Markets Activity

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##### i. Equity Offerings

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AXA Equitable Holdings Inc., the U.S. division of French insurance and asset management firm AXA SA, conducted its initial public offering in May, debuting at \$20.00 a share and raising \$2.75 billion in the largest initial public offering of 2018. The transaction enabled AXA Equitable to partially spin-off from its parent AXA and was followed by a subsequent sell down of an additional \$1.2 billion shares in November, at \$20.25 a share, which resulted in AXA reducing its interest to approximately 59%.

AXA Equitable sells retirement products, including annuities, and manages investments for clients. The company has more than \$650 billion of assets under management through its two principal franchises, AXA Equitable Life Insurance and AllianceBernstein, and is organized in four operating segments: Individual Retirement, Group Retirement, Investment Management and Research, and Protection Solutions. In 2018, the company implemented static hedge positions to maintain a target asset level for all variable annuities at or above a CTE98 level under most economic scenarios, and to maintain a CTE95 level even in extreme scenarios. For the non-variable annuity insurance businesses, AXA Equitable stated its aim to maintain a 350-400% RBC ratio, which, combined with the variable annuity capital, would result in a combined RBC ratio in excess of 500%.

The partial sale of AXA Equitable also helped to fund AXA's acquisition of XL Group Ltd, a global property and casualty commercial lines insurer and reinsurer, which was completed in September 2018.

Following its August 2017 partial spin-off of 80.8% of Brighthouse Financial, Inc., MetLife sold its remaining 19.2% stake of Brighthouse common stock in June 2018. The transaction was structured as a tax-free debt-for-equity exchange with MetLife receiving approximately \$944 million of its senior notes from certain investment

banks in return for the Brighthouse common stock. The investment banks had acquired the MetLife senior notes from third party investors in a series of tender offers prior to the exchange. After the investment banks had held the senior notes for a period of time, MetLife launched a secondary offering of its Brighthouse common stock and immediately prior to the pricing exchanged the senior notes for the Brighthouse common stock. The investment banks then sold the Brighthouse common stock to the market.

The debt-for-equity exchange reduced MetLife's indebtedness after the Brighthouse spin-off and was followed in 2018 by additional purchases of outstanding senior notes in June (\$160 million), August (\$566 million) and December (\$500 million). 2018 also saw MetLife issue \$500 million of non-cumulative preferred stock and \$805 million of depositary shares representing interests in non-cumulative preferred stock, with the proceeds of each issuance used in part to repay indebtedness.

In connection with the funding of its acquisition of The Warranty Group, Inc. for approximately \$2.5 billion, Assurant, Inc. sold \$250 million of mandatorily convertible preferred stock, \$400 million of subordinated notes and \$900 million of senior notes in March 2018. The preferred stock, subordinated notes and one series of the senior notes were redeemable to the extent the acquisition did not close, but one series of the senior notes did not include this feature and was used to refinance an existing series of Assurant's senior notes maturing in 2018. There were a number of secondary offerings of Assurant common stock, which had formed part of the acquisition consideration, by TWG related entities and persons in the third quarter of 2018.

In September 2018, Voya Financial, Inc. issued \$325 million of fixed-rate reset non-cumulative preferred stock. Dividends on the preferred stock will accrue at a fixed rate until the fifth anniversary of the issuance date, at which point the dividend rate will reset every five years to a rate equal to the then effective five-year U.S. treasury rate plus a fixed margin; Voya is able to redeem the preferred stock at its liquidation preference every five years. Concurrently with the preferred stock offering, Voya conducted two cash

## VI. Capital Markets

tender offers for any and all of three series of its debentures and a certain amount of a series of senior notes.

The Hartford Financial Services Group, Inc. sold \$300 million of depositary shares representing interests in its non-cumulative preferred stock in October 2018; the proceeds of which were used in part to fund its \$2.1 billion acquisition of The Navigators Group, Inc. The Hartford had previously issued \$500 million in senior notes in March 2018.

Other issuers of preferred stock in 2018 included The Allstate Corporation (\$500 million of depositary shares representing non-cumulative perpetual preferred stock), The Progressive Corporation (\$500 million of cumulative perpetual series preferred shares) and RenRe (\$250 million of depositary shares representing interests in preference shares).

In November 2018, National General Holdings Corp. sold \$120 million shares of common stock with the proceeds used in part to finance the company's acquisition of National Farmers Union Insurance and in part to support the company's current and future policy writings.

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### ii. Surplus Notes

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Surplus notes, which are issued by insurance operating companies under Rule 144A and Regulation S, are subordinate in right of payment to the insurance company's indebtedness and to policyholder claims. Similar to a standard debt security, surplus notes include a stated maturity and have periodic interest payments; however, principal, interest and redemptions of the surplus notes are subject to the prior approval of the insurance regulator of the issuer's state of domicile. If the regulator decides that the insurance company has insufficient funds to make a payment on the surplus notes without putting the insurance company or policyholders at risk, the regulator can cause the company to defer the scheduled payment.

Given the still historically low interest rate environment, surplus notes have been particularly popular for insurance companies over the last few years. According to A.M. Best,

from 2014 to 2017, the amount of surplus notes issued increased to \$49.5 billion from \$47.8 billion, although the number of issuers was down in 2018.

In July 2018, National Life Insurance Company issued \$350 million of fixed-to-floating rate surplus notes through a private placement and coupled that with an offer to exchange an existing series of its surplus notes for additional surplus notes to the same series it sold in the private placement. This is a similar approach to that taken by The Guardian Life Insurance Company, which sold \$350 million of newly issued surplus notes in January 2017 and later exchanged a prior series of surplus notes in January 2018 for additional notes of the January 2017 series.

In January 2019, following the closing of its \$1.55 billion acquisition of Gerber Life Insurance Company from Nestle S.A., The Western and Southern Life Insurance Company issued \$500 million of 30-year surplus notes. Western and Southern anticipates the proceeds from the surplus notes issuance to be utilized for general corporate purposes, which may include the repayment of amounts outstanding under the credit facility entered into in connection with the Gerber Life acquisition.

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### iii. Debt

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With interest rates rising only gradually in 2018, companies in the insurance industry regularly came to the market in advance of then anticipated interest rate increases in 2019. Multiple companies used the public markets to raise acquisition financing, while other companies took the opportunity presented by low spreads and investor demand to repurchase or redeem outstanding debt with high coupons and replace it with newly issued preferred stock or debt with lower coupons.

Lincoln National Corporation issued \$1.1 billion in senior notes in February 2018 to fund in part the cash portion of its transaction to acquire Liberty Life Assurance Company of Boston from Liberty Mutual Group. The transaction included reinsuring Liberty's Individual Life and Annuity business to Protective Life Insurance Company.

## VI. Capital Markets

In connection with its July 2018 \$5.5 billion acquisition of Validus Holdings, Ltd., AIG issued \$750 million of junior subordinated debentures and \$1.75 billion of senior notes in March. The junior subordinated debentures included redemption features in the event of a tax, rating agent or regulatory capital event, coupled with a special mandatory redemption in the event that the Validus acquisition was not completed; the senior notes did not include these redemption features.

In March 2018, Principal Financial Group, Inc. sold two series of pre-capitalized trust securities through two Delaware statutory trusts for \$750 million. The trusts used the proceeds of the trust securities issuance to purchase principal and interest strips of U.S. Treasury securities and Principal has the right from time to time to put senior notes guaranteed by an affiliate to the trusts in exchange for the U.S. Treasury strips at any time. Principal can also repurchase such senior notes from the trusts in exchange for a like amount of U.S. Treasury strips. Distributions on the trust securities are derived from the payments on the U.S. Treasury strips and a put option premium payable by Principal, which together amount to the interest payments that Principal would make on the senior notes. This structure, which has been utilized previously by Prudential Financial and Voya Financial, Inc., established a contingent facility that provides a guaranteed source of liquidity/capital for Principal.

Prior to its May 2018 IPO, in April, AXA Equitable sold a total of \$3.8 billion of senior notes of five, ten and thirty year maturities in a Rule 144A/Reg S offering. Holders of the unregistered senior notes also had the opportunity to exchange their securities in an A/B exchange offer, which AXA Equitable conducted in December 2018.

In October 2018, Nuveen, LLC, a wholly owned subsidiary of Teachers Insurance and Annuity Association of America (TIAA), issued \$1.0 billion of senior notes. TIAA acquired Nuveen in November 2014 and the new series of senior notes was used in part to fund the repayment of the earlier acquisition financing. In the refinancing TIAA, a regulated legal reserve life insurance company, fully and unconditionally guaranteed the Nuveen notes on a

senior basis, which is a somewhat novel structure in the marketplace and involved the prior review and approval of the New York Department of Financial Services, TIAA's principal regulator. The guarantee enabled the Nuveen issuance to achieve a higher credit rating from the rating agencies than it could expect on a standalone basis.

Other notable debt issuances during the year included issuances by Aflac Incorporated (\$550 million of senior notes and ¥53.4 billion of senior notes), The Allstate Corporation (\$500 million of senior notes), Aon Corporation (\$450 million of senior notes), Athene Holding Ltd. (\$1.0 billion of senior notes), Brighthouse Financial, Inc. (\$375 million of junior subordinated debentures), Chubb Limited (€1.8 billion of senior notes), Marsh & McLennan Companies, Inc. (\$600 million of senior notes), The Progressive Corporation (\$1.15 billion of senior notes), Prudential Financial, Inc. (\$1.5 billion of junior subordinated notes), Securian Financial Group, Inc. (\$500 million of senior notes), Torchmark Corporation (\$350 million of senior notes), Travelers Companies, Inc. (\$500 million of senior notes), Unum Group (\$300 million senior notes), Voya Financial, Inc. (\$350 million of junior subordinated notes), Willis North America Inc. (\$1.0 billion of senior notes) and W. R. Berkley Corporation (\$175 million of subordinated debentures).

Finally, in January 2019, Marsh & McLennan sold an aggregate of \$5.0 billion of senior notes, which it intends to use to fund, in part, its previously announced \$5.6 billion acquisition of Jardine Lloyd Thompson Group plc, a U.K.-headquartered provider of insurance, reinsurance and employee benefits related advice, brokerage and associated services

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### iv. Funding Agreement-Backed Notes

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Funding agreement-backed notes are designed to generate regular cash flows to service the debt on short- or medium-term notes issued through an SPV, and transfer credit quality of a policyholder claim at the insurance company to the notes of the SPV. In order to eliminate a mismatch, the terms of the funding agreements match the terms of notes to be issued by the SPV. The insurance company

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establishes the maximum aggregate principal amount for its funding agreement-backed notes program, but the notes can be issued in unlimited series or tranches.

Funding agreement-backed notes programs have been an attractive alternative for insurance companies that have participated in institutional investment markets to non-tradable guaranteed investment contracts (“**GICs**”) and standalone funding agreements. The notes attract a wider base of investors compared to illiquid GICs or funding agreements, which allows insurance companies to diversify their funding sources and reduce their overall cost of funds. From the investor’s perspective, the notes are tradeable securities, which offer access to highly-rated insurance company issuers at a level higher up in the capital structure than senior noteholders, with attractive relative spreads.

September 2018 saw Metropolitan Life Global Funding I issue floating rate notes tied to the new dollar funding benchmark that the Federal Reserve Bank of New York began to publish in April 2018 as an alternative to LIBOR, the secured overnight financing rate or SOFR. SOFR is calculated as a volume-weighted median of transaction-level tri-party repo data collected from the Bank of New York Mellon as well as GCF Repo transaction data and data on bilateral Treasury repo transactions cleared through FICC’s DVP service. Metropolitan Life was the first corporate name to issue SOFR-linked debt securities, following other benchmark transactions by Fannie Mae and the World Bank. Although there were only been a few additional SOFR note issuances in the fourth quarter of 2018, we expect other funding agreement-backed issuers will be adding SOFR as a floating rate benchmark in their offering documents this year.

As more fully discussed in “VI.B.i, European and U.K. Capital Markets Activity—Prospectus Regulation” (see *below*), Regulation (E.U.) 2017/1129 of the European Parliament and of the Council (the “**Prospectus Regulation**”) will come into force in full on July 21, 2019. The Prospectus Regulation’s Article 16 requires risk factors in the prospectus to be categorized by their nature and presented in order of their materiality. The European Securities and Markets Authority (“**ESMA**”) published a consultation

paper on risk factors in July 2018 seeking views on its draft guidelines to assist national competent authorities in their review of the specificity and materiality of risk factors, with the final report and guidelines to be published by March 31, 2019. Some funding-agreement issuers may choose to move their programs to other markets within the European Union, which are not subject to the Prospectus Regulation.

The market continues to be led by MetLife and New York Life but witnessed increased issuances from Principal Financial, Protective Life, Jackson National, Mass Mutual, AIG, Guardian, Prudential and Reliance Standard. MetLife has been the leading issuer of funding agreements in each of the last ten years, with New York Life the next largest. The year 2019 opened with nine new issuances in January, and we expect it to be a busy year as capacity continues to exist for additional issuances by industry participants based on stronger balance sheet positions, a reduction in operating leverage and a strengthening of statutory capital.

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### v. SEC Staff Comments

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In 2018, the SEC Staff continued to concentrate some of its comments on insurance company specific disclosure that we have discussed in prior years, but the staff was also interested in disclosure topics that are affecting registrants generally, regardless of their industry.

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#### a. Insurance Loss Reserves

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Significant judgement is required in connection with the preparation of disclosures related to insurance loss reserves. Short-duration contracts in particular require input from management and the SEC Staff has continued to focus on disclosure concerning and the appropriateness of these judgements. In particular, the SEC Staff has commented on the appropriateness of the level of aggregation of the information disclosed, especially when it involves the combination of information across reporting segments or products. The staff has also asked questions around the application of management judgement as to the impact of material acquisitions, reinsurance contracts and actuarial methodologies and assumptions on short-duration contract disclosure. To the extent that new information came to light

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during a reporting period, the SEC Staff commented on why this information was not available in the past, why it caused management to interpret things differently and challenging whether or not an adverse development resulting from new information should not instead be considered correcting an error.

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### b. Non-GAAP Financial Measure

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Following the Division of Corporation Finance's new non-GAAP compliance and disclosure interpretations in May 2016, which were subsequently updated in October 2017 and again in April 2018, the use of non-GAAP financial measures has resulted in frequent SEC Staff comments. Sometimes these comments have resulted in requests to remove or substantially modify non-GAAP measures, and often they have required companies to at least change some of the terminology being used. The most frequent comments have applied to (i) equal or greater prominence of the most directly comparable GAAP financial measure, (ii) reconciliation to the most comparable GAAP financial measure and (iii) the appropriateness of adjustments to eliminate or smooth items identified as non-recurring, infrequent or unusual. The SEC has also been prepared to take enforcement action against the more egregious violations and companies that they view as being repeat offenders.

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### c. Fair Value Measurement

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Similar to short-duration contracts, fair value measurements often require significant judgement from management and the SEC Staff has frequently commented on the disclosure companies make around those judgements and estimates. For example, in connection with Level 3 fair value measurements, the SEC Staff has asked companies about the quantitative information provided for significant unobservable inputs, including its sensitivity. The SEC Staff has also questioned company disclosure around the valuation techniques and inputs that companies have used to determine the fair value for significant classes of asset or liability, whether that determination has been made by a third party or by management. In addition, the staff has challenged the sufficiency of disclosure

relating to impairments and other non-recurring fair value measurements.

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## B. European and U.K. Capital Markets Activity

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### i. Prospectus Regulation

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The Prospectus Regulation (2017/1129) will come into force in full on July 21, 2019 and will repeal and replace the current Prospectus Directive (2003/71/EC) and Prospectus Regulation (809/2004).

Some provisions of the Prospectus Regulation are already in force, helpfully expanding the exemptions available from the requirement to publish an approved prospectus. For example, the exemption from the requirement to publish a prospectus for issuances of a class of securities already admitted to trading on a regulated market has been increased from 10% to 20% over a 12-month period of the class of securities already admitted to trading.

Another example of a provision of the Prospectus Regulation already in force relates to E.U. member states having been provided with the discretion to exempt from the requirement to publish an approved prospectus, public offers of securities with a total consideration in the E.U., calculated over a period of 12 months, of between €1 million and €8 million. The previous threshold was €5 million, calculated over a period of 12 months. The U.K. has set its threshold at €8 million. Notwithstanding this increase, we would note that other E.U. member states could set a lower discretionary threshold than the U.K., meaning issuers engaging in cross-border offerings will need to first check the corresponding discretionary threshold in each relevant E.U. member state into which they propose to market the offering.

Why the Prospectus Regulation? There were increasing calls from market participants to reform the European prospectus regime to make it more accessible for small and medium-sized enterprises seeking to raise capital. The European Commission identified the reform of the current European prospectus regime as a priority as part of its Capital Markets Union initiative intended to strengthen E.U. capital markets.



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Another key change being brought about as a result of the Prospectus Regulation will be the introduction of a new universal registration document regime (similar to the U.S. shelf registration scheme). The new regime should benefit frequent issuers, who will be able to gain faster access to the capital markets. Where a competent authority has approved an issuer's universal registration document for two consecutive years, future universal registration documents may be filed or amended without prior approval. Any prospectus published using a universal registration document will also benefit from a five working-day approval process (currently ten working days for other prospectuses). Additionally, issuers may use their universal registration document to satisfy their obligation to publish annual financial reports and half-yearly reports. Frequent issuers will appreciate the ability to consolidate their public filings, saving the time and expense currently required to replicate such information.

In addition, in other streamlining of disclosures, the Prospectus Regulation will introduce a new "prospectus-lite" regime, which will be available for follow-on issuances by issuers with existing securities admitted to trading on a regulated market continuously for the previous 18-month period.

We would note that at the time of printing this Review, the U.K. government is still anticipating implementing the Prospectus Regulations in full despite its anticipated withdrawal from the E.U. in 2019.

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### ii. New U.K. IPO Timetable Requirements

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In July 2018, the FCA promulgated significant changes to the process for all London-regulated market IPOs.

We first note two changes here that may significantly impact the IPO timeline: According to the new rules, where banks want to conduct and release pre-offering research and have their own analysts be in communication with the issuer, they must now (i) provide unconnected analysts with access to the information and representatives of the issuer as well and (ii) not disseminate the connected research until only after the registration document or prospectus

is approved and published. This is contrary to the current market practice where research reports are published around two weeks before the publication of the prospectus. The new requirements also seek to ensure a level playing field between connected and unconnected analysts by mandating that if an issuer wants to update connected analysts with revisions to a registration document, those updates must be given to the unconnected analysts as well. In addition to complicating an IPO timeline, these changes introduce the risk of deals being disrupted by unconnected analyst research that produces adverse coverage.

In practice, the combination of these rules has meant a move to two different public documents, each of which must be approved by the listing authority—one registration statement with general business and equity information but no offering-related specific information, followed by a consolidated prospectus with any updates to the registration document and with the details of the securities offering. While there is an option to publish a separate approved securities note with an accompanying summary, in practice investors will likely prefer to continue to see the complete prospectus and avoid the prospect of three separate documents.

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### iii. Tier 2 Capital Issuances

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The issuance of subordinated notes that are intended to qualify as Tier 2 capital under Solvency II continued in 2018 by insurance groups.

In 2018, issuances by insurance groups tended to be structured in such a way as to qualify as Tier 2 capital under Solvency II or under other applicable supervisory regulations (notably the BMA rules) in the event that the group becomes regulated in another regulatory jurisdiction. We set forth below a selection of these transactions:

- AXA issued €2,000,000,000 3.250% Fixed to Floating Rate Ordinary Subordinated Notes due 2049, intended to qualify as Tier 2 capital under Solvency II.

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- Legal and General Group plc issued £400,000,000 5.125% Fixed Rate Reset Subordinated Notes due 2048 as dated Tier 2 capital under Solvency II.
- Munich Re issued €1,250,000,000 Subordinated Fixed to Floating Rate Bonds due 2049, intended to qualify as Tier 2 capital under Solvency II.
- Prudential issued £500,000,000 6.250% Resettable Dated Tier 2 Notes due 2068, £750,000,000 Resettable Dated Tier 2 Notes due 2051 and \$500,000,000 6.500% Resettable Dated Tier 2 Notes due 2048 all as Tier 2 capital under Solvency II.
- RenRe issued 10,000,000 Depositary Shares, each representing a 1/1000th Interest in a 5.750% Series F Preference Share, intended to qualify as Tier 2 capital under BMA rules.

# VII. Principal Regulatory Developments Affecting Insurance Companies

## VII. PRINCIPAL REGULATORY DEVELOPMENTS AFFECTING INSURANCE COMPANIES

### A. United States Regulatory Developments

In March of 2018, at her inaugural National Meeting as NAIC President, Tennessee Insurance Commissioner Julie McPeak introduced the NAIC's three-year strategic plan, known as "State Ahead." The three themes of State Ahead are: (i) safe, solvent and stable markets; (ii) consumer protection and education; and (iii) superior member services and resources.

Summarized below are some of the key activities at the NAIC during 2018 in implementing State Ahead, along with summaries of developments at the IAIS and of emerging issues that will be of importance in 2019.

#### i. The Covered Agreements

This past year, the NAIC worked under an accelerated timeline intending to revise its Credit for Reinsurance Model Law and Model Regulation (the "Credit for Reinsurance Models") by year-end to bring them into compliance with the terms of the Bilateral Agreement Between the United States and the European Union on Prudential Measures Regarding Insurance and Reinsurance (referred to colloquially as the "Covered Agreement"). Among other provisions pertaining to group supervision and exchange of information between U.S. and E.U. supervisory authorities, the Covered Agreement eliminates U.S. reinsurance collateral requirements for qualifying reinsurers from the E.U. and allows qualifying U.S. insurers and reinsurers to operate in the E.U. without a branch office or other local presence. In order to qualify for exemption from reinsurance collateral requirements, E.U. reinsurers must satisfy certain financial conditions, including maintenance of (i) a minimum capital and surplus of 226 million Euros (where the ceding insurer has its head office in the United States) or \$250 million USD (where the ceding insurer is domiciled in the U.S.); and (ii) a solvency ratio of 100% SCR

under Solvency II or an RBC of 300% Authorized Control Level (depending on where the reinsurer has its head office or is domiciled).

#### a. Revisions to Credit for Reinsurance Models

Unless revised to incorporate the terms of the Covered Agreement, beginning in 2022, state credit for reinsurance laws based on the Credit for Reinsurance Models may be subject to federal preemption, thus explaining the NAIC's urgency in revising the Credit for Reinsurance Models.

The proposed revisions apply the Covered Agreement's zero collateral provisions to E.U. reinsurers that satisfy specified conditions. In addition, the proposed revisions would apply the zero collateral standard to qualifying reinsurers domiciled in "Reciprocal Jurisdictions"— comprising (i) jurisdictions that enter into a bilateral agreement with the same reciprocity terms as those in the Covered Agreement (*i.e.*, the bilateral agreement between the U.S. and U.K.); (ii) qualified jurisdictions (recognized as such by the NAIC under the current Credit for Reinsurance Models) that are not a party to a bilateral agreement, but whose laws are reciprocal and that recognize the U.S. state regulatory system; and (iii) NAIC accredited jurisdictions, such as U.S. states, deemed qualified jurisdictions under the current Credit for Reinsurance Models. The NAIC anticipates developing criteria and a process to identify Reciprocal Jurisdictions which will be similar to the process utilized to determine "Qualified Jurisdictions" (*i.e.*, jurisdictions whose qualifying reinsurers are entitled to reduced collateral obligations for assumed U.S. businesses).

The proposed revisions allow state insurance commissioners to impose additional requirements on Reciprocal Jurisdictions and on qualifying reinsurers from Reciprocal Jurisdictions beyond those set forth in the Covered Agreement or in future bilateral agreements. However, if the additional criteria is greater than what is required under a bilateral agreement, failure to satisfy the commissioner's criteria will not preclude a ceding insurer from taking credit for such reinsurance. The U.S. Department of Treasury as well as industry commenters have voiced concern over the amount of latitude afforded

## VII. Principal Regulatory Developments Affecting Insurance Companies

to state insurance commissioners in recognizing and policing Reciprocal Jurisdictions and Reciprocal Jurisdiction reinsurers. As such, further revisions are expected to the Credit for Reinsurance Models in 2019 to address these concerns.

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### b. U.S./U.K. Covered Agreement

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In light of the U.K.'s intended exit from the E.U. in 2019 (“**Brexit**”), on December 19, 2018, the U.K. and the U.S. signed a separate covered agreement with terms that mirror those in the Covered Agreement. This results in qualifying U.K. reinsurers enjoying the same collateral elimination provisions provided by the Covered Agreement post-Brexit.

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### ii. Group Capital and Systemic Risk

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We expect meaningful developments on the domestic and international supervision fronts in the coming year with respect to the creation of group capital standards and a focus on systemic risk and activities-based regulation, with a continued move away from certain post-crisis entity-focused measures.

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#### a. Group Capital

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The IAIS expects 2019 to be a “watershed year” with the culmination of much of its post-financial crisis work. With respect to the development of the Common Framework for the Supervision of Internationally Active Insurance Groups (“**ComFrame**”), the IAIS is on track to conduct the final round of field testing in 2019 of the Insurance Capital Standard for internationally active insurance groups (“**ICS Version 2.0**”), which is part of ComFrame. The IAIS expects to adopt ComFrame, including ICS Version 2.0, at its Annual General Meeting in November 2019. ICS Version 2.0 will then enter a five-year monitoring period prior to the planned implementation phase beginning in 2025.

In another significant development, the IAIS is developing criteria to compare the similarities and differences between the IAIS's and the U.S.'s group capital standards. At the NAIC's Summer National Meeting, the IAIS Deputy

Secretary General & Head of Capital and Solvency stated that the IAIS is developing this criteria because it wants to support the development of the aggregation method in the U.S. (discussed below).

During the past year, the Group Capital Calculation (E) Working Group has continued to develop a group capital calculation tool using an RBC aggregation methodology. The Working Group intends to enter the next phase of development by field testing the calculation tool in early 2019 using year-end 2018 data. In November, the Working Group exposed a field-testing template for comment through January 30, 2019. The scope of the template was intentionally broad since the goal is to test a variety of options and identify any “unintended consequences” resulting from how the scope of the group and adjustments are defined. The template is currently being modified to address comments received on the draft template during the exposure period. Following the finalization of the template, field testing of the group capital tool should begin around the second quarter of 2019.

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#### b. Systemic Risk

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On November 14, 2018, the IAIS released a draft of the Holistic Framework for Systemic Risk in the Insurance Sector (the “**Framework**”) for public consultation, the key elements of which are detailed in our Fall 2018 NAIC Report. At the NAIC's Fall National Meeting, the IAIS Secretary General described the Framework as a key component of the IAIS's post-financial crisis reform measures along with ComFrame and ICS Version 2.0.

The Framework continues the IAIS's move away from what the Secretary General called the “binary” entities-based approach, in which certain additional policy measures are applied only to a small group of G-SIIs, and toward an activities-based approach with an enhanced set of policy measures to address activities and exposures that can lead to systemic risk in the insurance sector as a whole. In light of the release of the Framework, the FSB decided not to identify new G-SIIs in 2018 and will reevaluate the need to either discontinue or reestablish an annual identification of

## VII. Principal Regulatory Developments Affecting Insurance Companies

G-SIIs following the adoption and implementation of the Framework.

The IAIS will refine the Framework based on feedback received from stakeholders during the consultation period, which closed on January 25, 2019. The Framework is scheduled for adoption in November 2019, with implementation in 2020.

The NAIC also continued to develop its Macro-Prudential Initiative (“**MPI**”) throughout 2018. The MPI is a priority on the NAIC’s agenda and it parallels the IAIS’s development of an activities-based approach for systemic risk. The MPI similarly focuses on systemic financial, economic and other common risk exposures in the insurance sector. As part of the MPI, the NAIC is developing a liquidity stress-testing framework for life insurers that exceed certain dollar thresholds for fixed and indexed annuities, funding agreements and guaranteed investment contracts, derivatives, securities lending repurchase agreements and borrowed money. The NAIC has indicated that the liquidity stress-testing framework will be a “regulatory tool” that will not result in “automated regulatory triggers” or “benchmarking” of insurers. The NAIC is currently working on designing the stress test based on a cash flow approach, and it expects to perform a field test exercise in 2019 before rolling out the stress test for all entities within its scope.

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### iii. U.S. Federal Developments

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Efforts to scale back post-financial crisis reforms continued throughout 2018. For instance, in October 2018, the FSOC voted to rescind the designation of Prudential Financial, Inc. as a SIFI. This decision was based on the FSOC’s view that there is not a significant risk that the company could pose a threat to financial stability. At the NAIC’s Fall National Meeting, Superintendent Eric Cioppa (ME), the state insurance commissioner representative on the FSOC, stated that this decision better reflects the insurance business model and its regulation and also recognizes the role of the New Jersey Department of Banking and Insurance as the state group-wide supervisor of Prudential. With the rescission of Prudential’s SIFI designation, there

are no longer any nonbank financial firms designated as SIFIs.

In addition, on May 24, 2018, President Trump signed into law the Economic Growth, Regulatory Relief and Consumer Protection Act (“**Economic Growth Act**”), which includes provisions meant to roll back certain banking regulations contained in the Dodd-Frank Act. Section 211 of the Economic Growth Act, “International insurance capital standards accountability,” directs the Director of the Federal Insurance Office and the Board of Governors of the Federal Reserve to support increased transparency at global insurance or international standard-setting regulatory or supervisory forums, and to achieve consensus positions with the states through the NAIC prior to taking a position on any insurance proposal by a global insurance regulatory or supervisory forum. However, President Trump issued a signing statement with the Economic Growth Act noting that he believes that Section 211(a)’s directives to the Federal Insurance Office and the Federal Reserve “to take certain positions before international bodies and to ‘achieve consensus positions’ with State insurance regulators in negotiations before such bodies . . . contravene [his] exclusive constitutional authority to determine the time, scope, and objectives of international negotiations.” The statement concludes by noting that the Trump administration “will give careful and respectful consideration to the preferences expressed by the Congress in section 211(a) . . . , but will implement this section in a manner consistent with [the President’s] constitutional authority to conduct foreign relations.”

In her opening remarks at the NAIC Summer National Meeting, Commissioner McPeak applauded passage of the Economic Growth Act and Section 211 in particular as one of the NAIC’s legislative priorities. Treasury Secretary Mnuchin also commended the “legislative effort to pass critical regulatory reform for the financial sector” in a statement following passage of the Economic Growth Act.

## VII. Principal Regulatory Developments Affecting Insurance Companies

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### iv. Insurance Company Business Transfer or Division Laws

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In recent years, several U.S. states have enacted legislation or promulgated regulations meant to approximate the effect of Part VII of the U.K. Financial Services and Markets Act 2000, which allows an insurer to transfer its business, or a book of business, to another entity or to divide into separate companies without the need for individual policyholder consents. 2018 saw an acceleration of activity in this area, with the passage of laws in Michigan, Illinois and Oklahoma and plans by the NAIC to focus on these laws in 2019. In addition to these states, such laws or regulations are in effect in Connecticut, Rhode Island and Vermont.

While each state provides a mechanism for insurance business transfers or divisions (“IBTs”) without affirmative policyholder consent, there are differences in the transfer process in each state, including whether the transfer is effected by a novation or the division of a company, the types of business that may be transferred, whether the transfer must be approved by a court or by the insurance regulator of the state, and whether policyholders may object to or “opt out” of the transfer.

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#### a. Permitted Transfers

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Under Vermont’s IBT law, a non-admitted insurer from any jurisdiction may transfer closed blocks of commercial non-admitted insurance policies or reinsurance agreements to a Vermont-domiciled company established specifically to acquire a closed block under a legacy insurance transfer plan.

Rhode Island’s IBT regime, Regulation 68, enables any insurer to novate blocks of U.S. property casualty business to a Rhode Island-domiciled assuming company.

Oklahoma’s IBT law allows any insurer to transfer and novate a book of business to an Oklahoma-domiciled insurer (including a captive insurer).

Unlike the Vermont, Rhode Island and Oklahoma laws or regulations, which allow transfers from non-domiciliary

insurers to domiciliary insurers, the Connecticut, Illinois and Michigan IBT laws provide for an insurer domiciled in the state to divide into two or more domestic insurers. Another key difference is that these “division” laws are not limited to certain classes of business (Rhode Island) or to closed blocks (Vermont). Rather, any domestic insurer may take advantage of the laws’ provisions with respect to any line of business. Similarly, the Oklahoma IBT law applies broadly to active and run-off books of business.

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#### b. Approval of IBT Plan

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The IBT laws in each state set forth the requirements for the contents of the IBT plan that shall be submitted to the insurance regulator in that state, as well as the requirements for approval of the IBT plan. In Connecticut, Illinois, Michigan and Vermont, the IBT plan need only be approved by the state insurance regulator.

In Rhode Island and Oklahoma, the IBT plan must also be approved by a court after it has been approved by the state insurance regulator.

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#### c. Policyholder Opt-Out

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In Vermont, if a policyholder or reinsurance counterparty objects to the IBT plan, the assuming company must revise the IBT plan to exclude such policyholder or counterparty and its respective policy/contract from the IBT plan. Under the Oklahoma IBT law, policyholders may comment on or object to the IBT plan, but do not have the right to opt out of or otherwise reject the transfer and novation. The IBT laws or regulations of Connecticut, Illinois, Michigan and Rhode Island do not contain policyholder opt-out provisions.

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#### d. New NAIC Working Groups

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To date, we are not aware of any transactions that have been completed under any of the IBT laws currently in place. As such, these regimes are untested and, in at least two states (Connecticut and Illinois), awaiting guidance from the insurance regulator.

## VII. Principal Regulatory Developments Affecting Insurance Companies

In addition, the NAIC's Financial Condition (E) Committee has formed two new working groups (including one focusing on accounting issues) to consider issues related to IBT laws, which may include recommending specific standards for review of IBT plans as well as analyzing any constitutional issues.

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### v. Annuity Suitability

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#### a. SEC Best Interest Proposal

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In April 2018, the SEC proposed a package of rule proposals and interpretations including Regulation Best Interest, which would establish a "best interest" standard of conduct for securities brokerage firms and their personnel when recommending a securities transaction or investment strategy involving securities to a retail customer. The proposed standard of conduct would require the brokerage firm or individual broker to act in the "best interest" of the retail customer without placing their own financial or other interest ahead of the customer's interest. The proposed standard would be higher than the "suitability" standard applicable under existing regulation, but would not create an explicit fiduciary duty. As a result, this proposal has drawn criticism from those who think it goes too far and those who think it does not go far enough in regulating the conduct of securities brokerage firms and individual brokers in dealing with retail customers. Other commentators have criticized the proposal on the grounds that it does not sufficiently define "best interest." In addition, some commentators have noted that, because the proposed rule only applies to recommendations involving securities, different standards might apply to the sale of insurance products subject to the securities laws, such as variable annuities, and other insurance products such as fixed indexed annuities, which could be subject to different standards under state insurance law. The comment period for this proposal has ended and Chairman Clayton of the SEC has indicated that completing the work on the proposed rules relating to standards of conduct for financial professionals, including Regulation Best Interest, is a key priority for 2019.

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#### b. Annuity Suitability Discussion Continues at the NAIC

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During the past year, the NAIC's Annuity Suitability (A) Working Group has been discussing proposed revisions to the Suitability in Annuity Transactions Model Regulation (#275). The revisions are intended to elevate the standard of care in existing suitability standards for the sale of annuities and to make consumers aware of any material conflicts of interest. The NAIC has undertaken this initiative "[in response] to requests from regulators and the industry for an updated and consistent standard of care for consumers considering annuity products," while "working in parallel" to the efforts under way at the federal level, such as with the SEC.

Following the NAIC's Fall National Meeting, the Working Group exposed for comment a further updated draft of the Suitability in Annuity Transactions Model Regulation through mid-February 2019. A drafting note in the current draft of the amended Suitability in Annuity Transactions Model Regulation indicates that the NAIC has opted to refrain from using the "best interest" standard "[u]ntil such time the NAIC can evaluate any distinction in the text of the SEC proposal between a 'best interest' recommendation and investment adviser fiduciary duties." The goal is to finalize the revisions to the Suitability in Annuity Transactions Model Regulation in 2019.

Following two notice and public comment periods, the NYDFS issued a final regulation on July 17, 2018 that adopts a best interest standard for insurance companies and producers that sell life insurance and annuity products in New York State. A transaction is in the best interest of a consumer, meaning the owner or a prospective purchaser of a life insurance policy or an annuity contract, when such transaction is in furtherance of the consumer's needs and objectives. Former Superintendent Vullo said that "[a]s the federal government continues to roll back essential financial services regulations, New York once again is leading the way so that consumers who purchase life insurance and annuity products are assured that their financial services providers are acting in their best interest when providing advice." The amendments to New York's

## VII. Principal Regulatory Developments Affecting Insurance Companies

existing regulation related to annuity contracts and life insurance policies will be effective on August 1, 2019 and February 1, 2020, respectively.

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### vi. Variable Annuities

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In 2018, following approximately three years of work, the NAIC's Variable Annuities Issues (E) Working Group (VAIWG) adopted revisions to Actuarial Guideline 43 ("AG43"), Valuation Manual Section VM-21, and the NAIC's Life Risk-Based Capital ("Life RBC") formula (C3 Phase II) that are designed to reduce the level and volatility of the non-economic aspect of reserve and RBC requirements for variable annuities ("VA") products (the "VA Framework"). The VA Framework intends to mitigate the "unprecedented complexity" introduced into the VA statutory balance sheet and risk management by the NAIC's adoption of C3 Phase II (in 2006) and AG43 (in 2009)—which are noted in the VA Framework as the causes that have led to the establishment of VA captives.

Among other changes adopted as part of the VA Framework is the removal of the Standard Scenario "floor" from the C3 Phase II RBC calculation. In addition, the Life Actuarial (A) Task Force will be required to consider during the next three years whether the AG43 Standard Scenario should also be removed. The relaxation of these Standard Scenario requirements was opposed by the NYDFS, which voted against the adoption of the VA Framework by the VAIWG.

NAIC subcommittees are now proceeding with incorporating the necessary technical language to effectuate the VA Framework's recommendations into AG43, the Valuation Manual Section VM-21 and the Life RBC formula.

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### vii. New York Governor Signs Principle-Based Reserving Legislation

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The revisions to the NAIC Standard Valuation Law that provide for a principle-based approach to life insurers' reserving methods ("PBR") will become a NAIC accreditation standard on January 1, 2020. As of November 29, 2018, PBR has been adopted in 49 states and it is pending adoption in Massachusetts and the District of Columbia. In

New York, the enabling legislation to implement PBR was signed on December 7, 2018, although PBR will not become effective in New York until January 1, 2020. The NYDFS announced on December 10, 2018 that it had issued an emergency regulation to permit the Superintendent to require a life insurance company to change an assumption or method if the Superintendent believes such change is necessary to comply with the requirements of the NAIC's Valuation Manual or applicable New York insurance law. The regulation also provides that a life insurance company must adjust its reserves as required by the Superintendent.

An important feature of New York's enabling legislation for PBR is that it authorizes the NYDFS to issue regulations that would result in deviations from the reserve standards and methods set forth in the Valuation Manual, including deviations based on a percentage of reserves required to be held under New York law prior to the operative date of the Valuation Manual. However, no such deviation may result in reserve valuations that are lower than minimum standards prescribed in the Valuation Manual. In terms of next steps, the NYDFS is meeting with members of the life insurance industry in order to discuss whether the NYDFS should exercise its regulatory authority and develop any such deviations from the Valuation Manual.

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### viii. Emerging Topics

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#### a. Cannabis

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Cannabis legalization by U.S. states for medicinal and recreational purposes presents new insurance-related challenges and opportunities to actors in both the insurance and cannabis industries. This will be an area to watch in the new year, as banks and insurers consider questions of legality and the cannabis industry addresses new obstacles and solutions to insuring its wide-ranging operations from seed to sale.

The cannabis industry is predicted to grow to a \$57 billion industry over the next decade, including growth, manufacture, distribution and retail sales, yet the legal framework surrounding cannabis in the United States is complicated. Under federal law, marijuana remains a Schedule 1 drug, meaning that aiding or abetting its growth,



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distribution or possession remains a crime. At the state level, however, 46 states have enacted some type of law permitting medicinal or recreational cannabis that conflicts with federal legislation.

To address the incompatibility between the state and federal schemes, in 2013, the Obama administration released the “Cole Memo”, which advised U.S. attorneys not to prosecute Cannabis Related Businesses (“**CRBs**”) that comply with state regulatory schemes. Accordingly, this gave some assurances to those in the cannabis business that compliance with state law would be acceptable and would safeguard them from prosecution by the Department of Justice. However, in January 2018, former Attorney General Jeff Sessions rescinded the 2013 Cole Memo. This has created confusion for those in the cannabis industry, including insurers that are insuring policies to CRBs, as to whether compliance with state regulatory schemes is enough to avoid federal prosecution. As well, federally regulated banks have indicated an unwillingness to engage with CRBs, and insurers remain hesitant to insure cannabis operations. In comments at the NAIC’s Fall National Meeting, the National Bank Association noted that it is illegal for banks to engage with companies in the cannabis industry. Somewhat curiously, former Superintendent Vullo of New York and former Commissioner Jones of California reacted contrarily, noting that banks refusing to engage with the industry will lose out on a large business opportunity.

Nonetheless, as the financial sector wrestles with the permissibility of engaging with the cannabis industry under federal law, CRBs present myriad insurance needs. For instance, CRBs can face a higher risk of theft than other businesses because federal banking restrictions often cause them to hold large amounts of cash. CRBs must also protect against risks ranging from workplace accidents and crop failure to product liability and risk of fire. Cannabis consumers similarly face insurance obstacles, such as a lack of coverage for prescribed medical marijuana, which is not FDA-approved. That most insurance companies will not insure these risks for CRBs or cannabis consumers presents a significant challenge to the cannabis industry, and even endangers coverage for companies providing services to

CRBs. Insurers may rely on standard exclusions of “illegal activity” or “contraband” to deny coverage in this area, and some courts have even refused to enforce otherwise covered contracts if related to cannabis.

Responding to these developments, in 2018 the NAIC formed the Cannabis Insurance (C) Working Group, which garnered significant interest from attendees at the Fall National Meeting. The NAIC is drafting a white paper outlining issues relating to cannabis in the insurance industry and recommendations for regulatory guidance, which it expects to present for approval this coming spring.

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### b. Climate Change

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As environmental threats caused by climate change pose increasing risks to insurers and the businesses they underwrite, climate risk remains an area to monitor in 2019. In 2018, the IAIS and the Sustainable Insurance Forum (“**SIF**”) published an Issues Paper outlining how climate change may affect the insurance sector. The IAIS and the SIF highlight “physical risks” (those resulting from climate trends and catastrophic events) and “transition risks” (those arising from a shift toward a low-carbon economy) as two main types of risk to insurers resulting from climate-related factors. The Issues Paper identifies liability risks as a third, less prominent category, noting a global increase in climate-related litigation over action or inaction to mitigate or adapt to developing climate risks.

The Issues Paper addresses climate-related considerations for insurers’ underwriting and investments as they relate to various business lines. General insurers, for instance, may see both increased premium revenue, provided the risks remain insurable, and increased weather-related claims. Acknowledging general and agricultural insurers’ experience with physical risks, the authors note that impacts of such risks “may be non-linear and increasingly correlated,” resulting in high claims burdens. With respect to life and health insurance, actuarial associations are increasingly focusing on the effects of climate change on mortality, and particularly on heat-related health issues. On the whole, reinsurers may be more resilient to climate-related factors, although a gap of reinsurance coverage for

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weather-related risks could develop if its cost becomes prohibitive for certain insurers.

Climate-related risks may affect insurers' investment activities, as well. Investments in high-carbon sectors such as oil, gas and coal present one transition risk for insurers' consideration. Additionally, physical risk could affect a municipality or sovereign's credit ratings and, consequently, affect investments in municipal or sovereign debt, while real estate portfolios may be affected by energy-related regulations and requirements of commercial properties, or if real estate is located in an area subject to great physical risk.

While many insurers seek to mitigate significant losses from catastrophic weather-related events using predictive models and enhanced risk modelling to update their products and processes, public-private partnerships are also working to ameliorate the effects of such events on the industry. Insurers and others in the insurance industry, for instance, assist governments in utilizing risk-based methods of addressing climate risk and catastrophic events. Relatedly, the NAIC Climate Change and Global Warming (C) Working Group recently highlighted collaborations between private investors, including insurers, and the environmental industry to reduce insurance risk by protecting natural ecosystems through innovative financing solutions. Environmental impact bonds and parametric insurance policies exemplify two such solutions. Environmental impact bonds finance environmental restoration projects utilizing a "pay-for-success" model, whereby private investors fund restoration efforts, and the investment is repaid based on previously agreed-upon project results. Likewise, parametric insurance policies guarantee a pre-agreed payment upon the happening of a triggering event, such as a particular weather event causing specific effects, and are used to fund repair and restoration of natural ecosystems with the end goal of reducing insurance risk.

Moving into 2019, the effects of and industry responses to climate risk, including the increasing confluence of severe weather events such as hurricanes and wildfires, remains an area to monitor closely.

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### B. European and U.K. Regulatory Developments

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#### i. Brexit

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With the Brexit withdrawal date drawing very close at the time of printing this Review, and the terms of the post-Brexit U.K. and E.U. relationship still unsettled, Brexit continues to be the dominant topic of U.K. and E.U. insurance regulatory discourse.

On November 25, 2018, the U.K. and E.U. agreed on the text of a draft Withdrawal Agreement ("**Withdrawal Agreement**") on the terms on which the U.K. will leave the E.U. and a political declaration ("**Political Declaration**") on future relations between the U.K. and E.U. The Withdrawal Agreement proposes the application of transitional provisions under which E.U. law would broadly remain in force in the U.K. until the end of December 2020. However, at the time of writing, there is no certainty as to whether the Withdrawal Agreement, which is subject to approval of the U.K. Parliament, will actually be executed—the Withdrawal Agreement has already been rejected twice by the U.K. Parliament, and attempts to amend it in such a way that would lead to its approval by the U.K. Parliament so far have been unsuccessful. In the absence of a Withdrawal Agreement, there would be no transitional provisions and a "hard Brexit" would occur on March 29, 2019, unless the U.K. Government were to revoke its notice to the European Council of its intention to leave the E.U.<sup>4</sup> (the "**Article 50 Notice**") or if the two-year Article 50 Notice period were to be extended, which looks increasingly likely.

Regardless of the fact that the long-term implications of Brexit are unclear, insurers are bracing themselves for significant regulatory changes as the U.K. becomes excluded from certain aspects of E.U. membership and the U.K. government moves to repeal, replace or replicate E.U. laws. The Financial Conduct Authority ("**FCA**") has recently stated<sup>5</sup> that it is of the opinion that the insurance sector will be one of the sectors most affected by Brexit out of those within its remit, due in particular to the extent of cross-border trade in the sector, and this is borne out

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<sup>4</sup> The notification was made by the U.K. Government in accordance with Article 50 of the Treaty on the European Union on March 28, 2017.

<sup>5</sup> FCA "Sector Views" report, published January 10, 2019.

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by the amount of new and amended legislation being produced just to allow the sector to continue to function effectively. We consider below the two areas of regulatory change which are expected to have a significant impact on insurance businesses in the context of Brexit: the E.U. passporting regime and the application of Solvency II, including in particular equivalence.

### a. Passporting

Perhaps the most significant area of potential regulatory change for insurers and insurance intermediaries as a result of Brexit relates to the E.U. system of financial services “passporting”. Passporting is a system which enables regulated financial firms in one E.E.A.<sup>6</sup> member state to provide financial services (including insurance and insurance mediation) into other E.E.A. member states without the need to obtain additional regulatory authorization in those other E.E.A. member states. There are broadly two main possible ways by which passporting will be affected by Brexit: (i) the U.K. leaves the E.U. with a transition period, as envisaged under the draft Withdrawal Agreement; or (ii) the U.K. leaves the E.U. without a transition period, in which case the Temporary Permission Regime (“**TPR**”) will go into effect.

### i) The Transition Period

The draft Withdrawal Agreement contemplates the application of a transitional period, from the date of the U.K.’s withdrawal until December 31, 2020, during which the passporting regime would continue to apply. This would allow U.K. insurers and insurance intermediaries to carry on regulated activities (including servicing existing insurance contracts) in other member states and other non-U.K. E.E.A. insurers and intermediaries to carry on regulated activities in the U.K. Passporting rights would still be discontinued at the end of the transition period but the temporary continuation of passporting would effectively provide firms with time to seek alternate authorisations in the U.K. or E.E.A., as applicable.

<sup>6</sup> The E.E.A. is the European Economic Area and comprises the 28 member states of the E.U. plus Norway, Iceland and Liechtenstein. Passporting rights apply to the whole of the E.E.A.

### ii) The TPR

As noted above, the proposed Withdrawal Agreement has not yet been entered into and if no Withdrawal Agreement is entered into prior to the withdrawal date, this could lead to a hard Brexit. In a hard Brexit, insurers will naturally want to be able to continue to write insurance in the markets in which they operated prior to Brexit and they will also need to be able to continue servicing cross-border insurance contracts which were written pre-Brexit. This applies to both E.E.A. insurers that passported into the U.K. (inbound firms) and vice versa (outbound firms).

To address the possibility of a hard Brexit, the U.K. Government has enacted legislation<sup>7</sup> providing for a TPR whereby E.E.A. firms which currently operate in the U.K. under the passporting regime may, following Brexit, be treated as though they had U.K. authorisation to undertake those regulated activities they currently carry out. The FCA and the PRA have each issued public consultations on their approaches to the TPR with a view to issuing policy statements and final rules on the TPR in Q1 2019.

The TPR, as proposed, is an opt-in regime whereby E.E.A. firms operating in the U.K. may, between January 7, 2019 and March 28, 2019, either make a full application for U.K. authorisation or notify their lead regulator of their intention to make an application for authorisation following Brexit and during the applicability of the TPR. Firms in the latter category (*i.e.* which have notified the regulator of their intention to submit an application for authorisation) will be allocated a three-month application period or “landing slot” to submit their application for full U.K. authorisation. It is expected that the TPR will remain in place for a maximum of three years from the date of withdrawal. All applications would be made during this period through the FCA’s Connect system.

The TPR will temporarily permit E.E.A. insurers to operate within the scope of their current permissions after Brexit while seeking U.K. authorisation, thereby allowing them to write new business and service existing business, including

<sup>7</sup> E.E.A. Passport Rights (Amendment, etc., and Transitional Provision) (E.U. Exit) Regulations 2018 (SI 2018/1149) (enacted November 6, 2018).

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the payment of claims to U.K.-based clients. However, the E.U. authorities and other E.E.A. member states have not yet given reciprocal assurances (with the exception of Germany, which has started laying the groundwork for a similar, though more limited, temporary regime), and so, as it stands, U.K. insurers may not be authorised to pay claims to, or otherwise service, E.U.-based clients.

### b. Solvency II

The most significant piece of Brexit legislation passed by the U.K. Government to date is the European Union (Withdrawal) Act 2018 (the “**EUWA**”). This is the statute that sets out the legislative procedure for the withdrawal of the U.K. from the E.U. It also contains provisions which are aimed at ensuring that the U.K.’s legal system functions effectively after Brexit. One of the EUWA’s key functions is to import all existing directly effective E.U. laws (including regulations, decisions and tertiary legislation) (the “**Retained Legislation**”) into the U.K.’s statute book, as if they had been passed as domestic legislation, and to make it clear that all “E.U.-derived domestic legislation” (i.e., legislation passed by the U.K. Government on the basis of or relating to E.U. laws) continues to have effect post-Brexit. As the Retained Legislation was originally drafted as E.U.-wide legislation, the EUWA also grants the U.K. Government wide powers to amend the Retained Legislation in order to correct “deficiencies” arising from Brexit, i.e., to ensure that the Retained Legislation operates effectively as U.K. domestic legislation post-Brexit. For the U.K.’s Solvency II based regime, correcting these deficiencies (which will be effected by the passing of a number of pieces of secondary legislation) is not intended to lead to any policy changes, however the changes required to make the regime work post-Brexit are wide ranging and include:

- the transfer of certain powers currently held by European institutions to HM Treasury, the PRA and the FCA – for example, there are a number of technical standards currently published by EIOPA (the European Insurance and Occupational Pensions Authority) which will be incorporated into U.K. law, and the power to amend these to correct deficiencies and the responsibility for these in future will be transferred to the relevant U.K. body;
- changes to the group supervision regime to reflect the fact that E.E.A. jurisdictions are third countries – in the absence of equivalence (further discussed below), E.E.A. groups with U.K. subsidiaries could be subject to supervision at a group level by both the PRA and the relevant E.E.A. regulator;
- the transfer of responsibility for making equivalence decisions to HM Treasury – the PRA will be responsible for carrying out the technical work required to assess equivalence, but HM Treasury will be ultimately responsible for making the determination of equivalence;
- the transposition into domestic law of a prohibition on regulators requiring assets to be pledged by reinsurers based in equivalent jurisdictions – there is no such prohibition where the reinsurer is based in a non-equivalent third country; and
- the removal of preferential risk charges for E.E.A. assets and exposures held by U.K. insurers – consistent with the approach taken throughout the amendments, preferential risk charges for U.K. insurers will be limited to U.K. assets and exposures and E.E.A. assets and exposures will be subject to the requirements for third countries, replicating the treatment of U.K. assets and exposures under Solvency II in the E.E.A. post-Brexit.

These changes will come into effect when the U.K. leaves the E.U., in the absence of a deal, or following the Transition Period in the event that one is agreed.

Following Brexit, in addition to the changes to address “deficiencies” discussed above, the U.K.’s Solvency II based insurance regulatory regime could be amended and this could have an extremely important impact on how insurers operate, in terms of prudential regulation (including capital requirements) and conduct of business regulation. Furthermore, if the post-Brexit U.K. regulatory regime diverges from Solvency II it may not be deemed “equivalent” by the European Commission. The equivalency mechanism affords insurers within the E.E.A. with certain benefits with respect to Solvency II compliance in relation to reinsurance, group supervision and group solvency calculations when

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dealing with insurers and reinsurers outside of the E.E.A. For example, an E.E.A. insurer can treat reinsurance from a reinsurer located in an equivalent jurisdiction in the same way as reinsurance from a reinsurer located in the E.E.A. This in turn means that reinsurers in an equivalent jurisdiction are competing on equal terms with reinsurers from within the E.E.A. from a regulatory perspective. While equivalence is beneficial to reinsurers in equivalent jurisdictions (such as Bermuda) who wish to access the E.E.A. market, it is in no way commensurate to passporting rights which give insurers and reinsurers rights to establish branches or to provide (re)insurance throughout the E.E.A. on the basis solely of their home state authorisation.

The draft Withdrawal Agreement sets out a framework for the future relationship between the E.U. and the U.K. and the Political Declaration pledges commitments by the U.K. and E.U. to preserve “financial stability, market integrity, investor protection and fair competition, while respecting the regulatory and decision-making autonomy, and [the U.K.’s and E.U.’s] ability to take equivalence decisions in their own interest.” The declaration adds that equivalence assessments by both the U.K. and E.U. will start as soon as possible after the U.K.’s withdrawal, with the objective of concluding such assessments by the end of June 2020. However, neither the draft Withdrawal Agreement nor the Political Declaration provide a firm commitment by the E.U. to grant the U.K. equivalence (although given that the U.K.’s regime will replicate Solvency II immediately post-Brexit, it seems likely that equivalence will be granted) and there continues to be concerns around the ability of the E.U. to revoke equivalence on short notice. Indeed, as noted above, it is not clear whether or not the Withdrawal Agreement will even be entered into. This essentially means that insurers and insurance intermediaries need to continue to plan for a hard Brexit whereby the U.K. will be treated in the same way as other non-E.E.A. “third countries”. The provisions of the EUWA which bring Retained Legislation on-shore apply to equivalence decisions already made, so although there is no guarantee that the U.K. will grant the E.U. equivalence, regimes which have been determined as equivalent to Solvency II (those of Bermuda and Switzerland in full and a number of other jurisdictions on a temporary or provisional

basis) will be automatically equivalent to the U.K.’s post-Brexit regime, subject to such amendments as are required to ensure the equivalence determinations work in a U.K. context.<sup>8</sup>

It may be argued that repeal or amendment of Solvency II would be a boon to the U.K. insurance sector and could result in streamlined regulation and reduced costs for insurers without harming the credibility of the U.K. insurance market. However, as we noted in this publication last year, it is not clear yet if there will be a reduced regulatory burden for insurers post-Brexit and the U.K. government would have to consider the implications of not having regulatory equivalence with the E.U. Furthermore, dismantling Solvency II so soon after its effective date would mean that the considerable time and money spent preparing for implementation may be wasted.

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### c. Lloyd’s and Brexit

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To address the possible implications of losing its passporting rights, Lloyd’s has set up a subsidiary in Brussels, Belgium, as a fully authorised insurance company from which all non-U.K. E.E.A. Lloyd’s non-life risks are and will be underwritten from January 1, 2019. The Brussels subsidiary will insure European risks and reinsure 100% of the business back to the relevant Lloyd’s syndicate(s).

The Brussels entity will have a branch in London, so that all underwriting would take place in London with dual stamps (for the syndicate(s) and the London branch of Lloyd’s Brussels subsidiary). Lloyd’s Brussels would also outsource its claims and administrative functions back to London. As such, Lloyd’s operations in Brussels would be limited to a relatively small number of its own staff that are required to administer the Brussels subsidiary. It is not expected that the staff of managing agents necessarily would be on the ground in Brussels.

We understand that the capital requirements of the Brussels subsidiary will initially be met by an injection from Central Fund. Further capital, as required, will have subsidiary funds

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<sup>8</sup> The Equivalence Determinations for Financial Services and Miscellaneous Provisions (Amendment etc) (E.U. Exit) Regulations 2019 (draft form).

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supplemented by use of syndicate loans, based on use of existing solvency assets, to the Central Fund. In the longer term, this may be replaced by capital from those members reinsuring the subsidiary, an assessment which is expected to be made for underwriting in 2021.

It is noted however that the new Brussels subsidiary does not necessarily secure full E.E.A. market access in the context of a hard Brexit in circumstances where the E.U. has not determined the U.K. to be Solvency II equivalent. In these circumstances, it has been noted, Lloyd's could lose access to both the Polish and German markets for treaty reinsurance, as these countries would not allow cross-border reinsurance with countries not granted equivalence by the E.U. As detailed in the previous section above, while the U.K. would meet the criteria for equivalence, it remains unclear when it would be secured.

The fact that the Lloyd's Brussels subsidiary, which is designed to ensure continuity of access across the E.E.A. in the context of a hard Brexit, may not provide access to German and Polish treaty reinsurance business, underpins the fact that establishing an authorised subsidiary in the E.E.A. will not necessarily create a perfect solution for U.K. firms seeking to maintaining full access to the E.E.A. market, as this will also be impacted by equivalence.

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### d. Data Protection Post-Brexit

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The General Data Protection Regulation ("**GDPR**"), which came into force in May 2018, governs the collection and use of personal data across the E.U. The U.K. has supplemented the GDPR with the U.K. Data Protection Act 2018, which ensures that the U.K.'s current data protection standards will continue to apply through domestic legislation post-Brexit. The U.K. Government has stated that the free flow of personal data from the U.K. to the E.U. will continue to be possible post-Brexit, however the position on the flow of personal data in the other direction, from the E.U. to the U.K., is not yet clear. The GDPR allows the E.U. to make an "adequacy decision" in respect of a third country, the result of which is that personal data can be freely transferred from the E.U. to such third country in recognition of the fact that their data protection laws are sufficiently robust.

The Political Declaration provides that the E.U. will start its assessment of the U.K.'s adequacy for data protection purposes as soon as possible after the U.K.'s withdrawal, with the aim of completing this before the transition period has expired. In the event of a no-deal Brexit, however, the U.K. will be deemed to be a third country with no adequacy decision on day one, and firms should therefore make sure that where they are transferring data from the E.U. to the U.K. there is a legal basis in place for this. This would usually include the entry into Standard Contractual Clauses, as set out in the GDPR. Given that the U.K.'s data protection rules are based on the GDPR, it would seem likely that the result of an adequacy assessment would be that the U.K. is deemed adequate for the purposes of the GDPR, so the need for alternative measures should only be temporary.

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### ii. The Extension of the Senior Managers & Certification Regime

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Following the 2008 financial crisis, the U.K. Government sought to replace the U.K. Approved Persons Regime ("**APR**") with a regime that was more focused on senior managers and individual responsibility. This led to the development of the Senior Managers & Certification Regime ("**SM&CR**") which has been in force for banks, building societies, credit unions and PRA-designated investment firms since March 2016. In December 2018, the regime was rolled out for U.K. insurers, including U.K. branches of foreign firms, insurance special purpose vehicles, the Society of Lloyd's and Lloyd's managing agents. The regime will be further extended to all other U.K. regulated entities, including insurance intermediaries, in December 2019.

The SM&CR seeks to ensure that senior persons who are effectively running firms, or who have responsibility for other key functions at those firms, meet standards of fitness and propriety for acting with integrity, honesty and skill and that senior management be responsible for compliance with U.K. regulatory requirements. The scope of SM&CR applies proportionately to a firm's size and risk to markets so firms are categorised, in order of increasing regulatory responsibility, as "Limited Scope Firms", "Core SMCR Firms" and "Enhanced SMCR Firms".

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The new regime builds on and replaces the existing regulatory framework of the Senior Insurance Managers Regime (“**SIMR**”) so many of the features of SM&CR are already familiar to insurers; however, there are some important distinctions. The main changes under the new regime are as follows:

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### a. Certification Regime

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The Certification Regime is the change brought about by the SM&CR that will probably have the greatest impact on how a firm operates. Insurers are required to identify the individuals who perform “Certification Functions”, which are functions that involve or might involve a risk of significant harm to the firm or any of its customers. Certification staff are not subject to approval by the FCA or PRA; instead, the responsibility for ensuring such individuals are fit and proper to carry out their tasks falls on the regulated firms. Accordingly, firms must annually assess whether someone is fit and proper to perform their role. In addition, firms are obliged to conduct ongoing fitness and propriety assessments of in-scope persons. Some individuals within the scope of the Certification Regime may previously have been subject to regulatory approval, but this is no longer required under the Certification Regime.

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### b. Senior Managers Regime

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The staff in the most senior positions of management in a firm (“**Senior Managers**”) need to be pre-approved by their relevant lead regulator, either the PRA or FCA, in a similar way to individuals currently subject to the APR or SIMR. Firms must assess, on at least an annual basis, whether such Senior Managers are “fit and proper” for their role.

Firms must designate specific prescribed responsibilities (“**PRs**”) to Senior Managers. All Senior Managers need to document their areas of responsibility through individual “statements of responsibility”, which are essentially regulatory role descriptions. PRs need to be kept up-to-date when individuals, responsibilities and/or firm circumstances change. The regulators expect that each PR is allocated to a single Senior Manager, but where a

responsibility is shared, each Senior Manager carrying out the PR is considered wholly accountable for it.

Senior managers are subject to a “Duty of Responsibility”, meaning that if something goes wrong in an area for which they are responsible, the regulators will consider whether they took “reasonable steps” to discharge their responsibilities. This is an important area of consideration for firms as the accountability and responsibility falls on the Senior Managers themselves, so firms and Senior Managers must consider how best to demonstrate how they are taking reasonable steps to discharge their duties.

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### i) Conduct Rules

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Individuals subject to the SIMR and APR were subject to conduct rules. However, the SM&CR Conduct Rules apply to a broader range of staff, including all employees working in financial services, other than ancillary staff, in relation to all activities, whether regulated or not, which could affect the integrity of the U.K. financial system or impair the firm’s ability to comply with its regulatory requirements. The conduct rules are aimed at shaping the culture and standards to be applied by individuals who work within a regulated entity.

There are two tiers of Conduct Rules, with the first tier being a set of rules which apply to most employees within a firm. These are referred to as the Individual Conduct Rules and comprise the following five key rules:

- You must act with integrity
- You must act with due care, skill and diligence
- You must be open and cooperative with the FCA, the PRA and other regulators
- You must pay due regard to the interests of customers and treat them fairly
- You must observe proper standards of market conduct

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In addition, Senior Managers are subject to the following four further rules:

- You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively
- You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system
- You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibilities effectively
- You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice

Firms are required to train staff to understand how the conduct rules are relevant to their individual roles.

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### *ii) A New Financial Services Directory*

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Following the extension of the SM&CR, it will be only individuals carrying out Senior Management Functions who will be required to be approved by the regulators and whose names will appear on the existing Financial Services Register. This will substantially reduce the overall number of individuals included on the Financial Services Register.

In response to concerns raised by firms during the FCA's consultation on the SM&CR, the FCA is proposing to introduce a new publicly accessible directory of individuals at financial services firms. This will allow consumers and other interested parties to access information about individuals performing most front/middle/back office functions at firms. The directory is proposed to include information on relevant individuals, including their workplace location, qualifications and any prior regulatory sanctions and prohibitions.

The FCA published its final rules on establishing the directory on 8 March which provide that it will make

available publicly, on an ongoing basis, details of all certified staff working in financial institutions, including their employment history. Firms are required to update this information on an ongoing basis within seven business days of any changes, so U.K. insurers should be mindful of this new administrative requirement.

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### *iii) Timing and Preparation*

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The SM&CR was extended to insurers from December 10, 2018 and will be extended to all solo-regulated firms, including insurance intermediaries, with effect from December 9, 2019. All firms have a 12-month "grace period" within which to complete their first round of annual assessments of the fitness and propriety of employees carrying out Certification Functions. The FCA adopted the same transition period approach when the SM&CR was introduced for banks and building societies in 2016. Firms need to submit a "Form K" (including Statements of Responsibilities) in order to convert approved persons under the APR to Senior Management Functions by no later than one week before the implementation date on which the regime will apply to the firm.

To ensure compliance with the SM&CR, U.K. insurers and insurance intermediaries need to, among other things, identify individuals who will perform SMFs; identify certification staff; draft statements of responsibilities for Senior Managers and establish systems and processes to ensure that: (i) an annual fit and proper assessment is carried out for Senior Managers and staff performing certification functions; (ii) all staff are trained on the relevant conduct rules; (iii) relevant background checks are made for new staff, including obtaining regulatory approvals; (iv) disciplinary action for breaches of conduct rules are recorded and reported to the FCA as required; and (v) the new Financial Services Directory is kept up to date with the firm's data.

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### *iii. Implementation of the Insurance Distribution Directive*

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On October 1, 2018, the Insurance Distribution Directive ("IDD") was implemented, replacing the 17-year-old



## VII. Principal Regulatory Developments Affecting Insurance Companies

Insurance Mediation Directive (“**IMD**”), representing one of 2018’s most significant regulatory changes for insurers, insurance brokers and the insurance market at large. The IDD is intended to address the inconsistent implementation of the IMD across E.U. member states and enhance and modernize regulation in this area to account for increased complexity of the market. It aims to better match individuals’ needs with the insurance products they buy, and reduce inappropriate selling.

Whilst the IMD applied only to insurance intermediaries like agents and brokers, the IDD covers all persons and institutions involved in the sale of insurance products, including insurers and reinsurers that sell their products directly to customers, any person who assists in the administration or performance of insurance contracts and persons who distribute insurance products on an ancillary basis (such as travel agents and car rental companies). Certain exemptions exist for entities such as claims managers, loss adjusters and consumer association websites that provide insurance product comparisons but do not seek to sell specific contracts.

Although a wider breadth of distributors are caught by the IDD’s scope, as compared with the IMD regime, the IDD regime is designed to be applied proportionately and the IDD explicitly states in its text that it should not be “too burdensome” for small and medium-sized insurance and reinsurance distributors.

The IDD is a “minimum harmonizing directive”, meaning that individual E.U. member states can gold-plate the directive by adding more stringent requirements when transposing the directive into national law. The U.K.’s FCA has gold-plated some IDD obligations, including by augmenting its requirements to ensure consistency with the E.U. Markets in Financial Instruments Directive (“**MiFID II**”), which came into force at the beginning of 2018.

Key areas of the IDD are as follows:

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### a. Insurance-Based Investment Products

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Insurance-Based Investment Products (“**IBIP**”) are insurance products which offer a maturity or surrender value and which are also affected by market fluctuations, such as unit-linked life policies or life policies with profit-sharing elements. IBIPs were not previously subject to the client reporting requirements under MiFID II but the IDD has extended these requirements to IBIPs. These include information requirements regarding costs and charges, risk warnings, appropriateness assessments for non-advised sales of complex products and suitability requirements, including suitability assessments, which must take place once a year, at a minimum.

The IDD is consistent with MiFID II in its definition of what constitutes non-complex products, which are available to all investors on an execution-only basis and there is no change to the pre-existing rules on how they may be sold. However, for complex products, the distributor/insurer must either (i) adapt the product so that it becomes non-complex; or (ii) undertake an “appropriateness test” on the individual buying the policy to ensure that the policy is appropriate for their needs and their level of investment knowledge.

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### b. Demands and Needs

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Firms are required to take an active role in identifying their customers’ demands and to ensure that products offered are consistent with their insurance demands and needs. Firms should not, for example, offer a customer all the firm’s products accompanied by generic statements about the sorts of needs each product would meet. Any personal recommendations provided by a firm must include an explanation as to how the proposed product best meets the customer’s needs.

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### c. Staff Knowledge and Capability

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The FCA believes that most of the IDD’s knowledge requirements were already being met under the pre-IDD

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regime and where the pre-existing requirements were more robust than those of the IDD the FCA sought to retain them. An important new requirement, however, is that employees with responsibility for insurance distribution, such as brokers and even staff whose role may be limited to conducting non-advised, script-based sales (such as call centre staff), are required under the IDD to undertake at least 15 hours of training and continuing professional development each year. It is important for firms to be aware that they need to maintain records to demonstrate compliance with the knowledge and capability requirements.

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### d. Product Oversight and Governance

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The IDD has introduced new product governance requirements which apply to anyone who manufactures insurance products and those who distribute them. The rules require manufacturers to identify target markets for each product, maintain, operate and review a “proportionate and appropriate” product approval process which ensures that customers’ interests are taken into consideration throughout the product life cycle and review the product and distribution strategy to ensure consistency with the target market.

Distributors/intermediaries now have a greater responsibility for ensuring their distribution arrangements do not cause customer detriment, including by obtaining all relevant information from the manufacturer and defining a distribution strategy for particular insurance products.

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### e. Insurance Product Information Document

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Under the IMD regime, customers needed to be provided with a “statement of demands and needs” but the new Insurance Product Information Document (“**IPID**”) is more prescriptive in setting out the information which must be covered. Distributors and intermediaries must provide customers with an IPID in good time before the insurance contract is actually executed. An IPID is a simple document outlining what an insurance policy does and does not cover, where the policy applies, how long it lasts and other key features. It is intended to be clear and easy for customers

to understand, thereby allowing them to easily compare the elements of different insurance products.

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### f. Brexit and the IDD

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Brexit may create knock-on effects to the way in which U.K. insurers and insurance intermediaries are regulated. Nevertheless, the IDD, as transposed into U.K. law and regulation, will continue to apply in full whilst the U.K. remains a member of the E.U. and most likely at least for a period following Brexit.

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### iv. New Regulatory Challenges for Lloyd’s Syndicates

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In June 2018, Lloyd’s issued a warning that “consistently loss-making syndicates”, defined as those that have made a loss for the last three years consecutively, would be under close watch. Flowing from this, the 2019 Lloyd’s planning process proved to be one of the most challenging ever seen by Lloyd’s syndicates as they sought to put together business plans that show Lloyd’s how they will return to profitability. Despite their efforts, a number of syndicates have been sent into runoff after withdrawing from the 2019 Lloyd’s planning process, and many stronger syndicates have secured only business plan approvals with premium reductions or capital loadings. The clear intention of the increased scrutiny is to return Lloyd’s as a whole to profitability after a large £3.4 billion underwriting loss in 2017, but it seems unavoidable that the Lloyd’s market as a whole will be smaller in 2019 and syndicates will need to hold more capital against risk than in previous years.

There has nevertheless been some positive news for high-performing syndicates as industry reports suggest that the Lloyd’s performance management directorate is planning to work with a group of high-performing syndicates to pilot “light-touch” oversight by Lloyd’s in 2019. It is envisaged that the new framework would reduce duplication arising from the combination of Lloyd’s, PRA and firms’ own internal regulatory requirements. It is also hoped that the prospect of availing of the new framework will motivate syndicates to regularly meet business plan targets and minimum standards set by Lloyd’s.

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### v. Updates in Relation to Part VII Transfers

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#### a. Issues Arising in Recent Part VII Transfers

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In anticipation of Brexit, a number of firms have carried out, or are in the process of carrying out, Part VII transfers of business from their U.K. carriers to existing or newly incorporated companies in another E.U. jurisdiction, with the aim of ensuring their ability to pay claims on existing contracts even in the event of a hard Brexit. As a result of this, it was anticipated that regulatory capacity would be stretched and that Part VII transfers carried out in 2018 could face delays. This has been borne out to some extent in practice - the regulators have clearly been stretched and firms have had to ensure that they have sufficient flexibility in their timetables to react to any delays caused by the regulators not being able to respond quickly enough or raising further questions at a late stage in the process.

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#### b. FCA Part VII Guidance

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In May 2018, the FCA published guidance on its approach to the review of Part VII insurance business transfers. The intention of the guidance is to help applicants understand the FCA's approach and requirements, which may be different from those of the PRA, and to help reduce costs by setting out in advance the criteria against which the FCA will be reviewing the Part VII documentation. Although the guidance is not intended to be a definitive list of requirements for applicants, and the FCA will consider each application on its own merits and circumstances, the FCA has stated that it will expect applicants to explain why they have diverged from guidance where it is applicable to the relevant transfer. In large part, the guidance formalises what has been the practice of the FCA in recent years. The key parts of the guidance are as follows:

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##### *i) Initial Considerations*

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Applicants should ensure that both the FCA and the PRA are notified of a proposed Part VII transfer as soon as possible, with a meeting to be held with both regulators if a transaction is unusual or complex. Applicants should keep the regulators informed of the timetable, including any

changes, and should submit documents at least six to eight weeks before the relevant court hearing.

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##### *ii) Review of the Appointment of the Independent Expert*

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The FCA is consulted on the appointment of any proposed Independent Expert. In the guidance, the FCA notes that its review will include consideration of whether the Independent Expert is able to demonstrate (i) independence and (ii) sufficient skill, experience and resources. Concerning the former, the FCA will consider various questions that show whether the proposed Independent Expert is connected to the applicants, including questions about previous work carried out and any actual or potential conflicts of interest. Applicants should provide the FCA with a full CV for the proposed Independent Expert and each of their proposed principal team members, statements of independence and capacity for both the proposed Independent Expert and a proposed peer reviewer and a draft letter of engagement (including details of fees). From these documents, the FCA will consider whether the proposed Independent Expert has sufficient skill and experience in the context of the proposed transaction, as well as sufficient resources at their disposal.

Although the FCA does not set out a time frame for their approval of the Independent Expert in the guidance, approval by the FCA and the PRA can take a number of months and may be further delayed if either regulator does not agree with the applicants' initial choice.

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##### *iii) Overview of the FCA's Approach*

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The guidance states that the FCA will generally expect to file reports at Court in advance of each hearing. As well as considering the proposed transfer in the context of the FCA's statutory objectives and any proposed regulatory issues involving the applicants, the FCA will look closely at any changes affecting policyholders and whether such changes have been adequately considered by the applicants and the Independent Expert. Any objections raised by policyholders will also be considered, as will how the applicants and Independent Expert have dealt with such objections.

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### *iv) Key Documentation*

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The guidance goes into detail about particular areas of the documentation (namely the Scheme document, Independent Expert's report, the communications strategy and the waiver application) where the FCA has raised concerns and explains how these have been resolved. These examples are not intended to be prescriptive, but are intended to help applicants understand the FCA's position. Key areas covered by the guidance are:

**Scheme document** – the FCA's guidance focuses on clarity on what is being transferred, continuity of proceedings and changes to the Scheme, including its effective date. In particular, the FCA notes that the language used must make the scope of the transferred liabilities absolutely clear, defined and identifiable, with no ambiguity; the Scheme should contain a standard clause that all proceedings which are in train, pending, threatened or in contemplation with respect to the transferring business will continue against the transferee; and that there is a distinction between minor changes to the Scheme, which may be made without returning to Court though which should still be notified to the FCA, and more substantive changes, which require Court approval and in respect of which the FCA should be provided with at least six weeks' notice. The FCA may object to changes, and may also require that additional policyholder communications be made.

**Independent Expert's report** – the FCA's review of the Independent Expert's report will be carried out from the perspective of a policyholder, so its focus will be on ensuring that it is easily readable and understandable. The FCA notes that it often finds that Independent Experts' reports do not contain enough analysis to support their conclusions that there is likely to be no material adverse effect on policyholder groups, including in particular consideration of reasonable benefit expectations, type and level of service and management, administration and governance arrangements. Independent Experts should ensure that they challenge information and reach their own conclusion after a thorough analysis.

**Communications strategy** – the FCA's guidance notes that the notification and advertisement requirements are a fundamental protection within the Part VII process. The guidance provides detail on the FCA's expectations with respect to the entire communications process, including how to define the scope of "policyholders" who need to be notified, the importance of identifying, tracing and contacting policyholders and the need to ensure that communications are clear, fair and not misleading. The FCA also sets out key topics that it expects should be included in policyholder communications and the need for translations if appropriate.

**Applications for dispensations** – although a waiver application is not a formal document in the Part VII process, applicants will discuss any areas of the notification requirements that they feel they cannot feasibly fulfil, or that they feel it would be disproportionate to fulfil. The FCA requires any such application to be supported by adequate reasoning and evidence and expects firms to have given adequate consideration to overcoming any challenges (e.g. difficulties in tracing policyholders or disproportionate costs) before making an application for dispensation.

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### *vi. Big Data*

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Big Data is generally thought to encompass the "three Vs" – volume (the creation of a very large amount of data), velocity (the speed at which data can be analysed, *i.e.* in real time) and variety (the number of different sources of data that are brought together). In November 2015, the FCA published a "Call for Input on Big Data" in retail general insurance, with the aim of gaining a better understanding of how the use of data by firms has developed and how this use might change in the future. The FCA's particular concerns were the rate of increase in the use of Big Data, its importance to the insurance sector and the way in which it may alter the analysis of risks. This was followed by a Feedback Statement (FS16/5) in September 2016, which identified two areas in which the FCA believed Big Data could lead to consumers being worse off – increased risk segmentation and certain pricing practices, including price discrimination and price optimisation.

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This was not immediately followed by either a full market study or any regulatory changes, but Big Data has continued to be a focus of the FCA, in conjunction with the U.K.'s Information Commissioner's Office, with the two holding a joint forum with stakeholders. In 2018, the FCA has continued this focus on Big Data – the FCA's 2018/19 Business Plan, published in April 2018, included "Innovation, big data, technology and competition" as one of its cross-sector priorities. In particular, the FCA noted that the increased use of Big Data has the potential to cause harm, especially to vulnerable members of society, and that its regulatory aim was to allow consumers and firms to maximise the opportunity of big data, while reducing or mitigating the associated harms. The Business Plan noted that the FCA was scoping work to formalise the debate around Big Data and to assess whether further action is needed to ensure future insurance pricing practices support a market that is not detrimental to consumers. A speech given in July 2018 by the Chair of the FCA anticipated that policymakers should be thinking about how to mitigate the risks created by the increased use of Big Data, together with artificial intelligence, machine learning and behavioural science, suggesting that U.K. regulators should lead from the front with innovative regulation to address such concerns.

Given the continued focus on Big Data, it is plausible that 2019 could see additional regulation to address areas that the FCA sees as a risk to consumers.

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### vii. European Systemic Risk Board—New Oversight Proposals

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On November 26, 2018, the European Systemic Risk Board (the "**ESRB**") (the European body set up in 2010 in response to the financial crisis to provide macroprudential oversight of the E.U. financial system and to help prevent and mitigate systemic risk) published a report on macroprudential provisions, measures and instruments for (re)insurance, which is intended to inform ongoing discussions and reviews of Solvency II.

The report noted that current European regulation, including Solvency II, generally deals with risks on a microprudential level, *i.e.* at the level of individual (re)insurers or groups

of (re)insurers, and was not designed to fully address systemic risks, in particular the risks of (i) the systemic withdrawal/failure of (re)insurance services and (ii) direct or indirect contagion. The ESRB analysed the chains of events that could lead to such a systemic issue and set out a conceptual framework of the same in its report. Looking at the gaps in current regulation, the ESRB then set out a number of proposed approaches to deal with these gaps, concluding with a shortlist of approaches that, based on its analysis, would be the most effective, most efficient and easiest to operate.

These shortlisted approaches were (i) the extension of Solvency II reporting requirements, designed to encourage firms to take into account the macroprudential aspects of their decisions and behaviours; (ii) the introduction of a harmonised E.U.-wide recovery and resolution framework, designed to provide orderly procedures in case of failures across the E.U.; and (iii) a variety of individual measures that make up a "macroprudential toolkit", including the alignment of treatment of bank-like activities, market-wide capital increases and dividend restrictions, symmetric capital requirements for cyclical risks, liquidity requirements for insurers and a discretionary intervention power in cases of mass lapse.

The report notes that further work is needed to analyse each of the shortlisted options in more detail before any decision is made, so this is an area to watch in the coming year(s).

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### viii. E.U. & U.K. Competition Law

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Following the opening of a number of significant new cases and market studies in 2017, the insurance sector continued to be under scrutiny from competition authorities in the U.K. and the E.U., with the U.K. Competition & Markets Authority ("**CMA**"), the FCA and the European Commission announcing new cases and/or continuing multiple investigations.

## VII. Principal Regulatory Developments Affecting Insurance Companies

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### a. CMA Investigation into MFNs in Insurers' Contracts with Price Comparison Website

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In September 2017, the CMA had launched a competition law investigation into certain so-called “Most Favoured Nation” (“**MFN**”) or “parity” clauses in the contracts between ComparetheMarket and a number of home insurers which appear to have required home insurers to give ComparetheMarket the best rates they make available on rival sites and other distribution channels.

In November 2018, the CMA sent a formal charge sheet (*i.e.* a “Statement of Objections”) to ComparetheMarket. The CMA said in a press release that its provisional view is that such clauses prevent rival comparison sites and other channels from trying to win home insurance customers by offering cheaper prices than ComparetheMarket. The CMA also noted that the relevant MFN clauses result in home insurance companies being more likely to pay higher commission rates to comparison sites, with such extra costs potentially being passed on to customers.

It is not clear whether the CMA’s concerns relate only to clauses which prevent better prices being quoted on other third-party intermediary sites (so-called “wide MFNs”) or also to clauses which prevent better prices being quoted on the insurance providers’ own direct channels (the so-called “narrow MFNs”). Similar wide MFNs have previously been challenged by competition authorities across Europe in the online hotel booking sector. We expect the CMA to conclude this case later this year.

ComparetheMarket may already have contacted certain home insurers regarding non-enforcement of these MFN clauses. If the CMA maintains its view in its final decision (and we expect that it will) these home insurers will be able to offer better prices on (at least) other rival third-party distribution channels.

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### b. CMA Investigation into “Loyalty Penalty” Super-Complaint

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In response to a “super-complaint” made by the U.K. consumer body Citizens Advice, the CMA investigated

concerns that in certain markets, including the household insurance market, existing customers are charged more than new customers for the same service.

In December 2018, the CMA set out its findings and noted that its investigation had uncovered damaging practices by firms, which exploit unsuspecting customers. These include continual year-on-year stealth price rises; costly exit fees; time-consuming and difficult processes to cancel contracts or switch to new providers; and requiring customers to auto-renew or not giving sufficient warning that their contracts will be rolled over. The CMA noted that 12 million consumers in the household insurance market were affected by such conduct.

In relation to household insurance specifically, the CMA noted that there is evidence of firms continually raising prices in this market. It recommended that the FCA look closely at these pricing practices in its current market study (*see below*) and take action to prevent people’s being exploited by firms. This should include considering pricing interventions. The CMA also recommended that the FCA explore how intermediaries can continue to benefit the home insurance market.

In addition, the CMA made a number of general, cross-sectoral recommendations to discourage and penalise (what it considers to be) exploitative “loyalty penalty” practices.

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### c. FCA Market Study on Wholesale Brokers

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Following the FCA’s publication of its wholesale insurance broker market study in February 2019, we note these key takeaways from the FCA’s market study on the large brokers in the London market:

- *Broker market power:* The FCA found that the wholesale insurance brokerage sector as a whole was not highly concentrated but noted that brokers may have market power in certain sub-segments. The FCA also did not find evidence of excessive profitability. Overall, the FCA found that clients exercised a sufficient constraint on broker market power.

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- *Conflicts of interest*: The FCA noted that brokers receive higher remuneration rates from placing risks into their own facilities and MGAs than in the open market. In this regard, the FCA noted that brokers needed to improve their conflict of interest policies.
- *Pay to play*: The FCA was unable to conclude that pay-to-play exists at scale or that there is any basis for the FCA to intervene to prevent pay-to-play agreements.

Overall, despite predictions that the report could result in an increase in regulation, the report is relatively light touch in its proposals and unlikely to significantly alter existing London market dynamics.

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### d. E.U. Commission Investigation into Aviation Insurance

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Following a series of co-ordinated dawn raids in April 2017, the FCA launched an investigation into aviation insurance over suspicions that a number of brokers, including Jardine Lloyd Thompson and Willis Towers Watson, have been sharing competitively sensitive information.

The E.U. Commission subsequently initiated its own proceedings, in October 2017, into the exchange of commercially sensitive information and possible co-ordination between competitors. In light of the Commission's proceedings, the FCA has now closed its investigation.

It is unclear whether or when the E.U. Commission may present the parties under investigation with a formal charge sheet (Statement of Objections); that said, if such a step is taken this may not occur before 2020.

## VIII. TAX TRENDS AND DEVELOPMENTS AFFECTING INSURANCE COMPANIES

### A. U.S. Tax Developments

We note first that in 2018 the guidance to the insurance industry on the application of Tax Reform has been limited. The Tax Cuts and Jobs Act (throughout this section, the “**TCJ Act**”), which was signed into law at the end of 2017, significantly altered the landscape for the international insurance and reinsurance sectors by, among other things, imposing a minimum tax on outbound cross-border affiliate reinsurance (and possibly inbound as well), revising the rules applicable in determining controlled foreign corporation (“**CFC**”) status of foreign corporations and the U.S. shareholders potentially impacted by the CFC rules, and creating another hurdle for foreign insurers (and foreign parented insurance groups) to qualify for the insurance company exception to the passive foreign investment company (“**PFIC**”) rules. The TCJ Act left many questions related to the application of these new rules unanswered, and little progress was made with respect to the interpretation of the new rules in 2018.

The discussion below highlights some of the issues that have been addressed by the U.S. Treasury Department (“**Treasury**”) and Internal Revenue Service (“**IRS**”) proposed guidance and the many interpretative issues that remain open.

#### i. Base Erosion and Anti-Abuse Tax

New Section 59A of the Internal Revenue Code of 1986, as amended (the “**IRC**”), imposes an additional tax known as the BEAT on “applicable taxpayers” in an amount equal to the excess of 10 percent (five percent for one taxable year beginning after December 31, 2017 and 12.5 percent for taxable years beginning after December 31, 2025) of “modified taxable income” for a taxable year over an amount equal to its regular corporate tax liability for that year reduced by certain credits (the “base erosion minimum tax

amount”). “Modified taxable income” generally is computed by adding back the “base erosion tax benefit” derived from a “base erosion payment”, and “base erosion payment” includes, among other items, any amount paid or accrued by an “applicable taxpayer” to a “foreign related person” that is deductible to the payor and any reinsurance premium paid to a “foreign related person”. An “applicable taxpayer” generally means a corporation with average annual gross receipts for the three-taxable-year period ending with the preceding taxable year of at least \$500 million (subject to aggregation rules for certain groups) with a “base erosion percentage” (defined as the aggregate amount of “base erosion tax benefits” for the taxable year divided by the aggregate amount of deductions for such year) of at least three percent. A foreign person is related to the applicable taxpayer if either (i) it owns 25 percent or more of the taxpayer, (ii) it is related to the taxpayer or any 25 percent owner of the taxpayer under IRC section 267 (related to loss disallowance rules applicable to transactions between related parties) or IRC section 707 (related to transactions between partners and partnerships) or (iii) it is related to the taxpayer under the transfer pricing rules of IRC section 482. The specific inclusion of reinsurance premiums as base erosion payments was likely a response to arguments that reinsurance premiums were not deductible payments otherwise subject to the base erosion minimum tax rules under the insurance accounting rules of Subchapter L of the IRC.

The Treasury and IRS issued proposed regulations interpreting the BEAT on December 13, 2018 that addressed some of the issues related to the application of the BEAT in the cross-border affiliate reinsurance context. Among other things, these proposed regulations provide that:

- (1) in determining gross receipts of any corporation that is subject to tax as an insurance company under subchapter L of the IRC (or would be so subject if the corporation was a U.S. corporation), gross receipts would be reduced by return premiums but not reinsurance premiums;
- (2) the numerator and the denominator of the base erosion percentage would include reinsurance premiums paid



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to a foreign related party, though such payments may be viewed as reductions in gross income rather than deductions (whereas the preamble to the proposed regulations indicates that reinsurance premiums paid to unrelated reinsurers may not be included in the denominator of the base erosion percentage);

- (3) netting of amounts owed between the applicable taxpayer and a foreign related party generally would not be permitted, providing as an example that reinsurance premiums paid to a foreign related party would not be reduced or netted against other amounts owed to the applicable taxpayer from the foreign related party (such as reserve adjustments);
- (4) payments to a U.S. branch of a foreign related party would not be base erosion payments to the extent that the foreign related party is subject to U.S. income tax on such payments under the IRC (as “effectively connected income”) or an applicable income tax treaty (as income attributable to a U.S. permanent establishment); and
- (5) payments to a foreign related party that has elected to be taxed as a U.S. corporation under Section 953(d) of the IRC would not be considered base erosion payments as the electing corporation is treated as a U.S. corporation for all purposes of the IRC.

In the context of inbound cross-border affiliate reinsurance, the proposed regulations do not provide definitive guidance on payments by a U.S. reinsurer to a foreign related insurance company, such as payment for losses. The preamble notes that loss payments may be viewed as deductions for life and nonlife insurers, but may also be treated as reductions in gross income of nonlife insurers. The IRS requested comments on the appropriate treatment of loss payments and whether a life insurer should be treated similarly to a nonlife insurer if it is determined that loss payments of a nonlife insurer should be treated as a reduction of gross income rather than a deduction for BEAT purposes (in which case the loss payments would not be a base erosion payment and possibly may be excluded from

the numerator and the denominator of the base erosion percentage).

Although, as noted above, the proposed regulations generally do not permit netting of payments in computing the base erosion payment, the IRS requested comments on whether reinsurance contracts should be distinguished from other contractual arrangements that allow for settlement on a net basis.

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### ii. Limiting the Active Insurance Exception to the PFIC Rules

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The TCJ Act also tightened the Active Insurance Exception (as defined below) to the PFIC rules. A U.S. taxable investor in an offshore insurer or reinsurer is generally able to defer U.S. taxation until a sale of its shares in the offshore insurer or reinsurer and to pay tax on such sale at long-term capital gain rates, if, among other things, the offshore insurer or reinsurer qualifies for an exception to classification as a PFIC because it is treated as an insurance company for U.S. tax purposes that is engaged in the active conduct of an insurance business (the “**Active Insurance Exception**”). The TCJ Act imposed a new restriction that generally limits the application of the Active Insurance Exception to companies that would be treated as insurance companies for U.S. tax purposes with (1) losses and loss adjustment expenses and (2) reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks equal to more than 25 percent of its total assets as reflected on the company’s applicable financial statement (with a lower 10 percent threshold applying in the case of certain run-off or rating-related circumstances, in which case a U.S. taxable investor may elect non-PFIC treatment) (the “**Reserves Test**”), provided certain other requirements are satisfied.

The IRS has received a significant number of comments and has met with industry representatives on a number of occasions, but has not issued proposed regulations interpreting the Active Insurance Exception to date. As a result, significant uncertainty persists in determining

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whether a foreign insurance company or a foreign parent of an insurance group should be characterized as a PFIC, including:

- (1) the status of proposed regulations issued in 2015 relating to the Active Insurance Exception, which required (among other things) the insurance company's employees and officers to conduct substantial managerial and operational activities;
- (2) the treatment of domestic insurance subsidiaries of a foreign-parented insurance group;
- (3) the application and coordination of look through rules in determining the PFIC status of a foreign parent;
- (4) the appropriate statement that serves as the "applicable financial statement" for purposes of the Reserves Test;
- (5) the run-off and rating agency circumstances that would satisfy the lower 10 percent threshold of the Reserves Test;
- (6) the method of election by a U.S. shareholder to treat a foreign insurance company as a non-PFIC if the lower 10 percent threshold is satisfied; and
- (7) the type of losses and loss adjustment expenses that could be taken into account for the Reserves Test (e.g., paid and unpaid, undiscounted, etc.).

Guidance in the form of proposed regulations is expected shortly, but such guidance may not resolve many of the open issues related to the Active Insurance Exception.

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### iii. Expansion of the CFC Rules

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The TCJ Act significantly expanded the universe of CFCs and U.S. shareholders impacted by a foreign corporation's CFC status (10% U.S. Shareholders). A 10% U.S. Shareholder of a CFC would be required to include in income for a taxable year its pro rata share of Subpart F income of the CFC, including certain insurance and related investment income, even if such income is not distributed. A foreign reinsurer would be considered a CFC if 10% U.S. Shareholders own

more than 25 percent of the vote or value of its shares. The TCJ Act expanded the definition of 10% U.S. Shareholder to include U.S. persons owning 10 percent or more of the value of the CFC's shares (whereas prior law only looked to voting power). In addition, the TCJ Act expanded certain attribution rules for stock ownership in a way that would cause foreign subsidiaries in a foreign-parented group that includes a U.S. subsidiary to be treated as CFCs through the repeal of a rule that would have prevented downward attribution of share ownership from a foreign parent to its U.S. subsidiary (the "**Downward Attribution Rule**"). Although the conference agreement providing an explanation of the TCJ Act clarified that the provision was intended to target inversion or similar transactions that avoid Subpart F by "de-controlling" a foreign subsidiary so that it is no longer a CFC and indicated that the proposed rule was not intended to impact other 10% U.S. Shareholders that are not related to the U.S. subsidiary if the foreign subsidiaries are not otherwise treated as CFCs, the legislative language did not comport with this intent. As a result of the modifications to the CFC rules, voting cutback and push-up provisions in the organizational documents of many foreign-parented insurance and reinsurance groups will be ineffective in avoiding 10% U.S. Shareholder status for 10 percent or greater U.S. economic owners in the CFC analysis. U.S. tax exempt entities subject to the unrelated business taxable income ("**UBTI**") rules that own 10 percent or more of the value of a foreign reinsurer that is characterized as a CFC should consider the implications of IRC section 512(b)(17), which could result in UBTI for such investors. Although these changes to the CFC rules should not impact foreign insurance groups with a widely dispersed shareholder group, U.S. investors in foreign insurance vehicles with a concentrated shareholder base could be adversely impacted.

In December 2018, the Joint Committee on Taxation, in its general explanation of the TCJ Act, indicated that a technical correction may be necessary to reflect the intent of Congress in repealing the Downward Attribution Rule. A bill introduced in the House of Representatives at the end of 2018 would restore the Downward Attribution Rule and provide for a limited exception to the general rule based on

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the narrow intent expressed by Congress; however, the fate of the bill or any similar proposal remains uncertain.

### B. International and U.K. Tax Developments

#### i. U.K. VAT—"Offshore Looping" by Insurance Intermediaries

A new anti-avoidance rule comes into force from March 1, 2019 to restrict VAT recovery by insurance intermediaries when the principal supply of insurance is made to U.K. customers.

A business can recover input tax (VAT on supplies made to the business) if the input tax is attributable to:-

- Taxable supplies.
- Supplies outside the U.K. that would be taxable if made in the U.K.
- Supplies specified in the Value Added Tax (Input Tax) (Specified Supplies) Order 1999 (SI 1999/3121) (the "**Specified Supplies Order**"), including financial and (re)insurance services supplied to customers belonging outside the E.U. and intermediary services connected with such financial or (re)insurance services.

Services are normally treated as supplied at the place where the recipient belongs if the recipient is a relevant business person; otherwise, the place of supply is where the supplier belongs. A relevant business person belongs in the country where it has a business establishment or, if it has a business establishment in one country and a fixed establishment in another country, it belongs in the country in which the establishment most directly concerned with the supply is located.

The provision of insurance cover and the provision of insurance intermediary services are both exempt supplies (rather than taxable supplies) for VAT purposes. This means that a U.K.-based insurer or insurance intermediary does not charge VAT on the supplies that it makes (*i.e.* on the insurance premium or commission). However, it cannot recover its attributable input tax (which then becomes a cost borne by the business which will ultimately

be reflected in its pricing) unless the supply falls within the Specified Supplies Order.

In the *Hastings* case,<sup>9</sup> the U.K. taxpayer company provided supplies of insurance broking, underwriting support and claims-handling services to an insurance company incorporated in Gibraltar. The Gibraltar insurance company provided insurance to U.K. customers, acting through the U.K. taxpayer company as its broker and intermediary. Over the relevant period, the two companies were at some points in time affiliated and at others unrelated. The U.K. company was successful in the First-tier Tribunal with regard to its claim to recover input tax that was attributable to the supplies made to the insurance company, on the basis that these supplies were made outside the E.U.; in other words, within the scope of the Specified Supplies Order. The tribunal rejected the tax authority's argument that the U.K. intermediary constituted a U.K. fixed establishment of the Gibraltar insurer and that the supplies were made in the U.K. to that U.K. fixed establishment. This conclusion was based on the detailed facts and contractual arrangements between the two companies.

The U.K. government responded by introducing a rule to restrict the scope of the Specified Supplies Order on the grounds that some businesses have been exploiting the rules and deliberately setting up so-called "offshore looping" arrangements solely for the purposes of recovering VAT. Under the new rules, VAT recovery by U.K. insurance intermediaries will now be denied where the ultimate supply of insurance cover is made to a person who belongs in the U.K.

This will create a level playing field for U.K.-based insurers but, given that the new rules do not distinguish between cases where the non-E.U. insurer is affiliated with the U.K. insurance intermediary and where they are unrelated, insurance intermediaries may find it difficult, where there is no connection, to determine the location of the insurer's own customers.

In addition, (re)insurance businesses should consider whether their intra-group arrangements, involving U.K.-

<sup>9</sup> *Hastings Insurance Services Ltd v HMRC* (2018) UKFTT 27 (TC)

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based intermediaries providing services to non-E.U.-based insurers with U.K. policy holders, might be caught by these new rules. The rules apply even if the arrangements have not been set up as a form of VAT planning but for other commercial reasons, for example with the goal of writing business through a Bermuda, Gibraltar, Guernsey or other non-E.U. insurer for reasons of capital efficiency and risk management.

More wide-ranging changes to the Specified Supplies Order are also a possibility. At the time of writing, there is no clarity as to the outcome of the Brexit process. In August 2018, the U.K. government published a paper outlining the impact of a “no-deal” Brexit. This flagged the point that, in that situation, the Specified Supplies Order might need to be restricted for budgetary reasons. If there is no withdrawal agreement or transition period and the U.K. simply ceases to be a member of the E.U. on March 29, 2019, there will be no logic in treating input tax attributable to insurance intermediary supplies into E.U. countries (not recoverable) differently from input tax attributable to supplies into non-E.U. countries (recoverable). However, leveling up input tax recovery for all such supplies is likely to be too expensive for the U.K. government.

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### ii. Insurtech - Proposed Digital Services Taxes: U.K., E.U. and Global Measures

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Insurtech businesses may be affected by a proposed digital services tax (“**DST**”).

The U.K. government is consulting on the detailed design and implementation of an interim U.K.-specific version of DST (“**U.K. DST**”), intended to take effect from April 2020.

Digital business models pose challenges for the international corporate tax system in terms of the allocation of taxing rights between jurisdictions due to their ability to generate value in a location without a physical presence there, and because some are perceived to exploit new sources of value creation derived from user participation.

In its current draft formulation, U.K. DST will be a 2 percent tax on gross revenues (rather than net profits) derived

from three specific “in-scope” business activities, namely the provision of a social media platform, the provision of a search engine and the provision of an online marketplace. It is this third activity, described as one which generates revenue through allowing users to advertise, list or sell goods and services to other users on the platform and the monetisation of users’ engagement, which is potentially relevant to insurance intermediary websites. Having said that, the boundary between in-scope and out-of-scope activities is not straightforward. The U.K. government has said that the provision of financial services will be outside the scope of DST because these activities are not considered to derive significant value from user participation.

U.K. DST will apply to third-party revenues linked to the participation of U.K. users. Businesses marketing their own services online will not be in-scope. In a cross-border transaction, the involvement of one U.K. user will be enough to bring revenues within scope.

U.K. DST is targeted at larger businesses—those generating more than £500 million in global annual revenues from in-scope business activities and £25 million in annual revenues from in-scope business activities linked to U.K. user participation. There will be a “safe harbour” for businesses which are loss-making or have a very low profit margin.

Reflecting the fact that the U.K. government, in proposing to introduce U.K. DST, is moving ahead of the global discussion on the taxation of digital business models being led by the OECD, and is also pre-empting E.U. proposals for a digital services tax, a sunset clause is proposed whereby U.K. DST will cease to apply if an appropriate global solution is implemented.

The U.K. government is taking the position that U.K. DST is consistent with its international treaty obligations and, in line with that argument, U.K. DST will not be creditable against U.K. corporation tax, although it will potentially be deductible as an expense in computing profits subject to corporation tax.

In practice, there are likely to be difficulties in identifying U.K. users. In the case of an insurance intermediary website,

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assuming U.K. DST is, in principle, applicable, IP addresses or payment details might provide acceptable evidence of user location.

In a cross-border context, there is a considerable risk of double taxation. If the company subject to U.K. DST is not a U.K. corporation tax payer, then the U.K. deduction for DST will be of no value and the net effect will depend on whether the company's relevant home jurisdiction tax regime allows a credit or deduction for U.K. DST.

Meanwhile, the OECD issued a policy note in January 2019 and a public consultation document in February 2019, outlining various proposals and seeking to identify and build an international consensus on digital taxation measures.

The E.U., like the U.K., has been considering an interim E.U.-wide DST measure in order to keep up the pressure on the international dialogue. However, several Member States are opposing any E.U.-level measures and believe that it would be better to wait for a multilateral global consensus to develop. In response, a Franco-German joint declaration now calls for an interim E.U. DST on advertising sales with effect from January 1, 2021 (if no international agreement is reached within the OECD by that date); however, the scope of the proposed E.U. DST has been narrowed so as to exclude intermediary activities. In the absence of agreement between E.U. member states, France, Spain and Italy have announced that they will introduce a unilateral national version of DST, to come into force on an interim basis, in 2019.

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### iii. Solvency II / Hybrid Capital Instruments—New U.K. Tax Regime

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In our 2013 Year in Review, we discussed the introduction of special U.K. tax rules for instruments that contain certain loss absorbency features in accordance with Solvency II capital requirements.

Greater clarity of U.K. tax treatment for Additional Tier 1 and Tier 2 capital of banks was achieved through the Taxation of Regulatory Capital Securities Regulations 2013 (S.I. 2013/3209) ("**RCS Regulations**"), introduced to

coincide with the E.U. Capital Requirements Directive IV ("**CRD IV**"), which had effect from January 1, 2014. These regulations were extended to insurance companies with effect from January 1, 2016.

From January 1, 2019, a new non-sector specific hybrid capital instruments regime came into force ("**new HCI regime**"). For many issuers, the new rules will bring additional complexity. Having said that, the new HCI regime does demonstrate a welcome continuing commitment by the U.K. government to cater for tax deductible regulatory capital.

The RCS Regulations will generally be revoked with effect from January 1, 2019 and be replaced by the new HCI regime. HMRC has stated that the change is due to the Bank of England finalising its approach to setting a minimum requirement for own funds and eligible liabilities that banks, building societies and investment firms need to maintain, as this will permit such institutions to issue types of hybrid capital that are not within the scope of the RCS Regulations. There are also concerns (which HMRC has not acknowledged in its policy announcement) that the sector-specific nature of the RCS Regulations (which apply to banks (under CRD IV) and insurers (under Solvency II)) could breach the E.U. prohibition of selective state aid. The E.U. Commission has challenged similar Dutch tax rules on that basis. This means that the U.K.'s new HCI regime will (in principle) be 'open to all'.

The RCS Regulations apply to all securities in debt form which qualify as Solvency II-compliant Tier 1 or Tier 2 capital for regulatory purposes. The new HCI regime does away with such a simple gateway test. Instead, to benefit from the new regime, the security must constitute a "hybrid capital instrument" (as defined). The qualifying conditions are that the debtor is entitled to defer or cancel a payment of interest; the debt has no other "significant equity features"; and an irrevocable election is made by the debtor.

A loan relationship has no other significant equity features if the holder has no voting rights in the debtor nor any right to exercise a dominant influence over the debtor; any provision for altering the amount of the debt is limited to

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write-down or conversion when the debtor is experiencing solvency or liquidity problems; and any provision for the creditor to receive anything other than interest or repayment of the debt is limited to conversion when the debtor is experiencing solvency or liquidity problems. Only write-down or conversion rights exercisable by the debtor are permitted.

The normal deadline for making the election is six months of the debtor becoming a party to the loan relationship. The time for making the election is extended to September 30, 2019, where the debtor was already a party to the loan relationship before January 1, 2019.

In practice, the conditions for constituting a “hybrid capital instrument” should be straightforward to meet in most cases but, unlike the current rules in the RCS Regulations, it will be necessary to review the particular characteristics of the instrument in question, on a case by case basis, to confirm the analysis. Certain unusual add-on features (such as voting rights or optional creditor conversion rights) could cause an instrument to fall outside the new HCI regime.

Under the new HCI regime, as under the RCS Regulations, a hybrid capital instrument will count as a “normal commercial loan” and accordingly should not risk breaking a tax grouping, by reference to tests which are based on equity relationships between companies. There is also an exemption from stamp duties on transfers of hybrid capital instruments (as there is under the RCS Regulations).

However, in some respects the new HCI regime is less generous than the RCS Regulations.

One important difference relates to the tax deductibility of the interest for the debtor. As a matter of general U.K. tax law, if interest payments are “results dependent”, the interest is effectively recharacterised as a dividend and is, therefore, not deductible in computing the issuer’s profits for corporation tax purposes, except to the extent that such interest is paid to another company which is subject to U.K. corporation tax. In addition, interest on certain “perpetual debt” that is held by a company associated

with the issuer is recharacterised as a dividend. Where the RCS Regulations applied, the results dependent rule was effectively disapplied in its entirety and the interest was definitively characterised as interest.

However, the fact that a hybrid capital instrument falls within the new HCI regime will not be sufficient to secure the desired tax treatment in this respect. Although the new RCI regime does confirm that a hybrid capital instrument will not be caught by the perpetual debt rule (which assists in relation to interest paid on instruments held by non-U.K. affiliates), an analysis will still be required in order to confirm that the results dependent rule does not apply. This will turn on whether, on basic principles, solely ignoring any debtor right to defer or cancel a payment of interest, payments under the instrument should be treated for tax purposes as interest or distributions. This will mean revisiting some of the pre-RCS Regulations jurisprudence and HMRC practice. In particular, HMRC’s pre-RCS Regulations published guidance in HMRC Brief 24/14 will become relevant again, along with the Technical Note issued by HMRC on October 29, 2018. The guidance is helpful. However, the new approach puts more responsibility onto advisors and requires a more detailed examination of the terms and conditions of a regulatory capital security before a U.K. tax opinion can be given. There will also be some areas where the position is less clear-cut than it used to be. For example, if the interest is excessive, by reference to a “reasonable commercial return” test, part of the coupon may be recharacterised as a (non-tax deductible) distribution.

Nor does the new HCI regime (unlike the RCS Regulations) include any special rule to protect against a tax charge on the issuer in the event of a write down or conversion. HMRC seem to envisage that the issuer could rely instead on one of the general provisions in the U.K. tax code, relating to debt for equity swaps or a release to avert a likely insolvency event within 12 months. However, there is a concern that a mandatory write down of restricted Tier 1 instruments issued by an insurance company could well be triggered in a situation where it is not likely that the company will otherwise be unable to pay its debts as they fall due within 12 months. The HMRC Technical

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Note refers to working with the industry to consider fully the impacts of the revocation of the RCS Regulations for insurers and reinsurers but the grace period is short – only write downs or conversions of existing instruments before July 1, 2019 enjoy “grandfathered” protection under the RCS Regulations.

Another potentially important difference is that the automatic exemption from U.K. withholding tax for interest payments on hybrid capital instruments has not been replicated in the new HCI regime. Such instruments are often listed on a “recognised stock exchange” (and therefore qualify for the exemption from withholding tax for “quoted Eurobonds”), in which case this change should have minimal practical implications. In addition, the exemption under the RCS Regulations is not revoked until the Finance Act 2019 is passed and will continue to apply to instruments in issue before January 1, 2019 in relation to payments before January 1, 2024. However, thereafter, if the securities are not listed, withholding tax would apply to payments of interest to a non-U.K. holder who is not entitled to double tax treaty protection.

Issuers of existing hybrid debt should review the terms and conditions in the light of the new RCI regime and, where appropriate, make the irrevocable election by September 30, 2019. In the future, U.K. issuers and their advisors will need to carry out a more detailed tax analysis before proceeding with a fresh issue of regulatory capital securities.

### IX. GLOSSARY

- **"AG 48"** means the NAIC Actuarial Guideline 48.
- **"AIG"** means American International Group.
- **"APR"** means the U.K.'s Approved Persons Regime.
- **"Authorized Control Level"** means a minimum capital level calculated by the RBC formula.
- **"BEAT"** means the U.S. Base Erosion and Anti-Abuse Tax.
- **"Brexit"** means the U.K.'s political decision and procedure to withdraw from being a member state in the European Union.
- **"CFC"** means a controlled foreign corporation under U.S. tax law.
- **"Code"** means the U.K. Corporate Governance Code.
- **"CRBs"** means cannabis-related businesses.
- **"DST"** means certain potential digital services taxes.
- **"E.E.A."** means the European Economic Area.
- **"ESMA"** means the European Securities and Markets Authority.
- **"E.U."** means the European Union.
- **"FCA"** means the U.K.'s Financial Conduct Authority.
- **"FSB"** means Financial Stability Board.
- **"FSOC"** means Financial Stability Oversight Council.
- **"FTSE"** means the Financial Times Stock Exchange with reference to an index of stocks.
- **"GDPR"** means the E.U.'s General Data Protection Regulation.
- **"GICs"** means guaranteed investment contracts.
- **"G-SIIs"** means Global Systematically Important Insurers.
- **"IAIS"** means International Association of Insurance Supervisors.
- **"IBIPs"** means insurance-based investment products.
- **"IBTs"** means insurance business transfers.
- **"IDD"** means the European Insurance Distribution Directive, which is replacing the IMD, below.
- **"ILS"** means insurance-linked securities.
- **"IMD"** means the European Insurance Mediation Directive, replaced by the IDD, above.
- **"IPID"** means Insurance Product Information Document and its legal regime.
- **"IRC"** means the Internal Revenue Code of the United States.
- **"IRS"** means the U.S. Internal Revenue Service.
- **"LPS"** means limited-purpose subsidiaries.
- **"MiFID II"** means the currently in force European Markets in Financial Instruments Directive.
- **"NAIC"** means National Association of Insurance Commissioners in the U.S.
- **"NYDFS"** means New York Department of Financial Services.
- **"PBR"** means certain principle-based methods of life insurance reserving.
- **"PCC"** means protected-cell company.
- **"PFIC"** means a passive foreign investment company under U.S. tax law.
- **"PRA"** means the U.K.'s Prudential Regulation Authority.



## IX. Glossary

- **"the Principles"** mean the Corporate Governance Principles for Large Private Companies under U.K. regulations.
- **"Prospectus Regulation"** means the governing E.U. securities prospectus regime.
- **"PRs"** refers to prescribed responsibilities of senior managers under the SIMR and SM&CR.
- **"RBC"** means Risk-Based Capital.
- **"RCS Regulations"** means the Taxation of Regulatory Capital Securities Regulations.
- **"SCR"** means Solvency Capital Requirement.
- **"SEC"** means the U.S. Securities and Exchange Commission.
- **"SIFI"** means systematically important financial institution.
- **"SIMR"** means the Senior Insurance Managers Regime, predecessor to the SM&CR, below.
- **"SM&CR"** means the Senior Managers and Certification Regime, successor to the SIMR, above.
- **"Solvency II"** means the European Union's Solvency II Directive (Directive 2009/138/EC) which went into effect on January 1, 2016.
- **"S&P"** means the rating agency Standard & Poor's.
- **"TCJ Act"** means the U.S. Tax Cuts and Jobs Act of 2017.
- **"UBTI"** means unrelated business taxable income under U.S. tax law.
- **"VA"** means variable annuities.



# Willkie's Insurance Transactional and Regulatory Practice

Willkie's Insurance Transactional and Regulatory Practice is one of the preeminent practices in the industry, representing insurance companies, investment banks, sponsors and other financial institutions in transactions involving M&A, ILS, finance, excess reserves, longevity, de-risking and traditional capital markets, as well as advice on regulatory and tax matters involving insurers in the U.S., U.K., Lloyd's, Europe and Bermuda.

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