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Willkie Insurance Industry Review

Corporate and Risk Transactions, Regulation and Tax Developments

January 2021

January 15, 2021

To Our Clients and Friends:

As lawyers we are trained to anticipate the worst case and to always have a Plan B. This has served us well for the decades we have been advisors to the insurance industry during which we and our clients have experienced financial market dislocations and recessions, armed conflicts, natural catastrophes and terror events. But never have we experienced anything like COVID-19 and its public health, economic and social impacts. Long after this pandemic has been conquered we will be living with its consequences and the sobering and tragic human toll it has left in its wake.

Before offering our insights and observations on a remarkable year, we would like to offer our thoughts and best wishes to our friends and clients who have been affected by this pandemic and to take note of the tremendous resiliency of the insurance industry and the essential role it plays in the global economy. We also wish to thank our clients for the privilege of advising them on many of the more significant transactions and issues involving the industry during this most unusual year.

Sincerely,

Insurance Transactional and Regulatory Practice

Willkie Farr & Gallagher LLP

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I. REVIEW OF M&A ACTIVITY

A. United States and Bermuda

Notwithstanding a COVID-19 pause that adversely affected deal making in the first half of the year, the overall level of insurance industry M&A activity remained surprisingly strong in 2020. More than 230 life, health and P&C deals were announced in 2020 compared to 280 in 2019. However, as was the case in 2019, 2020 was noteworthy for the relative absence of "megadeals" and, in particular, the muted insurance M&A environment in Bermuda. In prior years the consolidation of the Bermuda reinsurance sector had generated some of the larger transactions. This was not the case in 2020 where the largest announced transactions were Third Point Re's combination with Sirius International ($788 million) and Arch Capital's $700 million agreement to acquire Watford Holdings.

The largest U.S. deal announced last year was KKR's agreement to acquire life insurer Global Atlantic ($4.0 billion) followed closely by MetLife's agreement to sell its P&C business to Zurich's Farmers Group subsidiary and the Farmers Group reciprocal exchanges ($3.94 billion) and Allstate's acquisition of P&C insurer National General ($3.76 billion). The only other U.S. deals involving purchase prices in excess of $1.5 billion were Fidelity National Financial's acquisition of life insurer FGL Holdings ($1.8 billion) and MetLife's acquisition of managed care provider Versant Health ($1.675 billion). In an industry where megadeals are rare the occurrence of one or two such transactions can significantly skew comparisons with prior periods based on deal value. Also, much of the deal activity in 2020–particularly in the life and health sector–involved the sales of blocks of businesses effected through reinsurance, with Equitable's reinsurance of a significant portion of its VA business to Venerable Holdings being a prime example. These transactions are not always counted by public M&A databases, making it difficult to compile complete lists of deal activity and complicating comparisons with prior periods.

In addition, in March 2020, global insurance brokers Aon and Willis Towers Watson announced a definitive agreement to combine in an all-stock transaction with an implied combined equity value of approximately $80 billion.

i. Life and Health Transactions

In 2020, no "megadeals" occurred in the life and health sector. In fact, only three legal entity transactions that exceeded $1.5 billion in deal value were announced last year: KKR's acquisition of Global Atlantic, Fidelity National Financial's acquisition of FGL Holdings and MetLife's acquisition of Versant Health.

KKR's pending $4 billion acquisition of Global Atlantic continues the recent trend of financial sponsors acquiring insurers with large fixed annuity and life insurance reserves. Although KKR has long been an active investor in the insurance sector, the acquisition meaningfully expands its base of permanent capital, further diversifies and scales its business and grows its position within the insurance industry, which has been increasing its exposure to alternative investment strategies. With the acquisition of Global Atlantic, KKR joins the ranks of financial sponsors including Apollo and Carlyle with life and annuity platforms.

In June 2020, Fidelity National Financial, the leading provider of title insurance and closing and settlement services to the real estate and mortgage industries, acquired for approximately $1.8 billion the shares which it did not already own of FGL Holdings, a provider of fixed indexed annuities and life insurance company.

Also in 2020, MetLife acquired for $1.675 billion Versant Health from an investor group including Centerbridge Partners and FFL Partners. Versant Health owns the marketplace brands Davis Vision and Superior Vision. With a large percentage of employees interested in receiving vision insurance through their employers, the acquisition will further strengthen and differentiate MetLife's vision benefit offerings, and its customers will gain access to Versant Health's provider network that is one of the largest in the industry.

Although not a member of the $1.5 billion deal value club, Equitable's reinsurance of a substantial portion of its legacy variable annuity business backed by approximately $12 billion of general account assets to Venerable Holdings excited substantial favorable industry comment. Venerable was formed by an investor group led by Apollo to acquire Voya's annuity business in 2019 and to serve as a consolidation platform with variable annuity expertise. As part of the transaction, Equitable will also sell its run-off variable annuity reinsurance entity, Corporate Solutions Life Reinsurance Company. According to Equitable's press release, the transaction will generate approximately $1.2 billion of value on a statutory basis. The transaction is the largest variable annuity reinsurance transaction to date and we expect to see more of these kinds of transactions this year.

We also note that notwithstanding the absence of a significant number of large legal entity transactions in the life and annuity space, the market for blocks of business remained active in 2020–as evidenced by the Equitable transaction–and should remain so in 2021 and beyond. Increasingly, these reinsurance transactions are at the core of M&A activity in the life and annuity sector. Various factors are responsible for the 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 capital intensive, non-core, volatile or otherwise perceived to be problematic (e.g. long-term care). In addition, the scale bar is rising constantly, causing companies to evaluate operations regularly. A long-term, low interest rate environment has also been a significant factor encouraging exits from certain lines of capital-intensive and relatively low return businesses.

A growing roster of buyers is competing for blocks of life insurance and annuity business including industry consolidators, platforms affiliated with private equity firms and some of the larger mutual insurers. These buyers typically bring significant expertise and experience with respect to run-off management. As a result, deals that in prior years might have been difficult to accomplish, such as variable annuities, are now getting done. We also note that legislative developments in certain states may further facilitate the acquisitions of blocks of business. As we discuss in more detail below, several states have adopted business transfer legislation that permits the "division" of an insurer into separate legal entities in a sort of corporate mitosis. The practical and legal benefits of these statutes to the sponsoring insurers are manifest–but one significant benefit will be to permit a block reinsurance transaction to be structured as a sale of a legal entity which will substantially reduce counterparty credit exposure and the potential application of counterparty risk capital charges, which is a recurring issue of large block reinsurance trades.

ii. Property/Casualty Transactions

Consistent with 2019, P&C M&A transactions did not supercharge deal volume in 2020. We believe that several years of consolidation among Bermuda-domiciled reinsurers–a formerly active segment of the P&C M&A market–has substantially reduced the number of Bermuda-domiciled acquisition candidates with a knock-on effect on deal activity. In addition, because of COVID-19 and more fundamental factors the P&C industry–particularly certain commercial property and casualty lines and segments of the cat market – last year attracted substantial amounts of start-up capital reminiscent of prior periods of insurance company formations following specific events (e.g., 9/11 and Hurricane Katrina). Matching a management team with special underwriting and risk management expertise with investment capital liberates investors from the tyranny of the back book. For these reasons we believe the class of 2020 startups depressed P&C M&A activity.

2020 was not, however, without its share of significant P&C transactions. In December 2020, MetLife announced that it had agreed to sell its Auto & Home business to Zurich Insurance Group subsidiary Farmers Group, Inc. for $3.94 billion. Farmers Group intends to sell the insurance operations to the Farmers Exchanges that it manages. In connection with the transaction, MetLife and the Farmers Exchanges will enter into a strategic partnership through which the Farmers Exchanges will offer its personal lines products on MetLife's U.S. Group Benefits platform. The transaction, which followed the announcement of MetLife's

agreement to acquire Versant Health, is consistent with its articulated New Horizon strategy.

In July, Allstate announced its agreement to acquire National General Corporation for approximately $4 billion. The company in its press release stated the deal accelerates Allstate's strategy to increase market share in personal-property liability and will significantly expand its independent agency distribution. National General provides a wide range of property-liability products through independent agents with a significant presence in non-standard auto insurance.

iii. Financial Sponsors and Insurance M&A

Financial sponsors and private equity backed companies continue to be significant players in the insurance-related transaction landscape. Of the largest U.S. deals announced last year, private equity firms or private equity backed companies were acquirers (KKR's agreement to acquire Global Atlantic), or sellers (Fidelity National Financial's acquisition of FGL Holdings, MetLife acquisition of Versant Health) in three of the top five U.S. transactions with notable focus in the life and annuity sector. Financial sponsors have continued to be active in smaller transactions as well, such as Flexpoint Ford's partnership with TigerRisk Partners, a strategic advisor to the insurance and reinsurance industry, and in 2020 representing a significant portion of all deal activity in the agency/broker space. With substantial dry powder available for investment, we expect continued high activity levels from private equity firms (or private equity backed companies) in the coming year, including for InsurTech M&A, given private equity's existing expertise in the technology sector and related M&A transactions.

Larger alternative investment management firms, partnering their asset management capabilities across a broad spectrum of asset classes with available funds for investments, both directly and through established platform investments, continue to pursue both traditional M&A and acquisition by reinsurance opportunities, including variable annuity (as well as fixed annuity and life insurance) businesses, for example Equitable's reinsurance of a significant portion of its Variable Annuity business to Venerable Holdings.

PE-backed transactions continue to represent a different set of considerations from the regulatory approval perspective as compared to strategic M&A. Though PE-backed transaction are becoming ever-more commonplace, and state insurance regulators continue to gain familiarity and comfort with private equity sponsors generally and frequent industry participants specifically, the considerations to be taken into account by a state insurance regulator in evaluating whether to approve an acquirer of "control" of an insurer domiciled in that state, including when considering potential differences in the expected time frame for an exit and how a financial sponsor's investment horizon may impact the regulator's goal of policyholder protection, may raise different issues than a traditional strategic buyer, in particular around the terms of affiliate agreements such as investment management agreements, reinsurance agreements and administrative services agreements that may be entered into in connection with the transaction. The allocation of regulatory risk in transactions with financial sponsors, and the scope of the obligations of such financial sponsor and its equityholders, continue to be among the more heavily negotiated provisions of the acquisition agreement.

iv. Sponsored Demutualizations

While we have discussed in prior years the so-called "subscription rights" demutualization transaction, for which several states have laws permitting a mutual insurance company to convert to a stock company by providing rights to policyholders to subscribe for shares of the demutualizing company in lieu of the more traditional distribution to policyholders of their allocable share of the demutualized company's surplus in the form of stock or cash proceeds from a sponsored demutualization, February 2020 saw a significant traditional sponsored demutualization transaction announced in ProAssurance agreeing to acquire NORCAL Group for a base purchase of $450 million in cash (with additional contingent consideration possible) following NORCAL's conversion from a mutual insurance company to a stock company. NORCAL's plan

of conversion contemplates eligible policyholders having the option to exchange their membership interests in NORCAL for any one of: (i) a contribution certificate with a maturity date of 10 years in the amount of the member's allocable share of the appraised value of NORCAL, (ii) cash in an amount equal to 50% of the member's allocable share of the appraised value of NORCAL, or (iii) shares of NORCAL common stock having a value equal to the member's allocable share of the appraised value of NORCAL (for which ProAssurance would make a tender offer to purchase as part of the transaction following conversion of NORCAL to a stock company with an 80% acquisition condition). Industry participants continue to observe the market to determine if "subscription rights" demutualization structures will become a trend or remain an outlier to more traditional demutualization structures such as ProAssurance/NORCAL.

v. Deal Points

In what is unlikely to be a surprise, one of the more hotly negotiated points in acquisition agreements this year is how to treat the COVID-19 pandemic. The effect of COVID-19 was not just limited to structural factors such as (x) the need to conduct negotiations (and build the relationships critical to successful M&A activity) remotely, (y) remote due diligence efforts, and (z) pressure on valuations, but rather extends to several particular points in drafting acquisition agreements.

a. Material Adverse Effect Definition

Sellers typically seek to carve out pandemics, epidemics or similar outbreaks from the definition of material adverse effect ("MAE"), either expressly or falling under broader exceptions for Force Majeure events, acts of god or similar exceptions. The COVID-19 pandemic has created significant focus on this provision, and there has been a meaningful increase in explicit carve-outs to the definition of MAE for pandemics, epidemics or similar outbreaks and the COVID-19 virus specifically. As the threat of the virus has continued throughout the year, we have seen these carve-outs morph as buyers press to (i) exclude from such carve-out mutations or changes to the virus or new outbreaks, and (ii) qualify the carve-out by adding to the "disproportionate impact" exception (that a carve-out does not apply where the target suffers a disproportionate impact compared to other members of its industry or within its geography), and sellers argue that after several months the impact of COVID-19 is, to some extent, known or quantifiable and baked into the purchase price for the transaction, and therefore, should not increase closing conditionality or increase deal risk.

b. Interim Operating Covenants

Though not as obvious to some M&A participants at the beginning of the pandemic as the MAE risk, COVID-19 has had a significant impact on the negotiation of interim operating covenants. First, the typical use of phrases such as "ordinary course of business" and "consistent with past practice" to qualify what actions a target may take in the period between signing and closing received a second look as parties seek to clarify whether "ordinary course" or "consistent with past practice" relates to the period since March 2020, and the outbreak of COVID-19 in the United States, prior thereto or both. Where relevant, parties have begun to clarify timing (in some cases on a provision by provision basis) to a greater extent than we have typically seen in the past. Second, parties needed to determine what actions a target would be permitted to take, or refrain from taking, in respect of COVID-19. While the initial wave of issues on this topic stemmed from the lack of clarity in pre-pandemic negotiated transactions on what constitutes "ordinary course" (and whether any action taken as a result of or reaction to COVID-19 is a breach of the interim operating covenants, unless expressly required by applicable law (which was, and remains, a typical exception to these types of covenants)), current negotiations are far more nuanced. Constructs include, for example, permitting COVID-19-related actions (or failure to act) (i) only where required by law, (ii) if not expressly required by law, only upon a buyer's approval or with prior consultation with the buyer, (iii) where such actions (or failure to act) coincide with industry norms or actions taken by industry leaders, (iv) where such actions (or failure to act) are determined to be in the best interests of the company or similar standards,

and (v) where such actions (or failure to act) fit within certain caps or baskets on duration, expense, or extent. In the context of carve-out transactions, discussions can also focus on whether the actions taken (or failure to act) are consistent with a seller's other businesses. Finally, we note that this is not always a question of sellers seeking to expand what is permitted. Buyers may also seek to require a seller to take certain actions, for example, where industry leaders have already taken such action. In the P&C space, for example, this can be used to either require (or limit) rebates based on market practice.

c. Other

Though not as prevalent in the insurance industry given the typical size of the companies involved, where relevant, acquisition agreements also need to include representations and covenants around compliance with the various COVID-19-related laws and regulations, including the CARES Act, compliance with the Paycheck Protection Program (for companies that participated/received a loan) and similar matters. Representations also expanded in relation to changing work dynamics, for example, a focus on certain employee benefit and IT-related representations due to increased remote work.

d. Purchase Price Adjustments and Force Majeure Provisions

Two additional topics to note before moving on from the discussion of COVID-19's effect on drafting: first, in our 2019 Year in Review (found here) we noted our observation of an increased interest in "lockbox" structures (transactions with no post-closing purchase price adjustment, but rather reliance on stricter covenants between signing and closing to avoid value leakage). Given the uncertainty around COVID-19's effect on businesses, in particular early in the cycle of the virus in the United States, we observed a strong return to more traditional statutory value purchase price adjustment mechanisms. It will be interesting to see if this trend continues as the effects of COVID-19, hopefully, begin to decline in 2021, or if there is a return to interest in lockbox transactions. Finally, we note that Force Majeure provisions, which had previously been relegated in many transactions to "boilerplate" status, took on renewed importance, and we expect these provisions to be subject to heightened negotiation (and scrutiny) for some time to come.

vi. InsurTech (U.S. and U.K.)

In the United States, as the InsurTech industry has driven developments in marketing, underwriting, distribution and claims processing, investors have shown continued interest in the sector. In the third quarter alone, InsurTech firms globally raised $2.5 billion across 104 deals, according to Willis Towers Watson. However, after the wave of insurer acquisitions of InsurTech firms over the last several years culminated in Prudential Financial's $2.35 billion acquisition of Assurance IQ in 2019, insurers have pulled back somewhat in 2020 amid the uncertainty of the COVID-19 pandemic. It remains to be seen to what extent insurers will continue to pursue InsurTech targets, though there are several in the industry who expect growth in this sector as insurance companies seek innovative ways of reaching customers in a changing marketplace (for example, a focus on digital distribution channels) and interacting with customers in a remote-focused post-pandemic world (for example, virtual claims processing).

Some InsurTech firms have turned the tables, purchasing insurance carriers of their own for use in conjunction with their proprietary platforms. For example, in September 2020 Hippo Analytics, an online agency focused on home insurance, completed the acquisition of P&C insurer Spinnaker Ins. Co., which had been Hippo's largest carrier partner since 2017. In December, Bestow, a digital life insurance platform, announced the acquisition of Centurion Life Ins. Co., an Iowa-based insurer licensed in 48 U.S. jurisdictions. These acquisitions appear to be motivated by two main factors. First, having a licensed carrier "in-house" reduces the costs and frictions associated with a third-party carrier. Second, acquiring an existing, widely licensed insurance carrier can give an acquirer faster market access than forming a new insurance company. That is because, in many states, insurance regulators will not grant an out-of-state insurer a certificate of authority unless it has written insurance business in its home state for a number

of years (the so-called "seasoning" period), unless certain exceptions apply. On the other hand, an existing insurer generally may continue to operate in the states where it is already licensed, even if it is acquired by a purchaser without an independent operating history.

Insurers and InsurTech have also launched a variety of joint ventures focused on particular product lines. In August 2020, Verily, an Alphabet company, announced a subsidiary backed by Swiss Re Corporate Solutions, Coefficient Insurance Company, that is intended to leverage Verily's strength in integrating hardware, software and data science with Swiss Re Corporate Solutions's risk knowledge, distribution capabilities and reputation in the employer stop-loss market to develop and distribute precision risk solutions to the marketplace. Also last year, Hiscox announced a plan to offer short-term liability insurance products through a partnership with the startup Thimble, and the digital agriculture firm Farmers Edge announced a strategic collaboration with Munich Re to develop parametric weather insurance solutions.

Globally, investor appetite in the InsurTech sector remained strong throughout 2020. Although funding levels and the overall number of deals slowed from 2019, momentum was not lost, with the total amount of global fundraising rising steadily throughout the year before reaching approximately $5 billion by the end of the third quarter. M&A activity was also high, with year-end forecasts indicating that over 95 InsurTech M&A deals will be signed or completed by the end of 2020. A significant proportion of the acquisitions were funded by private equity sponsors, with private equity being behind over a third of acquisitions since the second half of 2019. By way of example, in May 2020, we advised FTV Capital on its investment in Bought By Many, a U.K. pet InsurTech company.

Additionally, while the majority of the InsurTech deal activity took place within the United States (followed by the United Kingdom), 2020 also saw the occurrence of deals in new geographies such as Taiwan, Croatia and Hungary as investors were looking to diversify their risk.

B. The United Kingdom and Europe

M&A and investment activity in the United Kingdom, Lloyd's and European Union markets were as active as ever in 2020. The year included blockbuster M&A deals involving listed insurance groups, high levels of private equity interest in existing carriers' scaling-up capacity, several billion dollar start-up reinsurers, and a steady stream of deals involving the Lloyd's and run-off sectors.

After several years in which the (re)insurance markets have been experiencing a softer rate environment, U.K. and European (re)insurers reportedly have seen premium rate increases across many lines of business over the past 12 months. This is widely considered to be responsible for increased interest in investing in (re)insurance businesses, via capital injections from public and private markets in existing carriers, capital backing new ventures, and increased interest in M&A.

The importance of the relationships of reinsurance underwriters in particular with deep sources of capital played out in much of the deal-making in 2020. The Insurance Insider estimated the scale of 2020 new equity capital for public and private start-ups, scale-ups, and recaps to be $11.2 billion which compares to capital base funds of $37 billion at Lloyd's (estimated to be less than 50% of London market total capital base), $471 billion of global reinsurance capital, and $800 billion of U.S. P&C surplus. Of the $11.2 billion, 55% was estimated to be attributed to scale-ups, 34% to start-ups, and 11.4% to recaps. In another breakdown of newly raised equity, London-based businesses account for 51%, Bermuda businesses for 27.7%, and U.S. businesses for 13.6%, although the lines become blurred especially between London and Bermuda with shared platforms as evidenced by firms such as Ark, Fidelis and Convex reflecting (re)insurers that have expanded capacity through the courting of strategic investors in the United Kingdom, United States and Bermuda.

In addition to the emergence of an improved (re)insurance rating situation, the low interest-rate environment has also been a factor in raising investor interest in the sector. As

a result the risk and reward thesis has started to make the U.K. and European (re)insurance sectors look more attractive to existing and new investors, including from private equity.

Coupled with the injection of new capital, many of the existing (re)insurers have been looking to manage their legacy liabilities in order to ensure that they are better able to take advantage of the new environment. This has provided further impetus to the burgeoning U.K. and European legacy sectors.

i. Listed Group M&A

Many of the large listed European insurance groups were active in M&A during 2020, illustrating themes of market consolidation, break-ups and a focus on core businesses.

The takeover of RSA Insurance Group plc was the largest deal at $9.6 billion and represents the loss of a U.K. insurance group with a heritage claiming to be among the oldest surviving insurance companies. This is perhaps mitigated by the fact that the deal was priced at 50% above the closing share price prior to the announcement in November. Readers will recall that RSA previously had been subject to a bid from Zurich in 2015, although this time the offer and deal came by way of a combined bid by The Intact Financial Corp and Tryg A/S, with each purchaser looking to acquire the areas of the business that have the most potential to deliver respective synergies.

Like in the United States, E.U.-listed insurance groups also faced pressure from rating agencies, equity research analysts and investors to optimize their liability portfolios and exit businesses that are capital intensive, lower return or otherwise non-core. The newly appointed CEO at Aviva plc, Amanda Blanc, announced and wasted no time implementing in 2020 a comprehensive strategy to divest from non-core markets in order to focus on Britain, Ireland and Canada. This led to the sale of a majority holding in its Singapore business in September and the sale of its Vietnamese business to Manulife Financial in December.

In another deal involving listed European insurers focusing on core businesses, Assicurazioni Generali SpA paid $203 million for the Greek operations of AXA SA. Generali indicated it has a continuing appetite for deals, with its CEO, Phillipe Donnet, stating in November that his company had designated up to €2.5 billion for further acquisitions.

The standout transaction in the listed insurance broker market was the announced merger of U.K.-headquartered Aon plc with Willis Towers Watson. This is notable in the context of the London insurance market as it provides yet another material consolidation in the large broker market following on the JLT/Marsh combination in 2019. The Aon/WTW deal is currently the subject of a competition investigation by the European Commission (further details of which are discussed in below in Section VII.B.), but whatever the outcome of that exercise it would seem unlikely that we will be reporting large U.K. broker consolidation at this scale for the next few years, not least due to the lack of potential merger candidates.

ii. Private Equity in Insurance M&A/Capital Raising

Private equity firms have retained a strong connection with the U.K. and E.U. insurance sectors for many years now, although the focus of this interest has changed depending on the position of the underwriting cycle. Support for fee-based insurance businesses such as brokers and intermediaries has remained strong throughout the past decade, both in relation to start-ups and established players, particularly where there is innovation or technology. The interest in providing capital for underwriting risk has been more cyclical, with funds being more cautious about the ability to deliver the returns they require in a lower rate environment.

The expectation of a hardening of premium rates since the beginning of 2020 has led to an increased interest in deployment opportunities in the risk-bearing areas of the (re)insurance sector, a trend seen across the deal-size spectrum. Notable transactions in 2020 include financial investor support for scale-ups and start-ups, including White Mountains' investment in Lloyd's and specialty player Ark Group, Atlas Merchant Capital's equity

investment in Hamilton Insurance Group, Sixth Street's investment in Convex, The Carlyle Group and Hellman & Friedman's investment in Vantage Group and the equity investments in Inigo Ltd by Caisse de dépôt et placement du Québec, Enstar, J.C. Flowers & Co., Oak Hill Advisors, Qatar Investment Authority and Stone Point.

Private equity firms also continue to be active investors in sales processes for U.K. brokers with HGGC winning Pollen Street Capital's auction for Lloyd's broker, Specialist Risk Group, as well as in long-term insurance businesses with the stand-out transaction coming at the end of 2020 when Bain Capital agreed to pay £530m to acquire Liverpool Victoria, a savings, retirement and protection mutual, following its strategic review.

iii. Reinsurance Start-Ups in London and Bermuda

There has also been renewed interest in investing capital in (re)insurance start-ups and growth stage (re)insurance companies in 2020 to back successful management teams and underwriters. Private equity investors likely have in mind the success stories of hard markets past, including, for example, in 2005 following the major loss events of hurricanes Katrina, Rita and Wilma, and in 2001 following the 9/11 attacks, during which periods many new entrants emerged, prospered and ultimately delivered to their founders a desired liquidity event of a sale or an IPO. With the right mix of capital provider support and experienced underwriting skills, new entrants could prove to be disruptors in the current market.

Start-ups offer the opportunity to invest in a rising market without needing to be concerned about legacy liabilities. The current round of newly established players will have an eye on the exposures that incumbent carriers may have arising from COVID-19-related property and casualty losses. On the other hand, as in any heavily regulated sector, there are hurdles to new entrants accessing the market, including regulatory approvals, obtaining the necessary licenses and ratings, and the minimum capital requirements and rating agency stress-testing that is required to get a start-up over the finish line. For any new entrant, the requirement for an experienced management team, with a successful track record, is critical to attract investor interest and to obtain the requisite financial strength ratings and regulatory licenses.

With that in mind, the "class of 2020" start-ups have taken different paths to launch its businesses, although each must now demonstrate their capabilities to brokers and clients in order to compete with the existing carriers, many of whom have also raised fresh capital. In a traditional path for new reinsurers, management and private equity firms Hellman & Friedman and The Carlyle Group launched Vantage Group Holdings, a Bermuda-based insurance group with $1 billion in initial equity capital. Its subsidiary Vantage Risk Ltd. is a Bermuda reinsurer focused on property catastrophe and specialty lines. Vantage has also announced plans to build a US insurance platform in 2021. Inigo Ltd chose to buy and build in Lloyd's as it completed a capital raise of approximately $800 million from a consortium of global investors, including pension, private equity and sovereign wealth funds. Inigo stated that it selected London as its principal base because it regards the insurance ecosystem offered by Lloyd's as exceptionally attractive and to best support the growth and development of its new syndicate. The Conduit start-up chose Bermuda as its base but raised its capital from institutional investors via a listing on the London Stock Exchange. With favorable hard market conditions and low investment returns in other financial sectors, the year showed that there are many capital-raising avenues open to existing players and potential new entrants in the underwriting sector.

iv. Lloyd's M&A and Capital Raisings

The Lloyd's market in 2020 saw its fair share of capital provider rotation and a re-positioning of capital for anticipated better returns in 2021 and beyond. Over two-thirds of syndicates were given permission by Lloyd's to increase their stamp capacity in 2021 and, not surprisingly, the capacity rises were concentrated in the top performing syndicates as measured by combined ratios.

On one end of the spectrum, the many disposal transactions were a continuation of the theme we discussed in last year's Year in Review, with smaller participants struggling to turn

a profit given the costs involved for smaller managing agencies and syndicates or loss-making syndicates having their Lloyd's capacity reduced. This was particularly the case when it came to entities supporting syndicates in run-off being acquired by the run-off consolidators. For example, the acquisition of Neon by RiverStone allowed American Financial Group to exit the market, having placed its Syndicate 2468 in run-off at the end of 2019. This followed an agreement by RiverStone to manage the run-off of Skuld's Syndicate 1897, also placed into run-off in 2019. Similarly, agreement was reached between R&Q and the Vibe group to buy Vibe's corporate member, managing agency and services company, supporting Syndicate 5678 (also placed into run-off at the end of 2019).

At the other end of the Lloyd's market, participants have been looking to raise capital and to increase their stamp capacity and remain competitive within Lloyd's and as measured against European and Bermuda markets. This includes Apollo at Lloyd's, which entered into an agreement to receive underwriting capital and form an operational partnership with Pelican Ventures, partly backed by J.C. Flowers, with respect to its property cat special purpose Syndicate 6133. At the same time, Pelican Ventures and J.C. Flowers also acquired Ariel Re (managing Syndicate 1910) from Argo Group, with Ryan Mather (the former CEO of Ariel Re) returning to lead the company. Other examples of the 2020 trend for raising equity capital to support the growth of Lloyd's businesses include White Mountains' $600 million investment in Ark and the private equity consortium which backed new Lloyd's player, Inigo Ltd, which purchased the syndicate and managing agency, StarStone Underwriting, from Enstar. Finally, numerous insurance groups with significant Lloyd's businesses, such as Lancashire, Beazley and Hiscox, raised equity capital in the first half of 2020 to take advantage of the momentum in the London and Lloyd's markets.

Considering stamp capacity under 2021 business plans, and reflecting on the capital raises throughout the industry, managing agencies remain keen to ensure that Lloyd's will allow them to grow written premium fast enough, including further pre-emptions at mid-year 2021, to take advantage of the rate rises and the opportunities to expand line sizes.

v. Runoff M&A and Part VII Transfers

Runoff acquirers have continued to be active throughout 2020, particularly in the U.K. company and Lloyd's market. The activity included acquisitions by traditional runoff acquirers, such as AXA Liability Managers' acquisition of the Tokio Millennium Re UK run-off company from RenRe and R&Q's acquisition of Inceptum Insurance from the Vibe group, which itself was later acquired by R&Q. In 2020, there also were a number of acquisitions of runoff firms themselves, notably by private equity investors. For example, CVC entered into an agreement to acquire RiverStone Europe, and Cinven, together with British Columbia Investment Management Corporation, agreed to purchase run-off specialist Compre from CBPE Capital and Hudson Structured Management. As across the wider insurance market, private equity investors are clearly seeing opportunities both in acquisitions and investments in the run-off space.

2020 saw a positive legal development for insurers seeking to consolidate or de-risk their back-book annuity portfolios, with the U.K. Court of Appeal's decision to overturn the High Court's refusal to sanction the Part VII transfer of a book of annuities from The Prudential Assurance Company Limited to Rothesay Life plc. Although the High Court has wide discretion to refuse to sanction a Part VII transfer, its original 2019 decision was a shock to the industry because it was such an unusual step, particularly as the transfer had been approved by the independent expert, the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA"). In a welcome judgment, the Court of Appeal were firm in their view that, although the statute gives a wide discretion to the High Court judge, there are still appropriate and inappropriate factors to be taken into account – the approval should not be a mere "rubber-stamping" process. Certain factors taken into account by Judge Snowden in the High Court were determined by the Court of Appeal to be irrelevant (for example, subjective factors such as the rationale for policyholders choosing to take out policies with Prudential in the first place) and it was noted that due weight is required to be given to the independent expert report and the opinions of the FCA

and PRA. We expect that this appellate court decision will lead to a return to the status quo of Part VII transfers in the United Kingdom, where parties can reasonably expect the transfer to be sanctioned where they have received a clean bill of health from the independent expert and the regulators, and that we may therefore see more back-book transfers by way of Part VII transfers in 2021.

vi. COVID-19 Impact on Deals in Europe

Given the active M&A market, there were a number of M&A transactions that were signed prior to the COVID-19 pandemic emergency being declared but were awaiting the necessary regulatory approvals to closing. For these deals, buyers and sellers were keen to review the closing conditions, particularly those that had material adverse change conditions or repetition of warranties at completion, both of which remain less common in the European market but which have increasingly crept into (re)insurance M&A transactions. As is the case in the United States, successfully invoking a material adverse change closing condition is notoriously difficult in European transactions. In some cases where they existed, however, the inclusion of this type of closing condition gave some buyers leverage to come back to the negotiating table to seek further concessions on deal terms, whether by adjusting the price or asking for certain further protections from the potential impact of the pandemic. Given that in "locked box" transactions (which are more common in the European market than in the United States), the economic risk transfer occurs on the "locked box date," this meant that many buyers were at risk for potential COVID-19 losses even though the transactions had not yet completed, which added impetus to these buyers looking for termination rights or options to limit the potential downside.

For transactions which were being negotiated during the pandemic, European market participants were also keen to ensure maximum deal and price certainty, and material adverse change conditions early in the year began to explicitly exclude the impact of COVID-19. In addition, negotiations related to purchase price adjustments also began to feature specific treatment for COVID-19 losses, where they were appropriate to the deal and to the business of the transaction parties. In particular, on transactions with completion accounts (where the economic risk passes at completion rather than signing) there were often discussions related to whether caps or specific treatment of reserves in relation to COVID-19 losses were needed to be adopted to increase price certainty for the parties.

Given the changing situation regarding COVID-19 as 2020 progressed, we also saw warranties specifically include the impact of the pandemic in order to enable sellers to make adequate disclosures. Given the difficulties of making COVID-19-related disclosures, W&I insurers in the early part of the pandemic specifically carved out losses for breach of warranty related to the pandemic, although we were pleased to see that W&I insurers appeared to become more pragmatic as the risks related to the pandemic became clearer. In order to properly quantify the potential risks from the pandemic on live insurance books, many buyers required greater levels of diligence of the books and, particularly, a detailed analysis of which treaties in a target company's portfolio could be impacted by the pandemic.

Although virtual closings and virtual data rooms for due diligence have long been the norm in M&A (and in particular in cross-border transactions), the stay-at-home orders in place during the pandemic and moving to the virtual work environment did pose some additional challenges. For example, sellers and targets need to be prepared to digitize those of their records that are not available virtually at the start of a transaction rather than into a small physical data room (as is often put together for company books), and it is not always practicable for parties to obtain documents that would typically be physically delivered at a closing (for example, share certificates). In our experience, these issues arising out of the COVID-19 pandemic are solvable, and clearly being proactive at the start of a transaction and scrutinizing boilerplate closing requirements during the negotiation of the transaction can help minimize any execution risk through to closing of the deal.

II. DEVELOPMENTS IN CORPORATE GOVERNANCE

A. U.S. Corporate Governance Developments

i. Governance and ESG

a. Board Diversity

In December 2020, in an announcement that received significant public attention, Nasdaq filed a proposal with the SEC to adopt rules that would require most companies listed on Nasdaq's stock exchange to include on each of their boards at least one woman and at least one director who is either an "underrepresented minority" or a person who self-identifies as lesbian, gay, bisexual, transgender or queer. The proposed rules would also require Nasdaq-listed companies to make public disclosures regarding board diversity. Nasdaq's proposal is indicative of what may be a rising wave of required disclosures and prescriptive rules regarding environmental, social, and governance ("ESG") factors.

If the proposed rules go into effect, companies will have between four and five years to meet Nasdaq's board diversity requirements. A company that does not meet these requirements must provide justification for its failure to do so. Accordingly, while it is unlikely at this time that companies will actually be delisted from Nasdaq's exchange as a result of these requirements, the requirements will, at the very least, force companies to seriously confront the issue of board diversity and arguably will also incentivize companies to meet the requirements so as to avoid attempting to explain the failure to do so. Similarly, the proposed rules' disclosure requirements are likely to influence the listed companies' board composition. If approved, the rules will require listed companies to disclose board diversity statistics within a year.

Companies are already facing pressure from investors to improve diversity among their directors and executives. According to data S&P Global Market Intelligence compiled from publicly available sources, approximately 23% of executives and officers at the large insurers that trade on the NYSE or Nasdaq are women, highlighting an issue that will be of increasing importance within the industry.

Nasdaq's proposal is only the most recent of several measures taken by public and private actors worldwide to increase the diversity of corporate boards. For example, on September 30, 2020, California Governor Gavin Newsom signed into law a bill requiring companies with securities listed on U.S. exchanges and that are headquartered in California to include representatives of "underrepresented communities" on their boards. The statute calls for companies to comply with its requirements by the end of 2021 and authorizes California's secretary of state to impose fines for violations of the requirements. In 2019, Illinois enacted a similar law requiring publicly listed companies that are headquartered in Illinois to make certain disclosures regarding board diversity. In addition, in November 2020, Germany–which in 2015 imposed mandatory gender diversity quotas on supervisory boards for listed German companies–announced that it will also impose similar quotas on management boards for listed companies.

The SEC's public comment process for Nasdaq's proposal will likely last months, and the decision as to whether to approve the proposal will be made under a Biden administration, as ushered in by the recent resignation of SEC Chairman Jay Clayton. More broadly, Nasdaq's proposal represents a significant step in the direction of uniformly mandating board diversity, and Nasdaq's rules, together with state and local laws like those enacted in California and Illinois, could serve as stepping stones for a Biden administration to take even more far-reaching measures regarding board diversity and other ESG issues.

b. ESG

The focus on ESG matters at public companies continued to grow in 2020, particularly against the backdrop of the COVID-19 pandemic. While many companies have proclaimed their commitment to ESG issues for years, the pandemic's effect on American workers, customers, and society served to heighten interest on ESG issues. Indeed, as companies receive pressure to prioritize employees,

customers, and other "stakeholders" over cost management and shareholder value, influential investors have pointed to the pandemic as validating their interest in companies that place emphasis on ESG factors.

2020 began with BlackRock announcing a number of key initiatives to place sustainability at the center of its investment approach, including: making sustainability integral to portfolio construction and risk management; exiting investments that present a high sustainability-related risk, such as thermal coal producers; and launching new investment products that screen fossil fuels. Other influential investment firms took similar steps in 2020. In August, State Street sent a letter to the boards of directors ("Board") of a number of large public companies detailing its expectations regarding Board and employee diversity. In response, public companies dedicated significant resources to ESG initiatives in 2020, with many companies hiring executives tasked specifically with ESG oversight and ESG receiving increased attention at the Board level. The insurance industry continued its push in relation to climate change in particular, with many high profile companies pursuing and making tangible efforts to combat climate change through their underwriting and investment portfolio strategies.

From a public disclosure perspective, ESG received focus in 2020, with new SEC rules taking effect in late 2020 requiring disclosures of "human capital" measures and objectives. While the "principles-based" rules provide significant flexibility to issuers in preparing compliant disclosure, based on early results, many companies are seeking to use the new "human capital" disclosure section of Form 10-K to highlight their ESG programs in relation to the workforce -moving information that has historically been disclosed on websites, sustainability reports or glossy brochures into SEC filings (now subject to potential securities law liability). See Section VI.A below. Many commentators believe that, under a Biden administration, the SEC will move beyond the current principles-based regime and require more detailed line-item disclosures regarding ESG matters such as diversity, climate change and sustainability, placing even more emphasis on these topics.

B. U.K. Corporate Governance Developments

i. Agency Responses – Reporting Reliefs

As this publication covers the period in which the COVID-19 pandemic emerged, it is unsurprising that a large number of the corporate governance developments relate to COVID-19. Regulators sought to mitigate the difficulties imposed by COVID-19 and provide companies with temporary support in fulfilling their legal obligations during the pandemic. For example, among other relief measures, the FCA, the PRA, the London Stock Exchange and U.K. Companies House all extended financial reporting and other filing deadlines in recognition of the practical difficulties companies are facing in the current circumstances.

Specifically:

- On March 26, 2020, the FCA, the U.K. Financial Reporting Council ("FRC") and the PRA released a joint statement permitting delays to the timetable for publication of financial results by companies listed on the London Stock's Exchange's main market in light of the pandemic (the same reliefs were subsequently extended by the AIM Regulation team at the London Stock Exchange to AIM-listed companies in the United Kingdom) and on November 5, 2020, the FCA published a policy statement confirming that the extensions would continue for reporting periods ending at least up to March 31, 2021. The package of measures have sought to provide U.K.-listed companies an additional two months to publish audited annual financial reports and an additional one month to publish half-yearly financial reports, meaning that annual financial reports may be published within six months (vs. four months previously), and half-yearly financial reports within four months (vs. three months previously), following the relevant financial period end-date.
- On June 26, 2020, U.K. Companies House published guidance extending filing deadlines for financial reports initially due between June 27, 2020 and April 5, 2021 (inclusive) for public companies, private companies, limited liability partnerships, Societas Europaea, overseas companies and European Economic Interest Groupings. Such entities are permitted to apply for an additional three

months to file their accounts with U.K. Companies House. In addition, extensions to certain other common U.K. Companies House filing requirements were permitted, including the filing of confirmation statements, charges, accounts and event-driven filings, such as changes in directors or persons with significant control.

- The filing extensions for companies and other entities registered at U.K. Companies House also were enacted pursuant to the Corporate Insolvency and Governance Act 2020 ("CIGA"), which itself became effective on June 26, 2020. CIGA has sought to amend insolvency and company law to support businesses in addressing COVID-19 challenges. Outside of reporting extensions, some of the temporary measures enacted have sought to provide greater flexibility around the manner in which meetings are held. For example, (i) companies may hold meetings and allow votes to be cast by electronic means, and (ii) extensions to the period within which a company must hold an annual general meeting ("AGM") have been granted (i.e., companies with deadlines for holding AGMs expiring between March 26, 2020 and March 30, 2021 now have until March 30, 2021 (extended twice from the original expiration date of September 30, 2020) to hold their AGM), and there is a power to extend that period by up to three months at a time, though the temporary period cannot currently be extended beyond April 5, 2021.

ii. The Financial Reporting Council – Corporate Governance Guidance

The FRC, responsible for publishing The U.K. Corporate Governance Code applicable to all companies with premium listings of equity securities in the United Kingdom, continued to update its governance guidance throughout 2020. The FRC has produced a number of important publications since the pandemic began in March 2020 offering substantive guidance, recommendations and "best practice" examples.

In March, the FCA, FRC and PRA issued a joint statement (as above) announcing a number of measures intended to ensure that information flows to investors and that the U.K.'s capital markets are supported during the COVID-19 pandemic. The joint statement included guidance from the FRC for companies preparing financial statements and guidance from the FRC for audit firms seeking to overcome challenges in obtaining audit evidence, including with respect to the related timing implications for completing audits in the pandemic, the heightened risk assessments and testing that may be required and the greater likelihood of audit opinions being modified, qualified or adverse, as well as the possibility for additional disclaimers given certain audit procedures may not be possible. In May, the FRC updated its guidance to include directions in relation to interim reports. The guidance dealt, in particular, with the assessment of the going concern assumption at the half-yearly date, and offered guidance on issues which could trigger a need to re-examine the going concern assumption and liquidity. In December, the FRC published its latest guidance for companies on corporate governance and reporting during the COVID-19 pandemic, updating the versions previously published in March and May 2020. In the guidance, the FRC highlighted some of the key areas of focus for boards in maintaining strong corporate governance and provided high-level guidance on some of the most pervasive issues when preparing annual and other corporate reporting.

Separately, in June 2020, two new reports were published by the FRC's Financial Reporting Lab ("FRC Lab") entitled "COVID-19: Going concern, risk and viability" and "COVID-19: Resources, action, the future," which provided guidance for companies and auditors on aspects of audits in 2020 and disclosures in narrative and financial reports in light of the impact of COVID-19 on businesses. These reports, which were updated in October, followed discussions with a number of individual investors and investor groups, with the aim of providing practical guidance and examples of the information sought by investors in areas of reporting that investors have highlighted as being most critical in these times of unparalleled economic uncertainty.

In July 2020, the FRC released its "COVID-19 – Thematic Review," which summarized the key findings of its review of the financial reporting effects of COVID-19 for a sample of interim and annual reports and accounts with a March

2020 period end-date. We note that this report provides useful guidance for companies preparing their annual and interim accounts by identifying areas where disclosures affected by COVID-19 could be improved, as well as providing examples demonstrating the level of detail provided by better disclosures.

Some other noteworthy initiatives advanced by the FRC in 2020, not directly related to the pandemic response, relate to:

- *The European Single Electronic Format ("ESEF").* The FRC Lab is continuing to monitor developments in the ESEF. This is the electronic format based on which issuers in E.U. regulated markets have been required to prepare their annual financial reports for financial years beginning on or after January 1, 2020. The ESEF requirements were expected to take effect on January 1, 2021. The FCA has proposed rule-changes to postpone the implementation of the ESEF requirements. The FRC Lab has been engaging with companies and service providers regarding the opportunities and barriers to effective digital reporting, and has conducted a survey on how well-prepared companies were for the regulations.

- *Climate Change Thematic Review.* The FRC Lab is continuing to coordinate a thematic project to highlight some of the FRC's work in reviewing how companies and auditors assess and report on the impact of climate change. The aim of this project is to put a spotlight on what boards, companies and auditors are/should be doing to consider and report on the climate-related issues they face.

iii. Shareholder Advisory Bodies

In general terms, institutional investor guidance and guidelines for corporate navigation of COVID-19 for U.K.-listed issuers emphasize a company structure that possesses strong decision-making processes, sound business acumen, accurate data collection ability, succession plans, effective boards capable of steering companies toward future success while fostering positive corporate reputations, and keeping investors informed. As boards of directors meet in early 2021 to consider annual reports from board committees, shareholder engagement and related proposals for their upcoming AGMs, the following developments may be worth considering:

- *Glass Lewis.* In May, Glass Lewis published additional resources to help navigate the proxy season, including in the United Kingdom, in light of COVID-19. On November 24, 2020, Glass Lewis published its 2021 U.K. Proxy Paper Guidelines, which provided an overview of Glass Lewis's approach to proxy advice in the United Kingdom. While Glass Lewis relaxed its position on virtual-only meetings in March 2020 in the United States for a limited period in light of COVID-19, it was not clear at the time whether the same approach would be taken by Glass Lewis in the United Kingdom. However, in the November U.K. Proxy Paper Guidelines, Glass Lewis supported the holding of virtual shareholder meetings where the company could ensure effective shareholder participation and communication. It also made recommendations on board and workforce diversity, environmental and social oversight, environmental and social initiatives, and alignment of remuneration with stakeholder experience, and therefore extended its guidelines for all premium-listed U.K. company boards to be at least 50% independent and to hold annual director elections from 2021, with no exceptions for smaller premium-listed companies outside the FTSE 350.

- *Institutional Shareholder Services Inc. ("ISS").* In April, ISS issued guidance on the application of its policies during the COVID-19 outbreak. The guidance set out how ISS will apply its benchmark proxy voting policies during the COVID-19 pandemic. In particular, the guidance provided direction in relation to certain AGM issues, such as postponements and virtual-only meetings, the adoption of "poison pills" and other defensive measures, shareholder rights and boards/directors, among other matters. With respect to AGMs and virtual-only meetings, ISS recognized the need for virtual-only meetings during the COVID-19 pandemic but encouraged boards to disclose clearly that the COVID-19 outbreak was the reason for the decision. ISS also encouraged boards to aim to provide shareholders with a meaningful opportunity (subject to local laws) to participate as fully as possible. ISS encouraged companies

to return to in-person or "hybrid" meetings (or to put that matter to a shareholder vote) as soon as practicable. ISS published its Benchmark Policy Updates for 2021 in November. The updated policies are applicable for shareholder meetings taking place on or after February 1, 2021. Key policy changes with U.K. relevance include (i) board gender diversity – ISS will generally recommend a vote against the chair of the nomination committee (or other directors on a case-by-case basis) of FTSE 350 companies if the board does not comprise at least 33% women, or, in the case of FTSE SmallCap, ISEQ 20 or AIM stock exchanges, companies with a market capitalization of over £500 million, if there is not at least one woman on the board, and (ii) capital issuances for closed-ended investment companies – ISS will recommend support for share issuance requests when accompanied by an explicit commitment that shares will only be issued at or above net asset value. This brings the ISS policy in line with the position set out by the Pre-Emption Group Statement of Principles, which are discussed below in Section VI.B.

- *The International Corporate Governance Network ("ICGN").* In December 2020, the ICGN, an investor led body considered a leading authority on corporate global standards, published its Policy Priorities 2020-2021. These priorities complement its core policy documents, in particular (i) the ICGN Global Governance Principles, published in December, reflects the significant societal changes, most notably those caused by the COVID-19 pandemic and growing concerns about climate change, board independence, stakeholder relations and sustainability issues, and (ii) the ICGN Global Stewardship Principles, published in September, reflect shifts in market practice and regulation. In September the ICGN published a report known as "Viewpoint" on what AGMs and other shareholder meetings could look like in the future following the COVID-19 pandemic. The Viewpoint report looked at the different aspects of physical, virtual and "hybrid" meetings and suggested how to combine their best features to create an optimal meeting format which offers flexibility to issuers and greater access to shareholders.

- *The Investment Association ("IA").* Executive remuneration policies continue to be vigorously discussed (see U.K. Say on Pay below) and the COVID-19 impact has only heightened awareness. In April, the IA published guidance for shareholders on how remuneration committees should adjust executive pay for the impacts of COVID-19. The IA stressed that the COVID-19 impact would differ for every company and company-specific circumstances should drive the decisions made. The IA addressed and made recommendations for remuneration adjustment in major areas impacted by COVID-19 including dividends, performance conditions, long-term incentive plans, and additional capital pursuit and/or government assistance.

iv. Other Developments

- *Environmental, Social and Corporate Governance.* In Europe and the United Kingdom, ESG factors have become increasingly important in evaluating the investment sustainability and impact of a company, and are proving to have a central role in predicting a company's future risk and return profile, including for insurance company groups. The impact of COVID-19 has further accelerated this trend, in particular from the social aspect. For example, shareholders would expect to be kept informed of the ways in which companies are ensuring the health and well-being of employees and other relevant constituencies during the pandemic. A survey from Willis Towers Watson published in December 2020 revealed that four out of five companies plan to incentivize ESG initiatives, with 78% of companies believing strong financial performance is strongly linked to ESG. Of interest regarding investments by insurance companies, we note the European Union's focus on a greener, more sustainable and longer-term business environment, supported by better engagement between listed companies and their investors, which is expected to become a key metric for investors seeking to measure and compare the ESG performance of listed companies. We expect similar initiatives in the United Kingdom on ESG to be developed by the FCA and applicable to U.K. companies.

- *Proxy Contests.* Shareholder activism in 2020 increased globally when compared to 2019 pre-COVID-19, though significantly dropped off at the onset of the pandemic. Although a greater level of shareholder activism remains

concentrated in the United States, the United Kingdom remains the main venue for the pursuit of activist strategies in Europe, while Japan is the main target of activism in Asia. In 2020, some of the more aggressive names in shareholder activism have pushed ESG considerations in their demands of targets.

- *U.K. Say on Pay.* In 2020 and in light of the COVID-19 pandemic, there was a high degree of scrutiny over executive compensation and votes at the AGMs of U.K.-listed companies on their remuneration policies and the annual directors' remuneration reports. The remuneration policy of a U.K.-listed company is subject to a binding shareholder vote every three years and in 2020, very few passed with overwhelming majorities, with one not passing at all. Although shareholder votes relating to directors' remuneration reports are advisory only, it is notable that several did not pass. Where there is significant opposition to a directors' remuneration report, the relevant issuer must consult with its stakeholders and, at the next AGM, report on how the directors have acted in relation to the concerns raised by the shareholders who voted against the resolutions.

III. INSURANCE-LINKED SECURITIES MARKET UPDATE

A. Introduction

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.

B. Market Overview: Shelter in the Storm

The investment thesis for ILS is rather simple: diversification through non-correlation to the broader financial markets. The COVID-19 pandemic presents both a challenge and an opportunity for that investment thesis. Despite initial worries that COVID-19 could bring forth an avalanche of business interruption losses, flowing all the way down the chain to retrocessionaires, such losses currently appear manageable and the ILS market has ultimately proven well-insulated from broader market and political turbulence. 2020 has been a remarkably successful year for the asset class for its steady deal flow and incremental growth, which is desired in these challenging times. In our view, the resilience of 2020 will accrue to the long-term sustainability of the ILS market as a key pillar of insurance capital. Three central themes have emerged for 2020:

i. Renewed Investor Discipline

Following significant catastrophe losses from 2017 through 2019, and increased pressure from COVID-19, many ILS investors have exhibited greater pricing, modeling and underwriting discipline when participating in transactions, which we view as positive over the long run. For instance, transactions with large unmodeled or undermodeled risks, particularly in annual aggregate structures, have been generally disfavored. In other words, structure matters. Despite several years of elevated losses, risk transfer capacity has not returned to a "hard" market–at least not compared to historical precedent. While there may be a slight contraction of overall capital, and an increase in premium rates–particularly in certain pockets, such as loss-impacted cedants in Florida and the retrocession market–one should not confuse a return to rate adequacy with a hard market. In fact, one can make a strong case that ILS capital has been remarkably effective in 2020 in helping to smooth out the hard/soft market cycle.

In the context of this investor discipline, catastrophe bond issuances generally fared significantly better than sidecars, although there were notable exceptions. The overall deal pipeline for Rule 144A catastrophe bonds remained robust in 2020 as an alternative to traditional reinsurance, with more than $11 billion in new issuances by approximately 40 unique sponsors, 10 of which were issuing catastrophe bonds for the first time this year. In particular, reinsurers purchasing indexed-based retrocessional coverage from catastrophe bonds accounted for nearly 24.5% of total issuances in 2020 by deal size. The market also saw an increasingly diversified sponsor base in 2020, with new European cedants entering the Rule 144A market (e.g., Achmea Reinsurance Company N.V.'s €100 million issuance against European windstorms using its Windmill II Re DAC vehicle). Although information about sidecar capacity is generally less transparent and more anecdotal than Rule 144A catastrophe bonds, the authors of this article observed that sidecar capital raises were flat to down overall, with certain deals struggling and greater reliance on large international institutional investors.

ii. Managing COVID-19 Exposure

The COVID-19 pandemic has presented unique coverage, reserving and valuation challenges to both cedants and investors. As should be no surprise to our readers, there are currently emerging litigation claims in the United States, the United Kingdom and Europe challenging whether insurers (and, by consequence, reinsurers and ILS funds) should be responsible for business interruption losses from COVID-19, notwithstanding the requirement for "physical damage" and other policy limitations. A comprehensive analysis of those considerations, which is

multi-jurisdictional in scope and often policy and contract specific, would far exceed the length of this Year in Review. Moreover, applying emerging COVID-19 coverage issues on insurance policies to reinsurance and retrocessional coverage becomes particularly complicated (and perhaps ambiguous) in the context of how to interpret an hours clause, peril definitions and other limitations from standard pre-COVID-19 reinsurance provisions.

Certain structures have largely been immune to COVID-19, such as catastrophe bonds, which typically contain clearly defined perils rather than the more amorphous "Loss Occurrence" formulation. However, sidecar vehicles and collateralized reinsurance contracts, which often contain broad perils and other coverage terms, could be exposed, depending on the underlying business and the contract language. In order to address potential exposures, the ILS and traditional reinsurance markets have moved rather quickly–across all deal structures–to adopt communicable disease exclusionary language for new contracts, whether through Lloyd's market language (e.g., LMA 5394 or 5503) or more bespoke provisions.

Nevertheless, despite prospective exclusions, fund valuations and cedant reserving for 2020 have been made significantly more difficult by the unique coverage issues raised by COVID-19 and the ongoing nature of the litigation challenges globally. Although market participants are optimistic about the overall loss impact of COVID-19, there are a wide range of views about how severe COVID-19 insurance and reinsurance losses could be in a "stress" case or "worst" case scenario, and the underlying coverage questions won't be definitively settled for many years. Concerns about the outcome of such litigation, which is still inherently unknowable, is likely to put pressure on open-ended ILS funds that must strike a net asset value or sidecar or collateralized reinsurance vehicles that must trap collateral based on cedant reserves. Unfortunately, there is no one correct answer or market standard.

So far the ILS market has managed its COVID-19 exposure well, but challenges remain and the coverage issues brought about by the pandemic will linger long after vaccines bring some much needed relief.

iii. Continued Innovation

While ILS remains predominantly a short-tail property and casualty market, ILS technology is often used in innovative ways to transfer other types of insurance risk to the capital markets, including as follows for 2020. The development of unique structures and the expansion of ILS capacity into other product-lines will be important for future growth.

- In April 2020, Global Atlantic launched its $1 billion co-investment vehicle Ivy Re, which mixes both sidecar and investment fund technologies to provide a source of long-term capital to underwrite life and annuity reinsurance deals. The transaction is significant in that it is the second such life and annuity sidecar vehicle in recent years (following Athene's Athene Co-invest Reinsurance Affiliated ("ACRA Re") transaction) and employs unique structure features to address the longer tail nature of the business in the context of investor liquidity needs.

- 2020 was a break-out year for the mortgage insurance-linked notes market, with almost $5 billion issued across 12 transactions. Although new issuances were delayed at the onset of the pandemic in March and April, the pipeline quickly got back on track as all six U.S. mortgage insurers came to the market in October alone, prior to the Presidential election. Mortgage insurance-linked notes combine diverse structural features from both the catastrophe bond and RMBS markets, and provide the sponsoring mortgage insurer with up to 10 years of collateralized excess of loss reinsurance protection through the formation of a Bermuda special purpose insurer. Unlike a traditional catastrophe bond that provides coverage for natural catastrophes such as hurricanes and earthquakes, investors in this transaction are exposed to the risk of defaults on an amortizing pool of residential mortgage loans. Insurance-linked notes ("ILNs") are a key source of PMIERs capital (which are the eligibility requirements imposed by Fannie Mae and Freddie Mac) for the entire industry and can be placed alongside traditional reinsurance. Given the correlation of mortgage credit risk to the broader capital markets, investors in ILNs are typically the more traditional ABS investors, rather than ILS investors.

- They say timing is everything. In October 2020, Minnesota-based Securian Financial sponsored the first extreme mortality catastrophe bond (La Vie Re) for a U.S. life insurer, which includes losses from COVID-19. The ground-breaking transaction, which was designed to satisfy U.S. statutory capital relief regulations, provides Securian with $100 million indemnity-based stop-loss coverage above a pre-defined loss ratio for three years.

- Credit Suisse returned to the market with its third operational risk transaction since 2015, for approximately $460 million. Pursuant to the transaction, Credit Suisse transferred a portion of its prospective operational risk to the capital markets on an excess of loss basis, including for certain cyber risk exposures, such as IT system failure that causes business interruption; fraudulent behavior both of external parties and employees of the investment bank; fiduciary issues; losses due to improper business practices or unauthorized activity; accounting errors; documentation errors; regulatory compliance issues; and human resources issues.

C. ILS Jurisdictions and Regulatory Developments

In relation to Bermuda regulatory developments, 2020 saw the introduction of a new class of collateralized insurance and limited purpose insurer known as the Collateralised Insurer ("CI") class. We understand that there has been a general philosophical change at the Bermuda Monetary Authority ("BMA") about the use of special purpose insurers for anything other than securitizations. As a result of this, the BMA has been promoting a new class of vehicle known as the CI class, which seeks to act as a compromise between a special purpose insurer and a Class 3A insurer. For instance, special purpose insurers are restricted in the categories of assets that they can invest in as well as the number of open risk periods. The BMA guidance is relatively new, and we have not seen this used in any significant transactions of which we are aware. For catastrophe bonds and the majority of property sidecar transactions, we believe that special purpose insurers will still make most sense, but we are of the view that this regulatory change could impact more bespoke vehicles such as run-off sidecars and longer tail vehicles. For 2021, we look forward to seeing whether market participants look to other jurisdictions in lieu of the CI class, as was the case with the most recent Elevation Re (Premia Holdings' sidecar launched out of the Cayman Islands), for regulatory arbitrage.

Similarly to 2019, 2020 has seen a number of jurisdictions vie for an increased share of the ILS market. In South America, Brazil recently targeted the creation of a framework for legislation on insurance-linked securities (for which a consultation process is currently underway). In Asia, the Hong Kong government introduced the Insurance (Amendment) Bill 2020, which seeks to create a regulatory framework for the issuance of insurance-linked securities in Hong Kong, similar to the U.K.'s ILS regulatory and tax framework. If successful, the legislation could provide another APAC alternative to Bermuda, which has been the longstanding jurisdiction of choice for ILS. As in prior years, 2020 has nevertheless seen the BMA continue to show its responsiveness and flexibility on transactions, proving it is a premier destination for ILS transactions. It will certainly be interesting to see how these initiatives in new jurisdictions play out in 2021.

Much of the focus in 2020 has been on Singapore, which has been proactively seeking out ILS investment through the introduction of the Monetary Authority of Singapore's ("MAS") Insurance-Linked Securities Grant Scheme, pursuant to which the transaction's legal and administrative expenses (up to SGD$2 million) are paid for by the Singapore government, provided certain thresholds are met. Crucially, 20% of the fees generated by the transaction must be domestically sourced so as to ensure that local service providers benefit from MAS's initiative. In July 2020, the MAS announced that it had extended the grant scheme to December 31, 2022, following an influx of interest by cedants and investors alike.

We have seen an increasing number of transactions in recent years with sponsors using Singapore as a jurisdiction for special purpose (re)insurance vehicles. Notable transactions recently issued out of Singapore include Manatee Re III Pte. Ltd.'s $40 million indemnity-trigger catastrophe bond issuance covering certain U.S. named

and severe thunderstorms as well as Easton Re Pte. Ltd.'s $150 million industry loss index trigger catastrophe bond issuance covering U.S. named storms and earthquakes – a transaction which signified Singapore as the jurisdiction of choice for Hamilton Re's first Rule 144A catastrophe bond issuance. The Texas Windstorm Insurance Association also issued a transaction through Alamo Re II Pte. Ltd., which issued $400 million in notes covering Texas named storms and severe thunderstorms based on an indemnity trigger – the largest catastrophe bond to come to market in Singapore in 2020.

We also note the recent MS Amlin-sponsored private catastrophe bond issued through Phoenix 1 Re Pte. Ltd., which was structured using participating notes in lieu of principal-at-risk notes (i.e., the investor's commitment was structured to function more like equities than fixed income securities). The Phoenix 1 Re transaction incorporated a combined set of features, including quota share retrocessional protection, securities clearance in Europe via Euroclear/Clearstream, settlement on a free-of-payment basis and listing on the Bermuda Stock Exchange.

Although we expect Bermuda to remain the jurisdiction of choice for many issuers by virtue of it being the well-trodden path (and, frankly, often more efficient from a deal timeline and regulatory perspective), we believe that some cedants may be attracted to the flexibility and incentives provided by overseas jurisdictions such as Singapore. We expect jurisdictions such as Brazil and Hong Kong to be slower to engage the market given no firm framework is yet in place, but overall we expect to see transactions being issued on an increasingly global scale in 2021. It remains to be seen how Singapore's push in ILS will play out (particularly given Bermuda's prominence and sophistication in the market), but it will certainly make for an interesting year ahead.

IV. EXCESS RESERVE FINANCINGS

A. Summary of Deal Activity

The year 2020 continued the favorable trend started in 2016, as the number of new excess reserve financing transactions remained consistent with 2019. Prior to 2016, the number of excess reserve financing transactions was depressed by an abundance of caution from both regulators and insurance companies in the life insurance reserve financing market, in large part because of the National Association of Insurance Commissioners[1] ("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. below of this Section IV.), which applies to all life insurance policies issued after December 31, 2014 that fall under Regulation XXX or AXXX.

In 2019 and 2020, the number of new excess reserve financing transactions increased due to an increased level of certainty as to what regulators will permit in current and future financings. In addition, the trend of restructuring existing transactions continued, as companies sought to take advantage of lower lending rates and the continued interest by reinsurance companies in acting as financing providers. Also, the use of a captive insurer to finance XXX and AXXX policies was bypassed by some companies, by adding admitted assets to the balance sheet of the insurer. Most insurers with 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 both 2019 and 2020.

i. AXXX Market Remains Open

As was the case in 2019, several recent transactions were designed to provide reserve financing for universal life policies subject to Regulation AXXX. In 2020, 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 to 25 years, although shorter terms intended to act as a financing bridge until other expected sources of funding become available are still commonly seen.

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. While for a time, in 2015, we saw a return to, or at least a heightened interest in, traditional letters of credit, the market has returned to the non-recourse contingent note structure, which remained by far the structure of choice in 2020. 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 insurer's capital, and a draw limited to an amount necessary for the captive insurer 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 contingent draw note. Transactions completed in 2020 continued to show that many regulators recognize that this approach is not expressly forbidden by the new rules, and that these bespoke sources of contingent funding are acceptable under AG 48. Collateral notes (demand

1 The organization composed of the chief insurance regulatory executives in each state and other U.S. territories.

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."

iii. Choice of Domicile for Captive Insurers and Limited Purpose Subsidiaries

Vermont and Delaware remained the preferred domiciliary jurisdictions for captive life insurers in 2020. 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 2019, 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 insurer structure of choice, at least for new AG 48 transactions. The exception appears to be Iowa, where Iowa-domiciled insurers continued 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.

B. Utilized Structures

i. Limited Purpose Subsidiaries

We are not aware of any new transactions that closed in 2020 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 general caution on the part of insurers and regulators alike.

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

As mentioned above, recent activity in the marketplace implies that the use of contingent credit-linked notes in a role analogous to a "synthetic letter of credit" will continue, along with collateral notes, to be the structure of choice for excess reserve financing transaction. 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 insurer. 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.

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

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 2020, 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 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

reinsurer'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.

iv. Funding Sources Beyond Banks

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 note that in both 2019 and 2020 at least one bank actively and successfully entered 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.

v. Use of Reserve Financing Structures on AG 33 Reserves for Fixed Annuity Contracts

The use of contingent credit-linked notes and XOL agreements expanded in 2019 and 2020 to address the reserve strain experienced by the issuers of fixed annuity contracts due to the application of AG 33 reserves using mortality tables that generate excessively conservative reserve requirements. In these transactions, the liability in excess of the account value of certain fixed index annuity contracts with respect to guaranteed lifetime withdrawal benefits are reinsured to the captive reinsurance company and backed by either an XOL agreement or a credit-linked note structure. Although not yet showing the same market attention as XXX and AXXX transactions, the need to finance AG 33 reserves has definitely caught the attention of several issuers of fixed annuity contracts as well as of the reinsurance companies that provide financing for these transactions.

C. Regulatory Environment

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 aimed 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 December 1, 2020, only five states (i.e., California, Connecticut, Iowa, Virginia and Wyoming) had adopted the Model Regulation. Because the Model Regulation will become an NAIC Part A Accreditation Standard effective as of September 1, 2022, we expect more U.S. states to adopt it in the relatively near future.

V. DEVELOPMENTS AND TRENDS IN LONGEVITY, PENSION CLOSE-OUTS AND DE-RISKING TRANSACTIONS

A. Developments in the United Kingdom

In our 2019 Year in Review found here, we reported that the market volume would be record breaking at over £40 billion. This was proven true, with the combined market value of bulk annuity transactions and longevity risk transfer transactions totaling £56 billion in 2019 (the bulk annuities market alone exceeding £42 billion in value).

Despite the COVID-19 pandemic the market has remained resilient and 2020 was a relatively strong year, with final figures expected to show that overall bulk annuity market volumes reached £30 billion and longevity risk transfer transactions totaled over £24 billion.

While the volume of bulk annuity transactions has decreased compared to 2019 (likely due to the focus on smaller to mid-sized deals, as noted below) the market volume of longevity reinsurance and swap transactions increased, with several high value longevity swap transactions announced during 2020.

We noted in our 2019 report that we had seen an increase in reinsurance transactions transferring both asset risk and longevity risk. This trend continued in 2020 – despite some volatile pricing which made transacting unpredictable at times, there was a strong interest in funded reinsurance transactions from cedants and reinsurers across the market, and a number of deals were completed despite difficult circumstances. We are aware of and advised upon a number of transactions that closed in 2020 but which have not been announced, where insurers have transferred market and longevity risk in respect of both retirees and deferred pensioners to reinsurers by entering into a reinsurance contract that provides for payment of an up-front premium by the insurer and regular payments by the reinsurer. The area of funded reinsurance brings with it a number of new considerations for parties that may have been involved in the longevity-only market for some time, including, in particular, how to reconcile the need for reinsurers to actively manage assets with the regulatory and compliance requirements of cedants. 2020 saw a number of insurers and reinsurers continue their participation in the market, and marked Prudential Financial entering the funded reinsurance market for the first time, with an initial transaction with Aviva, and we saw a number of new relationships established between cedants and reinsurers. We expect this market to continue to grow in 2021 as insurers look for a home for their assets and reinsurers look to capitalize on their existing expertise in active asset management.

Market activity slowed at the beginning of the COVID-19 pandemic, but regained momentum as the year progressed. One reason for the decreased activity was the wider market volatility at the start of the pandemic, with insurers facing the threat of asset downgrade risk and the resulting impact of asset downgrades on their matching adjustment portfolio. Another key area of concern for insurers was the volatility of the risk margin in light of falling interest rates. As the year continued, improved market stability helped assets recover from the lows of the second quarter. Despite the market volatility, generally bulk annuity pricing remained stable and in excess of gilt yields, with some of the volatility even creating favorable pricing for schemes during the first half of the year.

Further, at the start of the COVID-19 pandemic the pensions and de-risking industry immediately began exploring the impact of COVID-19 on longevity trends, seeking to know whether there would be any long term effects on longevity assumptions and how the pandemic could impact the pricing of de-risking transactions and the health of the industry as a whole. As time progressed, however, actuarial evidence demonstrated that the COVID-19 pandemic would most likely have a limited impact on longevity assumptions relevant for pension schemes and bulk annuity insurers. For example, in a paper co-authored by Amy Kessler of Prudential Financial published in May 2020, "The Impact of Covid-19 on Future Higher-Age Mortality," it was noted that COVID-19 had a relatively modest impact on mortality

rates in England & Wales and that the anti-selection among the surviving population was very small. Indeed, by the end of the year the market consensus was that the pandemic will have no significant long-term impact on overall best estimate mortality assumptions, as indicated by the fact that the Continuous Mortality Investigation has announced that it will place no weight on the data for 2020 when projecting mortality rates in its new model (expected to be released in March 2021) as the 2020 mortality experience is likely to be an outlier and not indicative of future mortality rates.

The actuarial developments along with the relatively stable (and at times favorable) pricing has resulted in the market remaining resilient throughout the COVID-19 pandemic, with schemes, bulk annuity insurers and reinsurers transacting throughout the course of the pandemic.

The COVID-19 pandemic also had several practical impacts on bulk annuity and longevity de-risking transactions. For example, schemes, (re)insurers and advisers alike quickly adapted to transacting virtually, including moving key meetings and negotiations online as well as signing and closing deals electronically. The industry was able to quickly adapt to the digital deal-making environment, with deals closing during the height of the various lockdowns. Additionally, certain manual processes such as scheme due diligence ceased to be an option within the lockdown environment. Without the ability to carry out in-person due diligence, some insurers sought to agree additional contractual protections which would mitigate the lack of due diligence.

As noted in our 2019 Year in Review, 2019 was the year of "jumbo" transactions. Following the COVID-19 pandemic, however, insurers shifted away from jumbo transactions and towards small and mid-sized deals, perhaps due to concerns about market liquidity and the risks of pooling a large amount of assets in one transaction. In order to accommodate the shift towards smaller schemes, insurers focused on pensioner-only transactions and there was an increased tendency to adopt standardized contracts which could be more quickly negotiated. The trend towards small and mid-sized deals ensured the resilience of the market; by the end of the first half of the year, the number of transactions had increased compared to the first half of 2019, albeit with a lower total value.

That being said, there were several high-value bulk annuity deals in 2020, including the de-risking transactions carried out by the Co-operative Group Pension Scheme which included a £1 billion bulk purchase annuity transaction with Aviva announced in January and a £1 billion bulk purchase annuity transaction with Pension Insurance Corporation ("PIC") announced in February. The scheme then took advantage of the improving pricing conditions at the beginning of the COVID-19 pandemic by adding to its existing buy-ins through follow-up transactions with PIC (deal value £400 million) in April and with Aviva (deal value £350 million) in May. The four consecutive buy-ins totaled approximately £2.75 billion of liabilities.

2020 was an especially eventful year for the longevity swaps market, with total deal value exceeding that of recent years. The largest transaction of the year was the £10 billion intermediated longevity swap and reinsurance transaction for the Lloyds Banking Group pension schemes, with Scottish Widows as insurer and Pacific Life Re as reinsurer. The swap was the second largest to have ever occurred in the United Kingdom, second only to the 2014 BT Pension Scheme longevity transaction, reinsured by Prudential Financial. Other notable transactions include the £3 billion longevity swap and reinsurance transaction between BBC Pension Scheme, Zurich and Canada Life and the £5 billion longevity swap between Barclays Bank UK Retirement Fund and the Reinsurance Group of America.

In our 2019 Year in Review, we observed the trend towards adopting facility and master collateral and/or payment-netting arrangements between bulk annuity insurers and reinsurers. These arrangements have proven useful during the course of 2020, as bulk annuity insurers and reinsurers have been able to turn to standardized documentation in order to transact swiftly and efficiently during the COVID-19 pandemic, particularly in relation to the many smaller and mid-size deals insured during the course of 2020. While these transactions do not tend to be announced publicly, we are aware of and have worked on a significant number

of longevity reinsurance transactions during the course of 2020 with counterparties who have master arrangements. For example, during the first half of 2020 Prudential Financial announced that it had successfully closed $1.7 billion worth of longevity reinsurance transactions and had also entered into facility style arrangements with a new insurer via its "flow reinsurance" platform.

In addition, this year saw the entrance of MetLife into the longevity reinsurance market, with MetLife having announced transactions with PIC (approximately £280 million), Rothesay Life (approximately £235 million) and Legal & General (approximately £1.47 billion across four transactions).

In 2020 the trend of converting existing longevity swaps to buy-ins continued, showing that trustees continue to see a longevity swap as an early stop on their schemes' de-risking journeys. For example, in February it was announced that the 2014 longevity hedge entered into by Pacific Life Re and the trustees of the Merchant Navy Officer's Pension Fund had been converted into a £1.6 billion buy-in with the PIC, and in July it was announced that the 2012 £800 million longevity swap for the LV= Employee Pension Scheme, originally insured by ReAssure and reinsured by Swiss Re, was converted to a buy-in with Phoenix Life, with Swiss Re continuing to provide reinsurance. As buy-in pricing continues to be attractive, we expect the trend for these swaps to convert into buy-ins to continue in future.

For insurers looking to consolidate or de-risk their back-book annuity portfolios via the United Kingdom's Part VII insurance business transfer process, we welcome the decision of the Court of Appeal in England to overturn the High Court judgement in the Prudential/Rothesay case. In line with the analysis offered in our 2019 Year in Review, the Court of Appeal noted that the High Court judgement had failed to give adequate weight to the independent expert report or the fact that the regulators had not objected to the scheme, and had inappropriately given weight to other factors including the extent of external financial support potentially available to the two parties and the assumed reasons for policyholders choosing Prudential as their annuity provider. The insurance industry has widely heralded this decision of the Court of Appeal and although judges on Part VII transfers following the original Prudential/Rothesay decision did not struggle to distinguish those transfers from the Prudential/Rothesay case, such a strong appeal decision provides reassurance that a non-objection from regulators together with a favorable independent expert report should reasonably lead to an expectation of the Part VII transfer being approved.

As noted above, 2020 was an active year in the longevity swap market, with around £24 billion of liabilities being hedged through longevity swaps. Unlike 2019, where the biggest longevity swap of the year utilized a captive structure, in 2020 the biggest deal in the market (the £10 billion Lloyds banking group swap) utilized a U.K. insurer (Scottish Widows, which sits within the Lloyds banking group). However, there were a number of large transactions which used a captive structure, including RGA's £5 billion transaction with the Barclays Bank UK Retirement Fund, Pacific Life Re's £3.7 billion arrangement for the Prudential Staff Pension Scheme and Munich Re's £1 billion deal with the Willis Pension Scheme. Each of these transactions used a Guernsey captive, with the Willis Pension Scheme taking advantage of the Willis Tower Watson Longevity Direct structure. There have been some reports in the market that off-shore captive structures are falling out of favor with trustees; however, this is not borne out by the value of transactions using Guernsey captives in 2020. That having been said, 2020 also saw a number of large transactions intermediated by Zurich, for example, the BBC Pension Scheme's £3 billion transaction with Canada Life (mentioned above), and a second Canada Life deal, this time for the UBS (UK) Pension and Life Assurance Scheme (£1.4 billion), showing that there are increasingly other options for trustees wishing to enter into a longevity swap who may not, for whatever reason, want to utilize an offshore captive, even for larger deals.

We noted in our 2019 report that commercial consolidators (pension schemes into which other pension schemes can transfer their liabilities) would probably not see any action until there is a clear regulatory framework in which they can work, despite there already being two consolidators in the market (Clara Pensions and The Pension SuperFund)

reporting strong interest and transaction pipelines. No transactions were reported in 2020, however there was some movement in the form of the Pensions Regulator issuing interim guidance for consolidators in June 2020. This guidance is not prescriptive and remains subject to updates; however, it is intended to allow consolidators to gear up for transacting despite the fact that formal legislation and a final regulatory framework have not yet been published. We therefore anticipate that 2021 may see the first consolidator transaction, given there seems to have been pressure to put some sort of regime in place to allow consolidators to operate. Key features of the guidance include prescriptive capital requirements (assumptions must be prudently set, a specific discount rate and other set assumptions must be used when setting Technical Provisions (the amount calculated on an actuarial basis to cover the scheme's liabilities), the capital buffer must comply with certain requirements including there being a 99% probability of the scheme being funded at or above Technical Provisions in five years and there are prescribed, legally enforceable triggers for intervention), limits on value extraction (for at least the first three years following the interim guidance being published, no surplus value can be extracted from the capital buffer or applicable scheme unless scheme benefits are bought out in full), non-exhaustive principles for investment strategies, including some specific limitations, and a requirement to have integrated risk management in place.

The guidance has not been received well by all industry participants. Although advisors have generally reacted positively, individuals including Andrew Bailey of the Bank of England have criticized the regime on the basis of the risk of regulatory arbitrage and the threat to financial stability. However, we have seen that schemes are looking to keep the door open to consolidator transactions, including when it comes to the menu of options available to them in the context of a longevity swap restructuring.

With respect to regulatory changes relevant to the longevity risk transfer market, in addition to the new regulatory regime for commercial consolidators discussed above, which has the potential to lead to disruption in the longevity risk transfer market, 2020 saw two key regulatory and legislative updates.

The first came out of the publication in December 2020 of the European Insurance and Occupational Pensions Authority's ("EIOPA") opinion on Solvency II, which is further discussed in Section VII.B. Of particular note to the longevity risk transfer market is EIOPA's concession that the risk margin should be changed to make it less volatile. The opinion provides that the 6% fixed cost of capital should remain, but that the risk margin calculation formula should be amended to include a "tapering" element, such that the outcome is lower and less volatile, particularly for longer-term liabilities. This approach was first suggested by the Association of British Insurers and was included as a proposal in EIOPA's information request. Insurers are likely to welcome this proposal. Although the volatility of the risk margin is often cited as a key driver for the reinsurance of longevity liabilities, our expectation is that other drivers for purchasing reinsurance are sufficient to ensure that demand stays high once the amendments to the risk margin come into effect.

In the United Kingdom, the government and the PRA have already announced their intention to reform the risk margin post-Brexit in order to reduce the size of the risk margin and the volatility noted above, as outlined in HM Treasury's Call for Evidence published in October 2020. HM Treasury has not set out a proposal in terms of how the risk margin calculation will be revised but rather has requested feedback as to the current "cost of capital" methodology and has invited views on how to modify the risk margin formula so that it is better suited to the U.K. insurance sector. In light of HM Treasury's Call for Evidence, it will be interesting to see whether responses from insurers show a preference for more radical reform of the risk margin than is proposed by EIOPA, whether the eventual outcome leads to a divergence from the EIOPA approach and, if so, whether this will impact any equivalence determination. For more information on the reform of risk margin within the United Kingdom, please refer to Section VII.B.

The second notable development relates to the Retail Price Index ("RPI"). It has long been recognized that RPI

is no longer a representative statistic for inflation in the United Kingdom, and the U.K.'s official statistical body (the "UKSA") has been pushing to either get rid of RPI entirely, or to change the basis on which it is calculated to make it more representative. The U.K. government recently announced that it would not propose legislation to discontinue RPI, nor would it agree to change the basis for calculation before 2030. As the UKSA can make the change without the government's consent from 2030, it is likely (though not set in stone) that from early 2030 RPI will begin to be calculated on the same basis as CPIH. This will have a significant impact on pension scheme liabilities and therefore on insurers' and reinsurers' related liabilities, given the volume of liabilities that are based on RPI. Insurers and reinsurers will need to consider how to reflect the anticipated change in their pricing.

B. Developments in Continental Europe

As in recent years, the Netherlands saw the most significant activity in continental Europe in 2020. In our 2019 Year in Review we noted that the Central Bank of the Netherlands ("DNB") was becoming increasingly comfortable with accepting reinsurance as a risk-mitigation technique under Solvency II. This has been borne out in the market, as in May of this year the NN Group announced indemnity-based longevity reinsurance transactions with Canada Life, Munich Re and Swiss Re to transfer longevity risk associated with €13.5 billion of pension liabilities in the Netherlands. The transaction was immediately beneficial for the NN Group, with NN Group announcing immediate upfront Solvency II capital benefits as the transaction reduced the amount of regulatory capital required to be held by NN, thereby strengthening NN's capital position.

C. Developments in North America

Turning to North America, 2020 proved to be a year of continuity for the U.S. market. The COVID-19 pandemic did have a disruptive effect, but it was largely limited to the second quarter, which saw the volume of liabilities transferred fall by approximately 48% compared to the second quarter of 2019. By the end of the third quarter, the market had begun to rebound as approximately $12 billion in single premium buy-outs (based on data from Secure Retirement Institute) were reported in the prior nine months. Given that the fourth quarter has historically seen the largest volume of transfers, some analysts think the year's total will approach $25 billion when the final tallies are made in the first quarter of 2021. If the market does reach that level, it would fall just shy of the $27 billion and $28 billion of liabilities transferred in 2018 and 2019, respectively. Regardless of whether that target is hit, the trends evident in prior years continued in 2020. As in recent years, the market gravitated both to small and mid-sized deals and to incremental approaches to de-risking that have seen plans and plan sponsors undertake multiple strategic buy-outs, often building upon lump sum offers or pension freezes, as steps in multi-year processes to reduce pension liabilities.

The year saw further steps to expand the connections between the pension risk transfer and capital markets with Global Atlantic Financial Group Limited's announcement in April of the establishment of Ivy Co-Investment Vehicle LLC ("Ivy Re"). Funded with $1 billion of third-party capital, Ivy Re utilizes a reinsurance sidecar structure to invest in the reinsurance of life and annuity blocks and pension risk transfers sourced, negotiated and underwritten by Global Atlantic's subsidiaries. By year's end, Ivy Re had announced three transactions, the last of which was its participation in a two-stage $8.5 billion reinsurance transaction with Unum Group. Ivy Re follows the establishment of ACRA Re by Athene in 2019 and, as noted in our March 2019 Insurance Industry Review found here, the establishment of Langhorne Re, a closed-end Bermudan reinsurance vehicle by RGA and Bermuda re/insurer RenaissanceRe. Similar to Langhorne Re and Ivy Re, ACRA Re intends to invest in large block and pension risk transfer transactions. The establishment of these vehicles provides crucial momentum in the development of reinsurance sidecars as a means to provide additional capital to the longevity and pension risk transfer market. In the coming years, we expect to see additional vehicles follow.

A key point of continuity between 2020 and prior years was the overall level of interest among plan sponsors in pension risk transfer specifically and de-risking more

broadly. While some commentators have predicted that the U.S. market may cool in the coming years because those plans best positioned to de-risk will have done so, interest among plan sponsors continues to be high. As we noted in our 2019 Year in Review, the biennial Mercer/CFO Research survey published in June 2019 found that 70% of plan sponsors were looking to execute a buy-out transaction in 2019 or 2020. Those findings were echoed by a survey of 200 U.S. defined benefit plan sponsors (all representing plans having assets of at least $100 million) conducted by MetLife in the summer of 2020. The survey found that 81% of plan sponsors reported an interest in undertaking some form of de-risking in the next five years. Interestingly, respondents' plans were evenly split among buy-outs, buy-ins and lump-sum offerings.

The respondents' enthusiasm for buy-ins in particular underscores the U.S. market's move toward a more incremental approach to de-risking. In the United States, as in the United Kingdom, buy-in transactions offer a means of reducing the plan's risk, and in both markets, the U.S. pension plan (or U.K. pension scheme) will remain responsible for administrative costs. But in the United States, those costs include Pension Benefit Guaranty Corporation ("PBGC") premiums, which have historically made buy-in transactions less attractive to U.S. plan sponsors either as an interim stop before completing a buy-out or as an end in itself. (Buy-outs, in contrast, eliminate the plan's responsibility to pay PBGC premiums and other administrative costs). Notwithstanding that impediment, the U.S. market witnessed a significant uptick in buy-ins in 2019, which saw six such deals reported. While those six deals comprised only a small portion of that year's total deal volume, they represented a significant tally considering that only 14 buy-ins had previously been executed in the United States prior to 2019. As of this writing, 2020 did not see a comparable number of buy-ins (by the end of the third quarter, only one had been reported), but the level of interest among plan sponsors suggests that U.S. plans are eager to use all potential de-risking options. We think that bodes well for the continued diversification of the U.S. market in the coming years.

We also expect such interest among plan sponsors to continue unless the factors currently incentivizing de-risking, namely PBGC premiums and market volatility, are significantly diminished. That result is unlikely, particularly in the case of PBGC premiums. As noted in prior Years in Review, PBGC premiums continue to rise. In 2021, the per-participant rate for single-employer plans will be $86 (up from $74 in 2018 and $35 in 2012) and $31 for multi-employer plans (up from $28 in 2018 and $9 in 2012). These increases were mandated by the 2012 Moving Ahead for Progress in the 21st Century Act, and are anticipated to continue on an annual basis. However, plans' efforts to de-risk will ultimately decrease PBGC revenue as more liabilities are shifted to insurers (which are not required to pay such premiums) or eliminated through lump sum offers. Given the U.S. Government Accounting Office's assessment, based on the 2019 fiscal year, that the PBGC's multi-employer program will almost certainly be insolvent in 2027, lawmakers may feel it necessary to disincentivize de-risking by freezing premiums, or slowing the rate of increases.

Market volatility is, of course, not as easy to forecast, but to date, declining interest rates have pushed plan sponsors to reduce their discount rates, which, in turn, has increased pension obligations and decreased funded status among U.S. plans. But given the U.S. Federal Reserve's announcement in September that it does not anticipate a raise in interest rates until the end of 2023 (at the earliest), it appears likely that the persistent low rate environment together with the steady increase to PBGC premiums will continue to drive the market forward. To that end, 2020 also saw two additional insurers – Nationwide and Midland National Life – join the market. That brings the total number of providers to 18. Some analysts suggested that the COVID-19 crisis may spur further interest from insurers as a potential means to offset losses incurred due to increased COVID-19-related mortality rates.

The year's ledger of noteworthy deals also evidences the trend away from jumbo transactions in favor of incremental and diverse de-risking. The year's largest reported deal was Lockheed Martin's buy-out transaction with Metropolitan Tower Life Insurance Company in

January, which transferred to the insurer liability for $1.9 billion in pension obligations and covered approximately 20,000 retirees. The transaction followed Lockheed's purchases of group annuities from Prudential and Athene, respectively, in 2019. Those transactions collectively transferred $2.6 billion in pension liabilities to the two insurers. That pattern was followed by a number of deals in 2020. They included the purchase by Atlanta-based Graphic Packaging Holding Co. of group annuity contracts from AIG subsidiaries American General Life Insurance Company and The United States Life Insurance Company in the City of New York in January. That transaction, which culminated in a plan termination and followed lump sum offerings in 2015 and 2019, transferred approximately $750 million in pension liabilities covering about 8,700 retirees to the two insurers in the aggregate. The New York Times Company purchased a group annuity contract from Massachusetts Mutual Life Insurance Company for $235 million in October. That deal covered approximately 1,850 retirees and follows The New York Times' purchase of a group annuity contract from MassMutual 2017. MassMutual also completed a transaction with Atlanta-based Newell Brands, Inc., which transferred liability for approximately $155-$160 million in pension liabilities and followed lump sum offerings in 2014 and 2015 by Newell Brands' predecessor, Newell Rubbermaid, Inc. In August, Idaho-based wood products and building materials manufacturer Boise Cascade Company announced that it had agreed to purchase a buy-in contract from Prudential and would convert it to a buy-out following the conclusion of a lump sum offering in October 2020. Significantly, Boise Cascade reported that the buy-out option would be exercised with no additional premium and would enable it to terminate its plan and thereby complete the final step in its de-risking process, which included the purchase of three group annuity contracts from Prudential since 2018.

Other noteworthy deals in 2020 included the purchase of group annuity contracts: by PotlachDeltic Corp., of Spokane Washington, from New York Life Insurance Company, transferring $100 million in liabilities; by Western New York-based aerospace and defense company Moog Inc., from MetLife, transferring $481 million in liabilities and covering approximately 3,000 retirees; by food manufacturer Kellogg Company, which transferred $407 million in liabilities to an undisclosed insurer; by General Electric Company from Athene, which transferred $1.7 billion in pension liabilities; and by Dallas-based Trinity Industries, from Banner Life Assurance and William Penn Life Insurance Company of New York, respectively.

The expansion of the U.S. pension risk transfer market has not been without pitfalls. In April, the New York State Department of Financial Services ("NYDFS") announced that it had entered into a consent order with Athene Holding Ltd. Pursuant to the consent order, Athene Holding agreed to pay a $45 million penalty as a result of its subsidiary Athene Annuity & Life Company having "solicited and [done] insurance business in New York without a license" in connection with certain pension risk transfer transactions. The penalty follows the NYDFS's issuance of a circular letter in September 2019, noting that it had "issued guidance to life insurers and insurance producers to protect New York pension holders from unlicensed activity in New York's pension risk transfer market [after learning]…that unauthorized life insurers, as well as insurance producers and unlicensed individuals representing unauthorized insurers or pension plan sponsors with offices in New York, have been soliciting, negotiating, selling, and servicing group annuity contracts related to transferring pension risk, including terminal funding or close-out contracts, issued by companies that are not licensed in New York and in violation of New York Law." Heightened scrutiny by the NYDFS of pension risk transfer transactions having a nexus to the State of New York is expected.

The COVID-19 pandemic had a more direct effect on the Canadian market as the Canadian Office of the Superintendent of Financial Institutions issued a freeze on commuted value transfers and buy-out annuity purchases that lasted from March until the end of August. The freeze was intended to address high levels of market volatility, which had a deleterious effect on Canadian plan funding ratios. While the result, understandably, was less market activity, there were nevertheless a few noteworthy deals in Canada in 2020. They included a CAD$660 million (US$500 million) longevity reinsurance transaction

between The Co-operators Life Insurance Company and the Co-operative Superannuation Society Pension Plan, and a CAD$46 million (US$36 million) buy-in agreement between RBC Life Insurance Company and Supremex Inc., the North American envelope and packaging producer, covering 361 retirees. The latter follows a similar, CAD$7 million (US$5.5 million) deal between RBC and Supremex in 2018. The freeze did not impact buy-in deals, and in May, Corby Spirit and Wine Ltd. and Hiram Walker & Sons Ltd. entered into a CAD$176 million (US$139 million) buy-in transaction with Sun Life Financial Inc., covering 750 retirees and beneficiaries. Both Corby Spirit and Hiram Walker are subsidiaries of Pernod Richard North America.

Despite the downturn in the Canadian market in 2020, there is reason to believe that such results are temporary. As we noted in prior reviews, the Canadian market doubled in size from 2013 to 2018 and several factors have contributed to its growth, including a stabilized pool of insurers and legislative changes in several provinces that permit plan sponsors to fully transfer liabilities 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 bespoke solutions, including longevity risk transfer. We would anticipate that, in the absence of further unforeseeable circumstances, the Canadian market will pick-up from 2019, which saw CAD$5.23 billion (US$4.12 billion) in liabilities transferred, and continue to expand in 2021.

D. Looking Forward to 2021

At the end of 2020, all indications suggest that the U.K. and North American markets will continue to expand in 2021. In the United Kingdom, key trends that we expect to continue and grow in 2021 are the high interest in funded reinsurance deals and the ease of transacting for small and medium-sized schemes, especially where framework bulk annuities and reinsurance contracts have been put in place. It also seems likely that 2021 will bring the first consolidator transactions, possibly with smaller schemes testing the waters first. In the United States, continued interest among plan sponsors and the pressure of ever-increasing PBGC premiums and low interest rates should continue to push U.S. plans to de-risk. We expect to see the current trend toward small and mid-sized deals and diversified, incremental de-risking continue, albeit not to the complete exclusion of jumbo deals. In Canada, despite the interruption posed by the COVID-19 pandemic, the foundations that have propelled significant growth in recent years remain in place and we would expect to see the market rebound in 2021.

VI. CAPITAL MARKETS ACTIVITY

A. U.S. Capital Markets Activity

i. Active Markets

One of the by-products of the COVID-19 pandemic and the governmental responses thereto was a steep increase in corporate debt issuances in 2020 as companies sought to strengthen their balance sheets and liquidity profiles (including to allay any potential regulatory capital concerns); especially in March and April, when companies faced the unknown, with pronounced potential market volatility and the possibility of decreased revenue. In many respects, given their high ratings, this was even more marked in the insurance and financial institutions sector. Investment grade bond issuances generally had already overtaken the previous yearly record of $1.2 trillion in 2017 by the middle of August 2020.

As the second quarter progressed, the decrease in market volatility accompanied by continued public assurances of support by the Federal Reserve, led many insurance company issuers to take advantage of the continued historically low interest rates. In addition to benefiting from low coupons, insurance companies have also pushed out their average debt maturity profile by more than a year. According to S&P Global Ratings, the average maturity of U.S. investment-grade bonds has increased in duration from 11.5 years at the beginning of 2020 to 12.8 years.

a. Funding Agreement-Backed Note Programs

The particularly low interest rate environment has also encouraged further expansion of spread lending products, such as funding agreement-backed note programs. Over the last 13 months no fewer than five new issuers entered an already competitive marketplace: Metropolitan Tower Life Insurance Company (December 2019), Equitable Financial Life Insurance Company (May 2020), Pacific Life Insurance Company (June 2020), The Northwestern Mutual Life Insurance Company (December 2020) and Forethought Life Insurance Company (January 2021).

Many of the long-established names in this marketplace also increased their issuance capacity in the face of strong market demand and this only continued in the first week of January 2021 with multiple issuances across currencies from the likes of Athene, Equitable Financial, Global Atlantic, MetLife, New York Life, Northwestern Mutual, Pacific Life, Principal and Protective Life.

As the transition away from LIBOR continues to approach (despite a prolonged process to account for existing outstanding securities), SOFR has become more and more the floating rate option of choice for U.S. issuers. In the last third of 2020, securities tied to Compounded SOFR using either the "SOFR Index" or the "SOFR Averages" calculation became more prevalent and we hope that over the next 12 months issuers and market participants will coalesce around a particular SOFR rate going forward.

b. Sustainability Linked Financings

ESG-related bond issuances also saw a dramatic increase in 2020. While green bond issuances continued to be a major component of sustainability-related demand, sustainability and social bonds have also received particular interest from investors, especially some of the big asset managers, in the months following the protests and demonstrations that followed the death of George Floyd. Both Prudential and MetLife issued sustainability bonds in the first half of 2020, while, in connection with its financing for the acquisition of National General, Allstate hired solely banks owned by minorities, women or veterans for their November notes offering, in the biggest corporate deal yet managed only by diverse firms.

c. InsurTech

The InsurTech space saw an uptick in IPO activity in 2020. InsurTech unicorn Lemonade floated in July, with companies Duck Creek and Root following soon after in August and October, respectively. Oscar also jumped on the bandwagon, filing its registration statement for an IPO in December. The wave of InsurTech companies going public reflects the strength of investment interest in the sector, with public interest mirroring the private investment.

ii. SEC Updates

a. Disclosure updates related to COVID-19

Then SEC Chairman, Jay Clayton, and other SEC officials released guidance from the Division of Corporation Finance in March and June, respectively, related to the COVID-19 pandemic and the SEC's expectations as to how companies would factor it into their reporting and compliance. CF Disclosure Guidance Topic No. 9 offered the SEC Staff's view on disclosure considerations, trading on material inside information and reporting financial results as they relate to COVID-19. Topic No. 9A, which supplements CF Disclosure Guidance Topic No. 9, urges companies to focus disclosure on operational adjustments made and financing activities undertaken in response to the effects of the COVID-19 pandemic. The guidance suggests companies provide robust and transparent disclosures about how they are dealing with short- and long-term liquidity and funding risks in the current economic environment. The guidance also indicates that the SEC will continue to monitor disclosures about the impact and risks of the COVID-19 pandemic on a company's business, financial condition and results of operations.

b. Streamlined Disclosure

Effective November 9, 2020, the SEC adopted amendments to modernize the description of the business, legal proceedings and risk factor disclosures that SEC registrants are required to make pursuant to Regulation S-K under the Securities Act. The amendments to the narrative description of the business under Item 101 of Regulation S-K emphasize a principles-based disclosure methodology. We expect that the new requirement to include a description of a registrant's human capital resources, to the extent material to the company's business, could be the most challenging for registrants to implement and monitor. Companies will need to approach human capital disclosure and any quantitative metrics they decide to provide with the same controls and procedures applied to other regulated disclosures. We expect human capital disclosure will evolve to include certain industry standards over the coming years, as they develop. Notable absences from the amendment to Item 101 of Regulation S-K are references to diversity and climate change, leaving it to the registrant to determine whether such information is material to the business discussion. ESG-type disclosure may make its way into this section of a company's annual report as investor trends continue to show a move toward companies that are strengthening ESG commitments in meaningful ways.

We also expect the changes to Item 105 of Regulation S-K, revising the presentation of risk factors, to impact insurance company disclosure as it is typically a lengthy part of the Exchange Act report or offering document of an insurance company. The amendment requires registrants to provide a two-page (or less) bullet point summary of their risk factor disclosure if the risk factor section exceeds 15 pages. The standard of disclosure has been changed from "most significant" to "material" risks and the risk factors are required to be organized under topic headings. Any risks that are generally applicable to an investment in securities will need to be included at the end of the risk factors section under a "General Risk Factors" caption.

Also in November, the SEC adopted changes to the rules governing Management's Discussion and Analysis of Financial Position and Results of Operations ("MD&A") and certain related financial disclosures. Keeping in line with the SEC's disclosure modernization program, the amendments, to a great extent, incorporate existing SEC guidance and a further move toward a principles-based approach for MD&A. The amendments become effective February 10, 2021. Registrants will be required to follow the amended rules for their first fiscal year ending on or after the date 210 days after publication in the Federal Register (the "mandatory compliance date") or in their annual report for the year ending December 31, 2021, for calendar-year companies. Registrants will be required to apply the amended rules in a registration statement or prospectus that on its initial filing date is required to contain financial statements for a period on or after such mandatory compliance date.

c. SEC Comment Letters

In 2020, the SEC Staff generally concentrated their comment letter focus on the same topics that have been under the spotlight in recent years and for insurance companies that was no different.

In our view, disclosures concerning non-GAAP financial measures, internal and disclosure controls and procedures, MD&A, short-duration contracts/loss reserves, revenue recognition, and reinsurance continued to receive, and will continue to receive, the majority of comments for insurance companies. Because the first four of those topics attract a large bulk of the Staff's comments, we have discussed them further below.

i) Non-GAAP Financial Measures

Following the May 2016 publication of the Staff's additional Compliance and Disclosure Interpretations on Non-GAAP financial measures and subsequent updates, the Staff have consistently commented on individually tailored accounting principles and the equal or greater prominence of the comparable GAAP financial measure. In some instances the Staff has questioned certain of the adjustments used to calculate the non-GAAP financial measure in the context of the issuer's explanation as to why the non-GAAP measure is useful to investors and management, i.e., a coherent reason must exist linking each adjustment to the ultimate use of the non-GAAP financial measure. The Staff has also indicated they are taking a close look at any COVID-19-related adjustments.

ii) Internal and Disclosure Controls

The Staff's drive here seems to be identifying material weaknesses in controls in a timely manner, i.e., not only when a control deficiency results in an accounting error. The issuer's evaluation and conclusion about the severity of a control deficiency should include a forward-looking analysis as to the likelihood and magnitude of any such error occurring and not being prevented or detected by the controls in place. The Staff is especially questioning instances in which management attributes a material accounting error to a control deficiency, but fails to conclude that such deficiency is a material weakness in internal controls. Out-of-period errors corrected during the current period may draw comment if the prior period amounts are not also revised. The Staff has expressed its concern surrounding the effectiveness of internal and disclosure-related policies and procedures in the new remote-work environment. These concerns are based on (a) inherent increased cyber-security risks as companies quickly transitioned to at-home work environments with potentially less secure IT controls and (b) administrative difficulties companies may face due to certain personnel potentially being unavailable and an inability to access information that otherwise was provided in the office.

iii) MD&A

The Staff continues to focus on the quantification of underlying drivers for changes in results of operations in period over period comparisons, further disclosure of material trends and uncertainties, or unusual or infrequent events that will impact a company in both the near and long term. In recent years the Staff has also focused on critical accounting policies and estimates, asking for more granularity on sensitive and uncertain assumptions which require management's judgement, particularly with respect to goodwill impairment and whether the appropriate analyses are being conducted in a volatile market.

iv) Short-Duration Contracts/Loss Reserves

Since these disclosures require significant judgment on the part of management, it is unsurprising to see that they attracted additional Staff comment. The amount and appropriateness of aggregation of information was questioned by the Staff, including the sufficiency of the underlying data, especially to the extent information was combined across segments or products. Companies were also asked to reconcile differences between information that they include on websites, earnings calls, investor presentations and that is disclosed in the short-duration contract tables.

B. European and U.K. Capital Markets Activity

i. Facilitating Capital Raising

The U.K. and European market saw numerous capital raises in the insurance and reinsurance sector in 2020, either, in a minority of cases, pre-emptively to address the risk of liquidity needs or, as noted above (see Section I.B.) to forge growth strategies and take advantage of the hardening (re)insurance rates by raising additional capital to support writing new business. The insurance groups which acted quickly and pre-emptively were able to ensure that any eventual losses relating to the COVID-19 pandemic could be met without having a material impact on the relevant group's regulatory capital position.

Given the extraordinary impact of the COVID-19 pandemic, the U.K. Pre-Emption Group ("PEG") relaxed its guidelines and recommended that equity investors, on a case-by-case basis, consider supporting non pre-emptive issuances by companies of up to 20% of their issued share capital (rather than the typical pre-emption disapplication recommendation of 5% for general corporate purposes and an additional 5% for specified acquisitions or investments). The relaxation by PEG of its guidelines acknowledges that, unlike U.S. or Bermudian issuers, the U.K. and E.U. tradition of affording pre-emptive rights to existing investors can result in delays in the equity capital raising process. These moves complemented the exemption from having to produce a prospectus under the Prospectus Regulation where companies listed on a European regulated market are seeking admission to trading for less than 20% of their issued share capital, which meant that many companies could now raise an amount up to 20% of their existing equity by way of a placing without having to publish a prospectus.

Additionally, in April 2020 the U.K.'s FCA, in urging market participants to review and consider PEG's new guidance carefully, reiterated the need expressed by PEG for companies seeking to avail themselves of the additional flexibility to consult first with a sample of its major shareholders (adhering to suitable Market Abuse Regulation ("MAR") wall-crossing measures) and, where possible, to follow "soft pre-emption" rights in relation to a placing of shares, i.e., whereby the bookrunners allocate shares to investors in accordance with an allocation policy that seeks, to the extent possible within the constraints of the exercise, to replicate the existing shareholder base.

The FCA also provided certain additional flexibility for issuers with a premium listing on the London Stock Exchange regarding the requirement to hold an extraordinary general meeting to comply with obligations under the U.K. Listing Rules made by the FCA. For example, unless an exemption applies, premium listed issuers must hold a general meeting to approve Class 1 transactions under Listing Rule 10 and certain related party transactions under Listing Rule 11. In its policy statement, where issuers were challenged by the time constraints for holding a general meeting, the FCA confirmed that it would consider dispensations related to the requirement to have a general meeting if (i) the issuer had obtained written undertakings from shareholders meeting the relevant voting threshold that they would approve of the proposed transaction and would vote in favor of it if a general meeting were held and (ii) the issuer will provide written confirmation to the market that it has obtained such undertakings. The FCA confirmed that the other requirements (such as publishing a circular to shareholders) of Listing Rules 10 and 11 would continue to apply. These dispensations are intended to be temporary and, where time permits, the FCA continues to prefer the use of approvals in a general meeting, including those held virtually, in order to allow shareholders to air their views.

ii. Capital Markets Activity

The European capital markets saw a busy 2020 as companies across all sectors raised debt and equity capital to address potential and actual challenges brought on by the COVID-19 pandemic. In particular, the second quarter saw £18.5 billion of secondary equity issuances in the United Kingdom as well as high volumes of European investment-grade debt capital market activity, which reached €201 billion as companies in all sectors sought to shore up their finances. Later in the year, as the European capital markets saw recoveries across many sectors, primary equity issuances and European high yield issuances, which were

both depressed in the first half of 2020, returned to pre-pandemic levels.

These general trends in the capital markets were also reflected by capital raises in the (re)insurance sector. In the first half of 2020, many listed (re)insurance issuers (including the likes of Hiscox, Beazley and Lancashire) took advantage of the PEG's new guidance discussed above and raised capital. Typically, these capital raises were conducted as accelerated book-builds (without publishing a prospectus) and utilized a "cash box" structure; a transaction structure that has been used frequently in relation to recent London equity issuances as an exception from the pre-emption requirements of the U.K. Companies Act 2006, provided the shares are issued for non-cash consideration. Although the PEG guidance did not directly address "cash box" structures, having investor support for a 20% capital raise on a non-pre-emptive basis was seen by market participants as allowing for "cash box" transactions. In addition, the "cash box" structure (which does not require the convening of a shareholders' meeting to disapply pre-emption rights) allows issuers to react nimbly to market conditions and to raise capital on an expedited basis.

In addition to these secondary offerings, new entrants have been able to tap into the U.K. capital markets to launch their platforms. In December 2020, Conduit Holdings, a new reinsurance company, raised over £780 million in one of the largest London IPOs in 2020 in any sector. The Conduit deal was accomplished without traditional anchor private equity investors and illustrates that, in favorable market conditions, many capital raising avenues remain open to potential new entrants. The Conduit IPO is also an example of the trend of (re)insurance start-ups and ramp-ups attracting capital inflows, which we discuss in Section I.B. above.

iii. EMTN Programs

As noted above, the second quarter saw an extraordinary volume of issuances of investment grade debt by issuers that could access the markets to provide additional liquidity to withstand the economic downturn from COVID-19 pandemic lockdowns and European (re)insurers with Euro medium term note ("EMTN") programs were amongst those able to access the capital markets nimbly to raise capital, including regulatory capital, on an accelerated basis. For example, in April 2020, Legal and General Group plc issued £500,000,000 Fixed Rate Reset Subordinated Notes due 2050 under its EMTN program, which was slated to qualify as Tier 2 capital, and in June 2020, Allianz SE issued €1,000,000,000 Subordinated Fixed to Floating Rate Notes and Aviva plc issued £500,000,000 Dated Tier 2 Fixed Rate Reset Notes under their respective programs.

iv. Post-Brexit Passporting and Prospectus Regulation

Although the United Kingdom officially withdrew from the European Union on January 31, 2020, the withdrawal agreement effecting the United Kingdom's departure included a transition period until December 31, 2020, that meant that the United Kingdom continued to follow E.U. law in key respects, including in relation to the European Union's Prospectus Regulation.

Following the end of the transition period, most of the substantive provisions of the Prospectus Regulation will be retained in U.K. domestic law (such as the requirement to publish a prospectus, many of the content requirements and the exemptions from the obligation to publish a prospectus).

One key consequence of Brexit and the end of the transition period, notwithstanding the Trade and Cooperation Agreement struck on December 24, 2020, which did not cover the prospectus regime, is that U.K. issuers have now lost the ability to passport a U.K.-approved prospectus into the European Economic Area ("EEA") and, similarly, EEA issuers cannot passport into the United Kingdom. Instead, issuers that are seeking to offer securities to the public in both the United Kingdom and the EEA will now need to have their prospectuses approved by the national competent authority in both the United Kingdom and the relevant EEA jurisdiction. However, as a transitional measure, a valid prospectus that was "passported" into the United Kingdom before the end of the transition period will continue to be valid for use in the United Kingdom up to the end of its normal period of validity (12 months from the date it was

originally approved). However, any prospectus supplement to a passported prospectus must still be approved by the FCA after the end of the transition period.

As implemented in the United Kingdom after the transition period, the U.K. prospectus regime came into effect and made a number of changes including:

- Functions that were exercised by the European Commission will be transferred to HM Treasury and those functions carried out by the European Securities and Markets Authority will be transferred to the FCA.

- U.K. issuers must use U.K.-adopted international accounting standards when presenting their historical financial information in a prospectus. Issuers established outside the United Kingdom must use U.K.-adopted international accounting standards or the accounting standards of other countries if an equivalence decision has been made.

- U.K. issuers will no longer be permitted to incorporate by reference information contained in documents (including other prospectuses) unless such information has been approved by the FCA, even if it has previously been approved by an EEA regulator. However, as a transitional measure, information that has already been approved by an EEA State regulator before the end of the transitional period can continue to be incorporated by reference into a prospectus for use in the United Kingdom going forward.

v. Other Capital Markets Consequences of Brexit

In addition to the on-shoring of the equivalent Prospectus Regulation in the United Kingdom as described above, following the end of the transition period a number of other European laws relevant to the capital markets have been transitioned into U.K. domestic law. We set out below some of the key pieces of capital markets regulation and the changes that are likely to be relevant to capital markets participants, namely:

- *The Market Abuse Regulation:* (i) issuers of U.K. listed securities must notify the FCA of any delayed inside information disclosure under U.K. equivalent of MAR (U.K. MAR), regardless of whether a notification has been made to another E.U. competent authority; and (ii) persons discharging managerial responsibilities within issuers of U.K. listed securities will need to send dealing reports to the FCA whether or not a notification has been made to another E.U. competent authority.

- *The Packaged Retail Investment and Insurance-Based Products Regulation ("PRIIPs Regulation")*: The U.K. government has confirmed that it does not intend to amend the substantive provisions of the PRIIPs Regulation other than to change the territorial scope to apply to PRIIPs sold to retail investors in the United Kingdom and to onshore the functions of the E.U. authorities to their U.K. counterparts. Therefore, the PRIIPs Regulation will continue to require the publication of a "key information document" when certain financial products are offered to retail investors in the United Kingdom. However, the U.K. equivalent of the PRIIPs Regulation is slated to be updated "when parliamentary time allows" to enable the FCA to clarify the scope of the PRIIPs Regulation, as it has been a source of much debate among capital markets participants.

C. Non-U.S. Regulatory Capital Transactions

2020 was another year in which (re)insurance groups continued the trend of raising private or public capital which qualifies for the desired "Tier" treatment under Solvency II or a Solvency II-equivalent regime, such as Bermuda's Group Supervision framework. With a hardening rate environment, many (re)insurance groups sought to increase their capital position by taking advantage of the historically low interest rate environment to issue debt or preference shares that would expand their capacity to write new business. Insurance groups such as Allianz, SCOR and Ageas issued regulatory capital under Solvency II, and Argo and Fidelis did so under the Bermuda Group Supervision regime. While these transactions generally require coordination with the applicable group regulator and analysis under the supervisory rules to ensure that the particular terms qualify the securities for Tier 1, Tier 2 or Tier 3 regulatory capital treatment, our experience in 2020 was that insurance regulators were responsive in providing feedback to issuers despite the extraordinary circumstances.

VII. PRINCIPAL REGULATORY DEVELOPMENTS AFFECTING INSURANCE COMPANIES

A. U.S. Regulatory Developments

"Uncertain Times," "Unprecedented Times" and more. All of these labels certainly applied to the U.S. insurance industry during 2020. An NAIC meeting was cancelled and two meetings were held remotely. Much of the time and attention of regulators was diverted from more normal regulatory activity to dealing with the crises caused by the COVID-19 pandemic. Regulators also reacted to the increased focus throughout the country on addressing racial inequality and to the continuing worldwide concern about climate change. Nevertheless, regulators continued with many projects that were ongoing from 2019, many involving group and individual company solvency.

Significant developments are summarized below.

i. Regulatory Response to COVID-19 Pandemic

Since March 2020, U.S. state insurance regulators have been active in issuing bulletins, directives and guidance in response to the economic impacts of the COVID-19 pandemic, which encouraged, requested or directed insurance companies to implement accommodations such as premium payment grace periods and forbearance on the cancellation or non-renewal of policies due to non-payment. In addition, some state governors issued emergency orders and state insurance commissioners promulgated emergency regulations requiring such actions. These and other regulatory guidance raised concerns about the impact on insurance company statutory financial statements, and in response the NAIC issued revisions of limited duration of the accounting rules applicable to insurers, as we previously reported here.

Industry and regulatory discussion has also focused on the appropriate role of pandemic business interruption ("BI") coverage in the context of the current COVID-19 pandemic. The NAIC issued a statement in March 2020 that it would caution against and oppose legislative proposals to require insurers to retroactively pay COVID-19 BI claims not covered by insurance policies, and in December 2020 expressed its view that a federal mechanism is necessary to address the BI coverage gap for pandemic risk. Proposals for a prospective federal backstop for pandemic BI coverages are currently under development and consideration, and will be an area to follow in 2021.

The pandemic also necessitated certain regulatory modernizations, ranging from more broadly permitting electronic signatures to expanding what can be done virtually in the context of claims facilitation and regulatory filings. In 2021, the NAIC Innovation and Technology (EX) Task Force will review and prioritize work based on responses from interested parties to a request for feedback about areas of regulatory relief or accommodations related to innovation and technology that resulted from the pandemic that they would like to see continued or made permanent moving forward.

ii. Focus on Race and Insurance

The NAIC formed the Special (EX) Committee on Race and Insurance (the "Race and Insurance Committee") in July 2020, following discussions on "race and its role in the design and pricing of insurance products" and the "need to improve diversity in the insurance sector," according to 2020 NAIC President and Director of the South Carolina Department of Insurance, Raymond Farmer. The Special Committee is co-chaired by Director Farmer and the 2021 NAIC President, Florida Insurance Commissioner David Altmaeir. In August 2020, the NAIC held a special session on race and insurance, during which regulators and outside experts addressed (i) the historical context of racial discrimination in the insurance sector, (ii) current insurance practices that can potentially disadvantage minority communities, and (iii) plans to increase diversity and inclusion in the insurance industry. Also in August, the NAIC adopted artificial intelligence principles (discussed in subsection vii.(b) below of this Section VII.A.) which include the principle that the insurance industry should be encouraged to take proactive steps to avoid discrimination

by proxy against protected classes when using artificial intelligence platforms. Director Farmer noted this was part of the NAIC's broader effort to address racial equity.

The Race and Insurance Committee met regularly during the Fall of 2020 to gather information related to these topics, and identified five work streams. Work stream #1 relates to diversity within the insurance industry and access to insurance products. Work stream #2 focuses on diversity within the state insurance regulatory community and the NAIC. Work streams #3–5 focus on identifying practices or barriers that potentially disadvantage people of color and/or historically underrepresented groups in the property and casualty, life and annuity, and health insurance areas, respectively. The NAIC has pledged that this work will continue in 2021 and the Race and Insurance Committee will recommend actions to the NAIC Executive Committee by the end of the year.

iii. Climate Risk

Climate risk is a strategic priority for the NAIC and it formed the executive-level Climate Risk and Resiliency (EX) Task Force (the "Climate Task Force") in 2020 in light of the "nearly unprecedented number of natural disasters" that occurred last year. The Climate Task Force will consider appropriate climate risk disclosures and evaluate financial regulatory approaches to climate risk and resiliency; look for innovative insurer solutions to climate risk; identify sustainability, resilience, and mitigation issues and solutions related to the insurance industry; and will also focus on the role of state regulators with respect to pre-disaster mitigation measures.

Climate risk and the management of the related financial risks are also a regulatory priority for the NYDFS. In September 2020, the NYDFS issued a circular letter to New York domestic and foreign insurance companies which states that it "expects all New York insurers to start integrating the consideration of the financial risks from climate change into their governance frameworks, risk management processes, and business strategies" (e.g., an insurer should designate a board member or board committee to oversee the assessment of these financial risks). The NYDFS will issue guidance on climate-related financial supervision, and it will incorporate questions on this topic into their examinations starting in 2021. In addition, on December 23, 2020, the NYDFS exposed for comment a draft amendment to New York's Enterprise Risk Management and Own Risk and Solvency Assessment regulation (11 NYCRR 82), which adds climate change (along with cybersecurity, epidemic and pandemic) as a category of material risk that, if applicable, must be included in a company's enterprise risk management function.

iv. Group Capital

a. NAIC Adopts Group Capital Calculation Tool

In December 2020, the NAIC adopted amendments to the Model Insurance Holding Company System Regulatory Act (the "Holding Company Act") and Model Insurance Holding Company System Model Regulation ("Regulation") to require the ultimate controlling person of every insurer subject to holding company registration to file a confidential annual group capital calculation ("GCC") with its lead state regulator. The GCC is intended to deliver regulators a view of the interconnectedness, business activities and underlying capital for an insurance group using a "bottom up" aggregation method that requires an accounting of available capital/financial resources and the required regulatory capital of corporate group members. The amended Holding Company Act and Regulation set forth certain exemptions from the GCC filing requirement, discussed in greater detail here.

The amendments to the Holding Company Act direct the annual GCC filing to be completed in accordance with the NAIC's instructions. The NAIC is expected to approve a GCC template (to be completed by the preparer) and accompanying instructions at its 2021 Spring National Meeting. The instructions provide detailed information on the entities to be included in the scope of the GCC, and currently provide that all insurance entities and entities owned directly or indirectly by the insurance entities in a group, along with all financial entities (as defined in the GCC instructions), are included in the scope of the GCC, while other non-insurance/non-financial entities within a group may potentially be excluded.

The amended Holding Company Act and Regulation will not be effective until adopted by individual states. While the NAIC focused on finalizing the GCC in 2020, we expect its work streams in 2021 to include the development of an NAIC Accreditation Standard and regulatory guidance to address how the GCC should be used by state insurance regulators.

b. The ICS and Comparability of the U.S. Group Capital Standard

Following the adoption of the Insurance Capital Standard ("ICS") by the International Association of Insurance Supervisors ("IAIS") in November 2019, the IAIS has been assessing whether the aggregation method to be used as part of the GCC, which leverages the legal entity approach inherent in the state-based insurance regulatory scheme, produces comparable (i.e., substantially the same) outcomes to the ICS. The IAIS has released for public consultation the draft definition and high-level principles that will inform the comparability criteria. Following completion of a public consultation period on this document in late January 2021, the IAIS plans to develop specific comparability criteria. The NAIC will provide feedback to the IAIS on the document.

v. Life Stress Testing Adoptions to Holding Company Act

In addition to incorporating the GCC filing requirement, the Holding Company Act amendments adopted by the NAIC in December 2020 implement a new liquidity stress test ("LST") framework for large U.S. life insurers and insurance groups (based on the amounts of certain types of business written or material exposure to certain investment transactions). The development of the LST as a regulatory tool has been an important component of the NAIC's Macroprudential Initiative, which got underway in 2017 and is intended to enhance risk identification efforts by building on the state-based regulation system.

The amended Holding Company Act requires the ultimate controlling person of every insurer subject to holding company registration that satisfies the scope criteria for a particular year to file the LST results with its lead state regulator. The filing must comply with the NAIC's instructions and template for the relevant year. The amended Holding Company Act also provides that the LST results and any supporting disclosures submitted to a state insurance regulator must receive confidentiality protection.

vi. Covered Agreement Update and Developments for 2020

Throughout 2020, the NAIC's Reinsurance (E) Task Force continued its work with respect to overseeing the implementation of the 2019 amendments to the Credit for Reinsurance Model Law (Model #785) and Credit for Reinsurance Model Regulation (Model #786) to address the U.K./U.S. and E.U./U.S. covered agreements. This included adoption of the new Uniform Checklist for Reciprocal Jurisdiction Reinsurers, which is an application form containing criteria for the assessment of applicant reinsurers from Reciprocal Jurisdictions, as defined in the amended model law and regulation. As of December 2, 2020, 16 jurisdictions have adopted the amended Credit for Reinsurance Model Law, with action under consideration in 13 additional jurisdictions, and three jurisdictions have adopted the Credit for Reinsurance Model Regulation, with action under consideration in five additional jurisdictions. The COVID-19 pandemic resulted in several state legislatures taking a "pandemic recess," thus potentially hampering the NAIC's goal to have all NAIC-accredited jurisdictions enact the amended Credit for Reinsurance Models into their laws and regulations by September 1, 2022. The Credit for Reinsurance Models will become an NAIC accreditation standard as of September 1, 2022, with enforcement beginning on January 1, 2023.

vii. Innovation and Technology

a. Modernization of Anti-Rebating Rules

At its 2020 Fall National Meeting, the NAIC adopted amendments to anti-rebating language in the NAIC Model Unfair Trade Practices Act (Model #880), which had dated back many decades and been supplemented with bulletins or revisions over time, resulting in inconsistent interpretation and enforcement across states. Amendments to the model

are intended to maintain the rebating laws' original intent of protecting insurer solvency, and to permit the offer or provision of certain value-added products or services at no or reduced cost when such products are not specified in the policy, or of non-cash gifts, items or services in connection with the marketing, sale, purchase or retention of insurance contracts. Further discussion of these developments is available here.

b. Other NAIC Initiatives

The NAIC made progress on several other innovation- and technology-related initiatives in 2020. In August, it adopted Artificial Intelligence (AI) Guiding Principles to provide guidance for regulators and the NAIC on insurance-specific AI applications in light of the increased availability of vast amounts of data due to ever-expanding computing power. In December, the NAIC's Property and Casualty (C) Committee adopted a Regulatory Review of Predictive Models White Paper, which discusses best practices for an insurance regulator when reviewing predictive models and analytics justifying an insurer's rate filing. In 2021, the NAIC will continue to work on initiatives related to accelerated underwriting in life insurance, data privacy and data security. Further discussion of these activities is available here and here.

viii. First "Insurance Business Transfer" Transaction Completed

On October 15, 2020, Enstar Group Limited ("Enstar") completed a transaction pursuant to the Oklahoma Insurance Business Transfer Act (the "IBT Act"), whereby one Enstar subsidiary transferred substantially all its insurance and reinsurance business to another Enstar subsidiary domiciled in Oklahoma. The IBT Act, adopted in 2018, is one of several recently enacted state laws that allow insurers to transfer business to another entity, via novation or a corporate "division" mechanism, without the need for individual policyholder consents (each a "Transfer Law"), as described in detail here.

The Enstar transaction, which required approval by the Oklahoma Insurance Commissioner and the District Court of Oklahoma County, was the first of its kind completed in the United States, and could accelerate the pace of transactions under Transfer Laws in 2021. At least one other IBT transaction was approved by the Oklahoma Insurance Commissioner in late 2020 and was pending court review as of early January 2021.

In response to the passage of Transfer Laws, the NAIC formed the Restructuring Mechanisms (E) Working Group in 2019 to consider issues related to IBTs, corporate divisions and similar mechanisms. This working group remained in an information-gathering mode in 2020 but is charged for 2021 with drafting a white paper on Transfer Laws and considering whether changes to existing NAIC model laws should be made as a result.

B. U.K. and E.U. Regulatory Developments

2020 was a notable year in the regulation of U.K. and European insurance businesses. First, and most obviously, the impact of COVID-19 on the insurance industry. Significantly, in the United Kingdom and elsewhere, policy wordings were examined to determine whether or not coverage for losses relating to the COVID-19 pandemic was available. A test case was brought by the U.K.'s Financial Conduct Authority to test coverage issues in a range of representative policy wordings that are in place in the market, primarily in relation to non-damage business interruption losses. We discuss that test case in subsection B.ii. below of this Section VII. The pandemic also gave rise to regulatory scrutiny around how consumers should be treated in this situation, and the U.K. regulators produced guidance on that topic.

The other significant event was, of course, Brexit. We discuss this in subsection B.iii. below. While we have known for some time that the U.K. government was determined not to extend the period for negotiating withdrawal, nor the period for negotiating the future relationship with the European Union, 2020 saw both the actual withdrawal from the European Union and an agreement on a future trade relationship. Another important aspect of Brexit is that the U.K. government now has the freedom to depart, if it so wishes, from the Solvency II regulatory principles and

indeed has sought evidence from the industry on a variety of regulatory matters that may be performed in the post-Brexit world. This exercise also coincides with an exercise on the part of EIOPA to review aspects of Solvency II and to consider reforms to Solvency II. This was written into the timetable of Solvency II and it is interesting to note that many of the topics that the U.K. government is looking at are also covered in the Solvency II review exercise.

In other areas, Lloyd's continues to advance its own program for reform. In the course of 2020, it issued its Blueprint Two document, which is a development from earlier work on areas of reform to the market. Key considerations include changes to the capital process, enhanced digitalization, the addition of new forms of entry into the market and significant cultural changes throughout the market. We discuss these aspects in subsection B.iv. below of this Section VII.

i. Impact of COVID-19 on the U.K. Insurance Industry

The practical and economic effects of the coronavirus pandemic have been a key area of focus for both U.K. and European financial services regulators, whose objectives include the fair treatment of customers and the prudential stability of regulated firms.

Unsurprisingly, the regulators have acted quickly in focusing on the impacts of COVID-19. We set out a number of these regulatory interventions in the paragraphs below.

a. Developments from the Prudential Regulation Authority and the European Insurance and Occupational Pensions Authority

The PRA response to the pandemic has been to focus on the financial strength of insurers and their ability to meet their insurance liabilities. In 2020, both the EIOPA and the PRA acted in relation to the prudential health of their respective insurance markets. Their initiatives have varied between providing relief from various regulatory requirements and reminding regulated firms of their obligations to their customers. We set out the key requirements below.

i) Regulatory Reporting and Disclosure Requirements

EIOPA and the PRA both recognised early in 2020 that insurers potentially faced difficult conditions as a result of the pandemic. As a result, in March 2020, EIOPA recommended that National Competent Authorities offered their regulated insurance and reinsurance undertakings operational relief by accepting a delay in the submission of various regulatory reports, with recommended permissible delays in respect of some documents being by up to eight weeks (depending upon the document in question). The PRA mirrored this approach, announcing permissible delays in respect of a wide range of annual reports for a year end of December 31, 2019 (or, if later, before April 1, 2020). In particular, the PRA stated that it would accept the delayed submission of the Solvency and Financial Condition Report ("SFCR"), the Own Risk and Solvency Assessment ("ORSA"), and certain solo and group quantitative reporting templates by up to eight weeks. The PRA also announced that the Regular Supervisory Reports in respect of the 2019 year-end would not need to be submitted.

ii) Payment of Dividends

Both EIOPA and the PRA were keen to ensure that insurers also take responsibility for their own prudential position during the pandemic. On April 2, 2020, EIOPA issued a statement requesting (re)insurers to suspend all discretionary dividend distributions and share buybacks aimed at remunerating shareholders. Similarly, the PRA issued a "Dear CEO" letter on March 31, 2020 requesting that U.K. insurers' boards consider the distributions of dividends and payment of variable remuneration during the period of high uncertainty. Insurers were reminded of the need to manage their financial resources prudently in order to ensure that they are able to meet the commitments that they made to customers. The PRA has not gone as far as introducing a formal prohibition on making dividends. Further, it has relied on U.K. insurers voluntarily supervising distributions during the pandemic.

iii) Matching Adjustment

The PRA issued a statement to insurers on the application of the matching adjustment ("MA") during the COVID-19 pandemic, offering reassurance and guidance on how insurers could ensure consistency in their interpretation of the PRA's policy on the matching adjustment. The PRA's statement responded to volatility on the asset side of the balance sheet, as opposed to increased mortality.

The PRA statement dealt with two areas that were of particular interest. The first concerned whether or not firms would need to review their risk management policy. In particular, as part of the original application for matching adjustment approval, firms have to set out their scope of risk management. Some of these policies involve the disposal of assets that are downgraded even where the asset in question continues to be eligible for MA purposes. The PRA noted that a downgrade on its own does not necessarily mean that the asset fails to qualify as a matching adjustment asset and generally there is no requirement or expectation to sell downgraded assets.

For firms whose approach to managing their MA portfolio requires that they sell downgraded assets, it may be undesirable to be forced to sell assets in the current market. The PRA statement made the point that firms who wish to hold on to assets to ride out the crisis should consider whether or not this would constitute a material change in their risk management policy that would require PRA approval. In the statement, the PRA invited firms to openly discuss with them any concerns they have over their matching adjustment policies and whether any temporary changes would be required or whether a new application for approval should be filed.

The second area of concern was around the eligibility of assets in the MA portfolios. The statement gave the example of loan obligations which may be subject to payment holidays as part of the response to the COVID-19 crisis, urging firms to consider whether internal ratings of assets are still appropriate and to consider whether the cash flows of such assets have been disrupted to the extent that they are no longer matching liabilities and should be removed from the matching adjustment portfolio of assets. This was an area of concern for firms who had assets under strain, as these assets could cease to be eligible. In the event of non-compliance with eligibility requirements, firms would be required to rectify the situation in a relatively short period of two months. The nuclear option for the PRA is to withdraw approval of matching adjustment treatment, which is likely to result in a significant increase in capital requirements for firms. As it turned out, we were not aware of insurers having significant difficulties in managing their MA portfolios, helped, no doubt by the bounce back in asset valuations during the year. However, this will continue to be an area of concern as we enter into the most challenging period of the pandemic.

b. Developments from the Financial Conduct Authority

The FCA is the U.K. regulator whose primary focus in relation to the U.K. insurance industry is to regulate how insurers conduct their business. Naturally, its response to the pandemic has been to concentrate on consumer protection issues and on operational issues facing insurers, which in turn could impact their consumers. The tension that the insurance industry and regulators faced in the pandemic was how policyholders could continue to have confidence that the products they bought would provide the cover they thought they had bought in a situation which was completely outside the contemplation of anyone when the insurance products were designed and offered for sale. Equally, one of the effects of the pandemic was to alter the nature of risks insured and, in some cases, diminish the utility of insurance – for example, public liability insurance is of little use to a business that is required to close down under government lockdown measures. Those considerations prompted several FCA interventions in 2020.

The FCA created a dedicated COVID-19 webpage containing information for both insurance consumers and firms. The guidance published on this webpage sought to ensure that customers: (i) receive sufficient value from their insurance products; and (ii) who are experiencing financial difficulties are treated fairly. Given the continued presence of the pandemic in 2021, these changes to insurers' conduct

will continue to apply for some time and will prompt the continued review of insurers' product design and pricing.

i) Operational Resilience and Business Continuity Review by Regulators

The FCA considered that it was essential for all general insurance firms to have plans in place to manage and mitigate the operational impact of COVID-19. More generally, firms were expected to have sufficiently robust systems and controls to continue to operate effectively in a stressed situation, with business continuity plans to manage such situations. Firms should consider, along with other challenges, the impact of staff absences and the need to ensure staff well-being on continuity of service. Similarly, firms should ensure that they are able to continue to provide critical services to customers during periods in which access to their business premises is restricted. If firms identify gaps through their planning that will, or could, cause harm to customers, they should notify the FCA through their usual supervisory contact.

ii) Renewals, Product Suspensions and Mid-Term Adjustments

One of the FCA's first publications related to firms' treatment of insurance products which could provide cover in respect of claims arising out of COVID-19. The FCA was keen to ensure that firms continued to treat customers fairly when determining either the continued scope of cover, or whether to offer products at renewal.

Accordingly, the FCA published general guidance which required firms to ensure that any new changes or exclusions to policy cover (e.g., COVID-19 exclusions) resulting from the pandemic would be tested through their product approval process before being introduced at renewal. Firms should give due regard to the best interests of their customers, and treat them fairly in making such amendments. In particular, the FCA was concerned that customers may not be treated fairly where they intended to rely upon continuity of cover at renewal. If a firm considered that such amendments would be appropriate, they should be clearly explained to customers in good time before renewal and prominently set out in updated policy documentation. Consumers' demands and needs should also be reassessed ahead of the renewed period to ensure that the amended scope of cover remained appropriate for them.

Similar considerations apply if firms wished to make similar changes midway through a policy period, where such alterations were permissible under the terms of the policy. If the policyholder is a consumer, firms would only be entitled to rely on their right to amend the policy if such provisions were fair and transparent and otherwise complied with consumer rights legislation.

Further, where firms decided to suspend some product offerings during the pandemic in order to manage their exposure to risks, they must carefully consider the needs of their customers and treat them fairly.

iii) Product Value and COVID-19: Guidance for Insurance Firms

The FCA also provided guidance to insurers and insurance intermediaries to consider the value of their products in light of the exceptional circumstances arising from COVID-19. The guidance highlights what firms should be doing to identify any material issues arising out of the pandemic that may affect the value of their products, and their ability to deliver good customer outcomes.

The COVID-19 pandemic may have effects which mean that firms are no longer able to provide expected contractual benefits, either in the expected form, to the expected timeframe, or at all. This may be the case where service providers' movements are restricted because of lockdown (e.g., boiler servicing) or some medical covers where customers cannot access certain benefits. There may also be a reduction in value corresponding to the diminution of the chance of an underlying insured event occurring. This may be due to the government lockdown or other circumstances connected with the pandemic. Further, there may be a fundamental change in the insured risk, which leaves the product providing little or no utility to customers (for example, public liability insurances for

businesses that are unable to open, such as hairdressers, bars and restaurants).

The FCA expects that firms who have a material role in designing insurance products (i.e., manufacturers) will prioritize a product level assessment in cases where the product now provides little or no utility to customers. Such firms should consider whether a product, including its costs and charges, remains compatible with the needs, objectives, interests and characteristics of the target market.

The FCA was not mandating specific actions where a firm identifies a material decrease in value, as it considered that firms should be able to demonstrate how they have met their product oversight and governance obligations and treat their customers fairly. However, the FCA stated that firms are expected to consider whether different actions are appropriate for specific segments of their customers at different stages of the product life cycle. For example, particular considerations may apply where a contract is approaching renewal or has now expired.

iv) Senior Managers and Certification Regime

Last year, we reported on the extension of the Senior Managers & Certification Regime (the "SMCR") to insurance intermediaries, and other "solo-regulated" firms that are only supervised by the FCA (which, following Brexit, will include a number of branches of overseas firms).

The COVID-19 pandemic has forced the FCA to alter its expectations as to how solo-regulated firms apply the SMCR. These expectations were contained in its publication "Senior Managers and Certification Regime (SM&CR) and coronavirus (COVID-19): our expectations of solo-regulated firms," and included measures on temporary arrangements and furloughed staff. These were:

- Temporary arrangements for Senior Management Functions – The "12-week rule," during which an individual is able to cover for a "Senior Manager" without being approved in the event of unexpected or reasonably unforeseen absences, is extended to 36 weeks where such absence is pandemic-related. Firms are also able to allocate the "Prescribed Responsibilities" of the absent Senior Manager to the temporary replacement, although the FCA would prefer for them to be allocated to other existing Senior Managers in the firm. The extension of the "12-week rule" will not be available from April 30, 2021.
- Furloughed staff – The FCA asked firms to identify their "key workers"; those individuals whose roles are necessary for firms to continue to provide essential daily financial services to consumers, or to the continued functioning of the markets. However, firms may be able to furlough Senior Managers if either: (i) they are unable to fulfill their responsibilities (e.g., due to illness or caring responsibilities); or (ii) they have no current practical responsibilities. Unless a furloughed Senior Manager is permanently leaving his or her post, he or she will retain their approval during his or her absence and will not need to be re-approved by the FCA when he or she returns. The firm is still responsible for ensuring that the Senior Manager is fit and proper.

Similar expectations were jointly set by the FCA and the PRA in respect of dual-regulated firms.

The FCA has, however, recently been criticized for pursuing only a handful of investigations in respect of SMCR breaches. According to the Financial Times on January 1, 2021, the FCA has only opened 37 investigations under the SMCR in the past five years, despite describing it as a "universal conduct tool" for "making individuals more accountable." Only five of these investigations related to "non-financial" misconduct (such as sexual harassment or discrimination). Similarly, the FCA has taken regulatory action in only five instances following an investigation. These figures have led to the FCA being accused of essentially "outsourcing" conduct enforcement against individuals to regulated firms, rather than handling such misconduct itself. This situation has potentially prejudiced senior individuals, whose employers have treated underperformance by certification staff as a failure to demonstrate requisite fitness and propriety. Firms have also taken a zero-tolerance approach to conduct-rule breaches for fear of failing in their own obligations under the SMCR.

Nevertheless, the FCA does not appear to be concerned about these figures and, instead, interprets its infrequent investigations as proving that SMCR is having the desired effect. According to the FCA, the real measure of the SMCR is whether it improves senior management accountability and standards, rather than a higher volume of cases.

COMMENTARY

The measures implemented by the E.U. and domestic regulators, which have been numerous and wide ranging in nature, reflect their shared concerns relating to the effect of the COVID-19 pandemic on all stakeholders in the industry. These measures, as a collective, strike the right balance between ensuring that firms continue to operate effectively and treat their customers fairly, whilst easing the increased administrative burden that the pandemic has caused. Many of these measures were put in place quickly, in order to prevent the initial impact of the spread of COVID-19 from causing shockwaves through the market that may later be difficult to repair. The regulators will be actively monitoring the situation now that these emergency procedures are in place and the effects of COVID-19 are better understood.

Notwithstanding the effects of COVID-19, both the industry and regulators have shown resilience in continuing to operate effectively. Insurance regulators have generally continued to perform their standard "business as usual" tasks during the pandemic in a similar manner as before, both in the United Kingdom and elsewhere. In particular, we have continued to work with regulators around the world in relation to change in controller approvals required to satisfy conditions to completion on insurance M&A deals. In our experience, whilst the effect of the pandemic has affected regulators to different degrees, they have generally been able to assess change-in-control applications efficiently, and have continued to grant approvals within their respective statutory deadlines. Insurance groups can therefore feel confident in planning their business strategies for 2021, including where such plans envisage new ventures, increased funding or mergers and acquisitions of existing businesses.

ii. The FCA Test Case on Business Interruption Insurance

a. Origins of the Test Case

One of the effects of the pandemic on the insurance industry has been a spike in BI claims, with customers generally under the impression that any losses arising out of the pandemic would be covered by their BI insurance. These expectations were not always met by the U.K. insurance industry, which rejected a number of claims based upon the wording of the policies that they had underwritten.

The FCA recognised the widespread concern about the lack of certainty for customers when making claims on their BI insurance, and the basis on which some insurers were determining BI claims. Consequently, the FCA sought to achieve clarity in relation to the extent of BI cover for losses resulting from the pandemic. The FCA approached 56 insurers and reviewed 500 relevant policies from 40 key insurers. A sample of 21 policy wordings (the "Sample Wordings") underwritten by a limited number of insurers (the "Defendant Insurers") were selected, which the FCA considered captured the majority of the issues that were in dispute. The FCA submitted the Sample Wordings to a test case in the High Court (the "Test Case"), during which policyholders' arguments were tested and heard.

The provisions contained in the Sample Wordings were limited to non-damage BI cover (i.e., provisions which provide cover for BI losses where there has been no physical damage to property). The Sample Wordings therefore fell within three categories: (i) where a notifiable disease occurs either at or within a certain vicinity of the premises ("infectious disease wordings"); (ii) where some form of authority acts to prevent or restrict access to or use of the premises ("prevention of access/public authority wordings"); and (iii) a hybrid of the two, where the restrictions placed by an authority result from a localized occurrence of a notifiable disease ("hybrid wordings").

The Test Case was heard by the High Court on an expedited basis, given the general importance of the matters in dispute. The High Court published its decision on September 15.

b. Outcome of the Test Case

(1) Infectious disease wordings

Arguments for the parties. The Defendant Insurers argued that these provisions did not provide cover to policyholders who were affected by the pandemic. Cover is only triggered where the policyholder is able to demonstrate that loss was caused by BI resulting from a localized occurrence of COVID-19. Any loss caused by the wider pandemic (e.g., the U.K. government's nationwide lockdown commencing on March 26, or general social distancing measures) was not within the scope of these provisions.

The FCA argued that the infectious disease provisions would provide cover for the wider effects of the pandemic. Any local outbreak of COVID-19 was an indivisible part of the wider pandemic and, therefore, constituted the requisite "proximate cause" of loss in order for cover to be triggered. The FCA also argued in the alternative that any localized occurrence of COVID-19 was one of many different (and equally effective) causes of loss; including the occurrence of the disease throughout the United Kingdom and the ensuing government action.

The High Court's Determinations. The High Court generally sided with the FCA's position. Key to this determination was the Court's view that: (i) the wordings did not expressly state that the disease should only occur within the relevant insured area. The insured fortuity was notifiable disease which has come near the premises, rather than discrete local occurrences; and (ii) the construction in (i) is consistent with the fluid and highly contagious nature of "notifiable diseases" that were the subject of insurance cover.

However, the Court took a different approach with two of the QBE wordings (QBE2 and QBE3). It was determined that the wording used in these policies (in particular the words "*in consequence of*" together with "*events*") limited cover to matters occurring at a particular time, in a particular place and in a particular way. Consequently, the Court held that policyholders would only be able to recover if they could demonstrate that the localized occurrence of the disease (as opposed to the wider pandemic) was responsible for the loss.

(2) Prevention of access/public authority wordings

The Court generally concluded that these clauses should be construed more restrictively than the infectious disease wordings. These provisions tended to require an "*emergency*", a "*danger or disturbance*" or a risk of "*injury*", in each case "*in the vicinity of the premises*". The inclusion of the term "*vicinity*" connoted a specific event which takes place in a specific area (e.g., a "neighbourhood"). Accordingly, the Court determined that, in order for cover to apply, the action of the relevant authority must be in response to the localized occurrence of the disease; nationwide measures taken in response to the general pandemic would not suffice. The Court suggested that this would be very difficult for a policyholder to demonstrate in practice.

The Court also held that any "*action*" by a local authority which "*prevents*" access does not need to physically prevent access (e.g., a police cordon). It would be sufficient if the "*action*" legally prevented the policyholder's existing business. However, it must be mandatory and have the force of law. Government advice (e.g., on social distancing) does not prevent access, although it could trigger cover which provides for loss caused by a *hindrance* to the access or use of insured premises.

Finally, the Court held that the term "*interruption*" did not require a complete cessation of the business. Instead, it was intended to mean "*business interruption*" generally, which may include disruption and interference with the business.

(3) Hybrid wordings

The Court held that the occurrence of the disease, which triggered the restrictions imposed by the public authority, could include the general pandemic (as opposed to merely a local outbreak). However, the Court construed the term "*restrictions imposed*" narrowly, such that any public authority instructions must be mandatory. Further, the term "*inability to use*" requires something more than just an impairment of normal use.

(4) "Trends" clauses

"Trends" clauses are the contractual mechanism by which BI loss is quantified. The Court determined that the aim of such clauses is simply to put the policyholder in the same position as she/he would have been in had the insured peril not occurred. The Court held that the appropriate counterfactual for quantifying loss must remove the entirety of the insured peril. Therefore, the correct counterfactual in respect of each of the Sample Wordings is as follows:

- *infectious disease wordings* – the entirety of the pandemic must be removed (as opposed to merely the localized occurrence of the disease);

- *prevention of access/public authority wordings* – all of the following composite elements of the provision must be stripped out: (i) the prevention or hindrance of access to or use of the premises; (ii) by any action of an authority; (iii) due to an emergency/incident which could endanger human life; and

- *hybrid wordings* – all of the following composite elements of the provision must be stripped out: (i) inability to use the insured premises; (ii) due to restrictions imposed by a public authority; (iii) following the occurrence of a human infectious or contagious disease.

(5) Causation and *Orient Express*

The Defendant Insurers relied heavily upon the decision of *Orient Express* to support their case on causation and the trends clauses. However, the Court stated that issues of causation should follow the construction of the wordings. In other words, any determinations relating to causation must be based upon the intended scope of cover provided by the provision.

The Court held that *Orient Express* could be distinguished from the Sample Wordings, as it related to damage-based BI cover. By contrast, the insured perils being considered in the Test Case were different in nature, particularly those which had composite or compound elements to them. However, given the importance placed on the case by the Defendant Insurers, the Court substantively considered its merits. The Court considered that the *Orient Express* was wrong in how it encapsulated the insured risk. Both the Tribunal and the trial judge determined that the proximate cause of the loss was damage to the hotel in the abstract. The risk instead should have been construed as including the underlying fortuity that caused the damage (i.e., the hurricanes). Further, the Court noted that, based upon the reasoning in the *Orient Express*, the more serious the fortuity (e.g., the wide area damage caused by the hurricanes), the less cover the policy provides for the consequences of the damage. The Court considered that this outcome was counter-intuitive and could not have been intended by the parties.

c. Decision of the Supreme Court

All of the parties, with the exception of Ecclesiastical Insurance Office Plc and Zurich Insurance Plc, sought leave to appeal the judgment in the Supreme Court on an expedited basis, which was granted by the Court. The Supreme Court heard the appeal in November 2020 and its judgment was handed down on January 15, 2021.

The Supreme Court broadly decided in favor of the FCA, and approved much of the High Court's decision. In particular, for the purposes of causation, the Supreme Court held that it would suffice for the purposes of infectious disease clauses if it could be proven that a single case of COVID-19 occurred within the insured perimeter. Similarly, the counterfactual used when quantifying loss under the 'trends' clauses should strip out the entire effect of the pandemic.

The Supreme Court's judgment was also more favorable to policyholders than the High Court's decision in certain areas. In particular, the High Court's judgment left open the possibility that insurers could adjust policyholders' claims downwards to reflect negative trends to their businesses caused by the impact of COVID-19 before cover was triggered. The Supreme Court has, however, stated that downwards adjustments can only be made in respect of unconnected trends.

A further important aspect of the Supreme Court's judgment is the overruling of the Orient Express case, which previously served as the leading case in respect of causation and quantum. The impact of this case will therefore have legal consequences that extend beyond the COVID-19 pandemic.

The decision of the Supreme Court will have important economic consequences for the U.K. insurance industry and the wider economy. In particular, the Supreme Court's ruling is likely to increase liabilities of insurers beyond those that they would have had under High Court Judgment. Insurers will now be assessing the full impact of the decision over the coming weeks, both in terms of their immediate liabilities to policyholders and the extent of available reinsurance cover. We will provide further commentary on the consequences of this judgment as they become better known over time.

iii. Brexit and Regulatory Reviews

In the course of 2020, the United Kingdom both formally left, and struck a deal with, the European Union. The agreement with the European Union on the United Kingdom's future relationship was made just before Christmas and was implemented and ratified into U.K. law by the European Union (Future Relationship) Act 2020. The Trade and Cooperation Agreement between the European Union and the United Kingdom primarily concerned security and trade matters. It did not deal with financial services in any detail. Independently of the Trade and Cooperation Agreement, the European Commission has not made any decisions concerning the "equivalence" of the U.K. insurance regulatory regime. It has, however, stated that it intends to continue its equivalence assessments of the United Kingdom's domestic financial services regime in the months immediately following Brexit. By contrast, the U.K. government has determined that E.U. jurisdictions are "equivalent" to the United Kingdom's insurance regulatory regime.

For U.K. insurers, the absence of any provisions concerning financial services means that the rights to "passport" into the European Union on the basis of home state authorisations has come to an end. Further, without a finding of "equivalence," E.U. insurers cannot treat reinsurance with a U.K. reinsurer automatically the same as reinsurance with an E.U. reinsurer, opening up the possibility of collateral requirements and/or separate authorisation requirements being needed for U.K. reinsurers who wish to provide reinsurance to E.U. cedants. It also means that group supervision by the PRA may not be recognised, with the possible consequence that European groups with a U.K. top company will need to take other measures, such as establishing an E.U. holding company, to satisfy E.U. group supervision requirements. The E.U. decision on equivalence could, therefore, have a significant impact of some U.K. reinsurers and groups. Even if the E.U. grants the U.K. equivalence status, it can revoke that status unilaterally.

U.K. and EEA firms have both been aware for some time of the probability that no comprehensive agreement on financial services will be reached, and most (if not all) will have already put in place new arrangements to continue to trade in a post-Brexit world. Such arrangements have included effecting intra-group transfers of insurance business and establishing branches or subsidiaries in new jurisdictions in order to become directly regulated entities.

a. The PRA's Proposed Approach Following the End of the Transition Period

The PRA confirmed that it intends to continue to use its temporary transitional power as broadly as possible, so that the vast majority of relevant onshored E.U. legislation will be delayed. However, the PRA considers that a maximum transitional period of 15 months would provide an adequate timeframe for firms to prepare and implement the required changes brought about by the onshored legislation, although some obligations are subject to a shorter transition period. For example, U.K. branches of E.U. insurers with temporary PRA permissions to carry out and effect insurance business will have until March 31, 2022 to calculate their U.K. branch Minimum Capital Requirement and SCR (the two levels of capital that insurance entities are required to hold under U.K. and E.U. regulation (as applicable)), and adhere to certain reporting requirements.

The PRA also finalised its approach to the publication of Solvency II technical information ("TI") at the end of the transition period. Such technical information comprises the relevant risk-free rate term structures and the fundamental spreads for calculation of the matching adjustment and the volatility adjustment. This information is therefore relevant for insurance companies' liabilities for solvency reporting. With effect from January 1, 2021, the PRA is required to publish this TI for the U.K. insurance market. The PRA has stated that it will publish TI from and including 11p.m. on December 31, 2020, which means that firms with a reporting year-end of Thursday, December 31, 2020 would need to use the PRA's published TI (as opposed to the TI published by EIOPA).

The PRA's TI will be derived by adopting the same technical methodologies embodied within EIOPA's TI at the end of the transition period, with some limited exceptions (which generally relate to the United Kingdom's changed status of having withdrawn from the European Union). The PRA considered that this approach will result in operational benefits for U.K. insurers, who could seamlessly transition from EIOPA's published TI to the TI published by the PRA.

COMMENTARY

The approach followed by the E.U. and U.K. regulators over the course of 2020 will have been expected by E.U. and U.K. regulated insurance groups and will not have affected their Brexit planning. The final loss of "passporting" rights, which has been confirmed by the failure of the United Kingdom and the European Union to reach an agreement on financial services, will not have surprised the U.K. insurance industry and, as a result, most U.K. insurers will have already put in place arrangements to operate in the new landscape.

b. HM Treasury's Review of Solvency II

The most significant development in insurance regulation resulting from Brexit is the United Kingdom's internal review of the Solvency II Directive. HM Treasury has published a "Call for Evidence," in which it has invited stakeholders in the sector to provide feedback on the future application of the Solvency II framework in the United Kingdom. This review is intended to ensure that the U.K.'s prudential regulatory regime is better tailored to support the U.K. market and is an early example of the government's post-Brexit ability to potentially diverge from the European-wide insurance regulatory framework. It is therefore expected that any changes resulting from this review will be implemented far quicker than those resulting from the European Union's parallel review of Solvency II (discussed below).

The most striking aspect of the "Call for Evidence" is that HM Treasury considers there to be scope for a move to a more principles-based approach to regulation – a departure from the rules-based approach contained in Solvency II. This will mean greater exercise of PRA judgement on regulatory matters. Another important feature of the review is a widening of the objectives of prudential regulation. Not only is policyholder protection important, but the U.K. government also wants the sector to provide long-term capital to support growth, including involvement in infrastructure, and to support the government's climate change activities.

HM Treasury's Call for Evidence focuses on certain areas, most notably the risk margin, which has been roundly criticised for being too large and its volatility caused by sensitivity to interest rates. The risk margin has been particularly problematic for the U.K. life sector which writes long-term products with guarantees such as annuities, unlike most other European countries. The government, in seeking input from the U.K. insurance industry on how the risk margin may be reformed, has not exhibited any preconceived options. U.K. insurers therefore have the opportunity to put forward radical ideas if they wish.

Other proposed changes relate to the eligibility criteria for assets used in the matching adjustment and the calculation of the Solvency Capital Requirement ("SCR"), which provides a more appropriate mix of judgment and rules. Group SCR and reporting requirements also feature in the Call for Evidence. Throughout the Call for Evidence is a desire for suggestions on what changes could be made to ensure long-term investment in the wider economy.

c. EIOPA's Review of Solvency II

Separately from the United Kingdom's internal review of Solvency II, EIOPA has also been reviewing certain provisions of Solvency II. The Solvency II review process is enshrined in the Directive itself, as the European Commission is obliged to review the following by January 1, 2021: (i) long-term guarantees measures and measures on equity risk; (ii) methods, assumptions and standard parameters used when calculating the SCR standard formula; (iii) Member States' rules and supervisory authorities' practices regarding the calculation of the MCR: and (iv) group supervision and capital management within a (re)insurance group. EIOPA's advice has been published in its "Opinion on the 2020 Review of Solvency II" ("Opinion").

The Opinion confirms that EIOPA is generally comfortable with how Solvency II operates from a prudential perspective. It considers that the key achievements are that: (i) a risk-based approach to assess and mitigate risks is applied; (ii) the insurance industry has better aligned capital to the risks it runs; and (iii) governance models and their risk management capacity have been significantly strengthened. EIOPA's approach to the overall review has therefore been one of evolution rather than revolution.

However, EIOPA expressed significant concerns from an economic perspective and has sought to address them as part of its review. Generally subdued economic growth across the world has led to extensive monetary easing and a general flight to safety. This situation was further intensified by the COVID-19 pandemic and its effect on global economies. EIOPA has previously proposed changes to the treatment of interest rate risk and to interest rate curves used by insurers in order to mitigate the level of economic risk.

EIOPA stated that any reforms should be balanced (thereby causing little net change in insurers' capital requirements). However, significant changes have been suggested to properly recognize the steep fall of interest rates during the last years and the existence of negative interest rates. EIOPA also highlighted the need to supplement the current microprudential framework with the macroprudential perspective and achieve a minimum harmonization in the field of insurance guarantee schemes.

The Opinion covered 19 areas of review, many dealing with the minutiae of technical regulation. It is interesting to note that there is considerable overlap in the topics covered in the Opinion and the HM Treasury's Call for Evidence. In particular, EIOPA is also suggesting a change to the risk margin, although, as discussed above, the U.K. insurance industry has the opportunity for more radical reform in this area. The EIOPA recommendation is the introduction of a floored, exponential and time dependent element λ in its risk margin calculations. This change will reduce each future SCR by increasing amounts, with the result that overall the risk margin will be lower than would have otherwise been the case under the existing risk margin formula. Clearly, firms with long-dated liabilities will see a greater reduction in this margin than insurers with short-term liabilities.

The other areas which are the subject of the Opinion and the Call for Evidence include: (i) the MA; (ii) the calculation of SCR (both individually and at group level); (iii) the use of transitional measures for the calculation of technical provisions; (iv) reporting requirements; and (v) thresholds for Solvency II regulation for smaller entities.

In addition, we note the following other areas covered in the EIOPA Opinion.

i) Extrapolation of Risk-free Interest Rates

EIOPA has proposed an amendment to the methodology of extrapolating risk-free rates.

Insurers under Solvency II are required to discount their liabilities using risk-free interest rates, which are extrapolated where such liabilities are particularly long term. The methodology behind this extrapolation is intended to ensure that insurers' long-term liabilities are neither underestimated, which could lead to future solvency issues, nor overestimated, which could require insurers to maintain an unnecessarily high level of capital.

ii) Volatility Adjustment

EIOPA has advised changes to the design of the volatility adjustment ("VA") (which is an additional discount factor used to estimate future liabilities) in order recognize the macroeconomic impact on fixed-income assets. The aim of these changes is to avoid overshooting effects, where the dampening effect of the VA exceeds the effect of a loss in the market value of fixed-income assets.

EIOPA has suggested that the adjustment should be split into a "permanent" and a "macroeconomic" part. The "permanent VA" will reflect the long-term illiquid nature of cash flows, whilst the "macroeconomic VA" will only be applied during a crisis to avoid cliff-edge effects and helps avoid insurers having to sell bonds into collapsing markets.

iii) Long-term Equity Investments

EIOPA has suggested changes to assist insurers when making long-term equity investments.

EIOPA has accepted the European Commission's introduction of a risk charge of 22% for long-term equity investments ("LTE"). However, EIOPA has advised various modifications to LTE rules in order to make compliance easier for insurers, by advising that LTE portfolios no longer need to be ring-fenced. EIOPA has balanced this concession against the new proposal that LTEs must be "clearly identified" and must be "managed separately" from insurers' other activities. EIOPA is also insisting that LTE portfolios are sufficiently well-diversified and have a sufficient liquidity buffer. Such changes will help long-term insurers who wish to invest in infrastructure and long-term investments.

iv) Proportionality

EIOPA has advised that the Solvency II framework should be amended so that a more proportionate approach will be introduced in respect of low risk profile insurers, who will be identified based upon the nature, scale and complexity of their risks. Entities who fit this profile will enjoy simplified capital calculations, easier governance requirements and reduced disclosure requirements.

v) Insurance Guarantees Schemes

EIOPA is of the view that every member state should have an insurance guarantees scheme, which have the aim of either: (i) protecting the policyholder in the event that an insurer fails; and / or (ii) ensuring the continuation of insurance policies. EIOPA is comfortable for each member state to determine how such schemes will operate, although it suggests that their features should be subject to minimum harmonization across the bloc. EIOPA is of the view that insurance guarantees schemes should be funded on the basis of ex-ante contributions by insurers, possibly complemented by ex-post funding arrangements in case of capital shortfalls.

COMMENTARY

It will be recognized from the Opinion that EIOPA is taking more of a balanced approached in its Solvency II review than might have been the case. Many of EIOPA's proposals set out in its 2019 consultation paper were criticized for their wide-reaching approach, and the potential for negative impact on the industry should they be implemented. Industry stakeholders also considered EIOPA's plans to extend into managing macroprudential and systemic risk as overreach beyond the intended perimeter of Solvency II, a microprudential regime. EIOPA is therefore likely to receive criticism from parts of the industry that a number these proposals were retained in the Opinion.

Insurers will be aware that a number of the changes will impact upon their capitalization, most notably due to the risk-free interest rates and the suggested recalibration of the interest rate risk. However, their impact will be mitigated by their gradual implementation over time.

By contrast, the Opinion also provides tangible benefits to insurers, including the new proportionality regime and a VA regime that is more firm-specific by being more generous to those entities with well-matched assets and liabilities. Similarly, policyholders will gain from suggested changes

to the SFCR and the introduction of insurance guarantees schemes.

In terms of next steps, the European Commission will review the Opinion and determine which of EIOPA's advice it will actually propose to be put into law. The European Parliament and Counsel will then review the European Commission's proposals as part of the ordinary E.U. legislative process. However, it is likely to take several years for any suggestions contained in the Opinion to come into force, with the process potentially being concluded as late as 2025 or 2026. Insurers will therefore have a significant lead-in time in order to adapt to any new requirements suggested by EIOPA.

iv. Developments at Lloyd's

a. Changes to Lloyd's capital requirements

Lloyd's CFO, Burkhard Keese, informed journalists on December 11, 2020 that Lloyd's is consulting on a range of reforms designed to simplify its rules and processes for setting Members' capital. It was reported that Lloyd's current rules are considered to be unnecessarily bureaucratic and costly to implement.

These developments are as follows:

i) New Coming Into Line Rules

Under Lloyd's current capital requirements, all members are required to hold funds at Lloyd's ("FAL") in accordance with the economic capital assessment ("ECA"), the solvency capital requirement under Solvency II plus a 35% uplift to maintain the overall Lloyd's financial strength rating and capital strength. Lloyd's members are currently required to ensure that their capital levels are aligned with this requirement twice a year, in a process referred to as "coming into line."

The new requirements will simplify the planning process by introducing a single coming into line date in May of each year, upon which date all balances will be settled. If the market supports this proposal, it will be put into force for the 2022 year of account. Lloyd's will also introduce a "corridor" for FAL of between 90% and 110% and will only collect shortfalls if they fall outside of these parameters, which will be done on a quarterly basis.

ii) New Capital Requirements

Additionally, Lloyd's will change its current methodology of calculating required capital, which is considered to be overly complicated and difficult to understand. Capital requirements are currently calculated by numerous deterministic rules, which apply in addition to the 35% uplift on the solvency capital requirement. These deterministic rules will be scrapped, and instead Lloyd's will focus on the pure ECA requirement.

iii) Funds at Lloyd's Currencies

Lloyd's is looking to streamline the number of currencies for FAL assets to six currencies: (i) U.S. dollars; (ii) British Pounds Sterling; (iii) Canadian Dollars; (iv) Australian Dollars; (v) Euro; and (vi) Yen. A total of 99.6% of FAL assets are already in these currencies.

iv) Automated Trading

Lloyd's is also proposing the introduction of automated trading of assets within funds at the market. Under the new system, Lloyd's will not need to grant preapproval in respect of FAL assets if they conform to a pre-approved list of assets and fall within a standard asset allocation.

b. Syndicates in a Box

The innovation at Lloyd's has also progressed with the implementation of Lloyd's new Syndicates in a Box ("SIAB") concept. SIABs were first introduced by Lloyd's as part of the "Blueprint One" and constitute a key component for its ambitious "Future at Lloyd's" transformation. SIABs are intended to be "fast build, fast fail" syndicate structures that are designed to encourage new and innovative participation at Lloyd's by facilitating market entrance in a way that is easier and quicker than ever before. It is intended that these platforms will act as "disruptors" in the insurance market, by attracting new entrants and enabling

participants to silo and nurture new concepts, which will be effected by nimbler entities with discrete business plans from those submitted by existing syndicates.

i) Benefits/Restraints of SIABs

There are clear benefits to using the SIAB structure. Applicants for a SIAB platform will be subject to a clear and streamlined assessment process, which takes around 90 days for Lloyd's to complete following the applicant's submission of a "Data Pack" setting out the SIAB proposal. In addition, SIABs are not subject to the traditional capital loadings of other new entrants. Contributions to the Lloyds Central Fund (which is used to protect policyholders where an underwriting member is unable to pay claims) in respect of the SIAB's initial underwriting years can also be deferred to subsequent years.

However, SIABs are subject to various restrictions, which may make them unsuitable for certain business models. Lloyd's requires that SIABs are "accretive or innovative" to the market; the offering must enhance the Lloyd's franchise by introducing new business, products services, methods of distribution or geographical opportunities. Consistent with the SIAB's profile as a "fast build, fast fail" platform, the structure should only be used to underwrite short-tail risks, although Lloyd's may permit longer-tail risks if it is provided with evidence of a profitable track record. SIABs also must be profitable by the end of their third year, with a combined ratio of less than 100% and an expense ratio of less than 35%. Further, they should have little or no exposure to Lloyd's peak risks, which include: (i) U.S./Caribbean wind; (ii) U.S./Canadian earthquake; and (iii) Japanese earthquake. Finally, perhaps ironically, all SIABs must be operated remotely and will not have a box space at Lloyd's.

SIABs are designed to have a three-year lifecycle, with success criteria for years one, two and three agreed on entry. Following this period, SIABs may: (i) reapply to continue as a SIAB; (ii) graduate to a "full" syndicate; or (iii) cease trading if performance conditions or success criteria are not met.

ii) Implementation of the SIAB Solution

SIABs have been introduced in the following stages:

- *Transition period (October 2019 to March 2020)* – During this period, Lloyd's piloted the scheme to ensure that: (i) applications for SIABs could be concluded within 90 days; and (ii) SIABs could begin to underwrite risks in early 2020. Lloyd's also held initial discussions with potential applicants who were interested in applying for SIAB approval at the start of 2020.

- *Phase 1 (January to December 2020)* – Lloyd's began to practically operate the SIAB work stream at the beginning of 2020 by operating a pilot SIAB under the new regulatory conditions and accepting new SIABs. Lloyd's has used this period to continue to refine its regulatory infrastructure, with the aim of making continued improvements to be effective for the 2021 underwriting year.

- *Phases 2 and 3 (Underwriting years 2021 and 2022)* – Lloyd's will seek to make further refinements to the SIAB process in future underwriting years in order to provide customers with a broader range of choice from the Lloyd's market and a wider range of carriers to underwrite insurance risks.

iii) Market reception to SIABs

The introduction of this new concept has, understandably, been popular with market participants, with Lloyd's revealing that it has already processed over 80 SIAB business enquiries and is entertaining around 20 advisor discussions. Competition for approval is likely to be fierce, as Lloyd's intends to cap SIAB ventures to around 2% of the overall market (measured by gross written premium).

iv) Current SIABs

There are currently four operational SIABs:

(1) *Munich Re's "innovation syndicate" (Syndicate 1840)* –This SIAB was the first to be approved by Lloyd's, and was announced on the same day as the "Blueprint One" was published at the end of September 2019. Syndicate 1840 started

underwriting risks from January 2020 and works with Munich Re's existing underwriting teams and infrastructure. In keeping with Lloyd's mandate, this SIAB will focus on emerging risks, green energy solutions, autonomous vehicles and on mitigating the financial risks of extreme weather. Certain risks will be insured using parametric products, rather than relying on more traditional loss adjusting methods.

(2) *Asta Carbon (Syndicate 4747)* –The second SIAB is a collaboration between the Lloyd's Managing Agent, Asta Managing Agency Ltd and Managing General Underwriter, Carbon Underwriting Limited. The SIAB will act as an incubator for new coverholders underwriting property and casualty risks, who will benefit from the comprehensive underwriting data produced by Carbon's underwriting platform. The SIAB will have stamp capacity of £15 million in year one, and it is expected to rise to £62.5 million in year three. This SIAB therefore provides a lower-cost and fast tracked route into the Lloyd's markets for entrepreneurial underwriters.

(3) *Ascot Parsyl (Syndicate 1796)* – This Syndicate launched in July 2020 (with underwriting commencing in January 2021) and will provide cost-effective insurance policies for shipments of vaccines and medical products to developing countries. Syndicate 1796, with the support of AXA XL, McGill and Partners and Gavi, will underpin InsureTech start-up Parsyl Inc.'s "Global Health Risk Facility"; an organisation that will provide billions of dollars of insurance coverage, together with risk mitigation services, to help protect and support the global distribution of COVID-19 vaccines and critical health commodities. Its establishment is therefore topical, and is viewed by Lloyd's as essential in establishing the requisite operational resilience (both in the Lloyd's market and holistically) to recover from the pandemic.

(4) *Picnic Syndicate (Syndicate 2460)* – The Picnic SIAB was approved by the Council of Lloyd's on October 22 and will commence underwriting on January 1, 2021. The Picnic SIAB was conceived by Australia's Picnic Labs with support from Willis Re Australia and aims to capitalise on the market trends towards "For-Community," "For-Purpose" and "Back-to-local" enterprise by supporting mutuals who are aligned to this movement. The SIAB will also provide reinsurance support to all mutuals globally.

COMMENTARY

In developing the SIAB platform, Lloyd's acknowledges the difficulties of entering into the market, and introducing innovation, in the current market structure. We believe that these structures have the potential to catalyse the market, by allowing participants to develop new insurance products and methods of distribution that will build upon and supplement Lloyd's traditional insurance offering. SIAB's slant towards innovation will also complement other projects set out in Lloyd's Blueprint documents, particularly where they rely on technology to improve the customer experience.

There will undoubtedly be stern competition for underwriting capacity through a SIAB structure, given that Lloyd's is likely to continue to restrict SIAB capacity to a limited percentage of the overall market. Existing participants should therefore act quickly to finalise any concepts that could potentially be implemented through this platform. Participants should also be aware that competitors' submissions of applications based upon similar concepts could impede them from being able to demonstrate that their own offerings are sufficiently "innovative" to be granted SIAB status.

Lloyd's should also be credited for its willingness to grant approvals to start-up companies who are seeking to enter the Lloyd's market for the first time. This openness is undoubtedly positive for policyholders and is consistent with Lloyd's quest to innovate the market. Ideas from outside the established industry players could be some of the most revolutionary, and could benefit from particular expertise in certain technologies, or experience in target

industries. Products introduced by new entrants could therefore have a "black swan" effect on the market, in which an "unknown unknown" rapidly alters the status quo. It is expected that Lloyd's will grant further approvals to such projects in the near future, particularly if they are well capitalised and seek to target topical issues such as COVID-19 and ecological risks.

Lloyd's SIABs are, by their nature, small in size and the number of approvals will be limited until Lloyd's has finessed its regulatory infrastructure both to approve applications and monitor performance. However, their impact on the market could be disproportionate in 2021 and beyond.

c. Blueprint Two

During 2020, Lloyd's of London has continued its initiative to effect tangible improvements to, and modernization of, its operations. Lloyd's ambitions for the next two years are comprehensively set out in its latest instalment, "The Future at Lloyd's Blueprint Two: Sharing risk for a braver world" ("Blueprint Two"). Blueprint Two builds upon its predecessor, Blueprint One (published by Lloyd's in 2019), and is similarly ambitious in revolutionising a market which is perceived to have become anachronistic, unnecessarily complicated and idiosyncratic. Blueprint One was received with a degree of industry scepticism, and was perceived as merely introducing a disparate range of grand ambitions that had barely evolved past the conceptual stage. These ambitions were ultimately pared back in Lloyd's update to Blueprint One, published in early 2020, as Lloyd's announced that it would focus on a few key areas including: (i) the Complex Risk Platform – investing in improving the Placing Platform Limited ("PPL"), the London Market's electronic placing platform; (ii) the Lloyd's Risk Exchange – developing an easy-to-use exchange for underwriting relatively non-complex, high volume, low value risks; and (iii) the Claims Solution – transforming the claims process by automating simple claims and using straight-through processing in order to speed up the claims handling process. By contrast, Blueprint Two is far more focused and realistic – a plausible mission statement signalling the start of the reformation of Lloyd's.

Blueprint Two focuses its attention almost exclusively on fixing the "plumbing" in Lloyd's two most common customer processes: open market and delegated authority, which between them account for more than 80% of the value and 90% of the insurance contracts placed at Lloyd's. Other processes, such as treaty reinsurance and automated placement, are given only limited attention in the document. In contrast to Blueprint One, which introduced six standalone work streams, Lloyd's adopts a far more integrative approach to achieving the goals set out in Blueprint Two, which recognises that achieving a high degree of interoperability between each component part of the customer journey is vital to delivering a fully digitalised end-to-end system.

i) Lloyd's Proposals

The key proposals contained in Blueprint Two in respect of each of these customer processes are as follows:

(1) Getting Covered

Open Market. The thinking has evolved since the publication of Blueprint One and Lloyd's will now not develop its own Complex Risk placement platform for open market business. Instead, it intends to: (i) support third-party platform providers in redesigning their platforms to improve the user experience; (ii) produce, in consultation with the market, risk placement standards and rules; and (iii) improve the collection of data by defining what data must be captured at bind, which will form a Core Data Record and be used to populate a new intelligent market reform contract. Lloyd's also intends to provide various placing support services to enhance the user experience, and establish a Digital Gateway that allows data to be validated before it is used for digital processing. Further, Lloyd's expects that its investment in PPL will accelerate the next generation of placing platform, which will seamlessly integrate its new placing process.

Delegated Authority. Blueprint Two sets out Lloyd's intention to create an end-to-end operating platform for delegated authority business, although market participants will continue to have the option to use their own systems

or third-party platforms. At the heart of the delegated authority customer process will be the "intelligent" collection and use of complete and accurate data, which will enable Lloyd's to automate processing. Automatic data collection will be built into the Lloyd's platforms and market participants will otherwise have a range of options to submit data, including application programming interface integration for a seamless experience, point-to-point file transfers and drag-and-drop file uploads.

ii) Claims Processing

Open Market. Lloyd's has continued to commit a significant amount of investment in open market claims handling processes, which its key aim being the delivery of a new claims platform to replace the existing platforms. This platform will have the following key features: (i) a streamlined electronic first notification of loss process; (ii) a triage process that intelligently routes claims to the appropriate workflow; and (iii) a modernised and collaborative workflow platform that allows all parties to interact with each other efficiently.

Delegated Authority. Lloyd's is not creating a new process for delegated authority claims. However, Lloyd's aims to support the existing delegated claims model by introducing: (i) intelligent quality checks for all incoming data from coverholders and delegated claims administrators; (ii) an automatic workflow that captures claims data; and (iii) automatic funding and cash flow. Lloyd's intends that these introductions will eliminate the need for loss funds and claims bordereaux.

COMMENTARY

Lloyd's is confident that Blueprint Two will revolutionise the way in which the market does business. Its focus on digitalisation is also timely, as the COVID-19 pandemic has forced (re)insurers to rely increasingly on conducting virtual business throughout 2020. Indeed, the "virtual" underwriting room (which was launched in June 2020) was solely developed in order to enable brokers to continue to be able to connect with each other during the closure of its physical underwriting floor. However, Lloyd's intended revolution is not merely technological; its ambitions extend to fundamentally changing the way in which business is performed in the Lloyd's market.

The Blueprint Two boldly proclaims that the efficiencies brought about by increased digitalisation will result in a collective reduction in costs for brokers and insurers of over £800 million (around a 3% reduction in operating costs). This figure is likely to be conservative and Lloyd's will privately be looking to better this result. However, this "better, faster, cheaper" way of doing business is not the end goal. Instead, it represents a challenge to market participants: less time spent on administrative activities should enable the market to foster innovation, information sharing and high performance. This message should therefore be viewed in tandem with Lloyd's other initiatives such as the Lloyd's Lab and the Syndicate-in-a-box, as part of a comprehensive strategy for relying on innovation for tangible growth. Following a difficult few years for Lloyd's, the establishment of sturdier foundations clearly starts with its plumbing.

d. Lloyd's MISPV

Lloyd's has also recently announced that it has received regulatory approval from the PRA and the FCA to set up a new multi Insurance Special Purpose Vehicle ("MISPV"). Lloyd's considers that this structure will make it easier for investors to access the Lloyd's market, and provides a new platform to improve the ease and transparency of managing capital.

U.K. legislation implementing the U.K.'s Protected Cell Company ("PCC") is relatively new, having only been introduced in 2017. Lloyd's has subsequently sponsored the creation of an independently-owned PCC, London Bridge Risk PCC Limited, which will be managed by Horseshoe. It is intended that this PCC will provide an access point for new classes of both U.K. and international investors (including ILS investors), such as pension funds, who will be able to deploy funds in a tax transparent way into the Lloyd's market. The PCC vehicle will also enable third-party investors to benefit from reduced set-up times and lower transactional costs, as well as standardize documentation

and streamline processes by which investors receive regulatory approval.

Lloyd's MISPV will not replace more traditional approaches already used in the market. ILS investment is also not new to Lloyd's. However, this is the first time that a U.K. PCC has been set up as a platform to allow investors to back and provide capital to corporate members at Lloyd's.

Lloyd's now aims to set up the mechanics to have the PCC ready for the market in early 2021, and it will form part of Lloyd's Future at Lloyd's strategy, which seeks to modernize and diversify the market.

e. InsurTech

The U.K. regulatory authorities continue to be supportive of innovation in the insurance sector, with the FCA having supported six regulatory sandbox cohorts by 2020. The FCA launched the Digital Sandbox in 2020 as a pilot for a permanent digital testing environment.

The FCA and EIOPA continue to monitor technological advancement and its impact on insurance consumers, including in relation to the use of big data and artificial intelligence and the negative impacts these technologies may have on pricing. Earlier in 2020, the FCA announced a new data strategy in order to optimize how it uses data as a regulator and also to better understand the advanced data processing and management technologies used by regulated firms.

One of EIOPA's key focal points has been the use of big data analytics, artificial intelligence machine learning capabilities and the risk of cyber underwriting strategies. While EIOPA will no longer be a supervisory authority in the United Kingdom after Brexit, its guidance will continue to be persuasive, particularly in relation to any InsurTech companies doing business across Europe.

The Lloyd's Lab also continues to act as an incubator in the insurance sector and has proven essential to encouraging innovation, including during the COVID-19 pandemic when investment activity slowed from the previous year.

v. E.U. and U.K. Competition Law

Following the opening of a number of significant new cases and market studies in 2019, the insurance sector continued to be under scrutiny from competition authorities in the E.U. and U.K., with the European Commission ("Commission"), the U.K. Competition and Markets Authority ("CMA"), and the FCA announcing new cases and/or continuing multiple investigations

a. European Commission's Phase II Investigation Aon/Willis Merger

On December 21, 2020, the Commission opened an in-depth Phase II investigation into the proposed $30 billion acquisition of Willis by Aon, giving itself until May 10, 2021 to complete its review. The Commission's market investigation in Phase I raised concerns in relation to the supply of commercial brokerage services, as the transaction would combine two of the three leading reinsurance brokers. A lengthy and complex review by the Commission is expected. The transaction is conditional on antitrust clearances in the European Union and the United States, as well as Canada, China, Mexico, Russia, South Africa, Australia, New Zealand, Singapore, and Turkey.

In particular, the Commission is concerned that the transaction may reduce the competition as regards brokerage services to large multi-national customers in the risk classes Property & Casualty, Financial and Professional services, Credit and Political risk, Cyber and Marine and brokerage services to customers of all sizes for Space and Aerospace manufacturing risks as well as in a few additional risk classes in specific national markets.

b. CMA Fines ComparetheMarket for Pricing Restrictions Concerning Home Insurance

On November 19, 2020, the CMA announced that it had ordered ComparetheMarket to pay £17.9 million in fines related to the comparison site's use of "most favored nation" clauses in the distribution of home insurance products. In online retailing, such clauses require the provider of a product to offer prices on the platform which are at least as

low as the prices listed by rival outlets. The CMA opened its investigation in 2017 on the basis of evidence obtained during the course of its earlier market study on digital comparison tools, completed in the same year.

c. CMA Orders Reversal of Motor Insurance Merger

On November 20, 2020, the CMA accepted a full divestiture of Bennetts Motorcycling Services, which was acquired in August 2020, by Ardonagh Group. Both parties are active in the supply of motorcycle insurance to private customers in the United Kingdom. During its investigation, the CMA found together they accounted for 30-40% of the combined share by number of polices (and 50-60% in certain customer segments) – nearly three times the size of their next largest competitor – and that the acquisition gave rise to a realistic prospect of a substantial lessening of competition.

d. CMA Clears Consolidation by the United Kingdom's Largest Private Medical Insurer

On September 24, 2020, the CMA approved in Phase I the acquisition of Civil Service Healthcare by Bupa Insurance, the leading supplier of private medical insurance in the United Kingdom. Although the CMA found that the parties together would account for 40-50% of the U.K. market for private medical insurance, the CMA concluded that the parties were not each other's closest competitors and that the merged entity would face sufficient constraints from next three largest competitors – which held shares of 20-30% (AXA), 10-20% (Aviva), and 10-20% (Vitality Healthcare).

e. FCA Publishes Final Report in General Insurance Pricing Market Study

In September 2020, the FCA published the final report concerning its General Insurance Pricing Market Study. The FCA launched the market study in October 2018 in relation to pricing for new and existing customers for home and motor insurance, in conjunction with its discussion paper "Fair Pricing in Financial Services." The FCA's final report recommends pricing intervention in relation to product renewals and additional measures to improve competition in relation to digital markets. The proposed measures are under consultation until January 15, 2021, with the FCA's response expected in the second quarter of 2021.

C. Registered Product Developments

i. Adoption of Summary Prospectuses for Variable Contracts

In March of 2020, the SEC adopted comprehensive reforms to its disclosure requirements for variable annuity and variable life insurance contracts ("variable contracts"). The reforms include new Rule 498A under the Securities Act of 1933, as amended (the "Securities Act"), which authorizes the use of a summary prospectus for variable contracts. The variable contract summary prospectus is designed to provide a concise, reader-friendly summary of information about the contracts' key features, fees, and risks (with additional information available online). The reforms rely on a layered disclosure approach similar to the approach adopted for mutual funds in 2009. The reforms also amend the requirements for variable contract statutory prospectuses.

Significantly, Rule 498A also provides that underlying fund prospectus delivery obligations are satisfied provided that, among other conditions, the fund summary prospectus and related materials are posted online at the address specified in the variable contract summary prospectus.

Collectively, the reforms should substantially reduce the volume of disclosures required to be delivered annually to variable contract investors. However, in the short term, the reforms will require significant work by variable contract issuers to conform their disclosures and systems to the new requirements. The reforms also may require restructuring of certain traditional arrangements between insurers and underlying funds related to satisfying underlying fund prospectus delivery obligations.

ii. Withdrawal of Great-West No-Action Letter

For decades, many variable contract issuers have relied on the *Great-West Life & Annuity Company, "Great-West"* line of

SEC staff no-action letters to forego updating registration statements for certain discontinued variable contracts subject to certain conditions. In connection with the adoption of Rule 498A, the SEC staff withdrew the *Great-West* line of no-action letters effective July 1, 2020, and the SEC announced a new position effectively grandfathering certain variable contracts with fewer than 5,000 investors. However, this relief was only available for contracts that already had been relying on the *Great-West* no-action letter; existing discontinued variable contracts that do not meet the conditions specified in the Rule 498A adopting release must be "un-*Great-West*ed," and no additional discontinued variable contracts are eligible for this relief from the registration statement updating requirements. The withdrawal of the *Great-West* line of no-action letters may affect insurers' cost projections regarding developing new or innovative variable contracts.

VIII. TAX TRENDS AND DEVELOPMENTS AFFECTING INSURANCE COMPANIES

A. 2020 U.S. Tax Law and Related Guidance Impact on the Insurance Industry

i. Treasury's Third Effort to Address the Insurance Company Exception to the PFIC Rules Produces a Mix of Final and Proposed Regulations

On December 4, 2020, the U.S. Internal Revenue Service (the "IRS") and the U.S. Department of Treasury (collectively with the IRS, "Treasury") released final and proposed regulations on (1) the implementation of the Insurance Company Exception (as defined below), which was substantially modified by the Tax Cuts and Jobs Act of 2017 (the "2017 Act") and (2) long-awaited general guidance on a range of issues relating to passive foreign investment companies ("PFICs") that have been left unanswered since the PFIC rules were introduced as part of the 1986 U.S. tax reform (such as determining ownership of a PFIC and applying the Income Test and Asset Test (as those terms are defined below) to determine PFIC status) (the "2020 Regulations"). The 2020 Regulations, taken together with the 2017 Act, could have substantial ramifications for U.S. investors in offshore insurance and reinsurance structures, including traditional global insurance and reinsurance corporate structures, insurance-linked securities funds and insurance-linked securities issuers. A U.S. taxable investor in the shares of an offshore insurer or reinsurer group is generally able to defer U.S. taxation until a sale of its shares and, if held long enough, pay tax on such sale at long-term capital rates if, among other things, the offshore insurer or reinsurer group qualifies for the Insurance Company Exception and the U.S. taxable investor is not subject to other U.S. anti-deferral regimes. If the PFIC rules were to apply to a U.S. taxable investor in an offshore insurance or reinsurance structure, the U.S. taxable investor would lose some or all of the benefits of U.S. tax deferral and long-term capital gain treatment. The 2020 Regulations finalized portions of regulations proposed in 2019 (with modifications in some cases) (the "2020 Final Regulations") while withdrawing some of the 2019 proposals and issuing new proposed rules (the "2020 Proposed Regulations"). The 2019 proposed regulations were discussed in our 2019 Year in Review. The 2020 Regulations responded to comments and criticism from the insurance industry to some extent, and Treasury again is reaching out to the industry for comments in a number of areas. The 2020 Regulations generally apply (or are proposed to apply) for taxable years beginning on or after the date they are filed in the Federal Register, although they may be applied to earlier periods subject to a consistency requirement.

a. General Summary of the PFIC Rules and the Insurance Company Exception

The Internal Revenue Code of 1986, as amended (the "Code"), provides that a foreign corporation will be considered a PFIC if in any taxable year either (1) 75% or more of its gross income in such taxable year is passive income (the "Income Test") or (2) the average percentage of assets held by such corporation during the taxable year that produce passive income is at least 50% (the "Asset Test"). Passive income is defined by reference to foreign personal holding company income ("FPHCI") under the controlled foreign corporation ("CFC") rules and includes dividends, interest, royalties, rents and other types of investment income. The PFIC rules provide that income derived in the active conduct of an insurance business by a qualifying insurance corporation (the "Insurance Company Exception") will not be treated as passive income. The 2017 Act limited the Insurance Company Exception to a non-U.S. insurance company that is a qualifying insurance corporation ("QIC"), which is a foreign corporation that would be taxable as an insurance company if it were a U.S. corporation and that either (i) maintains "applicable insurance liabilities" ("AILs") of more than 25% of such company's total assets as shown on the company's "applicable financial statement" ("AFS") for a taxable year (the "25% Test") or (ii) maintains AILs that at least equal or exceed 10% of its total assets for the taxable year, is predominantly engaged in an insurance business and satisfies a facts and circumstances test that requires a

showing that the failure to exceed the 25% threshold is due to runoff or rating agency circumstances (the "10% Test"). The 10% Test would require a U.S. investor to elect to treat the foreign corporation as a QIC, although the method of election is not prescribed by the Code. AILs mean (i) losses and loss adjustment expenses and (ii) 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. The Code provides a cap on the AILs equal to the lesser of the amount reported to the applicable insurance regulatory body in the AFS (or, if less, the amount required by applicable law or regulation) or as determined under Treasury regulations. The AFS is a statement for financial reporting purposes that is made on the basis of generally accepted accounting principles ("GAAP") or international financial accounting standards ("IFRS") (if no statement is prepared for financial reporting purposes on the basis of GAAP). If no statement is prepared for financial reporting purposes on the basis of GAAP or IFRS, the AFS would be the annual statement required to be filed with the applicable insurance regulatory body (except as otherwise provided in Treasury regulations). The "applicable insurance regulatory body" means, with respect to any insurance business, the entity established by law to license, authorize or regulate such business and to which an annual statement is provided. The QIC test could result in the application of the PFIC rules to offshore insurance and reinsurance structures that write business on a low frequency/high severity basis and take on significant insurance risk, such as property catastrophe companies (including insurance-linked securities funds) and financial or mortgage guaranty companies that generally do not book reserves for losses until a catastrophic or credit event occurs, a result that would seem at odds with the legislative purpose underlying the modifications to the Insurance Company Exception (that is, these are not companies conducting a token insurance business while focusing primarily on investment activities).

For purposes of the Asset Test and Income Test, a foreign corporation will be considered to (1) hold its proportionate share of the assets of a corporation and (2) directly receive its proportionate share of the income of a corporation if the foreign corporation owns, directly or indirectly, at least 25% (by value) of the stock of the other corporation (the "Look-Through Rule").

A special characterization rule also applies to the determination of whether a foreign corporation is a PFIC where such foreign corporation owns at least 25% (by value) of the stock of a U.S. corporation, which in turn holds the stock of another U.S. corporation other than a regulated investment company or a real estate investment trust ("qualified stock"). Under this provision, in determining whether a foreign corporation is a PFIC, (1) the stock of the second-tier U.S. corporation held by such first-tier U.S. corporation will not be considered to be an asset that produces passive income, and (2) dividends from such second-tier U.S. corporation to the first-tier U.S. corporation will not be treated as passive income, provided that the foreign corporation is subject to the accumulated earnings tax (the "Special Characterization Rule"). The application and coordination of the Look-Through Rule and the Special Characterization Rule are not statutorily addressed and may produce different results in analyzing whether a foreign corporation should be treated as a PFIC.

b. 2020 Final Regulations on Insurance Company Exception.

As noted above, the Insurance Company Exception would only apply to income derived in the active conduct of an insurance business by a QIC. The 2020 Final Regulations provide guidance on two of these requirements: QIC status and insurance business. The discussion below highlights the changes made to the 2019 proposed regulations.

i) QIC Status

(1) General Test

A foreign corporation will be treated as a QIC if it would be taxed as an insurance company under subchapter L of the Code if it were a domestic corporation and its AILs meet the 25% Test (or the 10% Test, assuming the U.S. investor elects to treat the foreign corporation as a QIC). The

2020 Final Regulations adopted the approach of the 2019 proposed regulations by defining an insurance company by reference to the Code. The 2020 Final Regulations modified the definition of AILs to conform to industry terminology, clarifying that AILs include incurred losses (unpaid losses and incurred but not reported losses) and unpaid loss adjustment expenses, regardless of whether the underlying losses were paid or unpaid. However, Treasury did not expand the definition of AILs to cover paid losses or paid loss adjustment expenses or revise the definition to provide special rules for financial guaranty and mortgage insurers. The 2020 Final Regulations also specify that amounts held by an insurer as a deposit liability (e.g., a guaranteed investment contract, funding agreement, etc.) or any other substantially similar contract issued by an insurer, as well as the amount of any reserve for a life insurance or annuity contract the payments of which do not depend on the life or life expectancy of one or more individuals are not AILs. The 2020 Final Regulations further provide that only the AILs of the foreign insurer that is being tested for QIC status are taken into account (not the AILs of other members of a consolidated financial group).

The 2020 Final Regulations also modified the AIL cap set out in the 2019 proposed regulations to the lesser of (1) the amount shown on any financial statement filed with the applicable insurance regulator, (2) the amount determined on the most recent AFS if prepared on the basis of U.S. GAAP or IFRS (even if not filed with an insurance regulator) or (3) the amount required by applicable law or regulations of the jurisdiction of the applicable regulator (or lower amount allowed as a permitted practice). Further, the definition of financial statement was revised to treat a statement as such only if it is prepared for a reporting period in accordance with the rules of a financial statutory accounting standard and includes a complete balance sheet, income statement and cash flow statement. If the AFS is not prepared on the basis of U.S. GAAP or IFRS and the AILs are not discounted on an economically reasonable basis, the AILs must be discounted under applicable U.S. GAAP or IFRS principles to the extent the AILs would be discounted under those principles (with the choice of U.S. GAAP or IFRS left with the foreign insurer).

Finally, Treasury noted that the AFS balance sheet is a starting point for determining the amount of AILs, and that it may be necessary to disaggregate components of balance sheet liabilities to arrive at the proper amount of AILs (noting that IFRS 17, which is scheduled to be effective January 1, 2023, provides for a balance sheet item of "overall insurance liabilities" which encompasses claims reserves (an AIL) and unearned premium reserves (specifically excluded from AILs)).

(2) Alternative Facts and Circumstances Test

As discussed above, a U.S. person can elect to treat stock in a foreign insurer as stock of a QIC if the 10% Test is met. The 2020 Final Regulations provide guidance on the 10% Test requirements.

- *Predominantly Engaged.* The 2020 Final Regulations make clear that a foreign corporation would be considered predominantly engaged in an insurance business if it meets the insurance company test described above and satisfies an additional facts and circumstances test that is based upon the character of the business actually conducted in the taxable year, but deleted the requirement in the 2019 proposed regulations that the facts and circumstances of the foreign insurer be comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's-length transactions. The relevant facts and circumstances in the 2019 proposed regulations were adopted in the 2020 Final Regulations (which also clarified that the list of factors was not exclusive).
- *Runoff-Related or Rating-Related Circumstances.* The 2020 Final Regulations modified the runoff-related circumstances test by eliminating the requirements that (1) the runoff company have a plan of liquidation (instead requiring the runoff company to be in the process of terminating its preexisting active conduct of an insurance business) and (2) claims payments cause the foreign insurer to fail the 25% Test (while retaining the requirement that claims payments are made during the annual reporting period).

- The 2020 Final Regulations revised the rating-related circumstances standard to conform to industry terminology by requiring that the 25% Test is not satisfied due to capital and surplus amounts that a generally recognized credit rating agency considers necessary for the foreign insurer to obtain a public rating of its financial strength and the foreign insurer maintains such capital and surplus to obtain the minimum credit rating necessary to enable it to write the business in its regulatory or board supervised business plan. However, the 2020 Final Regulations inexplicably restricted the rating-related circumstances to financial guaranty insurers, certain mortgage insurers and insurers writing a specified amount of catastrophe risk (specifically noting in the preamble that no special rule was created for fully collateralized reinsurers, which typically do not obtain credit ratings).

(3) Election Mechanics

The 2020 Final Regulations modified some of the election mechanics to apply the 10% Test, including revisions to the shareholder reliance on the foreign insurer's statement relating to the 10% Test, allowing a foreign parent to make the statement on behalf of its subsidiaries and providing for certain deemed elections by small shareholders in publicly traded corporations.

ii) Insurance Business

The 2020 Final Regulations retained the definition of insurance business in the 2019 proposed regulations, which includes investment activities required to support or substantially related to the insurance contracts written by the foreign insurer. Treasury noted that this definition is not intended to provide a maximum threshold for investment assets and income that may qualify for nonpassive treatment, but merely requires a sufficient factual relationship between a foreign insurer's insurance contracts and its investment activities.

iii) Active Conduct of an Insurance Business

The 2019 proposed regulations provided that the Insurance Company Exception to passive income applies to income that a QIC derives in the active conduct of an insurance business and income from a qualifying domestic insurance corporation ("QDIC") and provided that the treatment of a QIC's income derived from the active conduct of an insurance business was based on a rigid active conduct percentage test that did not comport with insurance industry practice. Treasury responded to industry comments on the active conduct test set forth in the 2019 proposed regulations by proposing a more flexible test for determining whether a QIC is engaged in the active conduct on insurance business, reflecting Treasury's understanding that certain outsourcing arrangements are common practice in the insurance industry. The 2020 Proposed Regulations on active conduct will be discussed in subsection (c) below of this Section VII.B.iii.

The 2019 proposed regulations provided that the income and assets of a QDIC would not be treated as passive. In the preamble to the 2020 Final Regulations, Treasury noted that this nonpassive treatment should be limited if certain thresholds are breached and the 2020 Proposed Regulations introduce a new limitation (discussed in subsection (c) below of this Section VII.B.iii). A QDIC is a U.S. corporation subject to tax as an insurance company under subchapter L of the Code and that is subject to federal income tax on its net income. This QDIC rule is intended to address situations where a foreign corporation that is determining its status under the PFIC rules owns a domestic insurance company through a structure where the Special Characterization Rules do not apply, and the 2020 Final Regulations explicitly provide that a QDIC only includes a subsidiary subject to the Look-Through Rule. This rule would not have applied for purposes of determining whether a foreign corporation is a PFIC for purposes of the corporate attribution rules that determine indirect ownership of lower-tier PFICs under the 2019 proposed regulations; however, the 2020 Final Regulations eliminated this rule.

For purposes of applying the Look-Through Rule, as well as the Look-Through Partnership Rule (defined below), the 2019 proposed regulations provided that an item of income treated as received or accrued or an asset treated as held by the QIC under the Look-Through Rule or the Look-Through

Partnership Rule that would be passive at the subsidiary entity level is treated as an item of income or an asset of the QIC for purposes of the Insurance Company Exception. However, such item of income or asset only would have been treated as used in the active conduct of an insurance business by a QIC if the AFS used to test the QIC status of the foreign corporation included the assets and liabilities of the subsidiary entity under the 2019 proposed regulations. In response to comments noting that the equity value of a subsidiary entity is reflected on the QIC's AFS even if not consolidated for financial accounting purposes, the 2020 Final Regulations modified the Look-Through Rules to apply in all cases, but limited the amount of assets that could be treated as nonpassive to the greater of (1) the product of (a) the QIC's proportionate share of the subsidiary entity's income or assets and (b) a fraction the numerator of which is the net equity value of the QIC's interest in the subsidiary entity and the denominator of which is the value of QIC's proportionate interest in the subsidiary entity's assets or (2) the QIC's proportionate share of amount of income or assets that are considered nonpassive in the hands of the subsidiary entity. In situations where the Look-Through Rule and Look-Through Partnership Rule do not apply (e.g., the QIC ownership interest is less than 25% of a look-through subsidiary), the stock or partnership interest (and income derived therefrom) is eligible for the Insurance Company Exception under the general rules.

c. 2020 Proposed Regulations on the Insurance Company Exception

i) AILs and Total Assets

The 2020 Proposed Regulations provide that AILs are reduced by an amount of assets reported on the AFS that represent reinsurance recoverables. Treasury found this rule is necessary because, for example, U.S. GAAP records reinsurance recoverables with respect to unpaid insurance losses and other reserves on the asset side of the balance sheet, which could lead to a manipulation of the ratio tests. The 2020 Proposed Regulations also provide for a reduction of the AILs for liabilities that may be recoverable from another entity included in a consolidated financial statement, regardless of whether the reinsurance transaction is eliminated in consolidation. The 2020 Proposed Regulations also provide for a corresponding optional adjustment to total assets, as well as an adjustment to total assets in situations where a foreign insurer's AFS is prepared on a consolidated basis and the insurance liabilities of affiliated entities are not included as part of the AIL of the subject foreign insurer. In the preamble to the 2020 Proposed Regulations, Treasury discussed modified coinsurance ("modco") reinsurance arrangements where the ceding company continues to hold the reserves and assets required to support the reinsured liabilities and noted that the proposed rules related to reinsurance recoverables are not intended to apply to modco arrangements.

ii) AFS Ordering Rules

The 2020 Proposed Regulations provide rules in addition to the general ordering rules in the Code relating to the order of priority between multiple financial statements prepared at the same level of priority (e.g., multiple financial statements prepared on a U.S. GAAP basis) and between multiple financial statements taking into account the assets and liabilities of different legal entities (e.g., nonconsolidated financials take priority over consolidated if both are prepared on U.S. GAAP basis). Further, only audited financial statements may qualify as the foreign insurer's AFS.

iii) Active Conduct

As discussed above, the active conduct percentage test set forth in the 2019 proposed regulations drew widespread criticism, and the 2020 Proposed Regulations allow for a more flexible approach to the satisfaction of the active conduct test through either a factual requirements test or a modified active conduct percentage test.

(1) Active Conduct Exclusions

The 2020 Proposed Regulations provide that a QIC cannot meet the active conduct test if (i) it has no (or a nominal number of) employees and relies exclusively (or almost exclusively) on independent contractors to perform its core functions or (ii) it is a securitization vehicle (such as a

catastrophe bond issuer, sidecar or collateralized reinsurer) or an insurance-linked securities fund that invests in securitization vehicles. The exclusion of the latter category of QICs was based on Treasury's determination that such vehicles are designed to provide an investment return that is tied to the occurrence of a fixed or predetermined portfolio of insured risks, events or indices related to insurance risks rather than to participate in the earnings of an active insurance business. It is not clear whether the second exclusion would extend to a market-facing sidecar or an insurance-linked securities fund that primarily writes reinsurance swaps characterized as reinsurance for U.S. federal tax purposes.

(2) Factual Requirements Test

A QIC will satisfy this test if (i) the officers and employees of the QIC carry out substantial managerial and operational activities on a regular and continuous basis with respect to its core functions (which include underwriting, investment, contract and claims management (unless the QIC is a reinsurer that delegates this function to the cedant in an indemnity reinsurance transaction) and sales activities) and (ii) the QIC's officers and employees perform virtually all of the active decision-making functions relevant to underwriting functions (i.e., the underwriting activities that are most important to the QIC's decisions related to assumption of specific insurance risks). The 2020 Proposed Regulations provide specific definitions for substantial managerial and operational activities, the components of core functions and active decision-making functions. Development of underwriting policies and parameters that are modified infrequently is not considered an active decision-making function in the absence of further ongoing active involvement in day-by-day decision-making.

(3) Active Conduct Percentage Test

The active conduct percentage test will be satisfied if (i) the total costs incurred by the QIC with respect to its officers and employees (including officers and employees of certain related entities) for services related to core functions (other than investment activities) at least equal 50% of the total costs incurred for all such services and (ii) the QIC's officers and employees oversee any part of the QIC's core functions, including investment management, that are outsourced to an unrelated party. Investment activities were eliminated from the first part of the test by the 2020 Proposed Regulations in response to industry comments on the 2019 proposed regulations. Services provided by officers and employees of certain related entities are only taken into account in the numerator of the active conduct percentage if the QIC exercises regular oversight and supervision over such services and compensation arrangements meet certain requirements. Ceding commissions and brokerage or agents' fees are not taken into account for purposes of the active conduct percentage test.

iv) QDIC

As noted earlier, the 2020 Proposed Regulations introduce limits on the amount of a QDIC's income and assets that could be treated as nonpassive. Those limits are based on a percentage of the QDIC's total insurance liabilities (200% for a life insurance company and 400% for a nonlife insurance company). The total insurance liabilities for a nonlife company is defined as the sum of its unearned premiums and unpaid losses, and a life company's total insurance liabilities is the sum of its Code Section 816 total reserves and certain reserve items described in Code Section 807(c) (to the extent not included in total reserves).

d. 2020 Regulations on General PFIC Issues

As noted above, the 2020 Regulations provided long-awaited general guidance on a range of PFIC-related issues. The following discussion briefly describes some of these provisions.

(1) *Application of the Corporate Attribution Rules.* The 2020 Final Regulations would apply the "top down" approach to the ownership attribution rules set forth in the 2019 proposed regulations with respect to a pass-through entity with a U.S. owner(s) that holds the stock of a PFIC indirectly through a foreign corporation that is not a PFIC and extend this approach to corporations.

(2) *CFC/PFIC Overlap*. Treasury declined to provide rules in situations where the PFIC and CFC rules overlap, including the interaction with the related person insurance income rules, noting that such coordination rules were beyond the scope of this rulemaking.

(3) *Active Banking Exception.* Treasury did not adopt the provision in the 2019 proposed regulations providing an exception to the definition of passive income for certain active banking income described in Code Section 954(h) which, in the case of a CFC, would be excluded from FPHCI; however, certain principles of Code Section 954(h) would apply for purposes of the active banking exception to passive income under the 2020 Proposed Regulations. The 2020 Proposed Regulations do not provide that principles of Code Section 954(i), which excludes from FPHCI certain active insurance income in the case of a CFC, would apply for purposes of determining PFIC status.

(4) *Effectively Corrected Income ("ECI")*. Treasury determined that an exclusion of ECI from passive income is inconsistent with the statutory definition.

(5) *Asset Test.* Although the Asset Test generally looks to the adjusted basis of a tested foreign corporation's assets in the case of a CFC, the 2020 Final Regulations provide that this rule would not apply if the corporation is a CFC solely as a result of the repeal of Code Section 958(b)(4), disregarding downward attribution from foreign persons.

(6) *Working Capital.* The 2020 Proposed Regulations provide a limited exception to the treatment of working capital as passive to take into account the short-term funding needs of operating companies.

(7) *Income Earned and Assets Held Through Partnerships*. The 2020 Final Regulations revised the definition of a "Look-Through Partnership" to more closely align with a look-through corporate subsidiary, treating income earned through partnerships similarly to income earned through corporate subsidiaries (the "Look-Through Partnership Rule"). Similarly, a foreign corporation with an interest in a Look-Through Partnership would be treated as owning its proportionate share of the partnership assets for purposes of the Asset Test. If the 25% ownership threshold is not met, the foreign corporation's distributive share of the partnership's income would be treated as passive and the partnership interest would be treated as a passive asset, unless the corporation is treated as an active partner (that is, a foreign corporation that would not be a PFIC under the Income Test and Asset Test if the tests were applied without taking into account partnership interests owned by the foreign corporation that do not qualify as Look-Through Partnerships).

(8) *Ownership Between the Look-Through Rule and the Special Characterization Rule*. The 2020 Final Regulations adopted the approach of the 2019 proposed regulations in generally giving priority to the Special Characterization Rule when there is potential overlap with the Look-Through Rule, on the theory that the Special Characterization Rule is the more specific rule where a foreign corporation owns at least 25% by value of a domestic corporation that owns qualified stock of other domestic corporations. However, the Special Characterization Rule is subject to certain limitations and anti-abuse rules which were modified by the 2020 Regulations.

ii. CARES Act Modification to Net Operating Loss ("NOL") Rules

As discussed in our 2017 Year in Review, the 2017 Act limited the deduction for NOLs of corporate taxpayers to 80% of taxable income for taxable years beginning after December 31, 2017, allowing for an indefinite NOL carryforward while eliminating the NOL carryback for most corporate taxpayers. Nonlife insurance companies, however, were not

subject to 80% limitation and were permitted to carry back NOLs for two years (and carry forward for 20 years). The 2017 Act conformed the treatment of NOL carryovers of life insurance companies to the general rules applicable to corporate taxpayers rather than special rules in effect prior to the 2017 Act (which allowed life insurance companies to carry back and carry forward operations loss deductions for three years and 15 years, respectively).

The CARES Act modified the treatment of NOLs arising in tax years 2018 through 2020, requiring taxpayers to carry back NOLs from such years to the prior five years (absent an election to forgo the carryback period) and eliminating the 80% taxable income limitation. Life insurance companies are entitled to the same five-year carryback that applies to other corporate taxpayers, and any NOL carried back to pre-2018 tax years will be treated as operations loss deductions under the pre-2017 Act law. The five-year carryback provision was extended to nonlife insurance companies, but such companies remain subject to the 20-year carryforward period.

B. International and U.K. Tax Developments

i. OECD Proposals to Introduce a Global Minimum Rate of Corporate Tax

The Organisation for Economic Co-operation and Development's ("OECD's") project to eradicate "base erosion and profit shifting" ("BEPS") has brought about extensive global tax reform over the last decade. The project continues now with the aim of tackling the unique challenges presented by "digitalization," although in fact the OECD's proposed reforms extend to virtually all global businesses.

a. Background

The OECD's proposed measures take the form of "Pillar One" and "Pillar Two," which are set out in two papers referred to as the "Blueprints." The Blueprints do not represent a consensus reached among the key jurisdictions; indeed, there are some substantial points of difference remaining. However, the OECD has presented an ambitious time frame to complete the project and so the Blueprints should, in light of the OECD's success with its earlier BEPS project, be taken seriously as representing possible future tax reform.

The Pillar One project has been generated by the recognition that in the "digital age" it is quite possible for a business to generate significant profits in jurisdictions in which it does not have a physical – and therefore taxable – presence. Pillar One therefore seeks to change established nexus rules, potentially to reallocate taxing rights toward market jurisdictions. Pillar One has been strongly resisted by the United States, which perceives it as unfairly targeting its home-grown digital businesses. The United States' current position is that Pillar One should be introduced only with a "safe harbor" allowing corporate groups to elect whether to be subject to Pillar One. Such a "safe harbor" would undercut the OECD's objective and prevent the regime from applying to a number of its key targets. It would likely also cause many jurisdictions worldwide to implement their own digital services taxes without international coordination – a situation Pillar One was intended to prevent. It is difficult to perceive how the project can proceed effectively until this key difference has been resolved. At any rate, financial services industries, including insurers, are intended to benefit from a sector-specific exclusion from Pillar One. While the precise scope of this exclusion in resulting legislation must be scrutinized, at this stage we are not anticipating that Pillar One will have a material effect on insurance groups.

Pillar Two is potentially much more relevant because, similar to the United States' global intangible low-taxed income ("GILTI") rules, it seeks to impose a global minimum rate of tax on large corporate groups through a series of interlocking measures. At a high level, there are two separate proposals, a global effective minimum rate of corporation tax (imposed through the "GloBE Rules") and a minimum level of tax on connected party payments, which are perceived to be potentially base-eroding (the "Subject to Tax Rule"). The GloBE Rules are proposed to apply only to multinational groups with global revenues exceeding €750m (in line with current Country by Country Reporting requirements) and therefore should be relevant to larger insurance groups only. The coexistence of the GloBE Rules

with the pre-existing GILTI regime will be the subject of further work by the OECD.

b. Subject to Tax Rule

The Subject to Tax Rule applies in priority to the GloBE Rules and is a simpler concept. It bears some similarity to the United States' base erosion anti-abuse tax ("BEAT"), although the Subject to Tax Rule has a narrower application.

In summary, where a "covered payment" is made between connected entities and the payee benefits from treaty protection such that the receipt of the payment is subject to a tax rate below the "agreed minimum rate," income taxing rights in the payer jurisdiction are restored under the applicable tax treaty so that the payer jurisdiction imposes a top-up tax similar to a withholding tax. The change in law would be implemented by a stand-alone treaty provision, codifying the Subject to Tax Rule. The OECD has indicated that 7.5% is likely to be the acceptable minimum rate. The Subject to Tax Rule will apply only to "covered payments," and those are identified by the OECD as presenting a significant risk of base erosion because they relate to mobile capital, assets or risk.

Unfortunately for insurance groups, both (re)insurance premiums and brokerage fees paid between connected entities are specifically identified by the OECD as "covered payments," thus being payments in respect of which the Subject to Tax Rule could apply. This is a disappointing outcome, and many groups will be surprised that the OECD is treating arm's-length reinsurance premiums similarly to franchise fees, royalties and interest payments. Such fees and payments typically represent predictable intragroup cash flows and even where they do not represent "pure profit," the expenses that go alongside them are usually predictable and often within the control of the corporate group. The same cannot be said for reinsurance premiums in respect of third-party risks, where there is invariably a substantive likelihood of the insured risk arising and the recipient of the premium suffering a considerable loss. There is no proposed mechanism for a refund of tax paid under the Subject to Tax Rule if the reinsured risk arises. Therefore, the effective tax rate may, in practice, far exceed the minimum rate proposed by the OECD.

Insurance groups will therefore wish to know the likelihood of the Subject to Tax Rule applying to their groups, and specifically to their group reinsurance premiums. The first aspect to consider is whether the payment is between "connected persons," the second is whether they are resident in treaty jurisdictions and the third is whether the payee jurisdiction taxes the payment at the minimum rate. The proposed definition of "connected persons" refers to persons who are under common control (or where one party controls the other) or where one party has a beneficial interest of 50% or more of the value and votes in the other (or a third party has such an interest in both). While most groups paying reinsurance premiums intragroup will be within the "connected persons" definition, there are relatively few treaty jurisdictions that will not seek to tax the receipt of a (re)insurance premium at the proposed minimum rate of tax.

On the other hand, the Subject to Tax Rule is only intended to restrict treaty relief; it does not apply to payments made to a nil tax jurisdiction which typically will not have entered into a network of full double tax treaties so, for example, the Subject to Tax Rule should not affect reinsurance premiums paid by U.K. companies to affiliates in non-treaty jurisdictions such as Bermuda.

The OECD notes in the Pillar Two Blueprint that connected party insurance and reinsurance tend to be more profitable than unrelated transactions and that, in the OECD's view, it can be difficult to find comparable transactions to test whether the pricing is at arm's length. In many circumstances this is not true, as multinational insurance groups typically rely on detailed comparative data to support their intra-group pricing in line with OECD guidelines. We note that the OECD's commentary in the Pillar Two Blueprint suggests a misconception of the nature of the insurance industry, as the OECD notes that "if" a risk does not materialize, the premium "can generate a high return." While true as a stand-alone fact, the OECD does not, within its Pillar Two Blueprint, acknowledge that if the risk does materialize, the loss will most likely significantly exceed the

premium and that over the long term some insured risks will materialize and those accumulated premiums (and regulatory capital) are designed to cover the realization of that risk. The unique nature of insurance, acknowledged in the Pillar One Blueprint but overlooked in Pillar Two, goes to the heart of why the industry merits particularly careful treatment under the proposed rules.

It may be that the OECD's proposed measures are intended to target (re)insurance premiums paid to a captive (re)insurer, although the ideas outlined in the Pillar Two Blueprint are broader in scope and would also affect multinational third-party insurance groups. It appears that the groups most likely to be affected by the proposals are those that pay (re)insurance premiums intragroup to companies located in low-tax "onshore" jurisdictions, thereby relying on tax treaties to eliminate withholding taxes. While currently it is fairly uncommon globally to impose a withholding tax on the payment of a (re)insurance premium, it is worth considering whether the OECD's proposals in Pillar Two could prompt more jurisdictions to impose withholding taxes on "covered payments" made to low-tax jurisdictions – rather than effectively ceding taxing rights to parent-company jurisdictions under the GloBE Rules (as discussed below).

The OECD has suggested a number of exemptions and carve-outs to the Subject to Tax Rule but it appears unlikely that these will be of general utility to insurance groups. The OECD is considering a materiality threshold based on one or more of the size of the multinational group, the value of the "covered payments" and the ratio of "covered payments" to total expenditure. The scope of such a threshold is not yet known and the OECD intends to carry out further technical work.

The Subject to Tax Rule shares some characteristics of BEAT and so the industry's response to those rules gives an indication of what is to come if Pillar Two is implemented. Following the introduction of BEAT, some non-U.S. parented insurance groups with U.S. subsidiaries restructured to terminate or modify reinsurance arrangements between those U.S. subsidiaries and non-U.S. affiliates. Although the Subject to Tax Rule has a narrower application than BEAT (being limited to treaty arrangements), similar solutions may emerge to prevent its application.

Insurance groups making payments to low-taxed group companies in treaty jurisdictions should keep the proposal under review as it develops and restructuring may be necessary to avoid tax leakage at potentially punitive rates.

c. GloBE Rules

In contrast to the relative simplicity of the Subject to Tax Rule, the GloBE Rules have a series of interlocking elements that together aim to ensure that large corporate groups are subject to a minimum level of global corporate taxation. Since the OECD announced its Pillar Two project, there has been extensive speculation from stakeholders about what that minimum rate should be. No decision has been reached but the Pillar Two Blueprint uses illustrative examples of between 10% and 12% (which is markedly lower than the forthcoming GILTI rate of 16.4% in 2026).

The OECD's objective with the GloBE Rules is that multinational groups should be subject to at least the minimum level of tax in each jurisdiction where they operate. To the extent that there is a tax shortfall, this is identified as tax that needs to be "topped up." This "missing tax" may be allocated to the ultimate parent company of the group or, failing that, to an intermediate parent company. Where this is not possible, for example, because the parent companies are resident in jurisdictions that have not implemented the GloBE Rules, the "missing tax" may be allocated to other group companies. In this respect the GloBE Rules differ from typical CFC rules in that they have an inbuilt "anti-inversion" strategy that does not allow the minimum rate of tax to be circumvented by, for example, utilizing a flat corporate structure with the corporate parent resident in a tax haven jurisdiction.

The crux of the GloBE Rules comes down to calculating a group's effective tax rates for each relevant jurisdiction. This contrasts with GILTI, which uses a worldwide blending approach. This rate determines whether the GloBE Rules apply. The calculation of this effective tax rate is an area of considerable complexity and the OECD dedicates a quarter

of the 200-page Pillar Two Blueprint to the calculation. Broadly, the concept is to determine, on a jurisdictional basis, a fraction comprised of "Covered Taxes" (the numerator) and "Covered Income" (the denominator) to calculate the overall rate, which may then be determined to be acceptable (or not).

Covered Taxes are intended to be taxes on an entity's income or profits (however they are described) and include taxes on distributed profits, retained earnings and corporate equity as well as taxes arising under CFC rules. Taxes on gross payments such as insurance premiums should be Covered Taxes to the extent they apply in lieu of general income tax – this should therefore cover U.S. federal excise tax and similar overseas taxes. Tax payable under the Subject to Tax Rule is also a Covered Tax.

Compared with many CFC regimes, the OECD proposes only a narrow "local substance" exemption from GloBE Rules for companies in low-tax jurisdictions. This intended substance-based carve-out has no regard to a group's capital structure and is based solely on a low fixed return on personnel costs and tangible assets. Such costs are likely to make up only a small proportion of an insurance group's expenditure.

The GloBE Rules have two tax allocation/collection elements, which operate as follows:

(1) *Income Inclusion Rule ("IIR").* The IIR operates similarly to a CFC charge in that it subjects a domestic taxpayer to tax on its share of foreign income of a controlled subsidiary operating in a low-tax jurisdiction. The OECD's concept is that regardless of where a corporate group is headquartered, its entire operations should be subject to a global minimum rate of tax. To achieve this, the OECD envisages that the IIR will be implemented consistently in as many jurisdictions worldwide as possible. Unlike most CFC rules, the IIR will be based on the average group-wide effective tax rate for each separate relevant jurisdiction (not determined on a subsidiary-by-subsidiary basis). The IIR is intended to apply to the "ultimate parent" of the group on a top-down basis – if the ultimate parent is based in a jurisdiction that has not implemented the IIR, the responsibility for applying the IIR will be delegated down the group, potentially to an entity that does not hold a controlling stake. In split ownership structures, a partially owned intermediate parent entity may be responsible for applying the IIR in place of one or more "ultimate parents." Special provisions mean that overseas permanent establishments should be taxed in the same way as foreign subsidiaries, even where a tax treaty might usually prevent this.

(2) *Undertaxed Payments Rule ("UTPR").* The IIR applies in priority to the UTPR, which is more complex and should theoretically have only a narrow application. The UTPR is a method of proportionately allocating tax that was not payable under the IIR to other group companies and operates along the same principles and with the same purpose as the IIR. In summary, the underpaid top-up tax of an undertaxed entity is allocated among group companies resident in jurisdictions that have implemented the UTPR ("UTPR Companies"), as follows:

   a. in proportion to the deductible payments made by the UTPR Company directly to the undertaxed entity in relation to all the deductible payments made by other UTPR Companies in the group; and

   b. if the UTPR Company has net intra-group expenditure, the remaining top-up tax is allocated proportionately to the amount of net intra-group expenditure incurred by all group UTPR Companies (to circumvent avoiding (a) by using conduit structures).

The UTPR operates so that the IIR cannot be fully circumvented by using a corporate structure with holding companies resident in jurisdictions that have not implemented the IIR. If that approach was used,

the "missing" IIR tax should be allocated to other group companies.

The key for insurance groups will be to ensure that provisions determining how their effective tax rate is to be calculated allow for the significant timing differences that arise for insurance groups between their accounting profits and their profits for local tax/regulatory purposes. The OECD suggests a number of measures designed to allow groups to "smooth out" potential volatility arising from the taxes imposed under local law or resulting from timing differences in taxation, in an approach it considers to be "more permissive" than that under GILTI. The OECD's stated policy intention is that Pillar Two would not result in imposing additional taxes where the effective tax rate is lower than the prescribed rate due only to a timing difference. The OECD suggests that this principle should be achieved using loss carry forwards, excess tax carry forwards, IIR tax credits from prior years, pre-regime losses, local tax carry forwards, post-filing adjustments and transfers of tax attributes. The intended policy result and the proposed methods of adjustment appear – in principle – to be helpful.

However, the detail is less reassuring with these timing differences intended to "smooth out" over a much shorter timeframe than that required by many insurance groups. While loss carry forwards are intended to be of unlimited duration, we note that IIR tax credits and local tax carry forwards will not be created until the "reversing year." For example, where increases to reserves are tax deductible, a sustainable or growing insurance business may find that those reserves do not become taxable under local law until many years in the future when it is winding down its business. The IIR top-up tax will have been paid up-front due only to this timing difference, which is not only disadvantageous from a cash-flow perspective but also unjustified as the (eventual) effective tax rate could far exceed the OECD's minimum rate. Carry forward attributes may expire before they are able to be used and the use of pre-regime losses is proposed to be limited to seven years (which would cause some insurance companies to be treated under the GloBE Rules as generating taxable profits even where under local law they are able to utilize older pre-regime losses).

Many of these problems could be resolved by allowing more generous timeframes for using tax attributes and by allowing insurance groups to calculate their profits and therefore their effective tax rates in accordance with local deferred tax and regulatory requirements. The OECD's intention of using accounting profits and then adjusting for timing differences through a number of measures is, without considerably more work, an inadequate solution for the insurance sector.

d. Conclusion

The OECD's Blueprints are, in some respects, detailed and complex outlines of how Pillars One and Two are intended to operate. It is interesting that the Pillar One Blueprint, which includes an insurance industry-wide exemption, contains a detailed summary of the unique characteristics of the industry, noting in particular that "[t]he ebb and flow of the insurance cycle makes the determination of normal returns for the industry difficult." In contrast, the Pillar Two Blueprint, which is stated as targeting the same industry, includes no details on the unique economics of an insurance group and no analysis as to how the calculations integral to the GloBE Rules could apply fairly to an insurance group. In fact, there are significant concerns that without considerable adjustments to the proposed calculations, the proposed rules would unfairly penalize insurance groups.

The OECD has been reviewing representations from many groups and industry bodies over the past few months. It hopes to bring "the process to a successful condition by mid-2021" by publishing proposed draft legislation and guidelines. This appears to be an aggressive time line given the substantial work remaining to be done. It is clearly important that implementation not be rushed, to allow proper thought to be given to issues specific to the insurance industry. This will be an important issue to watch, as the proposal develops in 2021.

ii. Updates to E.U. and U.K. VAT Rules for Insurers

a. E.U. Review of VAT Rules for Financial and Insurance Services

On October 22, 2020, the Commission published a roadmap for public consultation concerning the application of E.U. VAT rules to financial and insurance services. This is the first stage of a new review of these rules and follows a previous review initiated by the Commission in 2006 but ultimately withdrawn in 2016.

The current position is that supplies of financial and insurance services are typically exempt from VAT, which may (in principle) represent a cost saving to consumers of those services but means that the finance and insurance businesses making those supplies are not able to recover VAT on their own purchases.

The Commission believes this exemption has become outdated, complex and difficult to apply. As such, the problems the roadmap is intended to address include a lack of VAT neutrality, caused by businesses in this sector being unable to recover input VAT, as well as legal uncertainty and regulatory complexity.

The roadmap itself is designed only to define the scope of an evaluation of the existing law and set out the policy objectives to be achieved. A full public consultation is expected in the first quarter of 2021, followed by a legislative proposal by the end of the year. The roadmap does, however, suggest two alternate policy options:

(1) Removing the existing exemptions for financial and insurance services. The roadmap suggests that this approach would greatly simplify the VAT rules in this area, and enable financial and insurance businesses to reclaim their input VAT.

(2) Keeping the existing exemption, but modifying its scope through taxing certain types of services (e.g., where charges are fee-based as opposed to interest-based). This option, while less radical, would limit the impact of the review on consumer prices.

In addition to the two options above, the roadmap indicates that the Commission will consider other measures, including introducing cost-sharing arrangements as a way of limiting insurers' irrecoverable VAT costs (such arrangements were held to be inapplicable to the insurance sector under existing rules by the European Court of Justice in 2017). In addition, the Commission is concerned that, contrary to its principles of VAT neutrality, the VAT exemption increases the cost of outsourcing business functions compared with carrying on those same activities in-house. In practice, barriers to VAT neutrality in supply chains serve to increase prices for consumers. Solutions in these difficult areas will be welcomed by the insurance sector and its clients.

This is an important review concerning a problematic area of the VAT rules, and has been broadly welcomed by industry bodies. The roadmap leaves the door open to sweeping changes to the VAT treatment of insurance services within Europe.

b. Scope of U.K. Insurance Exemption

Meanwhile, following Brexit, the United Kingdom is no longer bound by the European Union's VAT rules, which opens the door for independent reform, including within this problematic area. Any simplifications in Europe are, however, likely to be considered for adoption in the United Kingdom, particularly as the United Kingdom has always sought to permit a more generous exemption than does Europe.

Following the decision of the European Court of Justice in 2005 in the Dutch case of *Arthur Andersen & Co Accountants C472/03,* HM Revenue & Customs ("HMRC") accepted that the U.K. domestic exemption for insurance-related services is drawn too widely but has never amended it to take account of the judgment. Its solution instead was to permit businesses to rely on the U.K. domestic exemption as drafted or to permit them to seek the direct effect of European legislation and treat supplies as VAT-able.

Over the years the precise scope of the United Kingdom's VAT exemption for intermediary supplies has been an area of conflicting case law and appears to be one ripe for

legislative reform. One case to keep under review in 2021 is *Claims Advisory Group Limited v HMRC.* Claims Advisory Group Limited ("CAG") is a claims management company specializing in recovering mis-sold payment protection insurance for consumers. CAG retained a fixed percentage fee of the compensation it obtained, which it claimed was VAT exempt, on the basis that it was providing either insurance services or insurance intermediary services.

CAG lost at the First Tier Tribunal and its appeal is due to be heard at the Upper Tribunal in June 2021, with the result expected later in 2021. Its argument runs contrary to the general view that the insurance and insurance intermediaries exemption applies only to the initial sale of the policy and not to its cancellation and refund. If the Upper Tribunal finds in favor of CAG, this could result in a further widening of the U.K. domestic exemption.

iii. U.K. Review of VAT Grouping Rules

On August 28, 2020, HM Treasury published a call for evidence relating to three areas of the U.K.'s VAT grouping regime. The areas under consideration are: (1) establishment provisions; (2) compulsory VAT grouping; and (3) the eligibility of certain partnerships to join VAT groups.

a. Establishment Provisions

The United Kingdom currently operates a "whole establishment" model for VAT grouping. This means all branches of an eligible person (whether in the United Kingdom or abroad) are considered part of a single eligible person. Therefore, provided the conditions for VAT grouping are met, all branches of an eligible person would be able to join a VAT group (provided there is at least one branch or the head office in the United Kingdom). This can provide VAT savings, as supplies made between the United Kingdom and branches located in another country, but within the VAT group, are not taxable.

In contrast, HM Treasury notes that most other European countries (with the notable exceptions of the Netherlands and Ireland) operate an "establishment only" model, whereby only U.K. fixed establishments would be able to be part of a VAT group. If the United Kingdom were to reform its rules in line with this approach, more supplies within a VAT group with a branch structure and a presence in the United Kingdom would be brought into the scope of U.K. VAT, likely increasing administrative complexity and VAT leakage.

b. Compulsory VAT Grouping

The United Kingdom currently operates an elective VAT grouping system, with corporate groups able to choose which entities should join a VAT group. The call for evidence suggests HM Treasury is concerned that this is open to manipulation by businesses seeking to optimize their VAT recovery.

There are a variety of commercial reasons why businesses decide whether to include an entity in a VAT group. The implications for joint liability often mean it is not possible to VAT group certain entities even where it would be advantageous to do so, whether because of covenants in financing arrangements or regulatory ring-fencing. A compulsory system would therefore be a significant change, which would potentially impact VAT recovery and have other commercial implications.

What next? The call for evidence is a first step in a potential review of the United Kingdom's VAT grouping rules and this is an important area to keep under review in 2021.

iv. U.K. VAT Recovery Insurance and on Insurance Intermediary Supplies into the European Union post-Brexit

U.K. insurers making supplies of insurance and insurance intermediary services to U.K. customers are unable to recover associated input VAT as a consequence of those supplies being exempt. In contrast, it has been possible for U.K. insurers making supplies of insurance or insurance intermediation or intermediary services to non-E.U. customers to recover their input VAT under the United Kingdom's "specified supplies" rules.

Following Brexit, it would be logical to presume that cross-border supplies to customers within the European Union would be treated the same as supplies to customers outside the European Union. Initially, the U.K. government legislated that this would not be the case and VAT recovery would be available only on supplies to non-E.U. customers. Fortunately, logic has prevailed and the government has announced that the position will be reversed effective from January 1, 2021.

However, the importance of properly analyzing and documenting relevant arrangements where recovery is sought was underlined in the recent case of *Safestore Limited v HMRC* (November 17, 2020). Safestore provides self-storage facilities to customers in various locations in the United Kingdom and France. Safestore required its U.K. customers to take out insurance provided under a policy between Safestore and its sister company, based in Guernsey ("GuernseyCo"). Safestore would pay 70% of the premium paid by the U.K. customer to GuernseyCo and retain 30% for itself. Safestore then sought to recover its associated input VAT on the basis that it was making a supply of insurance intermediary services to GuernseyCo, an entity outside the European Union.

HMRC and both the First and Upper Tier Tribunals disagreed, finding that Safestore was providing exempt supplies of insurance to its U.K. customers. With most of the arrangements between Safestore and GuernseyCo being undocumented, Safestore faced an uphill battle to convince either the tax authority or the Tribunals that its true customer was GuernseyCo. To ensure VAT recovery, it is essential to make sure that the paper trail is consistent with what is perceived as commercial reality.

v. U.K. Corporate Residence and Taxable Presence During the COVID-19 Pandemic

Insurance is a global industry and many of the large insurance groups are multinational, with directors based in several jurisdictions. As such, the international restrictions on travel throughout 2020 and continuing into 2021 present practical challenges for the sector. For directors and other key personnel, being restricted from travelling freely may also give rise to concerns about corporate taxation.

A company that is not incorporated in the United Kingdom may become subject to U.K. corporation tax if one of two situations occurs:

- its "central management and control" is exercised in the United Kingdom, in which case it will be treated as a U.K. resident for corporation tax purposes and its worldwide profits will be subject to U.K. corporation tax, at a current rate of 19%; or
- it carries on a trade in the United Kingdom through a permanent establishment, in which case all the profits attributable directly or indirectly to that permanent establishment will be subject to U.K. corporation tax.

Even if an overseas company is not subject to U.K. corporation tax, if it carries on a trade in the United Kingdom otherwise than through a permanent establishment, it may be liable to U.K. basic rate income tax (currently charged at 20%) on the profits attributable to that U.K. trading activity if it does not have the benefit of an applicable double tax treaty.

The U.K. tax authority was asked to confirm its view on how the COVID-19 travel restrictions would affect the U.K. taxation of overseas companies. It confirmed that there would be no concessionary treatment but that as a matter of law it considered that overseas companies should not become resident in the United Kingdom because "a few board meetings are held here," as it takes a long-term and "holistic view" in each case. Similarly, existing guidance confirms that a permanent establishment should not arise in a short period of time.

While the guidance is not a cure-all, it has been reassuring. Many groups have been able to take certain measures to reduce the likelihood of unforeseen tax consequences arising out of COVID-19. However, as the pandemic continues in 2021, corporate residence and permanent establishment concerns should be kept under review as risks will potentially increase the longer the pandemic and associated travel restrictions linger.

IX. GLOSSARY

- "2017 Act" means the U.S. Tax Cuts and Jobs Act of 2017.
- "ABS" means asset-backed securities.
- "AFS" means applicable financial statement.
- "AG 33" means the NAIC Actuarial Guideline 33.
- "AG 48" means the NAIC Actuarial Guideline 48.
- "AIL" means applicable insurance liabilities.
- "BEAT" means the U.S. Base Erosion and Anti-Abuse Tax.
- "BEPS" means base erosion and profit shifting.
- "BI" means business interruption.
- "Brexit" means the U.K. decision to and procedure to withdraw from the European Union.
- "CARES Act" means the Coronavirus Aid, Relief and Economic Security Act.
- "CFC" means a controlled foreign corporation under U.S. tax law.
- "CI" means Collateralized Insurer.
- "CIGA" means the U.K. Corporate Insolvency and Governance Act 2020
- "CMA" means the U.K. Competition and Markets Authority.
- "Code" means the Internal Revenue Code of 1986, as amended.
- "Commission" means the European Commission.
- "COVID-19" or the "COVID-19 pandemic" means the novel coronavirus COVID-19 pandemic.
- "CPIH" means the Consumer Prices Index including owner-occupiers' housing costs.
- "EEA" means the European Economic Area.
- "EIOPA" means the European Insurance and Occupational Pensions Authority.
- "ESEF" means the European Single Electronic Format.
- "ESG" means environmental, social and corporate governance.
- "E.U." means the European Union.
- "Exchange Act" means the Securities Exchange Act of 1934, as amended.
- "FCA" means the U.K. Financial Conduct Authority.
- "FPHCI" means foreign personal holding company.
- "FRC" means the U.K. Financial Reporting Council.
- "GAAP" means U.S. generally acceptable accounting principles.
- "GCC" means group capital calculation.
- "GILTI" means the U.S. global intangible low tax income regime.
- "GloBE" means the Global Anti-Base Erosion Proposal of the OECD.
- "IA" means the Investment Association.
- "IAIS" means International Association of Insurance Supervisors.
- "ICGN" means the International Corporate Governance Network.
- "ICS" means insurance capital standards.
- "IFRS" means international financial accounting standards.

IX. Glossary

- "ILS" means insurance-linked securities.
- "IRS" means the U.S. Internal Revenue Service.
- "LPS" means limited-purpose subsidiaries.
- "MAR" means the E.U. Market Abuse Regulation.
- "NAIC" means National Association of Insurance Commissioners.
- "Nasdaq" means the Nasdaq Global Select Market.
- "NOL" means net operating loss.
- "NYDFS" means the New York Department of Financial Services.
- "NYSE" means the New York Stock Exchange.
- "OECD" means the Organisation for Economic Cooperation and Development.
- "Part VII" means the relevant part of the Financial Services and Markets Act 2000, which governs the court-sanctioned transfer of some or all of the insurance policies of one company to another.
- "PEG" means the U.K. Pre-Emption Group.
- "PFIC" means a passive foreign investment company under U.S. tax law.
- "PIC" means Pension Insurance Corporation.
- "PRA" means the U.K. Prudential Regulation Authority.
- "PRIIPs Regulation" means the E.U. Packaged Retail Investment and Insurance-Based Products Regulation.
- "Prospectus Regulation" means Regulation (EU) 2017/1129 governing the European securities prospectus regime.
- "QIC" means qualifying insurance corporation.
- "RBC" means Risk-Based Capital.
- "RMBS" means reverse mortgage-backed securities.
- "RPI" means the Retail Price Index.
- "SCR" means Solvency Capital Requirement.
- "SEC" means the U.S. Securities and Exchange Commission.
- "Securities Act" means the Securities Act of 1933, as amended.
- "SM&CR" means the Senior Managers and Certification Regime of the U.K.
- "SOFR" means the secured overnight financing rate.
- "Solvency II" means the European Union's Solvency II Directive (Directive 2009/138/EC), which went into effect on January 1, 2016.
- "SPV" means special purpose vehicles.
- "Treasury" means the U.S. Treasury Department and the IRS.
- "VAT" means value added tax.

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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