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Life Insurance IPOs in Korea: Light at the End of the Tunnel?

by Mark J. Lee

After nearly two decades of debate, anticipation, false hopes and failed starts, it seems that the political and regulatory hurdles for initial public offerings and listings by Korean life insurance companies have finally been overcome. Korea is the 7th largest insurance market in the world (2005) and the largest market in Asia (ex-Japan), in terms of premium income, and it is understandable that market participants seem genuinely excited about the initiative this time around and seem to be eagerly awaiting final resolution of the matter.

The main barrier to the initial public offering (whether solely on the domestic market or a dual listing) of Korean life insurance companies over the years had been the very strong opposition from policyholders, certain citizen advocacy groups and non-governmental organizations, who, on behalf of policyholders, argued that Korean life insurance companies were mutual in nature and not joint stock companies, and as such, should share any proceeds from an initial public offering with former and current policyholders. The argument was and continues to be based on the notion that policyholders did not receive sufficient dividends under participating policies. These opponents argue that Korean insurance companies in the past used monies otherwise due to the policyholders (which were not segregated from company funds) to apply to their accumulated deficits and, while the amounts were subsequently paid, policyholders argue such payments are insufficient as the amounts due should also reflect the improved financial performance of the companies. Another related argument arises from an asset revaluation that the government allowed in 1990, which resulted in a significant increase in the valuations of the assets of certain of the life insurance companies. The resulting increase in net worth was offset by a reserve provision for the policyholders. Some of the advocacy groups argue that these amounts should be treated as equity or paid-in-capital of the companies and not as a liability.

The impetus for the initiative and renewed optimism began in 2006 when the Korea Exchange assisted in the formation of a blue-ribbon committee (the "Committee") with the sanction of various political groups to analyze and present its views on the matter. The Committee, consisting of leading industry experts, lawyers, accountants and academics, issued a final report on January 8, 2007. The Committee concluded, among other things, that Korean life insurance companies are joint stock companies under their constituent documents, have been operated as joint stock companies, and therefore need not share any of the IPO proceeds with their policyholders. The Committee also concluded that past policy dividends on certain policies were adequate and no more need be paid. Finally, the Committee concluded that revaluation

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Letter from the Editor

This is the first issue of our firm's Financial Institutions Report. We intend to review current developments and trends based on our experience in all sectors of the financial services industry around the world, including our decades of experience in all aspects of the insurance industry, and our experience in advising banks, securities firms, investment managers and private equity firms.

Our Financial Institutions Report complements our many Client Updates on recent developments and our annual book *Insurance and Investment Management M&A*, as well as the *Debevoise & Plimpton Private Equity Report*.

This issue includes contributions from New York, London and Hong Kong members of our Financial Institutions Group. These articles address new trends in capital markets transactions in Korea and the UK and in securitizations and sidecar transactions in the U.S. and Bermuda. They discuss new compliance and regulatory issues for financial institutions: complex structured finance transactions, anti-money laundering rules and U.S. insurers' affiliate receivables.

A great deal is happening in the financial institutions sector, and we hope that some of these articles will be useful to you. Please let us know if there are topics of interest to you that you would like to see covered in future issues of the *Debevoise & Plimpton Financial Institutions Report*. We welcome your comments.

Wolcott B. Dunham, Jr.
Editor-in-Chief

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Interagency Statement on Complex Structured Finance Activities

by Paul L. Lee

In January 2007, the Securities and Exchange Commission (the "SEC") and the federal banking agencies (collectively, the "Agencies") issued in final form an Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities (the "Interagency Statement"), governing complex structured finance transactions like those used by Enron. The Interagency Statement applies to federally regulated depository institutions and depository institution holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers. The Interagency Statement describes the types of internal controls and risk management procedures that financial institutions should establish to identify, manage and address the heightened legal and reputational risks that may arise from certain complex structured finance transactions ("CSFTs").

The text of the Interagency Statement closely follows the text of a revised proposed statement issued for comment by the Agencies in May 2006. The May 2006 revised proposed statement itself represented a significant change in approach from the original proposed statement that the Agencies had issued for comment in May 2004. The original proposed statement, which was based on regulatory enforcement actions taken against several financial institutions involved in Enron-related financing activities, was regarded by the industry as overly broad in its scope and excessively prescriptive in its approach. Among the concerns expressed by the industry were not only that the detailed requirements would impose significant burdens on financial institutions, but also that the prescriptive approach reflected in the original proposed statement would create new legal obligations and potential liability for financial institutions to customers, shareholders of customers, and other third parties.

Notwithstanding some residual ambiguity, the Interagency Statement comes much closer than the original proposed statement to reflecting the risk-based controls and processes that many large financial institutions have implemented in the wake of the Enron and other corporate scandals.

In response to comments from the financial institutions industry, the Agencies moved away from the highly detailed and prescriptive approach in the original proposed statement to a more risk-focused and principles-based approach in the revised proposed statement. The revised proposed statement responded to a number of specific concerns expressed by many industry commenters. First, the revised proposed statement addressed the concern that the original proposed statement was overly broad by focusing on CSFTs that present heightened legal or reputational risks ("elevated risk CSFTs"). Examples of elevated risk CSFTs include transactions that appear to a financial institution during the course of its transaction approval or new product approval process to:

- lack economic substance or business purpose;
- be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when executed at year end or at the end of a reporting period for the customer;
- raise concerns whether the customer will report or disclose the transaction in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
- involve circular transfers of risks that lack economic or business purpose;
- involve oral or undocumented agreements that would have a material impact on the regulatory, tax or accounting treatment or disclosure obligations;
- have material economic terms that are inconsistent with market terms; or
- provide the financial institution with compensation that appears substantially disproportionate to the services provided or the risks assumed.

The revised proposed statement stated that structured finance transactions that are familiar to participants in the financial markets and have a well-established track record, such as asset-backed commercial paper conduit programs and hedging-type

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transactions involving "plain vanilla" derivatives, would not be treated as CSFTs for this purpose. Second, the revised proposed statement recognized that the due diligence obligations of a financial institution that structures or markets an elevated risk CSFT to a customer are greater than those of a financial institution that acts merely as a counterparty on a CSFT. Third, as noted above, the revised proposed statement substituted a principles-based approach for the detailed and prescriptive approach contained in the original proposed statement. The revised proposed statement provided financial institutions with greater flexibility to tailor the controls and risk management procedures for CSFTs to the size, activities and general internal control framework of the institution. Fourth, the revised proposed statement expressly confirmed that it does not create any private right of action and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders, or other third parties.

The Interagency Statement carries forward each of these changes and further clarifies the application of the risk-based approach. The basic direction contained in the Interagency Statement is that a financial institution should establish policies, procedures and systems designed to identify elevated risk CSFTs as part of the institution's transaction or new product process and to ensure that transactions or new products with elevated risk are subject to heightened review, including review and approval at an appropriate management level. The Interagency Statement indicates that some institutions have established a senior management committee comprised of business executives and senior representatives of the relevant control functions to review and approve elevated risk CSFTs that are identified as requiring heightened oversight. Although such a senior management review committee is not required by the Interagency Statement, a designated review and approval process by individuals with "sufficient experience, training and stature" within the organization is required.

In adopting the Interagency Statement, the Agencies modified or clarified several points in the revised proposed statement. It was unclear from the text of the revised proposed statement whether the U.S. branch or agency of a foreign bank would be required to implement a separate U.S.-based control system in lieu of or in addition to any group-wide control system that is managed from the head office or other office of the foreign bank. The Interagency Statement clarifies that a separate U.S.-based control system is not necessarily expected, but that any group-wide system must be effective in allowing the branch or agency to manage the risks associated with CSFTs. The revised proposed statement also contained language indicating that when a financial institution's policy requires elevated risk CSFTs to be submitted to senior management for approval, the institution should maintain documentation to reflect the decision-making process, including the reasons for approval or disapproval. In response to various comments, the Interagency Statement was revised to provide that the decision-making process may be reflected in the minutes of any relevant senior management committee and may relate to the factors considered rather than a specific statement of the reasons for any particular action taken.

On the other hand, the Agencies declined to revise a warning contained in the revised proposed statement that in conducting due diligence on an elevated risk CSFT, a financial institution should carefully consider whether it is appropriate to rely on opinions or analyses prepared by or for the customer concerning any significant accounting, tax or legal issue relating to the CSFT. A comment letter from a major accounting firm had suggested that the language be changed to avoid the implication that a financial institution has some responsibility for the customer's accounting treatment of the transaction. The Interagency Statement continues to advise that it may be necessary for a financial institution to obtain specialized advice from qualified in-house or external accounting, tax or legal professionals in reviewing significant issues presented by a CSFT. In response to a request for clarification that the Interagency Statement should not be read to prevent a financial institution from proceeding with a CSFT simply because there may be some ambiguity in how a transaction might be viewed under legal or applicable accounting principles, the Agencies stated that a financial institution should have effective controls to determine whether any such ambiguity would create significant legal or reputational risk for the institution and to manage and address the risk as appropriate.

Notwithstanding some residual ambiguity, the Interagency Statement comes much closer than the original proposed statement to reflecting the risk-based controls and processes that many large financial institutions have implemented in the wake of the Enron and other corporate scandals. Heightened supervisory oversight as well as concerns for litigation risk have already combined with prudent risk management instincts to lead to more robust control processes in financial institutions that engage in complex structured finance activities. ■

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U.S. Life Insurance Securitizations: Capital Market Strategies for Funding "Excess" Reserves

by Nicholas F. Potter, John Dembeck, David D. Luce and Elizabeth K. Brill

The U.S. life insurance securitization market has burgeoned in recent years in response to a combination of heightened reserving requirements and the increasing expense, and growing capacity issues, associated with more traditional reinsurance alternatives. This innovative market solution allows life insurers access to capital markets funding for certain required statutory reserves, thus freeing capital for other uses. With the flexibility to adapt to various product reserving requirements and evolving regulatory requirements, the structure continues to garner interest among life insurers and market participants alike.

The National Association of Insurance Commissioners ("NAIC") Valuation of Life Insurance Policies Regulation, which is often referred to as "Regulation XXX" and was first adopted in 2000, sets statutory reserve requirements for level term insurance business. Similarly, Actuarial Guideline 38 sets forth reserving requirements for universal life insurance policies with secondary guarantees. The required term insurance reserves – known as XXX reserves – and universal life insurance reserves – known as AXXX reserves – are widely believed to exceed the economic reserves actually needed to fund future policy obligations.

Historically, these so-called "excess" reserves were reinsured on a coinsurance basis in traditional life reinsurance markets, usually via cessions to off-shore reinsurers collateralized by letters of credit. The reinsurance effectively released the capital associated with excess reserves by permitting the ceding insurer to take a reinsurance reserve credit on its statutory financial statements. However, U.S. bank consolidation led to fewer letter of credit issuers and consequently letters of credit became increasingly costly and concerns regarding capacity and credit exposure in the letter of credit market grew. Moreover, rating agencies recently instituted ratings policies that penalize insurers engaging in reinsurance transactions utilizing short-term letters of credit. As a result, life insurers began to explore alternative solutions, including XXX and AXXX securitizations and captive reinsurance involving long-term letters of credit.

One such alternative solution, the securitization of XXX reserves via the issuance of non-recourse debt securities in the capital markets, has become increasingly common. Though transaction structures vary somewhat

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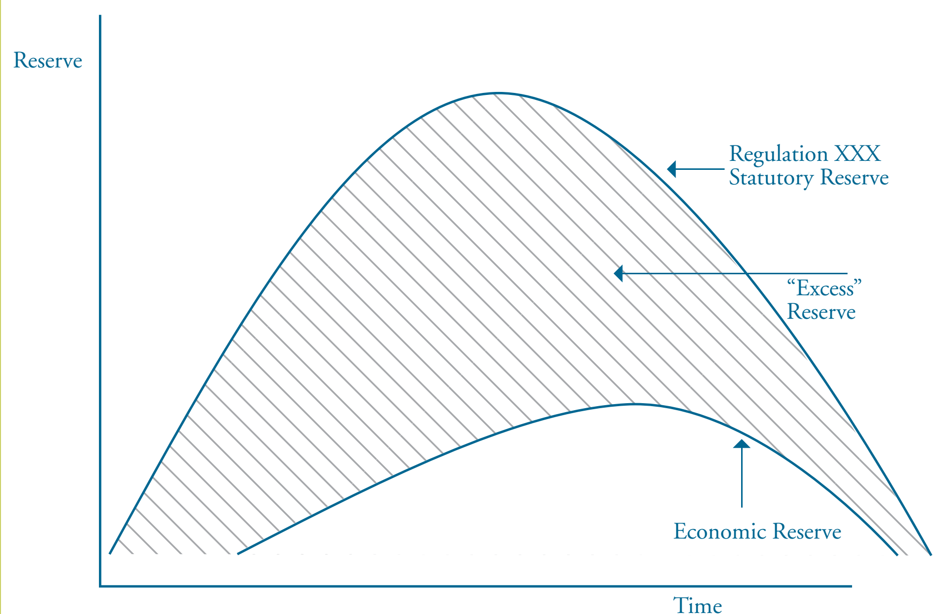
Securitization Transactions in the Insurance Industry

The recent wave of XXX and AXXX transactions are by no means the first securitization transactions in the insurance industry. Other uses of securitization structures in the insurance industry include:

- Closed block securitizations, securitizing future cash flows associated with closed blocks of life insurance business, often following the demutualization of a life insurer.
- Other embedded value financings, securitizing the embedded value of a block of life insurance business.
- Issuance of catastrophe bonds, or catbonds, transferring certain low frequency, high severity property and casualty risks to capital market investors.
- Issuance of mortality bonds, transferring catastrophic life insurance mortality risks to capital market investors.
- Securitization of variable annuity fees to finance initial new business cash strain.



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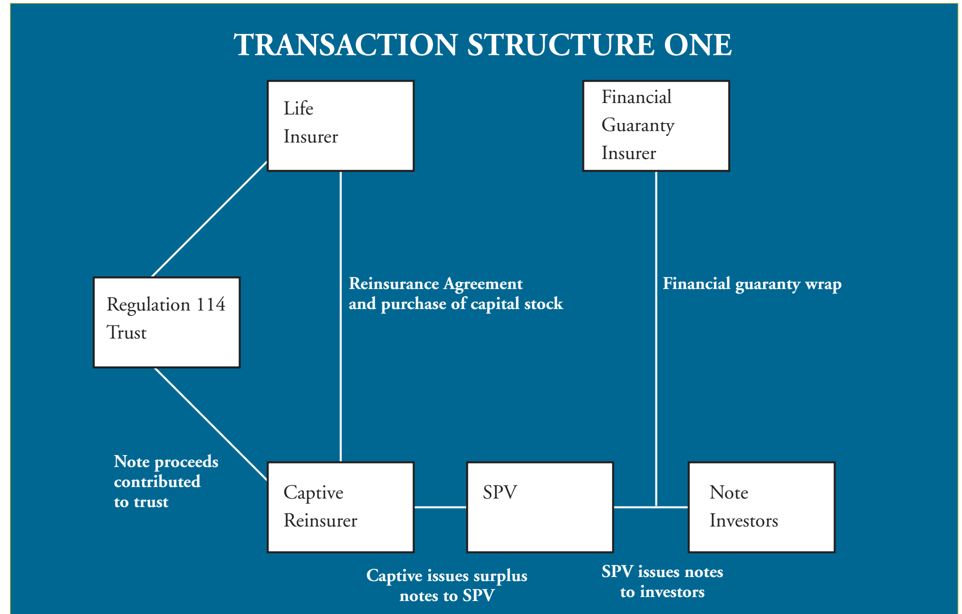
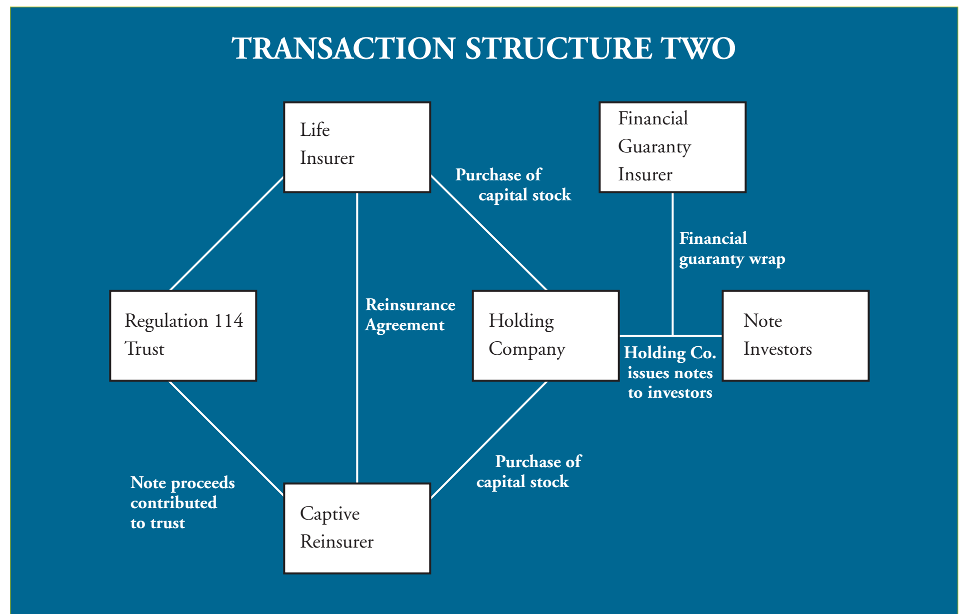
from deal to deal, XXX securitizations generally involve the formation by a life insurer of a new captive reinsurance company, generally in a "captive-friendly" jurisdiction such as Vermont or, more frequently, South Carolina. The life insurer then reinsures the excess XXX reserves to the newly-formed captive reinsurer, often via a 100% coinsurance agreement.

In one frequently used transactional structure, the captive reinsurer issues surplus notes to a special-purpose vehicle, which in turn issues notes to investors via a private offering. Approval of the captive reinsurer's domiciliary regulator is required prior to each payment of principal or interest on the surplus notes; however, no such approval is required in connection with payments on the notes sold to investors. The accompanying diagram captioned "Transaction Structure One" illustrates this structure.

In another common transactional structure, an intermediate holding company, usually organized as a limited liability company, is interposed between the life insurer and the captive reinsurer. The captive reinsurer pays dividends to the intermediate holding company. The dividends are in all cases subject to the prior approval of the captive reinsurer's domiciliary state regulator, even when they might not otherwise qualify as "extraordinary dividends" within the meaning of the state's insurance holding company laws. These dividends fund the payment of principal and interest on notes issued to investors by the intermediate holding company. The accompanying diagram captioned "Transaction Structure Two" illustrates this structure.

In both of the structures discussed above, a single beneficiary reinsurance trust, often referred to as a "Regulation 114" trust, is established so that the ceding insurer can take statutory reserve credit.[1] Any notes or





surplus notes issued in connection with the transaction are non-recourse to the ceding life insurer and therefore are treated as "operational" rather than "financial" leverage by rating agencies. Cash flows generated from investment earnings and the release of the excess reserves over time fund payments by the captive reinsurer, either in the form of payments on the captive reinsurer's surplus notes or in the form of dividends to its intermediate holding company. These payments by the captive reinsurer, in turn, fund payments of principal and interest to the ultimate investors.

To provide added credit quality, a "AAA" rated financial guaranty insurance company typically issues a financial guaranty insurance policy that "wraps" the notes issued to investors. This "wrap" provides assurance to investors that they will receive payments of

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principal and interest whether or not the captive reinsurer's domiciliary regulator approves payments on the surplus notes or dividends to the intermediate holding company. This allows the notes to be issued with a "AAA" credit rating, rather than the lesser rating the notes would otherwise carry. At least one recent transaction has included an unwrapped tranche of notes, but to date no XXX or AXXX securitization of which we are aware has gone completely without a financial guaranty.

Securitization transactions frequently have an extended time horizon, involving the issuance of debt securities with a thirty-year term (or longer), and thus can function as a long-term funding solution. Unlike traditional reinsurance, which typically involves only limited documentation and requires few if any regulatory approvals, life insurance securitizations are complex transactions involving a number of parties and regulators. Regulatory approvals typically are required in multiple jurisdictions, including the ceding insurer's state of domicile and sometimes other jurisdictions such as California and Wisconsin, which have broad statutes regulating insurance ceded by foreign licensed insurers operating in those states. One or more rating agencies generally are involved and all excess reserve securitizations to date have included a financial guaranty insurer. Apart from the often complex legal, accounting, actuarial and statistical modeling issues involved in these transactions, the sheer number of interested parties increases their level of complexity and the tactical difficulties involved in their execution. The legal issues raised by these transactions almost invariably span a variety of legal disciplines, including not only insurance and reinsurance law, but also securities, corporate, structured finance, bankruptcy and tax law. Yet, despite the high level of complexity involved, as an economic matter life insurance excess reserve securitizations have proved to be a viable alternative to traditional reinsurance for a variety of major life insurers.

In 2006, life insurers began to use this structure to securitize AXXX reserves related to certain universal life products with secondary guarantees. The reserving requirements for the secondary guarantees

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U.S. Credit for Reinsurance: REO Proposal

Regulation XXX and AXXX securitizations, and reinsurance transactions generally, are carefully structured so that the ceding insurer receives reserve credit for ceded liabilities on its statutory financial statements.

State insurance regulators are considering dramatic revisions to the long-standing U.S. reinsurance regulatory framework, and in particular the reinsurance collateralization requirements. The current regulatory framework focuses primarily on licensure of the assuming reinsurer, and in particular whether the reinsurer is licensed in the U.S. Reserve credit is available only if the assuming reinsurer is authorized or accredited in the ceding insurer's state of domicile (or, in some states, in at least one U.S. state) or the assuming reinsurer posts permitted collateral equal to 100% of the reinsurance obligations assumed. Critics argue that the current system is overly simplistic and advocate a new regime based on the risk and credit status of the reinsurer. State insurance regulators are considering a proposal called the NAIC Reinsurance Evaluation Office ("REO") proposal which would base reinsurance collateralization requirements on the rating assigned to the assuming reinsurer by a newly created centralized evaluation organization rather than licensure or accreditation of the reinsurer. The REO proposal, which was adopted by the NAIC Financial Condition (E) Committee on December 12, 2006, sets forth various rating criteria for reinsurers including the reinsurer's financial strength ratings as determined by nationally recognized statistical rating organizations, the strength of the financial solvency regulatory regime in the reinsurer's domicile, the operating history of the reinsurer, and the reinsurer's past payment history. Collateral required would range from 0% to 100% of gross liabilities ceded depending on the REO's rating of the assuming reinsurer. However, no collateral would be required for inter-affiliate reinsurance assumptions by U.S. authorized reinsurers, including inter-company pooling arrangements, or for unaffiliated assumptions by U.S. authorized reinsurers meeting certain REO ratings, capital, financial leverage ratio and claims-paying requirements. Acceptable collateral under the REO proposal consists of funds held on behalf of the ceding insurers, including funds held in a single beneficiary reinsurance trust, in the form of cash, publicly traded securities meeting certain requirements, letters of credit or other security acceptable to the REO – the same kinds of collateral permitted under the current 100% collateralization requirement.

The REO proposal could significantly impact various facets of the reinsurance market and therefore has been somewhat controversial. Issues subject to debate include: the appropriateness of a ratings-based approach to collateralization requirements; the appropriate range of collateralization percentages; the value of a U.S. license; the effect of a reinsurer's downgrade on collateralization requirements; the need for a broader reform of reinsurance regulation in addition to the revisions to the credit for reinsurance rules; the ability of ceding insurers to enforce judgments; and whether foreign trade issues are raised by the credit for reinsurance framework. No consensus has been reached on any of these issues, among state insurance regulators or the insurance and reinsurance industries.

For the REO proposal to proceed, state laws would have to be enacted, and state regulations adopted, to permit reserve credit based on ratings by the REO and lesser collateralization requirements tied to the REO ratings.

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associated with such products are similar to those required for term life insurance under Regulation XXX in that they result in "excess" reserves that can be supported by third-party borrowing via a securitization transaction.

AXXX transactions generally are structured like the XXX deals described above. However, AXXX transactions often employ a more complex coinsurance / modified coinsurance reinsurance arrangement, in which the reserves relating to secondary guarantees are reinsured on a coinsurance basis and the underlying universal life reserves are reinsured on a modified coinsurance basis. Consequently, the reserves for the secondary guarantees are held by the captive reinsurer while the underlying universal life insurance reserves are held by the ceding insurer, where they remain, to some extent, unaffected by the transaction. The captive reinsurer directly or indirectly borrows funds to support the excess AXXX reserves using the methods described above and deposits these funds in a reinsurance trust in order to support its coinsurance obligations.

AXXX securitizations present issues not raised in XXX transactions. For example, AXXX reserves involve significant investment risk, in addition to the mortality and lapse risk associated with XXX reserves. Financial guarantors and investors may not be prepared to take this risk, and therefore additional support may have to be provided to the captive reinsurer. Also, XXX reserves are limited to the level term period, typically 10-30 years, whereas AXXX reserves generally have a longer tail. While the legal structure of AXXX transactions largely mirrors that of the earlier XXX deals, the added complexity can make AXXX transactions more challenging.

Given the current state of flux in the reinsurance regulatory arena, the direction of the U.S. life securitization market in the coming years is unclear. State insurance regulators continue to work to develop a principles-based approach to reserve requirements for life insurers. In fact, the NAIC adopted an interim reserve proposal in 2006 that was specifically designed to reduce the conservative statutory reserve requirements applicable to term and universal life insurance products with secondary guarantees. The impact of a full principles-based reserving system, if and when adopted, remains to be seen. Additionally, proposed revisions to the U.S. reinsurance credit rules could also impact the life securitization market. See *"U.S. Credit for Reinsurance – REO Proposal"* on page 7 for discussion of these proposed revisions. In a XXX or AXXX transaction, the captive reinsurer typically is licensed only in its domiciliary state. Collateral is necessary for the ceding insurer to secure reinsurance reserve credit on its statutory statements. Therefore new collateralization rules could well alter the economics of securitization transactions. Nonetheless, the flexibility of the securitization structure may allow it to adapt to evolving regulatory and market constraints. Time will tell how securitizations will evolve in the coming years. ■

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[1] *These trusts are referred to as "Regulation 114" trusts because they are designed to comply with New York's Regulation 114 (11 N.Y. COMP. CODES R. & REGS., pt. 126) and similar regulations in other states, which set forth certain required criteria for trusts established to permit a ceding insurer to take statutory reserve credit. These regulations generally are based on the NAIC Credit for Reinsurance Model Regulation.*

Changes in California 1011(c) Transaction Approval Requirements

Historically, certain reinsurance, merger and other transactions have been subject to prior regulatory approval by the California Department of Insurance under California Insurance Code Section 1011(c), which applies to all insurers licensed to do business in California. Amended reinsurance credit laws and new reinsurance credit regulations became effective in California on January 1, 2007, portions of which interpret this Section 1011(c) approval requirement.

Under California Insurance Code Section 1011(c), for a foreign insurer, Commissioner consent is required to transfer or attempt to transfer substantially the entire property or business of the insurer or enter into a transaction the effect of which is to reinsure substantially its entire property in order to avoid a conservation order. Under the new California Regulations, the term "substantially its entire property or business" is defined to mean an amount of business such that the sale, cession, assumption or purchase thereof has the potential to render a company insolvent or create a hazard to its policyholders or creditors. The California Regulations then provide that a sale, cession, assumption or purchase that equals or exceeds either 75% of an insurer's total premium or 75% of its total liabilities (each of which include direct and assumed business), calculated before the subject transaction, constitutes "substantially its entire property or business" for purposes of Section 1011(c). Except if a Section 1011(c) filing is made or in the context of affiliated transactions, a licensed insurer which intends to sell, cede, assume or purchase an amount of business that equals or exceeds either 50% of its total premium or 50% of its total liabilities (each of which includes direct and assumed business) under one or more agreements with one party, must submit the proposed transaction to the California Commissioner for his examination and a determination that the transaction is not objectionable. The 50% calculation is to be made before the subject transaction. The transaction will be deemed not objectionable if the Commissioner has not objected within 90 days of receipt of the submission.

Contingent Commissions: Interim Report on Business Insurance from the European Commission

by Jeremy Hill and Christopher Henley

As a step in the European Commission's inquiry into the provision of insurance products and services to businesses in the European Community, the Commission published an Interim Report on Business Insurance on 24 January 2007. The Interim Report was based on desk research and a questionnaire-based survey of some of the major participants in the European Union insurance market. The Interim Report addresses competition in business insurance generally. We note three topics: contingent commissions, "best terms and conditions" clauses and transparency.

Contingent Commissions

The European Commission reviewed the prevalence of contingent commissions, which it defines as "payments made by insurers to intermediaries, based on the achievement of agreed targets." Contingent commissions, paid as brokerage commissions, were the subject of investigation in the U.S. beginning in 2004.

Although the European Commission specifically states that some of the responses submitted by insurers and intermediaries were not clear, the Commission concluded that there is apparently a high prevalence of contingent commission agreements in Belgium, Germany, Denmark, Spain, France, Hungary, the Netherlands and the UK, where at least 50% and in some cases up to 100% of the insurers responding indicated that they continue to operate such agreements. The Commission did comment, however, that there had been a noticeable decrease from 2004 to 2005 in the average number of insurers with whom the intermediaries had contingent commission agreements, and that this tendency is the greatest in the UK, where it may reflect the fact that some major brokers have announced that they have abandoned all or most of their contingent commission agreements.

As a step in the European Commission's inquiry into the provision of insurance products and services to businesses in the European Community, the Commission published an Interim Report on Business Insurance on 24 January 2007.

The View of the Financial Services Authority

The UK Financial Services Authority (the "FSA") is not mandating additional guidelines or action in respect of contingent commissions in addition to its more general rules.[1] All that it has done is to remind insurers and intermediaries that they must manage all conflicts properly.

"Best Terms and Conditions"

The Commission also commented on the potential impact of the "best terms and conditions" clause appearing in reinsurance contracts. A best terms and conditions clause is intended to permit a reinsurance company to benefit from the best terms available to other participating reinsurers on the contract, without specifically quoting those terms. The Commission compared this clause with what it interestingly called an "English" clause, whereby a buyer can ask its supplier to align the sale price with any better offer that the buyer can obtain. The Commission commented that this type of clause under certain market conditions might amount to a restriction of competition within the meaning of Article 81 of the Treaty of Rome, which governs agreements that distort competition. Some reinsurers have apparently argued that this clause provides uniformity of terms for the client, which is advantageous in the event of a claim, and that smaller insurers can submit offers because they would benefit from the terms of the larger insurers imposed on the market, and the clause would therefore increase market capacity. The Commission passed no comment on these justifications, of which there is no discussion of any substance at all.

Transparency

As a matter of English agency law an intermediary must disclose his remuneration when asked to do so by his client. The FSA has enshrined this principle within its rules.[2] The Commission comments that a lack of transparency reduces the potential for price competition in mediation services. There is a good prospect that the Commission will mandate the disclosure of broker remuneration. Major global insurance brokers are already doing so.

Prospects

The Commission concludes its report with a series of 13 questions upon which it will

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Contingent Commissions

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consult (on which it invites comments). In addition to the issues noted above, the questions address commission rebating, the effect on competition of long-term agreements and the extent of cooperation between insurers. There was a public hearing in Brussels on 9 February and interested parties can record their submissions by 10 April for further consideration by the Commission, which will then report further towards the end of the year. It may then legislate by Directive to rectify any issue that it considers as requiring rectification, or issue enforcement proceedings for breaches of Article 81. ■

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[1] *Insurance Conduct of Business (ICOB) Rule 2.3.2, states: "A firm must take reasonable steps to ensure that it, and any person acting on its behalf, does not: 1. offer, give, solicit or accept an inducement; or direct or refer any actual or potential business in relation to an insurance mediation activity to another person on its own initiative or the instructions of an associate; if it is likely to conflict to a material extent with any duty that firm owes to its customers in connection with an insurance mediation activity or any duty which such a recipient firm owes to its customers in connection with an insurance mediation activity."*

[2] *ICOB 4.6 states: "Before the conclusion of a non-investment insurance contract, or at any time, an insurance intermediary that conducts insurance mediation activities for a commercial customer must, if that commercial customer asks, promptly disclose the commission that he and any associate of his received in connection with the non-investment insurance contract in question, in cash terms, in a durable medium."*

NASD Enforcement Activities for Failure to Comply with AML Rules

by Paul L. Lee and Linda Lerner

A recent record fine imposed by the National Association of Securities Dealers ("NASD") is a reminder of the heightened scrutiny that the Securities and Exchange Commission ("SEC") and the self-regulatory organizations ("SROs") have brought to bear on broker-dealers for compliance with their anti-money laundering ("AML") program rules. At $3 million, the fine is the largest that the NASD has imposed to date for a violation of its AML program requirements. This is the latest and most prominent in a series of over 150 enforcement actions that the NASD has brought since January 2003 against member firms for violations of its rules governing members' AML obligations. As a result of the USA PATRIOT Act (the "Patriot Act"), similar AML rules apply to a variety of financial institutions, including insurance companies and mutual funds. Thus, the heightened scrutiny of financial regulators also has potential ramifications beyond broker-dealer firms.

The NASD found that a broker-dealer subsidiary of a major bank holding company (which neither admitted nor denied the findings) failed to obtain customer information relating to the beneficial ownership of a related group of accounts involving trusts and private investment companies domiciled in an off-shore tax haven. According to the NASD, the broker-dealer failed to obtain the information on the beneficial ownership despite repeated and ongoing requests from its clearing firm (which also pointed out circumstances that it believed could signal money laundering) and despite advice from an internal lawyer and a determination from its risk committee that such information must be obtained. The NASD also found that the broker-dealer had an inadequate compliance program for reporting suspicious transactions because the broker-dealer, which relied on its parent bank to determine whether a suspicious activity report ("SAR") would be filed, did not have sufficient procedures in place to ensure adequate communication between the broker-dealer and its parent as to whether a SAR should be filed.

As a result of the Patriot Act and its implementing regulations, registered broker-dealers are required to establish an AML program and a customer identification program ("CIP") and to report suspicious transactions to the Financial Crimes Enforcement Network ("FinCEN") in accordance with the provisions of the Bank Secrecy Act. The NASD and the New York Stock Exchange (the "NYSE") adopted rules in 2002 implementing these requirements for their member firms. AML compliance is now a prominent feature of the examination process of the SEC and the SROs.

The SEC's Office of Compliance Inspections and Examinations has reported that 33 percent of the brokerage firms inspected by the SEC and the SROs in 2006 had deficiencies in their AML programs. The top deficiencies related to independent testing of controls, CIPs, and suspicious activity monitoring and reporting. The SEC has brought only one AML enforcement action, in a case where the customer identification

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systems of the firm's outside vendor failed to operate and the firm violated its own CIP procedures by relying instead on the personal knowledge of its registered representatives to verify the identity of 2,900 customers. The NASD has sanctioned firms for a variety of AML deficiencies, including failure to adopt adequate AML procedures, to establish or implement a CIP, to identify and report suspicious activity, to obtain foreign bank certifications, to establish independent testing, to respond to FinCEN requests for information pursuant to section 314(a) of the Patriot Act, and to detect and report transactions structured to avoid the reporting obligation for cash transactions of more than $10,000. The NYSE has brought fewer than 10 AML enforcement actions since 2004 but has imposed significant sanctions in certain cases. AML review and enforcement will now be conducted by the merged NASD/NYSE regulatory entity.

SRO sanctions for failure to develop and implement an adequate AML system often are as low as $10,000, typically involving smaller firms with limited risk profiles. However, in cases involving significant or numerous "red flags", fines have been significantly higher. For example, at the end of 2005, a firm was fined $2.8 million by FinCEN and the NYSE for AML deficiencies, occurring primarily in a foreign branch, including, among other things, allegedly failing to monitor and report numerous wire journal transfers unrelated to securities transactions and with no apparent economic purpose, failing to detect a large number of apparently unrelated accounts that had the same home or business address (many of which were post office boxes or "care of" addresses) in Florida or in an off-shore financial center, and failing to have adequate AML staff. Nor are AML officers immune from sanctions. The NYSE imposed a three month supervisory suspension on an AML officer and the NASD has fined and/or suspended a number of AML officers, including a two-year suspension, for AML deficiencies (although most of these cases involved non-AML related deficiencies as well). Management in brokerage firms must understand their own exposure as well. In at least six cases in 2006 and in one case thus far in 2007, a principal of a firm was sanctioned for AML deficiencies. The sanctions included fines and suspension.

In addition to the general deficiencies in their AML programs, the NASD and NYSE enforcement actions have cited firms for specific failures to:

- have AML procedures approved in writing by senior management;
- develop and/or implement procedures to detect suspicious activity;
- file SARs and/or maintain evidence of such filing;
- document reasons for not filing SARs;
- implement procedures to prevent prohibited disclosure of a SAR filing;
- develop or implement CIP procedures;
- specify verification procedures in their CIP (reliance on representations of the registered representative has been a significant shortcoming in a number of cases);
- provide customers with notice that the firm was requesting information to verify identity;
- implement a CIP for private placement customers;
- have a written reliance agreement in place when relying on an investment adviser to perform CIP functions;
- verify reliability of third-party vendor systems used to perform CIP functions;
- designate an AML officer;
- inform the NASD of the AML officer and of changes in the AML officer contact information;
- conduct a needs analysis and continuing education program on AML; and
- document AML training.

As a result of the Patriot Act, similar AML rules apply to a variety of financial institutions, including insurance companies and mutual funds. Thus, the heightened scrutiny of financial regulators also has potential ramifications beyond broker-dealer firms.

This laundry list of AML failures should serve as a cautionary note. AML officers should carefully review their firm's AML procedures to ensure that they have been approved in writing by senior management, that all necessary compliance procedures are specified, including identification of the persons responsible for reviewing AML-related information and implementing the other required elements of an AML program, and that enhanced procedures are implemented for high-risk areas or accounts, such as for foreign branches, highly scrutinized domestic locations, foreign accounts, private banking accounts, multiple accounts of a single beneficial owner, and accounts with frequent inter-account transfers.

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These enforcement actions highlight the penalties for failing to identify or for ignoring red flags. They highlight as well the need for robust information technology systems to detect common addresses and beneficial ownership that may not be revealed by manual spot checks. Appropriate software programs must also be in place to monitor account activity and to generate exception reports or alerts that will enable analysis of unusual account activity, particularly when unrelated to securities trading. Effective AML compliance is dependent upon well designed policies, procedures and programs and robust implementation of these policies, procedures and programs. ■

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New 90 Day Receivables Rule for U.S. Insurer Affiliate Transaction Agreements Effective December 31, 2007

by John Dembeck

Affiliate transactions to which a U.S. controlled insurer is a party have long been subject to regulatory standards and oversight under state insurance holding company laws. However, a new accounting rule was adopted by the National Association of Insurance Commissioners ("NAIC") on December 11, 2006 that will affect all affiliate transactions to which a U.S. controlled insurer is a party and may require changes to existing U.S. insurer affiliate transaction agreements, such as loans, advances and services agreements. The new accounting rule will become effective December 31, 2007 and applies to all affiliate transactions, whether entered before, on or after December 31, 2007.

The new accounting rule is contained in Statements of Statutory Accounting Principles ("SSAP") No. 96 (part of the NAIC Accounting Practices and Procedures Manual) that amends Statements of Statutory Accounting Principles No. 25. SSAP No. 96 provides that receivables under an affiliate transaction agreement between a U.S. controlled insurer and its affiliate will be an admitted asset of the party to whom payment is due only if: (1) the agreement is in written form; and (2) the agreement provides for specified due dates for amounts owing. In that case, receivables 90 or fewer days past due will be an admitted asset of the receiving party while receivables over 90 days past due will be nonadmitted. However, if there is no written agreement or no due date, all uncollected receivables will be nonadmitted.

To the extent that a U.S. controlled insurer has one or more existing affiliate arrangements, such as a loan, advance or service agreement, each should be reviewed to assure that: (1) it is in writing; and (2) it includes a contractual due date for amounts due. To the extent that any affiliate arrangement is deficient, any required agreements or amendments should be prepared and executed before December 31, 2007 and, as necessary, agreements and amendments should be filed and any required insurance holding company regulatory consents or non-disapprovals should be obtained prior to December 31, 2007, such as "Form D" affiliate transaction filings.

In addition, all new affiliate arrangements, such as loans, advances and service agreements, should be drafted in a manner to assure admitted asset treatment of receivables consistent with SSAP No. 96. ■

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Opening of the Brazilian Reinsurance Market

In January 2007, Brazil published a new law that ends the state monopoly on the Brazilian reinsurance market held by IRB-Brasil Resseguros S.A., Brazil's state-owned reinsurer. This law sets forth a new regulatory framework that opens Brazil's reinsurance market to competition from private reinsurance companies, both domestic and foreign. Important aspects of the regulatory regime will be determined by regulations to be adopted by the National Private Insurance Council (*Conselho Nacional de Seguros Privados*) including, among other things, the amount of an annual underwriting maximum to be imposed on non-admitted foreign reinsurers, the precise mechanics of a limited right of first refusal that Brazilian ceding insurers must grant to reinsurers incorporated and located in Brazil, and the amount of funds that admitted foreign reinsurers must deposit as collateral with Brazilian regulatory authorities. Global reinsurers with an interest in establishing or expanding their participation in the Brazilian market should closely follow the development and implementation of these regulations. ■

Insurance Sidecars: Private Equity and Hedge Funds Are Using a New Type of Vehicle to Tap into the Reinsurance Market

by Andrew L. Sommer, Stephen R. Hertz and Michael D. Devins

As reinsurers replenished their coffers following 2005's record hurricane losses, private equity and hedge funds were a principal source of capital. A substantial portion of their funds flowed into innovative vehicles for reinsuring hurricane and other risks – reinsurance sidecars.

A sidecar is a special purpose insurer of limited duration formed to reinsure specific risks underwritten by a single reinsurer. The sidecar has none of the infrastructure normally associated with an insurance company (including employees), and instead relies on its reinsurance partner for marketing, underwriting and claims management.

From an investor standpoint, a sidecar offers a pure insurance play, typically limited to specific categories of underwriting risk (e.g., wind risk in a particular geographic location). Investors commit their capital on the expectation that their returns will be dependent entirely on the underwriting (and, to a significantly lesser extent, investment) performance of the sidecar.

There are a number of factors that have contributed to the development of the sidecar market:

Access to Management. The scarcity of management teams that are both strong and unengaged creates a limitation on the number of attractive insurance start-up opportunities. Sidecars provide a vehicle for new investment in reliance on a management team at an established insurer, without exposing investors to its historic business.

Ratings Advantage. The record hurricane losses have caused an industry-wide reassessment of catastrophe risk models, including by rating agencies. In order to maintain favorable ratings, many insurance companies have had to limit wind and other high severity exposures on their books. A properly structured sidecar allows its insurance company sponsor to underwrite a higher volume of volatile business in the sidecar without an adverse ratings impact, while sharing in positive underwriting results in the sidecar through the payment of a performance-based underwriting fee.

From an investor standpoint, a sidecar offers a pure insurance play, typically limited to specific categories of underwriting risk (e.g. wind risk in a particular geographic location).

Demand for Capital. The post-2005 contraction in capacity has made reinsureds receptive to alternative sources of coverage, including that provided by non-traditional reinsurers.

High Rates. These same market factors have led to a steep increase in reinsurance premium rates. Rates on line – the relationship between premiums and policy limits – are reportedly as high as 25 percent to 40 percent in certain risk classes, even at relatively high attachment points. The search for yield has caused a number of hedge funds that have not traditionally invested in the insurance sector to view sidecars, which offer high rates of return (on a no loss scenario) and relative liquidity, as attractive investments.

Quick Execution. Sidecars can be formed in response to dislocations in the insurance marketplace in very short order, because they do not need to recruit a management team, find office space in the very difficult Bermuda real estate market, put in place information technology systems or complete any of the myriad other tasks that face a start-up insurer. By the same token, their business can be wound down quickly.

Structuring a Sidecar

Although sidecars are customized to meet the requirements of their sponsors and investors, there are common structuring issues for all sidecars.

Corporate Form. The sidecar insurer is typically organized as a wholly-owned subsidiary of a Bermuda or Cayman company, which issues securities to investors. This permits borrowings in the holding company which can be downstreamed as equity capital to the insurer, increasing its underwriting capacity.

Market Facing or Not? As indicated above, sidecars may write reinsurance coverage for third party insurers directly on their own paper, may write retrocessional coverage for policies written on the paper of their insurance partner, or may do both. This is principally driven by commercial rather than legal considerations. Where the sidecar is a direct writer of reinsurance, it will enter into an underwriting agreement with its insurance partner, which will have the authority to bind

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the sidecar to any policy that meets prescribed underwriting guidelines.

A market facing sidecar may need to obtain a financial strength rating in order to compete for many types of business. If the sidecar simply stands behind reinsurance policies written on the paper of its insurance partner, it will enter into a quota share reinsurance policy pursuant to which it will share a percentage of the premiums and risks on each policy written by its insurance partner that conforms to the underwriting guidelines set forth in the quota share agreement.

Alignment of Interests and Adverse Selection. The sidecar's dependence on the insurance partner requires from the standpoint of the sidecar investor that the economic interests of the sidecar and its reinsurance partner are aligned with respect to the policies written by the sidecar. Without such an alignment, the sidecar could be used by the insurance partner as a vehicle for placing less profitable business or for granting an accommodation to an existing client in order to garner more favorable terms on business that will not be ceded to the sidecar. This alignment is generally accomplished in several ways.

First, the insurance partner may be required to share (generally a minority interest) in each risk written by the sidecar. The insurer may also or instead make an equity investment in the sidecar itself. Second, in the event that the sidecar is writing insurance directly, the insurance partner/underwriter should be barred from competing with the sidecar with respect to business that meets the sidecar's underwriting guidelines. Similarly, the quota share reinsurance agreement should provide that any business that meets its underwriting guidelines which is written by the insurance partner is automatically subject to sharing under the quota share, so that the insurance partner does not have the discretion to retain a disproportionate share of the most profitable business. In either event, the sidecar must receive its share of any business that meets the underwriting guidelines. Finally, the insurance partner's commissions under the underwriting agreement or quota share agreement largely will be based on the profitability of the sidecar in each policy year, and may be subject to clawback or loss carryforward provisions.

The sidecar's dependence on the insurance partner requires from the standpoint of the sidecar investor that the economic interests of the sidecar and its reinsurance partner are aligned with respect to the policies written by the sidecar.

Collateralization and Ratings

Sidecars typically write business on a fully- or highly-collateralized basis. Equity capital provided by investors and premiums paid by reinsureds are deposited into a trust account which may be used to collateralize each policy written by the sidecar up to the full limits of the policy or on a probable maximum loss basis. Alternatively, the sidecar may be permitted to fund the collateral trust with a letter of credit or financial guaranty by a creditworthy institution.

Collateral determinations will generally be driven by commercial considerations, principally the desire of the reinsured to avoid any funding risk if payment is required under its reinsurance policy. In addition, collateralization to limits may reduce an otherwise steep capital charge for rating agency purposes that would to some extent mitigate the benefit of obtaining reinsurance through the sidecar.

Exit and Distributions

Highly dependent on hedge fund capital, sidecars are designed to provide opportunities for short-term liquidity, since hedge funds are subject to investor withdrawals. This has a number of implications. First, sidecars are typically one- to three-year deals. Second, the business assumed by the sidecar generally involves low frequency "short tail" catastrophic risks, such as hurricane risk. Therefore, there is a probability of no losses during the life of the sidecar, and if a loss event occurs, the insurer knows of it immediately and quickly receives claims, permitting a reasonably informed determination of the approximate size of the loss (and the need to reserve capital) shortly after the conclusion of a policy year.

Sidecars are, however, still insurance companies, and so the ability to return capital is limited by the need for adequate reserves, including possible regulatory and ratings constraints. As a result, the interplay between reserving and collateralization requirements, including the timing and methodology for establishing reserves and releasing collateral on the one hand, and the availability of capital to be returned to shareholders on the other, is highly negotiated in most sidecar transactions.

In addition to regular dividends to investors whenever capital is available for release, many sidecars allow for early exit opportunities in the form of redemptions. Deals may provide for voluntary redemptions periodically or upon certain trigger events that would cause investors to want to cease partnership with the insurer, such as loss of license, insolvency, material breach of the transaction documents or change of control. Investors also typically

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have book value redemption rights at the end of the term of the reinsurance arrangements. This may be coupled with the right to force a commutation of the reinsurance agreement to provide for liquidity to enable the redemption. A critical mass of investors may have the right to extend the reinsurance agreement for an additional term with non-participating investors given redemption rights.

Sidecars are an innovative response to dislocations in the insurance markets caused by Hurricane Katrina and other significant loss events. Many factors will determine whether sidecars will become a fixture of the reinsurance market. The mild hurricane season this past year will mean that the first generation of sidecars will achieve very impressive financial results. On the other hand, recent legislation in Florida has allowed Citizens Property Insurance Corporation, the state-owned property reinsurer, to reduce its reinsurance rates and to expand the classes of business it is able to write. Many are predicting this will reduce reinsurance opportunities in the Florida market, one of the favored markets of sidecars, and will generally increase reinsurance capacity overall, which would potentially soften reinsurance rates beyond the Florida market and consequently dampen potential sidecar returns. Perhaps the long-term viability of sidecars will depend in large part on their evolution from a highly-customized product with attendant transaction costs to one that is more commoditized. ■

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IPOs in Korea

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reserves should be treated as liabilities of the relevant company as opposed to paid-in-capital or equity. The Committee submitted its findings and proposals to the Korea Exchange, and the Korea Exchange announced that it will draft rules relating to procedures and processes for IPOs of Korean life insurance companies, rules that will then be subject to the approval of the Financial Supervisory Commission and the Ministry of Finance and Economy before becoming effective. Although there is expected to be continued opposition, market participants seem to be in agreement that there is enough political will this time around to prevent the process from being derailed as it has so often in the past. Receipt of requisite final governmental approvals, which could come as early as this year, would clear the way for the more than 20 Korean life insurers to become public companies upon meeting the listing criteria to be set forth in the rules. ■

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Novae Group plc: Innovative Capital Raising Structure in the UK

by Jeremy Hill and Colin Scagell

On 17 May 2006, the High Court in London made an order sanctioning a scheme of arrangement pursuant to section 425 of the Companies Act 1985 whereby a new parent company, called Novae Group plc, was introduced for the SVB Group. This, however, was only one aspect of an innovative transactional structure set up to achieve a number of complementary objectives. In short, the structure had to allow fresh capital raised by means of a fully-underwritten rights issue to existing SVB shareholders to be deployed in a separate, newly-formed insurance company regulated by the UK Financial Services Authority ("FSA"). It also allowed for new shareholders to invest in the group, which would previously have been unattractive due to legacy issues resulting from SVB's historic Lloyd's book of business. Unlike other insurers' schemes, this structure did not require policyholders' consent. This article explores the key parts of the deal.

The transaction can be broken down into three component parts. Firstly, the court-approved scheme of arrangement of SVB Holdings plc, which involved preparing a circular to be sent to all SVB shareholders and instructing counsel to assist with the court process and documentation. The company and its advisers also had to consider convertible bondholders' rights in the context of the scheme and seek both FSA and Lloyd's consents. The insertion of a new listed parent company for the group thus allowed existing and new shareholders to participate in the potential for returns from both the new UK regional commercial lines entity, under the Novae brand, and at the same time provide capital for the group to continue to underwrite large, international and specialist risks in the Lloyd's market, as distinct from SVB's discontinued units from prior underwriting years. Crucial to Lloyd's approval of this structure was the understanding that reserves and funds at Lloyd's arrangements to cover historical risks would remain in place.

Secondly, in tandem with the preparation of the circular and associated formalities and approvals was the drafting of a prospectus in respect of the application of Novae Group plc to the official list of the UK Listing Authority and for its shares to be admitted to trading on the London Stock Exchange's market for listed securities. In addition, the prospectus contained the rights issue information and mechanics. As such, advisers had to work closely to coordinate a complex timetable of events that had to occur in the correct order. For instance, unlike in a straightforward rights issue there was a larger gap between the posting of the scheme circular and the prospectus (on the same day) and the issue of rights entitlements to shareholders as the new parent company could itself only become listed and begin to trade its shares on exhaustion of the court process. This had knock-on implications for the underwriting arrangements and SVB's continuing obligations to announce to the market key business figures such as its first quarter syndicate forecasts, which itself necessitated the publication of a supplementary prospectus.

Meanwhile, the third key element, the formation of the regulated insurance vehicle, Novae Insurance Company Limited, represented a further challenge to both the company and its advisers. This involved the preparation of detailed proposals, the completion of application formalities and interviews and the submission of a business plan to the FSA. This, by its nature,

In short, the structure had to allow fresh capital raised by means of a fully-underwritten rights issue to existing SVB shareholders to be deployed in a separate, newly-formed insurance company regulated by the UK Financial Services Authority.

remained at all times dependent on the timing of the fundraising exercise. Finally, it is perhaps worth noting that when Novae began underwriting its new UK regional commercial business lines in July 2006 the Group's market capitalisation had almost doubled with the injection of new funds. Arguably, this novel approach to creating such a transactional structure was instrumental in allowing a group with well-documented legacy issues at Lloyd's both to continue to use its capital to support prior years' obligations and to look forward to generating the potential for future returns for its shareholders in a new venture with a new brand name. ■

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