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Likely Legal Developments Affecting Insurers in Europe in 2011

by Christopher Henley

The financial regulation reforms announced by the UK's coalition government in June 2010 currently envisage the dismantling of the Financial Services Authority (the "FSA") and its replacement by the end of 2012 with a "twin peaks" structure of prudential regulation and conduct regulation. Prudential regulation is sub-divided into macro and micro regulation, the former focusing on systemic risk and financial stability and the latter on each individually authorised firm. The new Financial Policy Committee (the "FPC") will be responsible for macro-prudential regulation as part of the Bank of England,[1] and a new subsidiary of Her Majesty's Treasury, entitled the Prudential Regulatory Authority (the "PRA") will deal with micro-prudential regulation. Conduct (or consumer) regulation will be managed by the Consumer Protection and Markets Authority (the "CPMA"), which is intended to be "tougher and take a more pro-active approach to regulating conduct."[2] Given that the PRA will, in its conduct of micro-prudential regulation, have to apply any edicts given on a macro level by the FPC, it is not surprising that there will be a great deal of interaction between the two with not only the obvious obligation on each authority to have regard to the objectives of the other, but also seats on each board for the chief executive officer of the other, and requirements for formal consultation when making new rules. In essence, however, the PRA and the CPMA will simply divide the current role undertaken by the FSA, and many of the existing rules and guidance will be reused. The Financial Ombudsman Service, the Financial Services Compensation Scheme and the Consumer Financial Education Body, which currently operate independently of the regulator, will remain independent but will probably be responsible to the CPMA.

The fact remains, however, that the insurance industry has been given little guidance as to how its regulation will change in 2012. The Government Consultation on the Review of the Insurance Mediation Directive ("IMD") that closed in October 2010 is very focused on banking and capital markets. Insurers are likely to be regulated by both the PRA and the CPMA, with insurance intermediaries being regulated by the CPMA alone. Insurers at Lloyd's of London are concerned that they will be required to deal with three separate regulators whilst the brokers will be regulated by the CPMA alone.

In addition to the overhaul of the FSA, the European Insurance and Occupations Pensions Authority

WHAT'S INSIDE

has been established as another by-product of the financial crisis, replacing the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS"). It will be responsible for ensuring consistency in the application of the rules established by the European Union. Insurers continue to stare somewhat uncertainly at the Damoclean sword – or Gordian knot – of Solvency II, about which the European Commission is consulting on policy issues relating to Level 2 implementation measures to provide the technical detail necessary to fill out the Level 1 principles. The relevant Level 2 proposals are expected in June. Before its demise, CEIOPS greenlighted Japan, Switzerland and Bermuda as having regulatory systems equivalent to Solvency II. The US was not included, largely as a result of the fragmentation of insurance regulation by state and the current absence of federal regulation. However, the U.S. should pass muster without a full equivalence assessment given (1) the formation by the National Association of Insurance Commissioners ("NAIC")

Continued on page 11

Letter from the Editor

As this issue of the *Debevoise & Plimpton Financial Institutions Report* goes to press, signs of a slow but steady economic recovery continue to proliferate. In recent months, as balance sheets have strengthened and the capital markets have revived, many of our financial institution clients have shown a renewed interest in pursuing deals. At the same time, the regulatory landscape has changed immensely over the last year, and financial institutions around the world continue to grapple with the challenge of new and increased regulatory burdens.

Further regulatory changes remain on the horizon. We focus this issue of our newsletter on several of these potential changes. Christopher Henley of our London office describes a collection of regulatory developments that will affect insurers in Europe during the coming year. Edite Ligere, also of our London office, describes recent activities of the UK's Independent Commission on Banking that portend potentially sweeping proposals for reform of the UK banking sector later this year. In the United States, the National Association of Insurance Commissioners recently adopted a revised version of its model legislation governing insurance holding company systems. This model legislation is a linchpin of solvency regulation in the United States and plays a prominent role in acquisitions involving U.S.-based insurers. In this issue, John Dembeck and Michael McDonnell detail several important components of the new model legislation.

This month's articles only brush the surface of financial regulatory reform taking place worldwide. In Europe, the pending implementation of Solvency II is creating significant uncertainty among insurers, both inside and outside of the EU. In the United States, the rule-making process under Dodd-Frank continues at a steady pace. Meanwhile, the National Association of Insurance Commissioners, through its solvency modernization initiative, continues to explore potential regulatory reforms that extend beyond the recent changes to model insurance holding company legislation. These are only a few of the potentially significant changes that continue to be considered by policymakers.

As always, we will continue to monitor and report on these and other developments in the *Debevoise & Plimpton Financial Institutions Report* and in Client Updates. If there are topics of interest to you that you would like to see covered in future issues or in another forum, we would welcome your comments.

Nicholas F. Potter, *Co-Editor-in-Chief*

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Recent Changes to the NAIC Insurance Holding Company Model Act and Model Regulation

by John Dembeck and Michael K. McDonnell

In the wake of the financial crisis, the National Association of Insurance Commissioners (the "NAIC"), as part of its solvency modernization initiative, has engaged in a concerted effort to strengthen the ability of U.S. state insurance regulators to monitor U.S. insurance holding company groups. This effort is a natural response to the questions and criticisms that state insurance regulators faced after the federal rescue of AIG at the height of the crisis. Although the stresses faced by AIG were complex, much of the group's financial difficulty emanated from its unregulated derivatives affiliate, which conducted much of its business outside the purview of state insurance regulators. The historic focus of state insurance regulators in the U.S. has been the solvency of U.S. legal entities that underwrite insurance business, with less emphasis on the oversight of insurance groups in their entirety or on unregulated entities that do not underwrite insurance on the basis of an insurance license.

The U.S. insurance regulatory system handles group oversight through insurance holding company laws that have been enacted in some form in all of the states. These laws have traditionally given state insurance regulators the authority to review transactions involving U.S. insurers and their affiliates, as well as acquisitions of U.S. insurers, but in both cases with a focus on protecting the solvency of the legal entity authorized to underwrite insurance business, but not the group as a whole.

The NAIC's solvency modernization initiative, among other things, aims to expand the authority and focus of state insurance regulators to encompass U.S. insurance holding company systems at the group level. In the words of regulators, the aim is to adopt a "windows and walls" approach.[1] On the one hand, regulators aspire to maintain the strong system of regulatory "walls" that insulate regulated entities writing insurance business from potential financial stress. Examples of these regulatory "walls" include regulatory filing requirements for the payment of extraordinary dividends and entry into particular types of inter-affiliate transactions. On the other hand, regulators would like to have the benefit of regulatory "windows," extending across legal entities, that will permit them to understand and monitor the activities of insurance groups as a whole. As a result, during discussions of potential reform, regulators have passionately advocated changes that would give them the authority to seek and obtain information about the activities of an insurer's otherwise unregulated affiliates.

The holding company reform efforts at the NAIC culminated this past December in the adoption of significant amendments to the NAIC's Insurance Holding Company System Regulatory Act (the "Model Act") and its Insurance Holding Company System Model Regulation (the "Model Regulation"). Once enacted into law in the states, these amendments will significantly expand the scope of insurance holding company regulation in the U.S. Among other things, the revised Model Act and Model Regulation explicitly address "enterprise" risk – the risk that an activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse affect upon the financial condition or liquidity of the insurer or its insurance holding company system as a whole – and require annual reporting of potential enterprise risk as well as access to information to allow the state insurance regulator to assess such risk. The domestic state insurance regulator is also granted the power to examine affiliates of a controlled insurer to determine the financial condition of the insurer, the ultimate controlling person or the consolidated holding company system and is given new enforcement powers if an insurer fails to comply with these annual reporting or examination provisions. The amendments also address corporate governance issues, requiring a statement in the annual holding company registration statement that the insurer's board of directors oversees corporate

Continued from previous page

governance and internal controls (although an alternative formulation is that the insurer's board of directors is "responsible for and oversees" corporate governance and internal controls). The director independence requirements, included as optional provisions in the Model Act, have been amended to provide for additional exceptions and waivers. The revised Model Act and Model Regulation include many other significant amendments as well, some of which are summarized below. The purpose of this article is to explain what this development may mean to U.S. controlled insurers and persons seeking to acquire a U.S. insurer and to summarize these important changes.

Background

Model Laws and Regulations Generally; Accreditation. NAIC model laws and regulations are merely recommended laws and regulations relating to the regulation of insurance in the U.S. that become effective only when enacted into law or promulgated as a regulation in a state. Some models have been enacted in very few states and some models have been enacted in all states in some form or another. The NAIC developed a program to accredit U.S. state insurance regulators in 1990. Part A of the accreditation standards consists of confirming that a state has laws and regulations in place to address 18 key areas, one of which is holding company regulation. A state can satisfy this requirement by having a state law containing the Model Act or a substantially similar law and the Model Regulation.

Model Act and Model Regulation. Insurance holding company regulation was first introduced in the U.S. in 1969 when the NAIC first adopted the Model Act. The Model Regulation soon followed. The Model Act and Model Regulation have been amended periodically over the years. Significant amendments to the Model Act were made in 1985 in response to the failure of Baldwin-United. While some version of the Model Act and Model Regulation had been enacted in all states, there was some lack of uniformity among the states until the NAIC added the Model Act and the Model Regulation as accreditation standards in 1990. In the years that followed, most states updated their holding company laws and regulations using versions that existed in 1990 in order to satisfy the NAIC accreditation standards. All states are currently accredited by the NAIC. Hence, all state insurance holding company laws and regulations are supposed to be the same as or substantially similar to the Model Act and Model Regulation.

2010 Amendments; Accreditation Standard. In 2009, the NAIC, as part of its solvency modernization initiative following the financial crisis that began in the fall of 2008, set out to determine what additional changes were needed to insurance holding company regulation in the U.S. The NAIC polled its membership, came up with various lists of proposed amendments, discussed the proposed changes and drafted amendments. While these changes represent a recommendation by the NAIC, the NAIC may consider whether to make these changes a condition to satisfying the holding company regulation accreditation standard. This is a process that has many steps. If a decision is made to make all or part of these changes an accreditation standard, the changes will not, in the usual course, become an accreditation standard for at least 4 years from the beginning of the process. However, if all or part of these changes become an accreditation standard, that will serve as a strong inducement to each state to enact or promulgate the changes by the end of the 4-year process.

Model Act and Regulation Changes

Acquisition of Control of U.S. Insurers – "Form A" Content. The Model Act requires that a person that proposes to acquire control of a U.S. insurer file a "Form A" disclosure statement with the insurer's domestic state insurance regulator and obtain the approval of the regulator prior to completion of the transaction.

The amended Model Act makes the following additions to the "Form A" disclosure statement:

- The acquiring person must file a "Form E" (market share) pre-acquisition notification with the state insurance regulator at the time it files the Form A. (§3.A(3))
- The acquiring person must agree that it will provide an annual "enterprise risk report" on a new

"Form F" (see below) for so long as control exists. The report must, to the best of the knowledge and belief of the ultimate controlling person, identify the material risks within the insurance holding company that could pose "enterprise risk" to the acquired insurer. The term "enterprise risk" is defined to mean any activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse affect upon the financial condition or liquidity of the insurer or its insurance holding company system as a whole, including anything that would cause the insurer's Risk-Based Capital to fall into company action level as set forth in the NAIC Risk-Based Capital (RBC) Model Act or would cause the insurer to be in hazardous financial condition as defined in the NAIC Model Regulation to Define Standards and Commissioner's Authority or Companies Deemed to be in Hazardous Financial Condition. (§§3.B(12)), 4.L and 1.F)

- The acquiring person must acknowledge that it and all subsidiaries within its control will provide information to the domestic state insurance regulator upon request as necessary to evaluate enterprise risk to the acquired insurer. (§3.B(13))

The amended Model Regulation makes the following changes to the "Form A" disclosure statement:

- The Form A must disclose all affiliates of the acquiring person, including immaterial affiliates. A prior exception for an affiliate that had total assets equal to or less than 0.5% of the total assets of the ultimate controlling person has been removed. (Item 2(c)))

- Disclosure relating to an individual controlling person and a director and executive officer of the acquiring person has been clarified to include a biographical affidavit and third party background check for such an individual. As a matter of practice, most Form As already include biographical affidavits. (Item 3)
- 3-year financial projections of the acquired insurer must be included. While the prior Form A required disclosure regarding future plans for the acquired insurer, there was no express requirement that financial projections of the acquired insurer be included, although some states have, as a matter of practice, required that projections be included in the Form A. (Item 12(a))
- The acquiring person must agree to provide, to the best of its knowledge and belief, the information required by the new Form F in a confidential amendment within 15 days after the end of the month in which the acquisition of control occurs. For a list of the items to be included, see "New 'Form F' Enterprise Risk Report" below. (Item 13)

The Model Act has also been amended to add an additional sanction to accompany these new periodic reporting requirements. If the acquiring person fails to provide this information and that failure prevents the domestic state insurance regulator from having a full understanding of the enterprise risk to the controlled insurer by affiliates or by the insurance holding company, that may serve as an independent basis for the domestic state insurance regulator to (1) disapprove dividends or distributions; and (2) place the controlled insurer under an order of supervision. (§11.F)

Acquisition of Control of U.S. Insurers – Consolidated Public Hearings. The Model Act provides that a state insurance regulator must first hold a public hearing if the regulator intends to disapprove a proposed acquisition of a U.S. insurer. (§3.D(1)). The insurance holding company laws of some states vary from the Model Act on this point. In some cases, a public hearing is mandatory for every acquisition filing being considered by the state insurance regulator. The potential for a public hearing is often important to consider in planning the process and timeline for closing an acquisition of a U.S. insurer. Where an acquisition involves several insurers domiciled in different states, planning and coordinating multiple hearings can be challenging.

To mitigate the challenges involved where approvals are required in multiple states, the amended Model Act provides that the acquiring person may request a single, consolidated public hearing before all of the relevant state insurance regulators. Although helpful, this provision will only be effective if enacted into law in all

Continued from previous page

of the relevant states. In addition, the amended Model Act gives any particular state insurance regulator the power to opt out of the consolidated hearing at his or her discretion. (§3.D(2))

Registration of Controlled Insurers – "Form B" Content. The Model Act requires that each controlled insurer file an annual holding company registration statement on "Form B."

The amended Model Act makes the following additions to the "Form B" registration statement:

- If requested by the domestic state insurance regulator, the controlled insurer must include financial statements of or within an insurance holding company, including all affiliates. Financial statements may include annual audited financial statements filed with the U.S. Securities and Exchange Commission. (§4.B(5))
- The Form B must include statements that the controlled insurer's board of directors oversees corporate governance and internal controls and that the insurer's officers or senior management have approved, implemented, and continue to maintain and monitor corporate governance and internal control procedures. An alternative formulation of this provision requires a statement that the controlled insurer's board of directors *is responsible for* and oversees corporate governance and internal controls. (§4.B(7)) After significant discussion and debate among regulators and interested parties, alternative formulations were crafted so that each state would have the ability to enact the version consistent with existing state law.

The amended Model Regulation makes the following changes to the "Form B" registration statement:

- Like the Form A change, the Form B must disclose all affiliates of the ultimate controlling person, including immaterial affiliates. (Item 2)
- The new Form B removes the 10-year look-back limit for disclosure of criminal convictions for directors and officers of the ultimate controlling person. All prior criminal convictions must be disclosed. A similar disclosure requirement in the Form A is left unchanged. (Item 4)
- Any ultimate controlling person who is an individual, in lieu of audited financial statements, may file personal financial statements that are reviewed rather than audited by an independent public accountant. The review must be conducted in accordance with standards for review of personal financial statements published in the *Personal Financial Statements Guide* by the American Institute of Certified Public Accountants. (Item 8(b)) No similar disclosure alternative was added to the Form A.

Disclaimer of Control. Under the prior Model Act §4.K, a person could "disclaim" affiliation with another person (a person is deemed to control another person by owning 10% or more of the other person's voting securities) by making a filing with the domestic state insurance regulator and, upon filing, was relieved from any duty to register or report under Model Act §4 relating to the registration of insurers. The domestic state insurance regulator could disallow the disclaimer following notice and an opportunity to be heard.

> Once enacted into law in the states, these amendments will significantly expand the scope of insurance holding company regulation in the U.S.

Under the amended Model Act §4.K, relief from the registration duty is not automatic on filing. Following the filing of a disclaimer, the domestic state insurance regulator will have 30 days to disallow the disclaimer. If the domestic state insurance regulator disallows the disclaimer, the disclaiming person may request an administrative hearing. If the domestic state insurance regulator fails to disallow the disclaimer within the 30-day period, the disclaimer will be deemed to have been granted and the disclaiming person will be relieved from any duty to register under Model Act §4 relating to the registration of insurers.

Divestiture of Control. In an amendment put forward by the Pennsylvania Insurance Department, if a controlling person seeks to divest its controlling interest in a domestic insurer and does so in a manner that does not require any person that acquires the voting securities to file a Form A, the divesting person must give at least 30 days prior notice of the proposed divestiture to the domestic state insurance regulator prior to the cessation of control. The domestic state insurance regulator must then determine those instances in which the divesting person or acquiring person will be required to file for and obtain approval of the transaction. (§3.A(2))

This amendment was prompted by a dispute between the Pennsylvania Insurance Department and a company, Kingsway, that disposed of its interest in a Pennsylvania controlled insurer by distributing 5% of its voting securities to each of 20 charities. See "U.S. Insurance Holding Company Litigation: Kingsway and the Pennsylvania Insurance Department" in our *Financial Institutions Report*, Volume 4, Number 5, May 2010. It is unclear how this divestiture provision is intended to be implemented. See "U.S. Insurance Holding Company Model Law Amendment Resulting from Kingsway" in our Financial Institutions Report, Volume 4, Number 6, June 2010. Further confusion has been added by an amendment to Model Act §3.F(2) which provides that it is a violation to effect a divestiture of a domestic insurer unless the domestic state insurance regulator has given approval. This seems at odds with new Model Act §3.A(2) which mandates a notice filing but not a regulatory approval. Needless to say, if a person seeks to divest control of a controlled insurer domiciled in a state that enacts this statutory wording in a transaction in which no person must file a Form A acquisition of control application (such as an initial public offering), it may be prudent to seek guidance from the domestic state insurance regulator on how the divestiture should proceed.

NAIC Rejected as a Central Repository for "Form A" and "Form B" Filings. Under the Model Act, Form B and Form D filings are confidential and not subject to disclosure under state public disclosure laws. Form A filings are not so protected. Under the amended Model Act, new Model Act §3.B(12) and (13) items are also protected from public disclosure. (§8.A) The NAIC rejected a controversial proposed change to require that Form A and Form B filings also be filed with the NAIC. Many industry observers expressed concern that state law protections against public disclosure could be lost if documents were filed with the NAIC.

Instead, in contemplation of information sharing between state insurance regulators and the NAIC, the existing information sharing provisions of the Model Act were amended to provide that (1) the existing authority of the state insurance regulator to share documents with the NAIC or other regulators require that the recipient agree in writing to maintain confidentiality and verify in writing its authority to maintain confidentiality; (2) an existing exception to information sharing by means of a confidentiality agreement has been eliminated; (3) sharing information with another state insurance regulator relating to the new Form F enterprise risk filing (see below) is permitted only if the laws or regulations of that state are substantially similar to Model Act §8.A and the regulator agrees in writing not to disclose the information; (4) the state insurance regulator must enter into a written confidentiality agreement with the NAIC that meets certain minimum standards, including that ownership of the information remains with the state insurance regulator and prompt notice be given to an insurer if information held by the NAIC is requested or subpoenaed. (§8.C)

Affiliate Transaction Standards and "Form D" Filings. Under the Model Act, affiliate transactions to which the controlled insurer is a party are subject to prescribed standards and certain such affiliate transactions must be submitted in advance to the domestic state insurance regulator on "Form D." The amended Model Act and Model Regulation make the following changes to these standards and Form D:

- *Cost Sharing and Management Agreements.* Cost sharing agreements and management agreements must include provisions prescribed by regulation. (5.A(1)(b)) The amended Model Regulation adds 13 minimum requirements for cost sharing agreements and management agreements, including, among other things, that the agreement must, as applicable, (1) set forth the methods to allocate costs; (2) require timely settlement, not less than quarterly, and compliance

Continued from previous page

with the NAIC's Accounting Practices and Procedures Manual; (3) prohibit advancement of funds by the controlled insurer to the affiliate except to pay for defined services; (4) specify that all funds and invested assets of the insurer belong exclusively to the insurer and are subject to the insurer's control; (5) include standards for termination with and without cause; (6) include provisions for indemnification of the insurer in the event of gross negligence or willful misconduct on the part of the affiliate providing the services; (7) specify that the affiliate has no automatic right to terminate the agreement if the insurer is placed in receivership; and (8) specify that the affiliate must continue to maintain any systems, programs, or other infrastructure notwithstanding a seizure by the state insurance regulator, and will make them available to the receiver, for so long as the affiliate continues to receive timely payment for services rendered. (§19.B)

• *Affiliate Agreement Amendments.* All amendments or modifications of affiliate agreements previously filed on Form D must themselves be filed on Form D. This change may codify what is already the administrative practice of some state insurance regulators. Any such notice must include the reasons for the change and the financial impact on the domestic insurer. (§5.A(2))

• *Termination of Affiliate Agreements.* If an agreement previously filed on Form D is terminated, informal notice must be reported within 30 days to the domestic state insurance regulator for determination of the type of filing required, if any. (§5.A(2))

• *Reinsurance Pooling Agreements.* All reinsurance pooling agreements are subject to filing on Form D without regard to the materiality of the transaction to the controlled insurer pooling affiliate. (§5.A(2)(c)(i))

• *Other Reinsurance Agreements; Materiality Threshold.* The prior Model Act required a filing on Form D for reinsurance agreements in which the reinsurance premium or a change in the insurer's liabilities equals or exceeds 5% of the controlled insurer's surplus as regards policyholders, as of the prior December 31. Since the materiality of a reinsurance agreement may not be known on inception but over time, the amended Model Act changes this requirement to include any such reinsurance agreement in which the *projected* reinsurance premium or a change in the insurer's liabilities in any of the next three years equals or exceeds the 5% threshold. (§5.A(2)(c)(ii))

• *Tax Allocation Agreements.* All tax allocation agreements are subject to filing on Form D. (§5.A(2)(d))

• *Form D Contents.* Under the Model Act, all affiliate transactions must be fair and reasonable. The amended Model Regulation requires that the Form D include a statement of how the transaction meets this standard. (Item 2(c)) In addition, the amended Model Regulation requires that the Form D disclosure for cost-sharing agreements include (1) a brief statement as to the effect of the transaction upon the controlled insurer's policyholder surplus; (2) a statement regarding the cost allocation methods that specifies whether proposed charges are based on "cost or market" and, if market-based, a rationale for using market instead of cost, including justification for the insurer's determination that amounts are fair and reasonable; and (3) a statement regarding compliance with the NAIC Accounting Practices and Procedure Manual regarding expense allocation. (Item 6(e)-(g))

"Form E" Preacquisition Notification Form. The Model Act requires that a person acquiring control of an insurer in a non-domestic state file a pre-acquisition notification form on "Form E" if the acquisition has a certain potentially anti-competitive effect. Form E requires submission of certain market share data. The amended Model Regulation requires that (1) the Form E provide a determination whether the proposed acquisition would violate the competitive standards of the state as stated in the Model Act; and (2) if the proposed acquisition would violate competitive standards, the Form E provide a justification of why the acquisition would not substantially lessen the competition or create a monopoly in the state. (Item 5) This additional disclosure probably makes express the kind of information often provided in a Form E to convince a state insurance regulator that the transaction does not have an anti-competitive impact in the state.

New "Form F" Enterprise Risk Report. The amended Model Act and Model Regulation each require that the ultimate holding company

Continued from previous page

of an insurer subject to registration (on "Form B") file an annual enterprise risk report on a new "Form F." (§§4.L and 20) The Form F must be filed with the lead state insurance regulator of the insurance holding company as determined by the Financial Analysis Handbook adopted by the NAIC.

The Form F requires that the ultimate controlling person, to the best of its knowledge and belief, provide the following information regarding enterprise risk that is not disclosed in the Form B registration statement: (1) any material developments regarding strategy, internal audit findings, compliance or risk management affecting the insurance holding company system; (2) acquisition or disposal of insurance entities and reallocating of existing financial or insurance entities within the insurance holding company system; (3) any changes of shareholders exceeding 10% or more of voting securities; (4) developments in various investigations, regulatory activities or litigation that may have a significant bearing or impact on the insurance holding company system; (5) business plan of the insurance holding company system and summarized strategies for the next 12 months; (6) identification of material concerns of the insurance holding company system raised by a supervisory college, if any, in the last year; (7) identification of insurance holding company system capital resources and material distribution patterns; (8) identification of any negative movement, or discussions with rating agencies which may have caused, or may cause, potential negative movement in the credit ratings and individual insurer financial strength ratings assessment of the insurance holding company system (including both the rating score and outlook); (9) information on corporate or parental guarantees throughout the holding company system and the expected source of liquidity should such guarantees be called upon; and (10) identification of any material activity or development of the insurance holding company system that, in the opinion of senior management, could adversely affect the insurance holding company system. (Form F, Item 1)

Management of Controlled Domestic Insurers. The Model Act includes optional provisions, to be included at the discretion of each state, relating to the management of a controlled domestic insurer. (§5.C) Among these are the following provisions relating to the composition of a controlled domestic insurer's board of directors and board committees:

- *Required Independent Directors (Unchanged).* At least one-third of the directors and each board committee of the domestic insurer must be independent – persons who are not officers or employees of the insurer or of any entity controlling, controlled by, or under common control with the insurer and who are not beneficial owners of a controlling interest in the voting stock of the insurer or entity. At least one independent director must be included in any quorum for the transaction of business at any meeting of the board of directors or any board committee of the domestic insurer. (§5.C(3))
- *Required Committee of Independent Directors (Amended).* The board of directors of the domestic insurer must establish one or more board committees comprised solely of independent directors which has responsibility for nominating candidates for director for election by shareholders or policyholders, evaluating the performance of officers deemed to be principal officers of the insurer and recommending to the board of directors the selection and compensation of the principal officers. The term "principal officers" is undefined. (§5.C(4)) This provision has been amended to no longer require this board committee to recommend the selection of independent certified public accountants, review the insurer's financial condition, the scope and results of the independent audit and any internal audit.
- *Exceptions (Amended).* These requirements do not apply to a domestic insurer if the person controlling the insurer has a board of directors and board committees that satisfy these requirements. (§5.C(5)) This provision has been amended to provide examples of two such controlling persons: a mutual insurance holding company and a publicly held corporation.
- *Waiver (New).* A new provision has been added which provides that an insurer may make application to the domestic state

insurance regulator for a waiver from these requirements (1) if the insurer's annual direct written and assumed premium, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, is less than $300 million; or (2) based upon unique circumstances (in which case the domestic state insurance regulator may consider various factors including the type of business entity, volume of business written, availability of qualified board members, or the ownership or organizational structure of the entity). (§5.C(6))

Significant discussion was given to these management provisions, including potentially making the provisions mandatory rather than optional. Ultimately, however, since only a small subset of states had enacted the optional provisions included in the Model Act, the NAIC decided that these provisions should remain optional.

Examinations of Affiliates. The Model Act has been amended to extend the authority of a domestic state insurance regulator over affiliates of the controlled insurer for the purpose of determining compliance with the provisions of the Model Act – empowering the regulator to examine such an affiliate to ascertain the financial condition of the insurer, or the enterprise risk posed by the ultimate controlling person, other affiliates or the insurance holding company on a consolidated basis and to order an insurer to produce information not in its possession if it can obtain access to the information pursuant to existing contractual relationships, statutory obligations or other method. If the insurer fails to comply with such an order, the domestic state insurance regulator may examine the affiliate to obtain the information and issue subpoenas for the purpose of effecting compliance. In addition, if an insurer claims that it cannot provide information requested, it must provide a detailed explanation. If the regulator believes the explanation is without merit, the regulator may, after notice and a hearing, impose a daily fine or suspend or revoke the insurer's license. (§§6.A, B and E)

Supervisory Colleges. The amended Model Act includes a new provision authorizing a state insurance regulator to "participate in a supervisory college for any domestic insurer that is part of an insurance holding company system with international operations in order to determine compliance by the insurer" with the state's insurance law. (§7.A) Although the amended Model Act makes clear that this authorization is not intended to delegate the state insurance regulator's basic regulatory authority and jurisdiction to the supervisory college, the role and potential activities of the college are loosely defined and potentially broad in scope. Among other things, the participation of a state insurance regulator in a supervisory college may include the following:

- the establishment of a group-wide supervisor for an insurance holding company system (§7.A(3));
- the establishment of a crisis management plan (§7.A(5));
- participation, together with other state, federal and international regulatory agencies, in examinations of an insurer in order to assess "business strategy, financial position, legal and regulatory position, risk exposure, risk management and governance processes" (§7.C);
- information sharing with other regulators (§§7.A(4) and 7.C); and
- entering into agreements to provide a "basis for cooperation between the [state insurance regulator] and other regulatory agencies" (§7.C).

The amended Model Act specifies that the relevant insurer must pay the "reasonable expenses" of a state insurance regulator's participation in a supervisory college (including travel). If the supervisory college is convened as a "permanent forum for communication and cooperation between the regulators," then the state insurance regulator is authorized to establish a "regular assessment" for the payment of these expenses. (§7.B)

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1. See, for example, the presentation of the NAIC's Group Solvency Issues (EX) Working Group that can be found at www.naic.org/documents/frs_financial_summit_presentation_2010_group_issues.pdf.

Continued from page 1

of its Solvency Modernization Initiative Task Force (one of whose objectives is group supervision) and the NAIC's recent adoption of a revised model holding company law and regulation, (2) the Federal Insurance Office under the Dodd-Frank Wall Street Reform and Consumer Protection Act and (3) the letter written by the European Commission to CEIOPS confirming its wish for a transitional regime (with a limited period) for those countries not included in the first wave of equivalence ratings. The key criteria are that the country under review (1) has a substantive risk-based system of regulation and (2) is committed to moving towards a system equivalent to Solvency II. The deadline for assessment will be September 2011.

Solvency II also required the European Commission to revise the IMD by the end of 2010 but this review is still in progress and any revised text is not expected until later this year, following the results of a consultation scheduled to close on 28 February. This revised text would address the inconsistencies between Member States in their implementation of the IMD and is intended to produce a level playing field between brokers and insurers, with the possible introduction of a mandatory requirement of commission disclosure to customers.

Specific to Britain are two pieces of legislation. The first piece of legislation is the Bribery Act 2010 (which was scheduled for implementation by April 2011 but has now been further delayed pending review). The Act creates four new offences, with extreme penalties including 10 years in prison and unlimited fines, complementing the accelerating activities of the Serious Fraud Office in this area (although even this body may be replaced by the new Economic Crime Agency). There are three issues of particular significance with regard to this legislation: (1) the extra-territorial range of the Act, (2) the harshness of the Act given that the option for "facilitation payments" allowed by other jurisdictions does not exist, and nor is it possible to rely on the fact that the payment or gift was a reasonable and bona fide expenditure, both of which safe harbours are permissible under the U.S. Foreign Corrupt Practices Act and (3) the strict liability corporate offence of failing to prevent bribery, the only defence to which is that the company has adequate procedures in place to prevent bribery. The impact of this Act in relation to remuneration arrangements with brokers should be considered. Liability and D&O insurers should take particular note.

The second piece of legislation specific to Britain is the Third Parties (Rights Against Insurers) Act 2010, which should come into force in April 2011 following a review by the UK's coalition government of Labour Party-led legislation. This Act should make it considerably easier and less expensive for third parties to pursue insurers of insolvent insureds by (1) widening the definition of "insolvent," (2) providing creditors with greater access to information, (3) removing the need to establish liability against the insolvent insured and (4) eliminating the requirement of restoring an insolvent company to the companies register. An insurer may rely upon any defence available to its insured except that (1) a failure to notify its insurer or provide it with continuing information or assistance is no longer an absolute defence and (2) "pay first clauses" cannot be relied upon.

Finally, there are also at least two court cases which may have considerable impact on the insurance industry. The first is the decision of the Court of Appeal in *Safeway Stores Limited v Twigger.* [3] In that case, Safeway paid a fine imposed by the Office of Fair Trading for allegedly fixing dairy prices and then sued some of its directors to recover the fine as damages for their alleged negligence, which would therefore be recoverable by the directors against the Directors and Officers Insurance policy.The Court of Appeal decided in favour of the directors and held that the fine imposed on Safeway was personal to the company and could not be recovered from the directors. The second court case is the opinion of the Advocate General of the European Court of Justice in the test case, *Association Belge des Consommateurs Test-Achats ASBL.*[4] In that opinion, the Advocate General stated in effect that taking gender into account as a risk factor is incompatible with the basic principles and fundamental rights of EU law which require equal treatment for all. This opinion is not binding on the European Court of Justice but if followed – and such opinions usually are – it may change insurance pricing fairly radically.

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1. "Just as the role of a central bank in monetary policy is to take the punch bowl away just as the party gets going, its role in financial stability should be to turn down the music when the dancing gets a little too wild." Speech by Mervyn King, Governor of the Bank of England, 16 June 2010.
2. Statement to the House of Commons by the Financial Secretary to the Treasury, Mark Hoban MP, on Reforming the Institutional Framework for Financial Regulation, 17 June 2010.
3. [2010] EWCA Civ 1472.
4. C-236/09.

Is a Shake-up of the UK's Banking Sector Inevitable?

by Edite Ligere

On 22 January 2011, Sir John Vickers, the Chairman of the UK's Independent Commission on Banking ("ICB"), in his address to the London School of Business, proposed various structural reforms to the UK's banking sector designed to promote its stability and competitiveness. The markets reacted with a fall in the UK's bank share prices as the spectre of a potentially imminent shake-up of the UK's banking sector loomed over the City of London.

By way of background, the ICB was established by the UK's coalition government in June 2010 as an independent body entrusted with the not inconsiderable task of examining the structural and related non-structural measures that would help to:

(1) reduce the probability and impact of systemic financial crises in the future;

(2) maintain efficient flow of credit to the real economy; and

(3) preserve the functioning of the payments systems and guaranteed capital/liquidity certainty for ordinary savers.

While the ICB's remit is limited to UK banking, its work is in line with international work on systemically important financial institutions. The ICB is in dialogue with financial and competition regulators internationally and will submit its recommendations to the UK's coalition government in September 2011. Sir John's speech on 22 January 2011 provided an insight into what these recommendations may be.

The ICB's Work

There are two main differences of emphasis between the ICB's work and that of most other recent financial stability promoting initiatives. The first is its focus on competition as well as stability. The second is the UK's coalition government's request for the ICB's views on possible structural reforms, including forms of separation between retail and investment banking. "*Retail banking*" in this context means not just payment services and deposit facilities, but also mortgage lending and lending to small and medium sized businesses. "*Investment banking*" refers to wholesale and investment banking services including lending and operational services to large corporations as well as trading and other capital markets related activities. The ICB recognises that both types of banking carry risk and that the boundaries between the two are often fuzzy.

The Highlights from Sir John's Speech

In short, Sir John highlighted the paradox of the recent financial crisis in which "senior debt-holders generally came out whole as taxpayers rode, or were ridden, to the rescue…despite the state of public finances, fear of the consequences of senior debt-holders coming out less-than-whole forced taxpayers to jump the queue of loss-absorbency and become the main buffer to absorb the losses of the banks." This seems to have been largely due to the fact that banks "felt that they were compelled to shield senior debt-holders for fear of what would happen if they did not, which is not how things should be". Sir John pointed out that currently "we are in a position where all senior debt-holders are de facto fully covered, at least in systemic crises if the public finances can bear it."

One of the roles of financial institutions and markets is efficiently to manage risks. Sir John emphasised the fact that "their failure to do so and indeed to amplify rather than absorb shocks from the economy at large has been spectacular. Rather than suffering a perfect storm we had severe weather that exposed a damagingly rickety structure."

The Merits of "*Ring-Fencing*"

A response to the concerns above could be somehow to "ring-fence" the retail banking activities of systemically important institutions and require them to be capitalised on a stand-alone basis. Such ideas meet objections, however, both about practicability (especially if adopted without international agreement) and desirability. Sir John was generally in favour of segregation but recognised that separated capital pots may result in sub-optimal capital allocation across different types of lending. He welcomed further analysis of the efficient use of capital and how it might be affected by alternative ways of regulating the capital and corporate structures of banks.

It is worth bearing in mind that growth in UK bank leverage in the run-up to the recent financial crisis was explosive. From 2000, UK bank leverage rose to 30 times and beyond. The capacity of their liability structures, beyond equity, to absorb losses was poor and balance sheets often proved brittle. Sir John posed the question whether the potential loss absorbency of bank debt can credibly be restored and said that "it might be a useful first step to make insured retail deposits senior to, rather than on a par with, other senior debt-holders, in the creditor pecking order, but that would not in itself be enough."

It is generally accepted that equity is better able to absorb loss than debt. Basel III for the international banking sector and Solvency II for the European insurance and reinsurance sectors seem to endorse this view.

However, equity is comparatively expensive to debt and in Sir John's words: "equity holders may be especially reluctant to issue fresh equity when, as in times of stress, much of the benefit accrues to bondholders". Sir John recognised the fact that there was no easy solution to the problem of ensuring that systematically important banks hold equity capital whilst at the same time ensuring that equity holders are not penalised to the benefit of debt holders and welcomed ideas from businesses and other stakeholders.

Many from within the UK banking sector believe that universal banking allows for diversification of risk, allowing for the universal bank to offset the probability of a high risk event being realised against the capital and reserves of low risk activities. Sir John's answer to this was that:

"universal banking has the advantage that a sufficiently profitable or well-capitalized investment banking operation may be able to cover losses in retail banking. But it has the disadvantage that unsuccessful investment banking may bring down the universal bank including the retail bank. In shorthand… retail banking is safer with universal banking than with separated banking if and only if the probability that the investment operation saves the retail operation exceeds the probability that the investment operation 'sinks' the retail operation."

Sir John accepted that, at present, his address "contained more questions than answers, as is appropriate at this stage of the ICB's work" and concluded by saying that:

"It cannot be disputed that banks of systemic importance need much more loss-absorbing capacity than they had a few years ago, and to be much more easily resolvable. There is a wide range of views on how much more loss-absorbing capacity is appropriate for different kinds of institution, and on how to achieve it by equity, contingent capital, etc. The first general question is whether, and if so how, structural reform of systemically-important institutions might affect appropriate levels of loss-absorbing capacity. If the probability and/or impact of bank failure particularly of retail service provision can be reduced by forms of separation between banking activities, then so too might capital requirements. If so, the case for structural reform might be greater the higher is the cost of bank capital. The second general question is whether, and if so how, forms of structural separation might enhance the credibility and effectiveness of resolution schemes. The observation is that, if forms of separation were thought desirable in terms of public policy, there would be the further question of whether they should be required of the institutions concerned, or incentivised, for example by appropriately different capital requirements for different business models. Riskier structures need deeper foundations."

The proposals put forward by the ICB are not wholly dissimilar from the so-called "Volcker Rule" in the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 which, by amending the Bank Holding Company Act of 1956, imposes a general prohibition on certain systemically important banking entities and their affiliates and subsidiaries from: (1) engaging in proprietary trading; and (2) acquiring or retaining any ownership interest in, or sponsoring of, a hedge fund or a private equity fund.

Credible Recovery and Resolution Tools

Sir John called for the development of credible recovery and resolution tools and recognised that much work is under way in the UK and internationally to tackle this problem. The resolvability of global investment banking operations is a particular challenge, and of heightened importance to the UK given the scale of bank balance sheets relative to the UK's GDP. He proceeded to say that: "credible resolution would seem to require at least some form of separability, and arguably there is a case for some form of ex ante separation so that bank operations whose continuous provision is truly critical to the functioning of the economy can clearly be easily and rapidly carved out in the event of calamity. But perhaps the credibility of resolution plans can be ensured otherwise than by forms of separation, and the benefits of creating such options would of course need to be weighed carefully against costs they impose."

Reaction from the UK Banking Sector

The reaction from the UK's banking sector to the ICB's proposals has not been optimistic. It is generally thought that any form of "ring-fencing" or subsidiarisation is likely to be costly not only in terms of organisational cost but perhaps more importantly in terms of creating "separate capital pots." More retail-orientated UK banks, for example, Lloyds, would likely feel only minimal pain. However, for the majority of UK banks, the idea of splitting retail from investment banking is abhorrent, mainly because the health of one is very often dependent on the other.

Bob Diamond, the new chief executive of Barclays, recently told Members of the UK Parliament that subsidiarisation would not make the UK banking system safer and could, in fact, impact the bank's ability to lend given that around 80% of Barclays profits are generated by its investment bank, Barclays Capital. In Mr. Diamond's opinion: "we have to focus much more on what the implications are in terms of funding. There would be a significant increase in the funding levels for a firm modelled such as Barclays, and that has implications in terms of the capacity for lending as well as the price of lending." He also stressed that Northern Rock failed despite being a pure retail bank, while Barings went bust in the 1990s notwithstanding its subsidiarised structure.

House of Commons Treasury Committee's Preliminary Report on the UK's Coalition Government's Proposals for Financial Regulatory Reform

On 3 February 2011, the UK's House of Commons Treasury Committee (the "Committee") published its preliminary report on the UK's coalition government's proposals for reform of financial regulation in the UK. The Committee's recommendations are that the government should:

(1) take time to get its reform of financial regulation right;

(2) fully consider the conclusions of the ICB before reaching a final view on financial regulatory reform in the UK; and

(3) not publish a new bill to replace the Financial Services and Markets Act 2000 until after full and careful consideration of the responses to the government's initial consultation.

Conclusion

It seems reasonably clear that the ICB is contemplating recommending some form of separation between the retail and investment operation of systemically important banks to ensure that the investment side of a systemically important bank is less likely to have a debilitating effect on its generally less risky retail operations. At this stage, Sir John's speech merely serves to illustrate the general direction in which the ICB may be heading. However, on a practical level, given the lack of any draft legislation or other details, at present, the apparent uncertainty of the shape of things to come has increased anxiety within the UK banking sector. It is anticipated that a greater level of detail about the ICB's proposals will emerge when the ICB publishes its interim report in April 2011. This will be followed by a further round of consultation ahead of the publication of the ICB's final recommendations to the UK's coalition government in September 2011.

The additional, but at this stage hard to quantify, consideration is the extent of internal disagreement within the UK's coalition government on banking reform. Sir John's report was jointly commissioned by the Conservative Chancellor of the Exchequer George Osborne and the Liberal Democrat Business Secretary Vince Cable. The two are believed to have differing views over banking reform, reflecting the attitudes of their parties, with Cable favouring a deeper division between retail and investment operations. Further, it would appear that the majority of political opinion in the UK is still against the banking sector. Therefore, it is possible that disagreements within the UK's coalition government may mean that uncertainty will remain over banking reforms, even after the ICB's conclusions are published in September 2011.

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