HFW

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1. REGULATION AND LEGISLATION

UK: PRA warning to run-off firms planning capital extractions

In April, the PRA published a "Dear CEO" letter reminding firms about the PRA's expectations when a firm in run-off is preparing a request for a capital extraction.

The PRA's letter states that the quality of the information supporting some requests has been *"inadequate"*. In particular, information relating to stress tests and reserving has not met the PRA's expectations, causing *"delays in the PRA's assessment, and inefficient use of resources."* The letter reminds firms to consider Supervisory Statement 4/14[1] when preparing requests.

In our experience, the PRA has been reluctant to permit firms in run-off to extract capital, even where capital projections suggest that the firm will have no trouble meeting capital requirements following the extraction.

We think the PRA's letter can be read in a number of ways. Taken at face value, the letter is clearly a reaction to requests for capital extraction which have been accompanied by poor supporting evidence, and have caused the PRA unnecessary work at what is undoubtedly a busy time for the regulator.

However, the letter could also be a way of managing firms' expectations as to the PRA's reluctance to approve extractions, by emphasising that a relatively high bar must be met before the PRA will approve a capital extraction.

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1 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2014/ss514.pdf

UK: LMA publishes Brexit Binding Authority sunset endorsement

The Lloyd's Market Association (LMA) has published a Brexit Binding Authority Sunset Endorsement. The clause is designed to help with the transition of European binding authority business from the UK to Lloyd's new subsidiary in Brussels, in preparation for Lloyd's managing agents losing their permission to write EEA business as a result of Brexit.

As explained in Lloyd's Market Bulletin Y1566[1], Lloyd's expects all EEA risks to be written on behalf of its Brussels subsidiary from 1 January 2019. In the Market Bulletin, Lloyd's requests that either all binding authorities covering EEA business be terminated with effect from 31 December 2018, or coverholders be instructed not to bind any EEA business under those binding authorities after that date.

The LMA's sunset endorsement is consistent with the second option, and prohibits the binding of business after 31 December 2018 if the business has an EEA regulatory risk location. The endorsement is designed to be used in any binder which terminates after 31 December 2018 and has a territorial scope which includes EEA business. A copy of the endorsement can be found at: http://www.lmalloyds.com/LMA/News/LMA_bulletins/LMA_Bulletin_2013/LMA18_022_TH.aspx

Although Lloyd's and other (re) insurance businesses are preparing for Brexit, their preparations are being made more difficult by not knowing the answers to some important questions on the future relationship between the UK and the EU. We have recently published a briefing on these questions and their impact on (re) insurance businesses. The briefing can be found at: http://www.hfw.com/Insurance-and-reinsurance-Brexit-considerations

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1 https://www.lloyds.com/~/media/files/the-market/communications/market-bulletins/2018/03/y5166.pdf

UK: The Financial Conduct Authority's (FCA) consultation on Financial Services Compensation Scheme (FSCS) funding

The FCA recently published its third consultation paper on its review of the FSCS (CP18/11) and is proposing to require providers to pay a quarter of the cost of funding the FSCS in a radical shake-up that is set to take effect from April 2019. This recent consultation follows on from the FCA's second consultation (CP17/36), which was published in October 2017.

The FCA sets out a range of proposed amendments to the Interim Prudential sourcebook for Investment Businesses, including requiring personal investment firms (PIF) to have professional indemnity insurance (PII) that does not limit claims where the policyholder or a third party is insolvent or where a person other than the PIF (such as the FSCS) is entitled to make a claim. The FCA recognised that some PII providers were seeking to limit their liability by preventing the FSCS from making a claim on the policy and this proposal aims to address this point. The FCA decided against requiring PIFs to pay capital into a trust account or purchase a surety bond (in lieu of or in addition to existing capital requirements), which it proposed in its second consultation (CP17/36).

The FCA intends to go ahead with its proposals regarding FSCS compensation limits in the compensation sourcebook and seeks to increase the FSCS compensation limit for investment provision, investment intermediation claims, home finance intermediation claims and debt management claims, from £50,000 to £85,000. In addition, the FCA proposes to change the limit for claims in relation to the intermediation of long-term care insurance to match the limit for other kinds of pure protection intermediation, to 100% of the claim, from the current limit of £50,000.

The FCA intends to proceed with the reforms proposed in its second consultation (CP17/36) concerning funding classes and provider contributions and proposes to merge the life and pensions intermediation funding class with the investment intermediation class. The FCA is further seeking to (i) extend the retail pool so that it applies to all FCA funding classes (except deposit acceptors), (ii) require providers to contribute 25% of the funding requirements for insurance/ investment intermediation funding and (iii) move pure protection intermediation from life and pensions intermediation funding class to general insurance distribution funding class.

The FCA is seeking responses to the consultation and the deadline for receiving them is 1 August 2018, which the FCA will publish in a notice. Appendix 1 and Appendix 2 contain the text of the proposed handbook (Professional Indemnity Insurance (Insolvency Exclusions) for Personal Investment Firms Instrument and the Financial Services Compensation Scheme (Funding Review) Instrument respectively). The new rules are set to take effect from April 2019.

A copy of the full consultation paper can be accessed at https://www.fca.org.uk/publication/consultation/cp18-11.pdf and a copy of the second consultation published in October 2017 can be accessed at: https://www.fca.org.uk/publication/consultation/cp17-36.pdf.

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RUPERT WARREN
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2. COURT CASES AND ARBITRATION

England & Wales: Double Whammy for Primary Insurers

The Commercial Court has recently handed down judgment in relation to preliminary issues in the case of *The Cultural Foundation (doing business as American School of Dubai) and Abu Dhabi National Exhibitions Company v Beazley Furlonge Limited and Ors*[1].

The case arose from the appointment of a Scottish firm of architects by the claimants (ASD and ADNEC) under three separate contracts to provide services in relation to the (a) the construction of a new school campus at Al Barsha and (b) the construction of the Abu Dhabi National Exhibition Centre. Several disputes arose from these contracts resulting in two arbitration awards in favour of the Claimants, respectively the "ASD Award" and "ADNEC Award". These arbitration awards were not paid and in September 2015, the architects became insolvent. Accordingly, ASD and ADNEC pursued the insurers directly under the Third Parties (Rights against Insurers) Act 1930.

The most significant preliminary issue dealt with the relevant policy year under which the awards would be covered. During the currency of the contracts, the architects made a number of notifications to their PI insurers across different policy years, including in relation to the issues which gave rise to the arbitration awards. It was common ground that the ADNEC Award had arisen from circumstances notified in the 2008/09 year of account. However, there was a dispute as to whether the ASD Award arose from circumstances notified during the 2008/09 or 2009/10 policy periods. The claimants argued for the latter – that way they would have the benefit of two separate limits of indemnity – Beazley argued that both claims ought to be dealt with under the 2008/09 policy.

The Judge held that the insured had made valid notifications of circumstances and/or claims, which could have resulted in the ASD Awards in both the 2008/09 and 2009/10 policy periods. He further held that the existence of a notification to an earlier policy did not preclude a claim on a later policy, providing that a valid notification was also made during that policy period and there was no exclusion of prior notified circumstances (which in this case there was not). Thus, an insured could potentially be in a position to make an election as to which policy period they pursued. The question of whether the ASD Award did in fact arise from the 2008/09 or 2009/10 notifications was not decided as a preliminary issue.

Insurers would be wise to take note of the decision on this issue and to take steps to avoid the possibility that a claim could be made on more than one policy period.

The judge also decided preliminary issues in relation to (a) equitable set-off of the claims against overpayment of defence costs by Beazley, (b) the recoverability of defence costs from the excess insurers and (c) the recoverability of interest under the policies.

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1 [2018] EWHC 1083 (Comm)

England & Wales: England & Wales: Permission to appeal mesothelioma reinsurance allocation arbitration award

Equitas Insurance Limited v Municipal Mutual Insurance Limited[1] was a decision of the Court of Appeal in which Lady Justice Gloster and Sir Jack Beatson considered the application by Equitas for permission to appeal against an arbitration award of Flaux LJ (sitting as a judge-arbitrator). The application was made under s.69 of the Arbitration Act 1996 which allows a party to appeal an arbitration award on a question of law providing, amongst other things, it is possible to show that the question is one of general importance and the decision is at least open to serious doubt.

1 [2018] EWCA Civ 991

The hurdles set down by s.69 are difficult to satisfy. A good indication of just how hard it is to obtain permission to appeal under this provision can be seen in the Commercial Court statistics (the latest of which have just been published). In 2016, there were 46 applications to the Commercial Court for permission to appeal and none were granted. In 2017, 56 applications were made and only 10 were granted and then only 1 of those 10 was successful.

The dispute between the parties raised questions concerning the treatment of mesothelioma claims for the purposes of certain contracts of employers' excess of loss liability reinsurance. This is an issue of some controversy in the reinsurance market and, as yet, there has been no authority on it. The issue arises in summary because mesothelioma is an (indivisable disease). An underlying employer is liable in full for any material exposure of the employee to asbestos and its insurer is in turn liable in full (pursuant to the Compensation Act 2006 and IEG v Zurich) in each year of exposure – leaving the insurer with rights of contribution as against other insurers or recoupment as against the insured in respect of uninsured years.

The particular issues in the appeal were (1) whether MMI was entitled to present each outwards reinsurance claim to any single triggered reinsurance contract of its choice (referred to as "spiking"); and (2) if so, how the resultant rights of recoupment and contribution, arising from the Supreme Court decision in International Energy Group Ltd v. Zurich Insurance Plc UK Branch [2016] AC 509, in particular, as to annual reinsurance retentions, were to be calculated.

In the arbitration award, as reported in the Court of Appeal's decision, MMI appeared to win on all of the key issues. Flaux LJ found that MMI was entitled to spike each reinsurance claim to any applicable year of reinsurance cover of its choice (as per the approach at the underlying level). He found that there was no good faith restriction on this and if there was then MMI was not in breach of it. He also found that the rights of recoupment and contribution acquired by the reinsurers to whom a claim was spiked should be calculated using MMI's methodology, namely, the 'independent liability' method. The independent liability method involves apportioning the loss for which the spiked reinsurance contracts were liable between the retentions and the various layers of reinsurance in each of the applicable years of reinsurance cover, in proportion to: (a) the amounts that would have been borne by each such layer or retention if the whole of the claim had been presented to each relevant year, and (b) the relative amount of exposure which occurred in each relevant year. The net effect seems to be what the market would refer to as "pro rata/pro rata" or the ACOD/B approach (the latter being in reference to a standard term included from the 1980s onwards). This involves pro-ration of both limits and retentions across the years of exposure to produce the ultimate financial position between the market. It is assumed this would occur also for any reinsured period through recoupment.

Having carefully considered the award of Flaux LJ, Gloster LJ, who gave the leading judgment, found that notwithstanding the high threshold, the decisions on the three key issues as to the ability to pick and choose which reinsurance cover to spike, whether the duty of good faith applies, and then what recoupment and contribution rights are open to the reinsurer who has been spiked, were open to serious doubt. Interestingly she seemed to accept Equitas' arguments that there was a case for treating the insurance and reinsurance positions differently and/or if the reinsured can pick and choose then there could be some basis for a duty of good faith in order to restrain the manner of the exercise of the freedom of choice by the reinsured. As regards recoupment she said that she saw considerable force in the submission that the higher layers of reinsurance in subsequent years should be made good first in any contribution and recoupment process.

She also found, perhaps less surprisingly, that the issues being determined were something that was of general public importance. She specifically said in her judgment that *"the question as to how*

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mesothelioma losses should be allocated for reinsurance purposes does appear to be a significant open question for many participants in this market". Consequently, permission to appeal was granted.

The point is obvious but simply because permission to appeal has been granted does not mean that any subsequent appeal by Equitas will be successful. However, it is noteworthy that permission to appeal was granted and the subsequent decision is something that the market will, no doubt, watch closely.

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3. HFW PUBLICATIONS AND EVENTS

Sanctions Update: US Sanctions on Iran

President Trump announced on 8 May 2018 that the US would pull out of the Joint Comprehensive Plan of Action (the Iran nuclear deal). He issued a National Security Presidential Memorandum that begins the process of re-imposing sanctions on areas including Iran's energy, petrochemical and financial sectors. HFW has produced a Briefing[1] considering the implications of this development.

1 http://www.hfw.com/downloads/HFW-Sanctions-Update-US-Sanctions-on-Iran-8-May-2018.pdf

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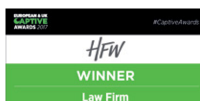

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