Insurance/
Reinsurance

22 October 2015

INSURANCE BULLETIN





Welcome to HFW's Insurance Bulletin, which is a summary of the key insurance and reinsurance regulatory announcements, market developments, court cases and legislative changes of the week.

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Should you require any further information or assistance on any of the issues dealt with here, please do not hesitate to contact any of the contributors to this bulletin, or your usual contact at HFW.

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1. Regulation and legislation

UK: ABI issues guidance on good practice for cluster policy providers

The Association of British Insurers (ABI) has published a statement[1] setting out guidance on good practice for providers of cluster policies, with a particular focus on withdrawals.

A cluster policy is a product offering the policyholder the ability to split an investment (typically a single premium investment bond) equally between a number of identical life insurance policies or "segments". The policyholder may withdraw a sum of money from a cluster policy, by way of either a full or part surrender of the policies within the cluster, or a combination of both (i.e. a full surrender of one or more policies and a part surrender of one or more others). However, the tax consequences of such steps can vary significantly, depending upon the chosen method for withdrawal. Once a withdrawal has been validly completed, the tax consequences cannot be reversed.

In a number of cases, policyholders have been faced with significant tax bills which could have been avoided if the policyholder had withdrawn their investment differently (see for example *Joost Lobler v HMRC*[2] in which the first tier tribunal dismissed the policyholder's challenge to the tax consequences of the surrender, in spite of the tribunal finding this was 'outrageously unfair', a decision which the policyholder only managed to overturn on appeal on the particular facts of that case because he had been acting under a mistake when requesting the partial surrender of his policies).

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The ABI statement deals in particular with matters including:

- The tax consequences of withdrawing a specific sum from a cluster policy, by reference to examples.
- The point at which a surrender or part surrender becomes irrevocable.
- The extent to which a provider should intervene to ensure that a policyholder contemplating a surrender or part surrender is properly informed of the consequences. The ABI advice is that providers should either intervene in every case, or have risk assessment processes in place to ensure intervention where appropriate.
- The nature and timing of a provider's intervention.
- The training and procedures that providers should put in place to ensure appropriate interventions are made.
- The possible scope for a default approach to apply in limited circumstances (such as where an urgent request is made and the provider is unable to contact the policyholder).

The matters dealt with in the ABI statement illustrate that providers of cluster policies should pay particular attention to the advice and information which they give to their policyholders and should also consider carefully whether in any particular set of circumstances it is appropriate to recommend that the policyholder seek independent financial advice.

For more information, please contact Ben Atkinson, Associate, on +44 (0)20 7264 8238, or ben.atkinson@hfw.com, or your usual contact at HFW.

Europe: Solvency II - ultimate forward rates to remain unchanged until end of 2016

The European Insurance and Occupational Pensions Authority (EIOPA) have issued a press release[1] confirming that the ultimate forward rates (UFRs), used by insurance and reinsurance undertakings to calculate the risk-free interest rate term structures under Solvency II, will remain unchanged until the end of 2016.

1 https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2015/Taxation/Cluster%20Policies.pdf
2 [2015] UKUT 152 (TCC)

1 https://eiopa.europa.eu/Pages/News/Review-of-the-methodology-to-derive-the-ultimate-forward-rates.aspx

EIOPA wants to ensure the stability of the framework for the implementation of Solvency II and intends to decide on the outcome of the review and on how and when to implement it in September 2016.

There is a requirement under Solvency II for the calculation of UFRs to take account of the expectations of the long-term real interest rate and of expected inflation. For most currencies, including the Euro, the UFR is currently set at 4.2% as the sum of the long-term averages of past real rates (2.2%) and on the inflation target of the European Central Bank (2%).

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International: Conduct of business in inclusive insurance

The International Association of Insurance Supervisors (IAIS) has published a revised issues paper[1] on conduct of business in inclusive insurance, following feedback received during consultation. The IAIS uses the term "inclusive insurance" in the broad sense of the word, denoting all insurance products aimed at the excluded or underserved market, rather than just those aimed at the poor or a narrow conception of the low-income market. The paper looks specifically at the low-income or lower middle income due to specific requirements in terms of service and consumer protection.

Conduct of business supervision in inclusive insurance aims to ensure suitable conduct of business by insurers in order to protect the interests of inclusive insurance customers, where the need for providing consumer value is particularly relevant. The IAIS considers that, as these customers are often first time users of insurance, it is essential to establish and maintain their confidence in the insurance industry.

The aim of IAIS' paper was to provide an overview of the issues relating to conduct of business in inclusive insurance markets that affect the extent to which customers are treated fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied. Where insurers are launching new products that specifically address the needs of the "inclusive insurance" market, this IAIS paper could be a helpful summary of the supervisory approach they are likely to encounter when doing so.

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Enterprise Bill – new legislation in relation to late payment of claims

In our 1 October 2015 bulletin[1] we reported on the launch of the UK Enterprise Bill (the Bill), which contains proposals to amend the Insurance Act 2015 to create a new liability regime for late payment of claims. The Bill had its second reading in the House of Lords on 12 October 2015.

Lord Patten described the Bill as *"a big legal pudding made up of all sorts of ingredients hauled off the shelf"* but spoke in support of the claims payment provisions, exhorting the insurance industry to start observing the new principles before the Bill becomes law. However the Conservative peer Lord Flight highlighted concern in the Lloyd's and wholesale insurance markets and the lack of consultation with the LMA or IUA. He observed that the Bill's Impact Assessment was flawed, with *"unrealistic underestimates of the damage for late-payment provisions, with continuing costs of investigating unmeritorious claims of just £375,000 per annum for the entire industry and increased litigation costs of £100,000 for five years for the entire industry. These sums could be absorbed by just one major speculative claim."*

He then called for the Government to come forward with their own amendments to disapply the provisions in respect of large insurance risks, where statutory protection was not appropriate or necessary for international business and commercial risks written in London.

The Labour peer Lord Stevenson indicated that he broadly supported the proposals but that there was still *"a long way to go"* to refine them and said that he looked forward to picking them up again in committee. The committee stage, a line-by-line examination of the Bill, will begin on 26 October 2015. The full transcript of the 12 October 2015 debate is available in Hansard[2].

For more information, please contact Ashleigh Williamson, Professional Support Lawyer, on +44 (0)20 7264 8311, or ashleigh.williamson@hfw.com, or your usual contact at HFW.

1 http://iaisweb.org/index.cfm?event=showHomePage&persistId=A0AB09FC155D89A4062619B48FD643BA

1 http://www.hfw.com/Insurance-Bulletin-1-October-2015

2 http://www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151012-0001.htm

2. Court cases and arbitration

New Zealand: Christchurch earthquakes – meaning of *"physical loss or damage"* to property

Comment

The Christchurch earthquakes of 2010 and 2011 continue to produce litigation and insurance case law. Some of these cases have considered the meaning of *"physical loss or damage"* to property.

These cases confirm, as a matter of New Zealand law, that there is no basis to follow US authorities supporting a broader interpretation of physical loss or damage than that taken in the Commonwealth jurisdictions. *"Physical loss or damage"* to property requires that the property has itself undergone a physical change and not simply that it has become less valuable (or even unusable).

Background

In *O'Loughlin v Tower Insurance Limited*[1], the New Zealand High Court (The Honourable Justice Asher) held that the creation of the "red zone" in Christchurch did not constitute or cause "physical loss or damage" to the claimants' house. The red zone designation affected significantly the economics and practicalities of property ownership (for example, the government could decide to acquire compulsorily, and the council could decide not to continue providing services to, properties in the red zone), but there was no prohibition on the occupation of houses in the red zone. It was important to the decision in O'Loughlin that the red zone did not require physical alteration or repair to the house, and did not prohibit habitation, repair or rebuilding, or the grant of a building consent.

By way of comparison, the Full Court of the High Court in *Earthquake Commission v Insurance Council of New Zealand Inc.*[2] held that a change in land levels constituted *"physical loss or damage"* to the property on the basis that, as a direct result of the earthquakes, there had been a disturbance to the physical integrity of the land and a change to its physical state which affected adversely its use and amenity.

Similar issues, involving the meaning of *"physical loss or damage"* to property, have been considered in more recent 2015 cases.

Kraal v The Earthquake Commission

In *Kraal v The Earthquake Commission*[3], the New Zealand Court of Appeal considered a claim where the claimants (and appellants in the Court of Appeal) argued that they were entitled to insurance cover of their house under the Earthquake Commission Act 1993 (EQC Act). The EQC Act provided cover for *"natural disaster damage"*, defined as meaning *"any physical loss or damage to the property occurring as the direct result of a natural disaster"*, and also *"any physical loss or damage to the property that … is imminent as the direct result of a natural disaster"*.

It was argued by the claimants that there had been actual *"physical loss or damage to the property"* not that loss or damage was *"imminent"*. The claim resulted from the Christchurch City Council prohibiting any occupation of the property due to a significant and ongoing risk from rock fall. Accordingly, a potentially significant difference from the facts in *O'Loughlin* was that, in *Kraal*, the claimants were prohibited from occupying their house. It was argued that the fact that the claimants were unable to have access to and enjoyment of their house was an event that was a *"physical deprivation of use"* and, therefore, a *"physical loss"*.

Nonetheless, the Court of Appeal upheld the earlier High Court decision that the definition of *"natural disaster damage"* in the EQC Act, which required *"physical loss or damage to the property"*, did not extend to claims for losses (such as loss of the right to occupy) which did not arise from physical disturbance to the property.

The Court of Appeal considered the ordinary meaning of the EQC Act definition of *"natural disaster damage"*: *"... any physical loss or damage to the property occurring as the direct result of a natural disaster..."* and held that:

- The word *"physical"* qualified both *"loss" and "damage"* and applied to the property rather than to the claimants. The use of the qualifying

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1 [2013] NZHC 670
2 [2014] NZHC 3138
3 [2015] NZCA 13

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word *"physical"* indicated that something material or tangible as opposed to mental or spiritual had happened to the property.

- The ordinary meaning of the word *"damage"* is harm done to something which impairs its value or usefulness. The word *"damage"* taken alone often meant physical harm, and although it could mean *"emotional or reputational or other non-physical harm"*. In ordinary parlance it would not be said that a statutory notice prohibiting occupation caused damage to a property.
- The word *"loss"* has a broader meaning than the word *"damage"* and is broad enough to cover conceptually what happened to the claimants, in the sense that they had suffered a loss, namely the ability to use their property, and other associated losses. However, the loss in *Kraal* was not *"physical"* and had happened to the claimants and not to the property. By way of comparison, the court stated that "if a house or land is swept away in a tsunami or lahar flow it is physically *"lost"*.

C&S Kelly Properties Ltd v Earthquake Commission and Southern Response Earthquake Services Ltd

The case of *C&S Kelly Properties Ltd v Earthquake Commission and Southern Response Earthquake Services Ltd*[4], also considered the application of the EQC Act definition of *"natural disaster damage"*. Whilst the High Court in this case was also concerned with multiple other issues, it had to consider whether floor dislevelment (in circumstances where there was evidence of historical floor dislevelment which was present before the earthquakes) constituted *"natural disaster damage"* on the basis that there was a *"physical change or loss [to the property] which affects the use or amenity of the property."*

The defendants argued that there had not been any *"physical loss or damage to the property"*, because: (a) there had been no physical change to the floor levels as a result of the earthquakes; or (b) the claimants could not establish some impact on the utility of the floor in terms of its structural integrity, functionality, aesthetic quality or value, in comparison with the floor's pre-earthquake utility, and a minor or slight change to the existing floor dislevelment as a result of the earthquakes was of itself insufficient to meet the test of *"physical damage"*.

On the evidence, the High Court held that the floor dislevelment did constitute *"physical damage"*; finding that the dislevelment of the floor system caused by the earthquake was considerably more than de minimis and did have an impact on the amenity and utility of the house, and therefore on its value.

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4 [2015] NZHC 1690

3. HFW news, publications and events

United Kingdom

On 16 October, John Barlow and Richard Spiller gave a presentation at Generali's Financial Lines Training and Strategy Conference in Rome on the subject of bank operational risk insurance.

Latin America

HFW Partners Christopher Cardona, Geoffrey Conlin, Jonathan Bruce and Jeremy Shebson will attend the FIDES LatAm insurance conference in Santiago, Chile from 26 to 28 October. To find out more about this event, please visit http://www.fides2015.com/eng/Noticias.aspx?N=321

Hong Kong

Vincent Liu and Caroline Thomas have published an article discussing the Hong Kong Competition Commission's draft leniency policy. The policy sets out the circumstances in which whistleblowing undertakings will escape penalties for cartel activities. The consultation closes on 23 October 2015. The full article can be found here: http://www.hfw.com/Competition-law-update-Draft-Leniency-Policy-October-2015

Middle East

HFW has been nominated as a finalist for the "Law Firm of the Year" award at the 2nd Middle East Insurance Industry Awards. The awards dinner will take place on 17 November.

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