HFW

# INSURANCE BULLETIN
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In this week's Insurance Bulletin:




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**"While acknowledging the benefits of cloud services, EIOPA raised concerns regarding their unique challenges in terms of data protection and location "**

## 1. HFW PUBLICATIONS AND EVENTS

### **HFW** launches new client videos on Insurtech and the SM&CR

HFW has launched two client videos which discuss current issues in the insurance market.

Senior Associate Will Reddie explains the legal and regulatory challenges for start-ups when launching insurtech products at: http://www.hfw.com/Insurtech-Start-Ups-Dealing-with-Legal-and-Regulatory-Challenges.

Associate Rita Kato joined Will to discuss the extension of the Senior Managers & Certification Regime (SM&CR) to insurance intermediaries. Their discussion can be found at: http://www.hfw.com/Senior-Managers-and-Certificate-Regime-how-to-prepare.

## 2. REGULATION AND LEGISLATION

### **UK:** FCA proposes ban on sale of crypto-derivatives to retail consumers

The FCA has proposed restricting the sale of derivatives and exchange traded notes (**ETNs**) referencing certain types of cryptoassets (**crypto-derivatives**) to protect retail consumers.

The FCA considers that these products are ill-suited to retail consumers who cannot reliably assess their value, and that they may cause them harm from sudden and unexpected losses, because of:

- the lack of a reliable basis of valuation for the underlying assets;
- extreme volatility in cryptoasset values;
- the prevalence of market abuse and financial crime in the secondary market for cryptoassets (e.g. cyber theft);
- retail customers' incomplete understanding of cryptoassets; and
- the lack of a clear investment need for crypto-derivatives.

The FCA committed to explore a potential ban in the UK Cryptoasset Taskforce Final Report, which was published in October 2018. The FCA is therefore consulting on banning the sale, marketing and distribution to all retail consumers of all derivatives (i.e. contract for difference - CFDs, options and futures) and ETNs that reference unregulated transferable cryptoassets by firms acting in, or from, the UK.

On a similar topic, the FCA's consultation on draft guidance on Cryptoassets (CP19/3) concluded in April 2019. The FCA expects to publish its final guidance later in the summer, which will clarify the types of cryptoassets that fall within the regulatory perimeter.

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### **EU:** Outsourcing to Cloud Service Providers: EIOPA consults on new guidelines

EIOPA is currently consulting on new guidelines on the use of cloud service providers by (re)insurance undertakings and has called for responses by 30 September 2019.

While acknowledging the benefits of cloud services, EIOPA raised concerns regarding their unique challenges in terms of data protection and location, security issues and concentration risk. In particular, there is a risk at industry level "*as large suppliers of cloud services can become a single point of failure when many undertakings rely on them*".

EIOPA's proposed guidelines (which take into account the recent guidance on cloud outsourcing published by the European Banking Authority) aim to:

1. *"provide clarification and transparency to market participants avoiding potential regulatory arbitrages";* and

2. *"foster supervisory convergence regarding the expectations and processes applicable in relation to cloud outsourcing."*

The key issues covered in the proposed guidelines are:

1. **Outsourcing definition:** in the context of cloud services, what amounts to "outsourcing" (as defined in Solvency II – see guideline 1) and what constitutes "material" outsourcing (see guidelines 1 and 7).
2. **Risk assessments:** these should be carried out prior to cloud outsourcing and should be reflected, where appropriate, in an undertaking's ORSA (see guidelines 2 and 8).
3. **Notification:** undertakings should notify their supervisory authority of any material cloud outsourcing (see guideline 4).
4. **Use of cloud service providers:** undertakings should (a) carry out due diligence on cloud service providers, (b) ensure that agreements include the EIOPA recommended contractual requirements (including in relation to sub-outsourcing), (c) have access and audit rights over cloud service providers, (d) ensure that cloud service providers comply with appropriate IT security and data protection standards, (e) monitor the performance of the cloud service providers and their compliance with agreements on an on-going basis, and (f) have an exit strategy (see guidelines 9 to 15).
5. **Supervisory oversight:** supervisory authorities should assess the impacts arising from cloud outsourcing arrangements (see guideline 16).

The draft guidelines can be found at: https://eiopa.europa.eu/Publications/Consultations/2019-07-01%20ConsultationDraftGuidelinesOutsourcingCloudServiceProviders.pdf

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## **EU:** EFRAG Questionnaire relating to IFRS 9 and IFRS 17

The European Financial Reporting Advisory Group (EFRAG) has launched a questionnaire targeted at insurers.

EFRAG's goal is to gain a better understanding of the impact of adopting IFRS 9 Financial Instruments and IFRS 17 Insurance Contracts on hedging strategies and practices. EFRAG is seeking this information as part of its endorsement advice on IFRS 17 for the European Commission.

The Financial Reporting Council has encouraged UK insurers to participate and provide their feedback to EFRAG. Responses are due by 16 September 2019.

The questionnaire can be found at: http://www.efrag.org/(X(1)S(zapm32ivb5hlal24mqywoeks))/News/Project-369/EFRAG-issues-hedging-accounting-questionnaire-for-insurers?AspxAutoDetectCookieSupport=1

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## **UK:** All Change at Lloyd's

**Here is our round-up of three recent developments at Lloyd's.**

### 1 Lloyd's Prospectus: Sharing risk to create a braver world

In its prospectus, "The Future at Lloyd's" (the **Prospectus**), Lloyd's has declared its new purpose: Sharing risk to create a braver world.

At the Lloyd's New York City Dinner, the Lloyd's Chairman, Bruce Carnegie-Brown, delivered a speech in which he set out the ideas for the future of Lloyd's strategy: to "revolutionise" the way the insurance and reinsurance marketplace operates and serves customers, "powered by technology designed to create the most customer-centric digital insurance platform in the world," comprising dual platforms for complex and non-complex risks.

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The Prospectus forms part of a six month consultation with Lloyd's users, who have said they want three things:

- **more comprehensive cover** and the highest **quality protection**;
- a **simpler process** for accessing products and services at Lloyd's; and
- **lower costs** of doing business at Lloyd's

The Prospectus also proposes:

- greater flexibility around capital attaching to risk at Lloyd's, while simplifying the process to appeal more to capital providers; and
- greater diversity and inclusion to attract the best talent for its workforce.

Finally, the Prospectus sets out six examples which could form the blueprint of the "new Lloyd's":

- A platform for complex risk that makes doing business easier and enables efficient digital placement of complex risks
- Lloyd's Risk Exchange through which less complex risks can be placed in minutes at a fraction of today's costs
- Flexible capital that can simply and effectively access a diverse set of insurance risks on the Lloyd's platform
- A Syndicate-in-a-Box solution, which offers a streamlined opportunity for innovators to bring new products and business into the market
- A next generation claims service that improves customer experience and increases trust in the market by speeding up claims payments
- An ecosystem of services that helps all market participants develop new business and provide outstanding service to their customers

## Closing the insurance gap

A key challenge – and opportunity - facing Lloyd's is closing the "insurance gap" between the growing risks of, for example, cyber attacks and natural catastrophes, and the relatively low take-up of cover. For example:

- the estimated insured loss from extreme cyber event is $2bn; modelled economic loss from same event is $31bn; and
- the estimated insured loss from natural catastrophe is $90bn; modelled economic loss from same event is $225bn.

Lloyd's believes that this problem can be addressed – and the opportunity can be met – by implementing the following four initiatives.

### (i) Better align products and services to customer needs

Even when they are aware of their exposure, customers cannot always find the insurance products and services they need; one 2017 annual risk survey[1] shows that half of the top 10 risks identified by risk managers are uninsurable.

The asset value of S&P500 companies has shifted from 83% tangible assets (e.g. property, equipment) in the 1970s, to just 16% today, so companies require fundamentally different insurance products.

Lloyd's will expand the Lloyd's Innovation Lab to be a hub for news on emerging risks and new products and services, and also an innovation incubator.

Brokers and underwriters will have access to new "ecosystems" of products and services, and policyholders will experience a more responsive and automated claims service. Lloyd's aims to reduce costs by simplifying risk transfer and distribution chains.

Lloyd's view: "insurers must supercharge innovation".

### (ii) Make risk transfer more efficient and reduce buying costs

Acquisition and administration costs are high and are reducing more slowly than those in other sectors. The cost of doing business in the insurance industry (30% or more) does not compare favourably to the 4-13% cost of an equity IPO.

Binder/managing general agent business has grown significantly in recent years and now makes up nearly 40% of Lloyd's business, bringing with it materially higher acquisition costs and marginally lower administration costs.

Lloyd's aims to cut acquisition and administration costs for the most common risks from 30-40% today to 10-20%, and to cut the time it takes from request to bind and policy issuance from weeks to days. This will free up access to expertise on more complex risks.

Lloyd's view: "reducing costs must be a priority".

**(iii) Embrace opportunities for new capital**

Third-party capital now makes up 16% of reinsurance capital, having grown from USD5bn in 2002 to USD98bn in 2018. New capital has increased rate competition over the past few years, forcing down prices.

Other hubs such as Bermuda have been highly effective at attracting capital.

Lloyd's view: "insurers must make it easier for new forms of capital to attach to risk".

**(iv) Attract new talent to the industry by building an inclusive and innovative culture**

The workforce of insurance is ageing and firms must begin recruiting and developing the next generation of individuals who will become experts and leaders.

To do so, firms have to define and communicate more appealing employee value propositions to candidates, and create an inclusive culture in which everyone is respected and valued.

Lloyd's view: "human capital is scarcer than financial capital. What would it take to make insurance a top-three choice for STEM graduates?"

## 2 Syndicate in a Box

"Syndicate-in-a-box" is a concept introduced by the 2019 Lloyd's Prospectus, which describes a new structure by which MGAs or new and innovative entrants can access the Lloyd's market and sell their products.

The aim is to enable a more streamlined and cost-effective route to market for innovators, and to incubate new firms as they develop into established syndicates or operators at Lloyd's.

Lloyd's recognises the need to reduce the expense and delay involved in acquiring insurance; it needs to innovate. For example,

- the current cost of starting a syndicate at Lloyd's is prohibitive – around £20m over three years. Since requirements for a three-year incubation period were introduced about five years ago, the growth of start-up syndicates has declined sharply; and
- there is an "insurance gap" between the growing risks of, for example, cyber attacks and natural catastrophes, and the relatively low take-up of cover. In order to close the gap, products need to be better aligned to customers' needs, and capital needs better access to market.

The high costs facing start-up syndicates are currently due to one-size-fits-all regulation and structures. Innovators that otherwise may have offered new products to solve new problems are turning away.

There is very little public detail about the structure of "syndicate-in-a-box" or how it might work. The consultation on Lloyd's future strategy ended on 10 July 2019, with a blueprint due to be published at the end of September 2019.

The 2019 Lloyd's Prospectus includes a hypothetical case study of "syndicate-in-a-box", in which a US-based provider of specialist cyber insurance (the **Provider**) was able to join the market and work as a "remote syndicate" at Lloyd's, without having to set up a London office. The joining process was digital, streamlined and fast. Capital providers are matched with risks or syndicates based on pre-set criteria. The Provider can access all the data and services in the Lloyd's ecosystem, including the Lloyd's Centre for Innovation, which provides third party data and insights. Further, the Provider can outsource functions like HR, claims and reporting, and save costs.

The "disintermediation" which "syndicate-in-a-box" could achieve would likely be welcome to customers, as the proportion of premiums taken in expenses by brokers, MGAs or syndicates would be expected to fall.

While the fact that the 2019 Lloyd's Prospectus does not refer in detail to the MGA framework may have disappointed some market participants hoping for more concrete signs of innovation, John Neal did address the Managing General Agents' Association directly at a conference, telling them that MGAs had a big role to play in Lloyd's future strategy.

## 3 New Oversight Regime for delegated claims administrators

Lloyd's oversight framework for coverholders and third-party administrators (**TPAs**) is set to change with effect from Q1 2020.

The new regime will establish a risk-based approach to delegated authority approval and oversight, placing more reliance on the judgment of managing agents where risks are lower, allowing Lloyd's to focus resources on higher risk arrangements.

Some approvals, such as straightforward changes in permissions, will become automated, and the entire approval and ongoing oversight process will be centralised on a new online system.

Lloyd's assessment of risk will take account of the lead managing agent's capabilities, the profile of the firm in question, and the type of products that it deals with.

The aim is to reduce compliance costs, reflect modern distribution methods and enable more risk-based oversight and application reviews. These aims align with the Future at Lloyd's vision unveiled in the 2019 Lloyd's Prospectus (see our summary of the 2019 Lloyd's Prospectus above).

## CURRENT REGIME

### Coverholder controls

The current controls which Lloyd's has in place for coverholders include: approval for all coverholders; setting coverholder permissions; annual compliance checks; and minimum standards for managing agents in respect of delegated authority arrangements. Lloyd's can intervene and potentially remove coverholder permissions where standards are not met.

### TPA controls

Lloyd's currently does not require TPAs to gain prior approval for delegated authority, although managing agents are required to carry out due diligence before appointing TPAs, and to notify Lloyd's of any intention to make such an appointment.

## THE NEW REGIME

### Coverholders

A key part of the new system will be the new integrated, online compliance system, Chorus, which will replace ATLAS and BAR. All coverholder applications for approval or to vary permissions will be made on Chorus, which will triage applications based on pre-determined risk factors. If certain criteria are met, Chorus will refer the application to the Lloyd's Performance Management Directorate team. Applications that do not meet certain criteria will benefit from a more automated process of review and approval.

When placing reliance on managing agents' capabilities, Lloyd's will apply an initial rating of "standard" or "strong" based on minimum standards compliance. This rating system will be developed over time and Lloyd's will continually review the risk criteria in accordance with changes to risk appetite and changes to the legal and regulatory landscape.

Lloyd's estimates that of the application tasks dealt with in 2017, under the new system 30% could have been dealt with on a self-serve basis, 30% could have been dealt with on a limited review basis, and 40% would have required a full Lloyd's review.

### New delegated authority

Lloyd's will implement a new "flexible discretion" to give delegated authority to firms without pre-approval by Lloyd's, and also to allow the sub-delegation of authority, which will no longer be prohibited.

The proposal to enable firms to have delegated authority without first obtaining Lloyd's approval will allow coverholders to appoint "distributors" of high volume, low premium risks with pre-set terms and rates which do not require individual risk underwriting, particularly advantageous for online distribution.

The removal of the prohibition on sub-delegation will only apply to restricted cases, such as where coverholders wish to distribute products through online portals, which involves only a limited element of sub-delegation.

Lloyd's will apply strict criteria and controls over both new permissions, and managing agents will be required to have their own appropriate controls in place.

### TPAs

The new regime will bring TPAs within the scope of Lloyd's approval and centralised oversight processes. The approval and oversight processes will be consistent with the coverholder approval and oversight processes, and will cover all firms with delegated claims authority, including those appointed to determine claims from open market business or under a line slip. However, managing agents will remain responsible for choosing which TPAs they want to use and the level of authority they will give them. TPAs will be given approval in respect of specific classes of business, and minimum standards will be set for delegated authority contracts. Existing TPAs will have their approved firm status automatically transferred to Chorus.

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**Footnotes**

1 Aon Benfield Global Risk Management Survey, 2017

## 3. COURT CASES AND ARBITRATION

### **England & Wales:** When is a claim in tort a claim in contract? Applying jurisdiction provisions to third party claims

This case[1] involved the determination of complex jurisdictional issues in a dispute concerning an insurance policy. The central issue was whether or not a bad faith claim brought against the insurer by third parties to the Policy was in substance a claim under the Policy (such that the dispute resolution provisions should apply).

The case is a reminder of the complex jurisdictional issues which can arise in cross-border disputes, particularly where third parties remote to the contract are involved. Indeed, whilst it is commonplace (and correct) to advise that parties to insurance and reinsurance should make sure that their dispute resolution provisions are clear and unambiguous, this case is an illustration of the issues which can arise even where such terms are present. From a claimant's perspective, the case illustrates the potential pitfalls involved in ignoring the dispute resolution provisions in a contract when bringing a claim which in substance amounts to a claim to enforce a right under that contract, even where the claim has some other jurisprudential basis.

The claimants, Mr and Mrs M, are a couple resident in Texas, USA. Mrs M suffered very serious injuries during a holiday, whilst using facilities owned and operated by the insured. Having issued proceedings in the courts of Miami, and subsequently having entered into ad hoc arbitration, Mr and Mrs M obtained an award for US$65.5m against a director of the insured.

The insurer provided D&O cover to the insured and its directors under a D&O liability policy (the "Policy"). However, the Policy contained an exclusion in respect of bodily injury and property damage. Relying on this, the insurer rejected, save in respect of defence costs, cover for the insured's director in respect of his liability to Mr and Mrs M.

Mr and Mrs M submitted a "bad faith" claim in the Miami courts against the insurer, alleging that, if the insurer had confirmed cover under the policy, it would have been possible for the insured's director to settle Mr and Mrs M's claim at an early stage for a much lower sum. Mr and Mrs M argued that the insurer's failure in this regard exposed the insured's director to a liability of US$65.5 million (i.e. to them) and that the director in question therefore had a corresponding claim against the insurer for this amount. Mr and Mrs M further argued that they had a right under Florida law to claim directly against the insurer for the US$65.5 million, based on their status as judgment creditors of the insured's director.

The insurer successfully obtained from the Hong Kong courts an ex parte anti-suit injunction, preventing Mr and Mrs M from pursuing the bad faith claim in the Miami courts. Upon applications from each party, the Hong Kong court had to decide whether or not that injunction should continue.

The insurer argued that there could be no claim for bad faith without a determination as to whether or not there was cover under the policy, the correct forum for which determination was arbitration in Hong Kong, as per the terms of the Policy.

Mr and Mrs M argued that their claim was not a claim under the Policy, but a standalone claim in tort, such that they were not bound by the dispute resolution provisions in the Policy.

Referring to the English case *The Prestige*, the Hong Kong court identified the key question in this regard as being the correct characterisation not of the nature of the claim, but of the question at issue. In other words, the court had to look at the substance, rather than the form of the claim.

Applying these principles, the Hong Kong court determined the key question to be whether these were in substance proceedings to enforce an obligation under the Policy, or proceedings to enforce a liability independent of the contract.

Under Florida law it was a necessary ingredient of Mr and Mrs M's bad faith claim for them to first obtain "a resolution of some kind in favor of the insured" on the coverage issue. The Hong Kong court held that this issue was clearly contractual, since it determined the liability of the insurer to the insured under the terms of the Policy.

It further followed that so far as they related to determination of the coverage issue, the Miami proceedings were in substance proceedings to enforce a contractual obligation under the Policy. The claim may have been framed in tort, but the issue was a contractual one.

The Hong Kong court concluded by noting that, under the law of Hong Kong (the position is the same in England and Wales), a party is not entitled to found a claim on rights arising out of an insurance policy without also being bound by the dispute resolution provisions in that policy. The underlying rationale is that the dispute resolution provision is seen as an essential part of the contractual basis upon which coverage arises under the policy, and that a party seeking to enforce the policy cannot do so free of the contractual dispute resolution mechanism. In this case, the establishment of coverage was a precondition to the "bad faith" claim against the insurer. Accordingly, the insurer was entitled to have it determined in accordance with the contractual procedure, by way of arbitration in Hong Kong. The anti-suit injunction was upheld.

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**Footnotes**

1 *AIG Insurance Hong Kong Ltd v. Lynn McCullough* [2019] HKCFI 1649

**WE'RE TAKING A SHORT SUMMER BREAK AND OUR NEXT BULLETIN WILL BE PUBLISHED IN SEPTEMBER.**