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1. REGULATION AND LEGISLATION

EU: EIOPA stress test to assess cyber risk

The European Insurance and Occupational Pensions Authority (EIOPA) launched its latest stress test on 14 May 2018 which will include an assessment of Europe's major insurance groups' exposure to cyber risk. 42 European insurance groups, which together are said to represent 78% of total European market coverage, will be participating in the test. The insurance groups have been selected based on their size, relevance to overall financial stability and market coverage.

EIOPA commented that *"cyber risk has been gaining momentum as a growing concern for institutions, individuals and the market"* and *"cyber risk is currently considered as one of the main emerging risks as it climbed to the top position in the list of global risks for business in less than five years"*.

The stress test will also include three scenarios which will examine the impact of environmental catastrophe and extreme weather events across Europe as well as the impact of a rise and fall in interest rates. The EIPOA chairman, Gabriel Bernardino, explained that the test is designed to assess insurers' response to *"severe but plausible external shocks, including insurance specific shocks"*. Mr Bernardino also commented that this is the first time that exposure to cyber risk and best practices in dealing with these risks has been assessed.

Insurers will need to submit their completed questionnaires to the regulators by 16 August 2018. EIOPA anticipates that the results of the stress test will be published in January 2019. According to EIOPA, the test is designed to raise awareness of potential threats to financial stability and assess potential vulnerability of the European insurance market in certain scenarios. Gabriel Bernardino expects that the stress test will provide *"further valuable insight to the resilience of the European insurance sector"* as well as *"increase transparency to ensure a level playing field and enhance market discipline among the stress test participating groups"*.

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EU: EIOPA publishes opinion on impact of Brexit on solvency of insurers

EIOPA published an opinion on 18 May 2018 on the impact on EU 27 (re)insurance undertakings (i.e. all EU members apart from the UK) of the UK leaving the EU and becoming a third country for the purposes of applying the Solvency II framework. The EIOPA opinion did not consider the mitigating measures that may be taken as part of the UK's exit, as these remain subject to political negotiations.

In some areas relating to the determination of technical provisions, own funds, and capital requirements, Solvency II differentiates between exposures situated inside or outside of the EU. The Capital Requirements Directive, CRA Regulation, MiFID II and MiFIR include provisions that are relevant to the solvency position of (re)insurance undertakings and these include distinctions between activities inside and outside the EU.

As a result, technical provisions, own funds and capital requirements of EU 27 (re)insurance undertakings may change when the UK becomes a third country.

The EIOPA opinion stated that in relation to the risks arising from the UK becoming a third country, national supervisory authorities should:

1. ensure that (re) insurance undertakings identify, measure, monitor, manage and report such risks and record them in their own risk and solvency assessment; and
2. take steps to assess the risks arising for their national markets and, where necessary, take mitigating supervisory actions.

The EIOPA opinion also sets out 14 changes to the determination of technical provisions, own funds and capital requirements of (re) insurance undertakings in the EU 27 member states as a result of Brexit. These included changes in relation to the following:

Servicing contracts concluded in the UK

(Re)insurance undertakings must take measures to ensure service continuity regarding insurance contracts concluded in the UK. Where measures are not taken or they turn out to be ineffective, undertakings will not be authorised to service such contracts. As a result, the technical provisions for such contracts may need to be changed if the expected profit from these contracts cannot be earned or can be earned only after a period of delay.

However, it should be noted that on 20 December 2017, HM Treasury stated that the UK government will legislate to ensure that EU (re) insurers can continue to meet their contractual obligations in the UK following Brexit.

UK reinsurance

Depending on the national legal framework for reinsurance activities, the UK may not be able to provide reinsurance services in some EU 27 states. In such circumstances, EU undertakings may need to reduce the amount of recoverables from UK (re)insurance undertakings because the payments expected from the UK undertakings may not be made or may be made only after a period of delay.

Risk transfer

If UK banks and investment firms lose their MiFID II passports to provide derivative services in the EU then derivatives provided by UK banks and investments firms may not be able to transfer risk effectively. This would have a knock-on effect on the solvency capital requirements of undertakings.

EIOPA will continue to monitor the risks arising from the UK becoming a third country.

The EIOPA opinion can be found here: https://eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-18-2018_opinion_on_solvency_and_Brexit.pdf

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UK: Breach of confidence claims & the new EU Trade Secrets Directive

By 9 June 2018, the UK must implement the new EU Trade Secrets Directive (the Directive). The objective of the Directive is to harmonise the meaning of a 'trade secret' throughout the EU member states.

Trade secrets constitute confidential information but not all confidential information is a trade secret. For information to be considered confidential it must have the *"necessary quality of confidence"* and be contingent upon an obligation of confidence. Although English law does not have a statutory definition of 'trade secret', the meaning of the term has developed over numerous years through case law. In order to qualify as a 'trade secret' under English law, the confidential information must additionally cause real or significant harm if disclosed to a competitor.

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"Confidential information and trade secrets are increasingly taking centre stage with recent changes in data protection law and in a world where the threat of cyber crime is ever-present."

The Directive brings the definition of 'confidential information' closer to that of the English law definition of a 'trade secret'. Under the Directive, a 'trade secret' must meet the following requirements: (i) the information must be confidential; (ii) the information must be of commercial value as a result of its confidentiality; and (iii) the holder of the trade secret must have made reasonable efforts to maintain its confidentiality.

Confidential information and trade secrets are increasingly taking centre stage with recent changes in data protection law and in a world where the threat of cyber crime is ever-present. The insurance industry has seen a rising number of general breach of confidence claims, especially in circumstances where directors and officers move from one company to a competitor company, and businesses are becoming more aware of the need to protect themselves against potential liabilities concerning intangible property.

Insurers may wish to review policy wordings prior to the UK's implementation of the Directive, for example to assess the suitability of the definitions of 'confidential information' and/or 'trade secret', as well as any exclusions pertaining to the same.

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2. MARKET DEVELOPMENTS

A Tricky Science: Modelling Hurricanes Harvey, Irma and Maria

2017 is set to become the costliest year in history for weather disasters. Weather-related insured losses for 2017 have been estimated at US$134bn and some 60% of this figure comes from the three major events of the 2017 hurricane season: Harvey, Irma and Maria (HIM).

In this context, catastrophe modelling has assumed an increasingly important role in recent years for the (re)insurance industry. It has become highly sophisticated, a unique combination of actuarial science, engineering, meteorology and seismology. These models combine analysis of long-term climate change trends, economic growth and coastal construction with windstorm patterns and effects of storms over land. However, the 2017 hurricane season has raised significant questions about the methodology and accuracy of catastrophe modelling.

Following the onset of hurricanes HIM, modelled loss estimates varied significantly, and it is the level of fluctuation that has drawn criticism from some in the industry and prompted calls for better models. The widest variations were seen for Maria, where estimates ranged from US$15bn up to US$85bn. The actual insured losses from Maria are yet to be confirmed, but Swiss Re has estimated them at US$32bn. In total, hurricanes HIM caused US$215bn of overall losses, of which US$92bn is expected to be insured, according to Munich Re. Catastrophe modelling has never been an exact science and modellers accept the ranges of errors and uncertainties in their models.

What makes catastrophe modeling difficult?

Hurricanes HIM demonstrated that there are many reasons that it is difficult to model hurricane losses accurately. Whilst catastrophe modelling can predict a given level of physical damage following a storm, the quantum of actual insurance claims is another matter and can depend heavily on the policy terms and an insurer's claims adjusting practices. For example, policy provisions for basis of indemnity can significantly affect the amount of a claim. Another issue is that catastrophe models can struggle

when strong wind events are also major flood events. This was the case for Harvey, whose impact at landfall was relatively modest, but was followed by record levels of rainfall over Houston – the fourth largest US city. This was difficult to model, because catastrophe modelling does not typically take account of rainfall and flooding.

Sometimes there are specific circumstances in play which significantly affect insured losses whilst eluding the most sophisticated models. One example is Superstorm Sandy in 2012, which led to US$300m in lost fine art in the many expensive beachfront homes that were damaged.

The speed at which residents leave storm-threatened areas can also have a significant impact on ultimate insured losses. For example, the exposure to car insurers varied wildly between Irma and Harvey because many residents had left Florida before Irma hit, but had not left Houston before Harvey. There are now fears that certain auto insurers in Houston may go out of business.

These complicating factors for property damage (PD) modelling also have a knock-on effect on business interruption estimates, which are typically modelled as a function of PD estimates. Moreover, the margins can be extremely fine. It is estimated that a mere 20cm rise in the sea level at the southern tip of Manhattan Island increased storm surge losses from Superstorm Sandy by 30% (around US$8bn).

How can models be improved?

Some in the (re)insurance industry have put forward suggestions as to how models could be made more accurate and useful for future events such as HIM. David Flandro of JLT Re recommended *"a combination of models or...completely different methodologies from the usual distribution-driven, stochastic analyses currently widely used"*.

Flandro also discussed the option of moving away from emphasis on severity, windspeed and trajectory to an approach encompassing multiple storm trajectories, modelling them every few miles apart in real time. He said *"storm surge and flooding could be calculated for each of these scenarios and ramped up to different severities"*.

Others have commented that closer attention should be paid to the quality of the loss estimates generated by the different models and on how well the scientific data is implemented to produce reliable loss estimates.

With the new hurricane season set to begin officially on 1 June, catastrophe modelling will again take on an important role, especially given that forecasters are already predicting a high level of activity. It remains to be seen whether the modelling of future weather events will prove easier than HIM. In any event, insurers will be striving to keep premium rates high so as to build up reserves to cater for the next high loss year.

In October 2017, HFW London hosted a presentation and panel discussion about the impact of hurricanes HIM with Gerard Kimmitt and Sheshe Evans from HFW's Houston office together with HFW London partners Chris Cardona and Andrew Bandurka. To read more about the discussions, follow the link: http://www.hfw.com/Hurricanes-Harvey-Irma-and-Maria-October-2017.

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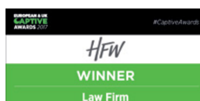
HFW has over 500 lawyers working in offices across Europe, the Americas, Australia, Asia and the Middle East, For further information about our Insurance/reinsurance capabilities, please visit http://www.hfw.com/Insurance-Reinsurance-Sectors



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