Insurance/
Reinsurance

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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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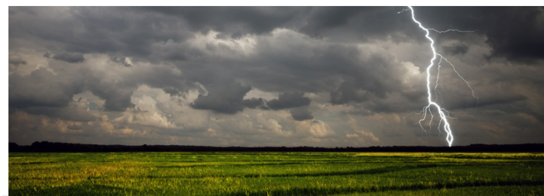

hfw 1. Regulation and legislation

Hong Kong: The Independent Insurance Authority sets out its plans for the year ahead

In our 14 January 2016 bulletin, we reported[1] that the appointments to the Independent Insurance Authority in Hong Kong (IIA) had been announced.

The IIA held its first meeting on 29 January 2016[2]. Dr Moses Cheng, the newly appointed IIA Chairman, highlighted that the priority of the IIA is to prepare for the smooth transition from the existing regulatory regime to the new regime. He confirmed that the process would be implemented in phases. The government's target is for the IIA to take over the regulation of insurance from the Office of the Commissioner of Insurance (OCI) by the end of 2016 and to commence the supervision of insurance intermediaries in the next two to three years. In doing so it will replace the three self-regulatory organisations (namely Hong Kong Federation of Insurers, Hong Kong Confederation of Insurance Brokers and Professional Insurance Brokers Associations). The Chairman explained that the IIA would build on the work of the Working Group on Transition to IIA, which was set up by the Financial Services and the Treasury Bureau and OCI, and continue to work with the insurance industry during the transition.

According to the press release the following issues were specifically discussed:

- The IIA's corporate plan for 2016-2017.
- The organisation structure and recruitment of staff for the IIA's executive arm. In this regard, an earlier recommendation by a consultancy commissioned by the Government to recruit 299 staff was noted. This is a slightly higher number than previously indicated (240-250) which probably reflects the amount of work that the IIA is likely to take on.
- The establishment of three committees:
  - **Corporate Services Committee –** to oversee and advise the IIA on recruitment, office accommodation and accounting issues.
  - **External Relations Committee –** to advise on matters related to the publicity programme and stakeholder engagement strategies.
  - **Audit Committee –** to advise on matters relating to auditing.

  The IIA also plans to form an Investment Committee to advise on the investment strategy for the IIA's funds. One of the new functions of the IIA, which was included following consultation, is to *"formulate effective regulatory strategies and facilitate the sustainable market development of the insurance industry, and promote the competitiveness of the insurance industry in the global insurance market"*. It will be very interesting to see how IIA will carry out this function, especially in view of the successful strategies adopted by the Singapore authorities.
- The Government's proposal regarding appointments to the two industry advisory committees on long-term business and general business. The committees will be appointed by the Financial Secretary and comprise practitioners from different lines of insurance business and experts from related fields such as consumer protection, compliance and accountancy. They will advise the IIA on industry-related issues.

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1 http://www.hfw.com/Insurance-Bulletin-14-January-2016

2 http://www.info.gov.hk/gia/general/201601/29/P201601290412.htm

Europe: EIOPA opinion on group solvency calculation methodology

The Solvency II Directive provides for alternative methods for carrying out the group solvency calculation:

- Consolidation under Article 320.
- Deduction and aggregation under Article 233.
- A combination of both methods, subject to group supervisor approval.

EIOPA recently published an opinion[1] (EIOPA-BoS-16-008) concerning the use of a combination of methods, highlighting matters which the group supervisor should consider when approving the use of a combination of methods.

The EIOPA opinion states that when a combination of methods is used, the provisions of the Solvency II Directive relevant to (i) the consolidation method; and (ii) the deduction and aggregation method should be applied respectively. This means that distinct tier limits should be used for the parts of the group using each method.

1 https://eiopa.europa.eu/Publications/Opinions/20160127_EIOPA%20opinion_combination%20of%20methods.pdf

However, EIOPA also recognises that the use of a combination of methods may lead to unintended consequences for example, where groups organise their funding through a central holding company. In such circumstances, EIOPA recommends that the group supervisor should assess the potential impact of the application of a combination of methods before taking the decision, so as to ensure that prudential concerns are duly addressed and that no group is placed in an advantageous position compared to groups exclusively using the consolidation method.

EIOPA states that it will monitor developments in the issues addressed in its opinion.

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UK: Regulators take enforcement action on PI insurance failings

The Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) have taken disciplinary action against three insurance firms and five senior individuals at those firms holding regulated positions. The eight Final Notices, which were issued by the FCA on 1 February, were the outcome of a joint investigation by the FCA and PRA into unauthorised schemes in the solicitors' professional indemnity (PI) market. This concluded that there had been a failure in the management oversight throughout the distribution chains, significant integrity and competency failings, and failure to carry out adequate due diligence in arranging reinsurance.

Among those sanctioned by the FCA were UK insurer Millburn Insurance Company Limited (Millburn), Bar Professions Limited (Bar), a London broker specialising in solicitors' PI insurance, and Coverall Worldwide Limited (Coverall), another intermediary. The firms and individuals were fined a total of £15.5 million.

The schemes used were highly complex, and led to the FCA liaising with over 20 regulators and agencies globally to carry out its investigations. In essence, the distribution chains involved using binding authorities issued by a managing general agent in London, Aderia UK Limited (Aderia), to various coverholders including Bar. Aderia was an appointed representative of Millburn and a UK insurance intermediary, Coverall, whose director Shay Reches was central to the unauthorised practices and he also controlled the main risk carrier, Sinclair Insurance Company. Mr Reches performed the CF1 (director) controlled function at Coverall, with responsibility for Aderia, which were central to establishing and operating the insurance schemes, despite note being approved to do so. In doing so, Mr Reches "recklessly" transferred insurance premiums to parties other than the (re)insurers who were responsible for paying the claims, thus increasing the risk that the policyholders' claims would not be paid. According to the FCA Final Notice, the scheme also "contributed to" the administration of three insurers: Millburn, Icelandic insurer European Risk and Insurance Company and Balva, a Latvian insurer. It has also prompted the Financial Services Compensation Scheme to pay out £12.7 million as of the end of 2015.

This case is of particular interest to insurers because it is the first time that the FCA and PRA have worked together to take enforcement action against a combination of insurers, intermediaries and individuals. It is also notable due to its sheer scale. The insurance arrangements that were subject to regulatory investigation related to the insurance of 1,300 law firms in England and Wales.

Perhaps most significantly, the FCA has announced that the outcome of this case highlights a number of wider concerns that the FCA has about the insurance sector. This includes not only regulated activities carried out by unauthorised firms but also the responsibilities of intermediaries such as brokers. The FCA has stated that its concerns are as follows:

- Lack of due diligence applied by market participants when selecting potential insurance and reinsurance security.
- Poor understanding and scrutiny of appointed representatives and those carrying out other delegated authority functions.
- Need for clarity and certainty about roles and responsibilities.
- Responsibilities of intermediaries used in the distribution chain.
- Lack of understanding and correct application of the client money rules.
- Lack of adequate systems and controls in ensuring client money is protected.

This matter also highlights the fact that brokers and insurers are increasingly being held accountable for activities that they may previously have considered not to be their responsibility. This is particularly the case when insurers and brokers are involved in complex distribution chains involving delegated authority and/or outsourcing arrangements. Insurance firms must therefore continue to monitor their internal due diligence procedures very carefully to ensure

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they comply with the expectations of the FCA and PRA.

The FCA's June 2015 thematic review TR15/7 Delegated authority: Outsourcing in the general insurance market is available at https://www.fca.org.uk/static/fca/documents/thematic-reviews/tr15-07.pdf.

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2. Court cases and arbitration

England and Wales: Brokers, beautiful places, and the "TOWIE effect"

***Sugar Hut Group Ltd & Ors v A J Insurance Service (a partnership)* [2016] EWCA 46[1]**

Main proceedings

In the main proceedings in this case[2] the claimant, Sugar Hut, claimed damages against its insurance broker, A J Insurance. Sugar Hut had suffered losses as the result of fire at its nightclub premises - *"a beautiful place teeming with beautiful people"* according to the evidence of the owner. Sugar Hut had been unable to claim under its insurance policy because that policy had been avoided due in part to the negligence of A J Insurance in placing it.

Sugar Hut claimed damages from A J Insurance representing the sums that it said it would have recovered in respect of property damage, business interruption and other associated losses under its insurance, but for the avoidance.

Questions of liability having been agreed prior to the trial, the court had to decide, amongst other things, the appropriate method for calculating the loss of turnover during the period of closure, so as to be able to quantify the business interruption portion of Sugar Hut's loss. A lack of available evidence meant that various alternative methods for carrying out this exercise were considered.

The court held that, on the facts, no assistance could be gained from analysing the turnover actually achieved after the club reopened. This was due in part to the "TOWIE effect", which was the effect upon the turnover of the club of its use in a popular television programme "The Only Way Is Essex" (*"I have not had the benefit of seeing this TV show"*, Mr Justice Eder admitted). The loss in turnover was accordingly instead assessed solely by reference to a "necessarily crude and somewhat inexact" analysis based upon a comparison of turnover during certain periods prior to the fire. On this basis, the court assessed Sugar Hut's business interruption loss at £568,670, against Sugar Hut's claim of £862,024.

Costs proceedings

Following the judgment in the main proceedings, a separate dispute arose over costs. In our 30 January 2015 bulletin[3] we reported that, when called upon to adjudicate this dispute, the court had ordered Sugar Hut to pay A J Insurance's costs relating to the assessment of damages from 21 days after the date on which A J Insurance had made a Part 36 offer.

This was on the basis that although Sugar Hut had (by a small margin) beaten A J Insurance's overall Part 36 offer (to settle the entire claim), the figure for business interruption upon which A J Insurance's offer had been based (£600,000) was in fact higher than the assessment of the business interruption loss arrived at by the court (£568,670, as above). In the court's view it was unreasonable for Sugar Hut to have continued to pursue a claim for business interruption losses which was larger than the figure that AJ insurance had offered.

1 http://www.bailii.org/ew/cases/EWCA/Civ/2016/46.html

2 *Sugar Hut Group & Ors v A J Insurance* [2014] EWHC 3352 (Comm) http://www.bailii.org/ew/cases/EWHC/Comm/2014/3352.html

3 http://www.hfw.com/Insurance-Bulletin-30-January-2015

Appeal of costs decision

In this latest decision, however, the Court of Appeal has overturned the decision on costs. The Court of Appeal held that Sugar Hut's conduct in pursuing a higher figure for business interruption had not been unreasonable. A J Insurance had made no standalone offer capable of acceptance to compromise the business interruption losses for £600,000. The offer was part of a wider offer which Sugar Hut had ultimately beaten. It could not be unreasonable conduct simply to pursue one head of loss in an amount greater than that at which it was valued by the other party.

The Court of Appeal also disagreed that certain other factors relied upon at first instance in categorising Sugar Hut's conduct as unreasonable (supposed exaggeration of the claim and an unreasonable approach to disclosure) were made out.

In addition, the first instance court had already penalised Sugar Hut for failing to make out a large portion of its business interruption claim by reducing the amount of costs recoverable by Sugar Hut relating to the period prior to the Part 36 offer. The lower court's order in respect of the period following the offer therefore meant that Sugar Hut was being "twice penalised" for the same shortcoming.

The main proceedings in this case are:

- An important reminder of the large liabilities that can be incurred by brokers in failing properly to discharge their obligations upon the placement of a policy. In this case, the broker was effectively required to stand in the shoes of the insurers and to pay damages equivalent to an indemnity under the avoided policy, albeit adjusted to reflect the agreed apportionment of liability.
- An interesting illustration of a court attempting to reach a sensible means of assessing a business interruption loss in circumstances in which the crucial evidence was lacking in some respects.

The costs proceedings provide a useful reminder of the operation of Part 36 principles, in particular as to the other factors which may in certain circumstances displace the usual Part 36 consequences.

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3. HFW news

HFW wins Onshore Law Firm of the Year 2016 at UK Captive Services Awards

On 11 February, HFW was named Onshore Captive Law Firm of the Year 2016 at the UK Captive Services Awards. The awards recognise and reward those captive insurance service providers that have demonstrated exceptional customer service and innovative product development. Senior Associate Alison Proctor accepted the award on behalf of the firm. A full list of winners is available at: https://www.eiseverywhere.com/ehome/143331/327150/?&

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