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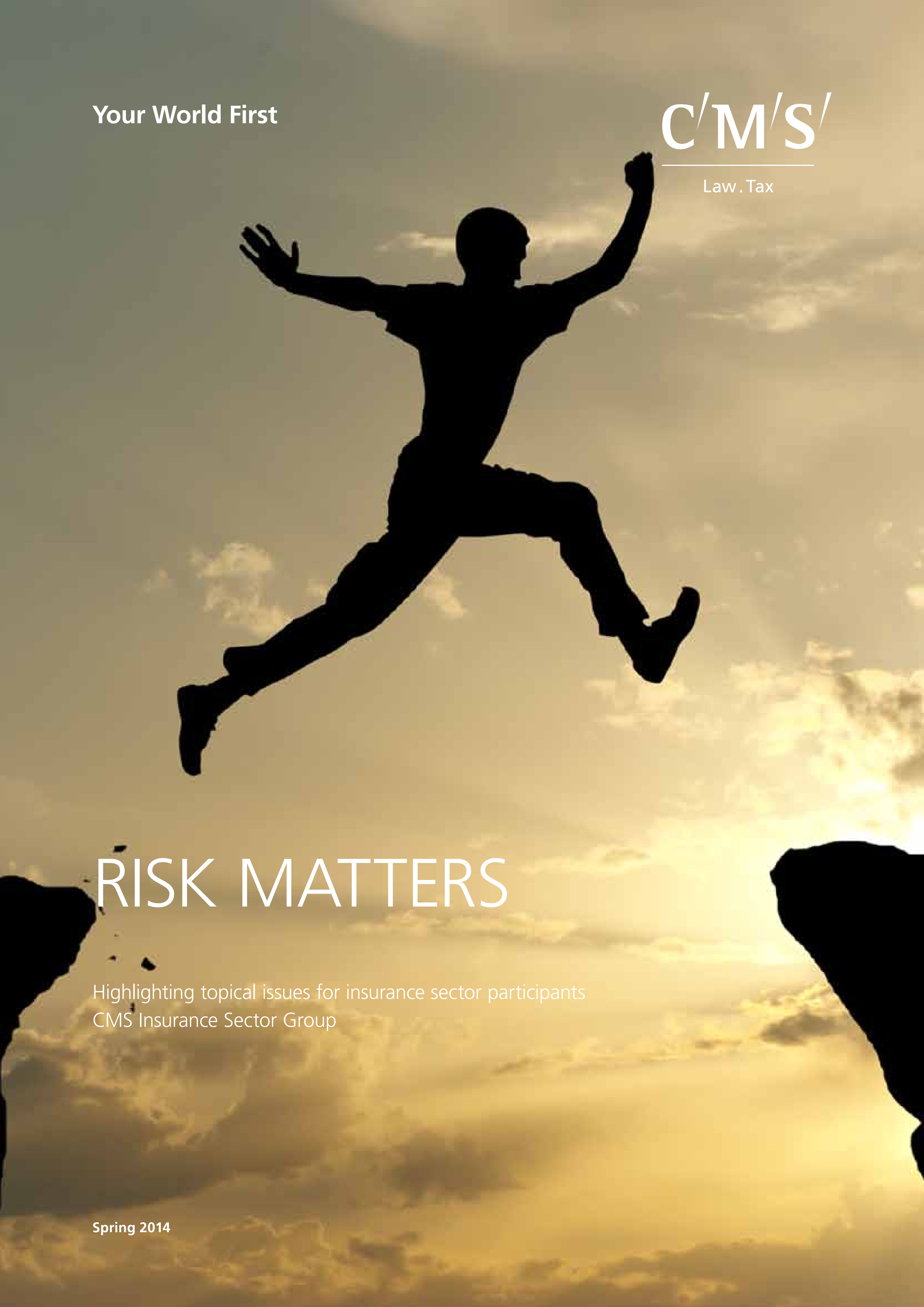

RISK MATTERS

Highlighting topical issues for insurance sector participants
CMS Insurance Sector Group

Spring 2014

Contents

Forthcoming seminars

Date	Location	Seminar
2 April	Mitre House, London	**Employment - a review of recent employment law cases** Please register by 12.00 Tuesday 1 April. To apply for a place please email jo.brogan@cms-cmck.com or liam.kerr@cms-cmck.com
30 April	Mitre House, London	**Employment - Atypical workers** Please register by 12.00 Tuesday 29 April. To apply for a place please email caroline.humphries@cms-cmck.com
13 June	Lloyd's of London	**Global flooding trends and lessons learned** Speakers include: — Professor Tim Palmer *Climatologist, Oxford University* — Dr Jane Toothill *Director, JBA Risk Management* — Robert Muir-Wood *Chief Research Officer, Risk Management Solutions (RMS)* — Jonathan Clark *Head of Business Solutions & Syndicate Claims, SCOR* To apply for a place, please email globaltrends@cms-cmck.com

Introduction

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Reactions
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Welcome to this spring 2014 edition of Risk Matters, your guide to the latest themes and subjects affecting domestic and international insurance markets.

In this issue, we explore emerging topics that position the insurance industry in a variety of roles as both leader and intermediary.

Our guest commentators in this issue are Rod Logan and James King from the Association of British Insurers. In the article, they explain how the sector is delicately placed between a new regulator (FCA) with an expanded remit to promote competition, and the consumer, whose protection is its other primary goal. Within that dynamic, they point out that with no less than five overlapping competition and regulatory enquiries already underway, the FCA is yet to properly map out how it will promote both compliance and competition. Therefore they provide five recommendations for both sides so that they might contribute to a relationship that benefits insurers and consumers alike.

Meanwhile on a more commercial footing, CMS lawyers are regularly instructed on some of the most innovative projects within the market. In this issue of Risk Matters Aaron Fairhurst and Jason Zemmel consider the potential of new types of warranty and indemnity products that are driving M&A activity across the globe. Successful M&A and investment transactions are obvious signs of an economic recovery and Nancy Eller continues this theme with a report on the increasing role played by insurers to bridge the funding gap for infrastructure and energy.

While insurers seek out new opportunities for their funds under management, Melville Rodrigues details the regulatory hurdles facing them as they navigate the alternative investment market. He explains how there will be a ‘double-whammy’ business effect on managers of a fund-of-funds (FoF) that invest in private equity, hedge, real assets and other alternative investment funds, with many managers requiring new authorisations as soon as July 2014.

Returning to the non-life sphere, 2014 has already been a year in which property insurers have endured heavy weather-related losses globally and here in the UK. Simon Kilgour details this country’s development of Flood Re, a pooled system funded by a levy on household policies that aims to provide cover for ‘at risk’ properties. As Simon reveals, the questions still outnumber answers on this particular scheme.

Also changing in 2014 are the employment regulations that govern our approach to recruitment, redundancies and employee protection. Here, Sarah Ozanne explains the ins and outs of these latest developments including the Government’s continued review which aims to peel back some of the ‘gold-plated’ interpretations that have squeezed employers in recent years.

I also review with my colleague Alaina Wadsworth, the recent and topical developments on potential business insurance law reform in the UK.

We hope you find this edition of Risk Matters a helpful round up of key issues and welcome any feedback you would care to give.

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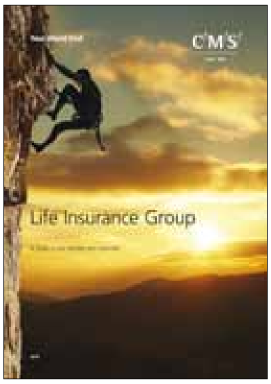

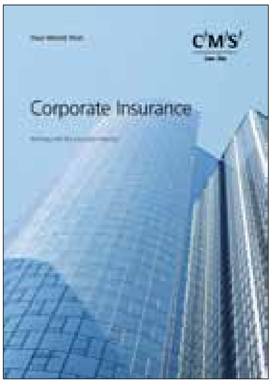

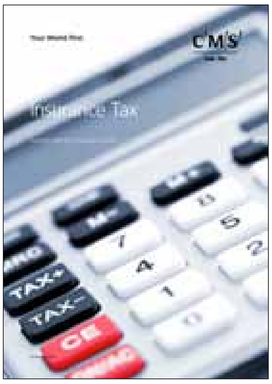

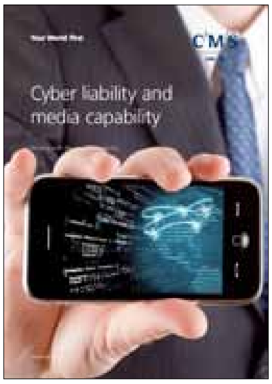

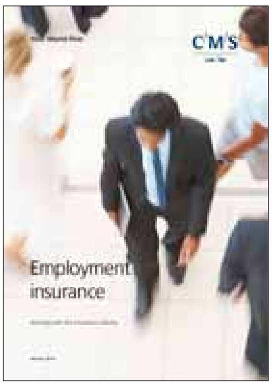

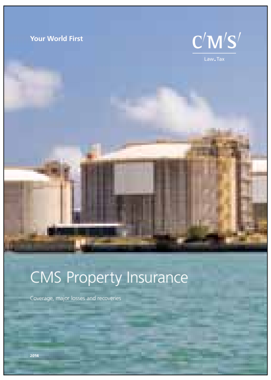

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Guest contributor – ABI

FCA and competition: a new direction for financial regulation?

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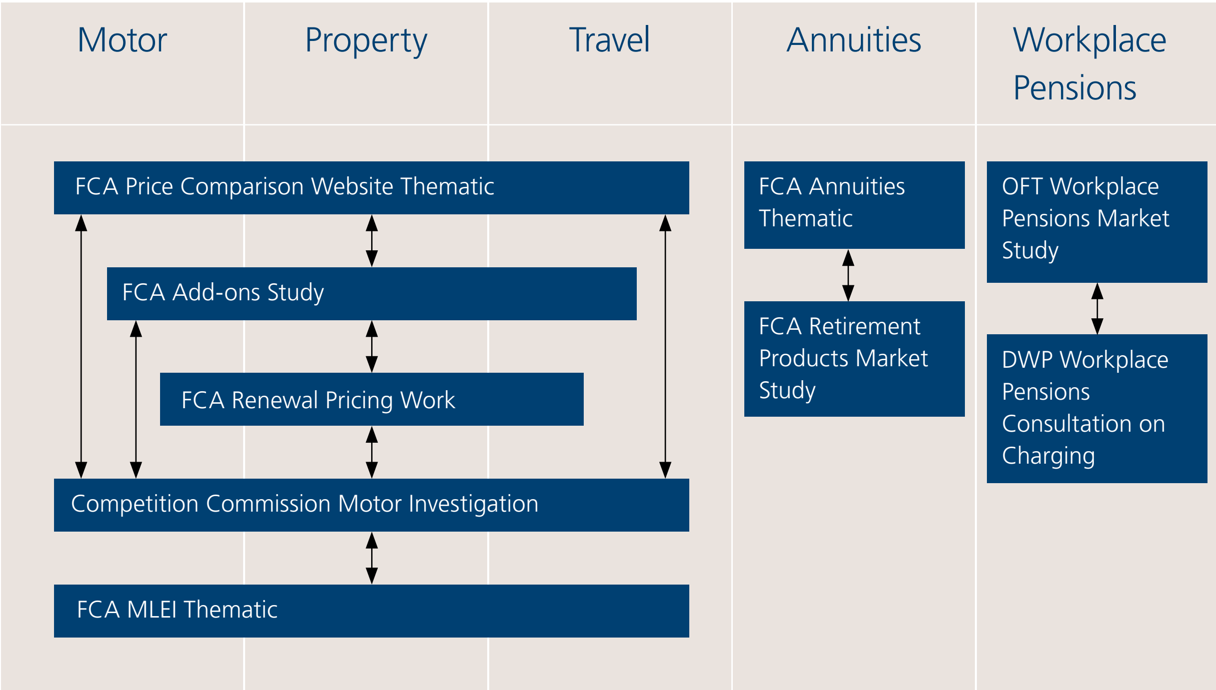
The creation of the Financial Conduct Authority (FCA) with its expanded remit to promote competition marks an important step change in financial services regulation. Instead of focusing only on the compliance of individual firms with the rulebook, the FCA is placing greater emphasis upon understanding and influencing the dynamics of markets as a whole. This new regulatory environment presents some new challenges and opportunities to insurers.

At the time of writing, the FCA has published provisional findings and remedies from its first market study in to general insurance add-ons. However, while this report signals willingness to adopt new types of interventions, it is still early days in assessing how the FCA's competition objective will impact upon its overall approach to regulation. The calls for evidence issued in relation to this and the other initial market studies – cash savings and retirement income products – have been very high level and give only a limited indication of the FCA's concerns and theories about how those markets are operating. With this in mind, the ABI has developed five key recommendations for the FCA and a further five for the insurance industry, so that the new regulatory environment can benefit both consumers and firms.

Five recommendations for the FCA

1. *We recommend a joined-up approach within FCA to market analysis and interventions* – The FCA has hit the ground running with a series of reviews and studies. While a more 'hands on' approach is understandable given what went before, the level of activity should not be overdone, particularly when multiple reviews relate to the same market. For example, as illustrated by figure 1, there are currently five ongoing investigations in the motor market (including the Competition Commission's (CC) private motor insurance investigation). Insurers need to spend time and resource on responding to these reviews which would otherwise be directed at improving their businesses. So it is important that the FCA does not introduce too much regulatory burden and uncertainty by launching numerous and potentially overlapping or contradictory reviews at the same time. Furthermore, the boundaries between a thematic review and a market study need to be made clearer – this has not been obvious in relation to annuities, for example. Finally, the FCA needs to be clear about the market issues under consideration when it seeks stakeholder input – we regret that it did not engage with the industry about the development of its thinking in relation to general insurance add-ons ahead of publication of the report.



Source: Association of British Insurers

Key

◄──► = potential overlap

2. *We recommend close coordination with the new Competition and Markets Authority and Government departments* – Other bodies continue to scrutinise and regulate the same markets as the FCA (e.g. Office of Fair Trading (OFT) market study on workplace pensions). Coordination is vital where there is regulatory overlap with the work done by the Competition and Markets Authority (CMA) (soon to replace the OFT and the CC) such as motor insurance add-ons. In markets where the investigation extends beyond the FCA's remit (such as motor repairs in the motor insurance market) the competition bodies should take a lead role in conducting the review. However, it is very important that there is clarity on the respective roles/responsibilities of the FCA and the CMA.

3. *We recommend that FCA should provide more insight on how Behavioural Economics analysis will influence competition policy* – The FCA has placed Behavioural Economics (BE) at the heart of its competition regulation work as it can be used to better understand consumer behaviour. However, it is questionable how much BE takes account of consumers' heterogeneous behaviour, which is problematic for the FCA as it means that a policy intervention designed to improve the welfare of one group of consumers may lead to another group being worse off. This begs the question of whether the FCA should weight the welfare of one group of consumers any differently to another group. So far, the FCA has focused primarily on the theoretical implications of the use of BE, with the add-ons market study offering the first clues as to how the FCA intends to use BE within its policy framework. We would nevertheless encourage the FCA to provide guidance on this.

4. *We recommend caution when conducting profitability analysis and pricing interventions* – The FCA has identified profitability as a potential regulatory consideration. However, assessing whether profits are 'fair' or 'competitive' is complicated and a hasty snapshot analysis based on an arbitrary threshold of 'good' profit where everything greater is 'bad' profit is not advisable. The FCA should take note of OFT guidance which states that performance indicators, such as profit alone, yield little information about the state of competition in a market. Economists also recommend caution regarding regulatory interventions to set prices, as they can push prices towards a ceiling if set too high or result in a shortage of the product if set too low.

5. *We recommend that FCA should operate on the basis that neither different markets nor consumer interests are homogenous* – The FCA needs to avoid a 'one-size-fits-all' approach. While some issues transfer across to different markets, care needs to be taken not to assume a perfect fit. When the FCA conducts market studies and thematic reviews it should clearly define the markets it is scrutinising and should recognise the differences in the relevant markets (e.g. distribution channels, number of providers, target consumers) when drawing conclusions and devising interventions.

Five recommendations for the industry

1. *Insurers should be prepared for a different type of regulation focused on markets and overall consumer outcomes, not just individual firms' compliance with conduct rules* – The industry needs to proactively cooperate with the regulator. By being transparent and recognising that the FCA now has a new focus and objective, insurers can make it easier to build a positive relationship with them. The ABI is already actively engaging with the regulator, and it is important for the industry to show it is committed to making markets work well.

2. *Insurers should take the time to explain to regulators how each of our insurance product markets works in practice as this improves the effectiveness of data requests* – Insurers know what they sell, how they do it, how consumers engage with their products and what specific market features merit regulatory scrutiny. As a result, they should work with the regulator to explain some of the nuances and complexities that exist across different insurance lines, as well as listening to their concerns and acting on them where appropriate to address or prevent a market failure.

3. *Insurers should engage the whole business in responding to FCA, not just compliance* – The FCA's broader remit to monitor whole market dynamics means that effective engagement should involve every level and division of the business, not just compliance. Insurers need to develop new skills and source relevant expertise to understand and adhere to the new competition-focused regulation and act proactively to avoid costly regulatory intervention further down the road.

4. *Insurers should be aware of political interest in our markets, and the risks of quick fix solutions, and recognise the advantages of interventions which are evidence-based and firmly set within the FCA's regulatory framework* – The financial services industry remains an ongoing priority for politicians, and arguably sometimes an easy target based on the fallout from the global economic crisis. So to circumvent the risk of rushed political interventions without proper economic analysis, insurers should work constructively with the FCA and political stakeholders with the aim of agreeing evidence-based, regulator-led market interventions where appropriate.

5. *Regulatory change represents a challenge to business models, but insurers should also recognise the potential for strategic opportunities for growth as a result of changing regulation and market dynamics* – Insurers should embrace the regulatory shift towards understanding and analysing markets and away from an emphasis only on compliance with detailed rules. The shift can represent an opportunity for insurers to explore new niches and grow market share e.g. through reduced barriers to entry. The FCA's focus on the bigger picture should also help firms who consider distortions in the market, and indeed regulations, currently impede competition and consumer access to products and services that meet their needs.

In summary, insurers should not be afraid of competition regulation as it can be viewed as an opportunity to improve the operation of markets. For its part, the regulator should ensure that it conducts high quality market analysis and pursues well-considered interventions. While some markets may require some regulatory intervention to function more effectively, there is plenty that already works well within the highly competitive insurance sector.

UK Floods: Flood Re is not yet watertight

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The not-for-profit insurance industry and government scheme, Flood Re, has the potential to be an effective solution to the challenge in making competitive insurance terms available to policyholders most at risk of flooding. However, in its present guise the scheme raises as many questions as it answers and onlookers are monitoring developments with interest in advance of the targeted implementation date of August 2015.

The recent catastrophic floods across many parts of the UK have highlighted a number of challenges that the insurance industry now has to face, from questions on causation to the logistics of claims management. However, the wider issue of being able to offer affordable insurance cover to those most at risk of flooding remains one of the hottest topics in the wake of this year's weather conditions. The impact of the recent floods should not be underestimated; Credit Suisse has estimated that the insurance losses arising from the floods may reach up to £1.2 billion. As a result, the proposed application of Flood Re has come under increased scrutiny as in its current guise many properties affected by this year's flooding would not be eligible to benefit from its protection.

Flood Re builds on parts of the ABI Statement of Principles which were established in 2003 but were due to come to an end in June 2013 (although the Government and the ABI have reached an understanding to continue to act in accordance with the Statement of Principles until the Flood Re scheme comes into force in August 2015). Under the Principles ABI members are committed to continue to offer flood insurance to existing domestic properties and small business owners even where the property is at significant flood risk.

Flood Re will operate as a fund (funded through a levy of around £10.50 on each annual household insurance premium) which aims to subsidise the premiums of those who live in 'at risk' areas (subject to certain exceptions). Flood Re will also function as a reinsurance scheme by allowing insurers to transfer the premium they receive in respect of the 'flood risk element' of home insurance policies to Flood Re and in return be compensated for flood claims that they pay out to their customers. The levy, together with the income from premiums, will be used to pay out claims, purchase reinsurance and fund the running of the scheme. The Levy is set at £180 million p.a. for the first five years and the levy will be used, alongside Flood Re's premium income, to buy reinsurance, pay claims, and fund the running of Flood Re. The reinsurance limit is envisaged to be £250 million and it will take some time (assuming no large losses) to build up the fund. If a loss event occurs that Flood Re's funds and reinsurance cover are unable to fully meet, the pool will charge each of its member firms an additional amount to make up the shortfall known as the 'top-up levy'.

As presently drafted Flood Re is restricted in scope. The scheme excludes:
— Properties in the highest Council Tax Band H
— Properties occupied by a tenant rather than the owners
— Businesses falling within the 'Small and Medium Enterprise' category and
— Homes built after January 2009 (this exclusion was designed to disincentivise the building of properties in high flood risk areas).

In all, the exceptions mean that as many as one in six properties across the UK would not have access to the benefits of the scheme. Flood Re only goes so far and as it is not aimed at the commercial market it was never intended to meet any business interruption or supply chain losses. Of greater controversy is that Flood Re will not address the problem of finding competitive cover for those outside the scheme. Prohibitively high costs of flood insurance or the unavailability of cover for policyholders inside high flood risk areas but outside Flood Re's scope remain very real concerns.

The government has confirmed it is considering a carve out for categories of property such as Bed & Breakfasts which may fall within the scheme as they are owned and resided in by the policyholder. It has stated it will provide further guidance on the treatment of these properties in due course. Those business policyholders reconsidering their insurance arrangements in the light of recent flooding should also be aware that not only will Flood Re not provide them with access to competitive terms for flood risk but that 'normal' PD/BI cover will not indemnify them for losses attributable to a general loss of attraction in the flood affected area distinct from the business interruption losses the insured might suffer as a result of flood damage to their property.

The insurance industry's aim is to ensure that flood insurance remains affordable and available for everyone who needs it. Flood Re is a step in the right direction and sees the government and the industry working together to try and achieve this goal; historically government supported CAT schemes have proven they can work as market solutions to problems securing appropriate levels of cover. However, were the exceptions in the proposed Flood Re scheme to remain as presently envisaged, then it is likely that we would see homeowners or business owners who are excluded from the scheme facing increases in premiums as well as certain insurers offering tighter coverage, or no flood coverage at all to such homeowners. These are the precise issues Flood Re is intended to deal with.

Lobbying continues over Flood Re's scope and recently David Cameron confirmed the government is reconsidering the position on Band H properties, but a similar concession for SMEs is unlikely as these are classed as commercial enterprises that need to consider flood insurance cover as one part of their usual costs of effecting business.

Since its announcement, Flood Re has been plagued by criticisms from various industries including parts of the insurance industry such as the British Insurance Brokers Association (BIBA) and insurer Hiscox, which described the scheme as 'unfair and unworkable'. There is a real concern that some policyholders will be in the perverse position of paying the levy to subsidise their neighbour's flood insurance but buying their own on the open market.

The political will for change is apparent but the negative impact of the recent flooding on insurance policies and insurers' ability to offer cover could actually be exacerbated by the exceptions in Flood Re, should these flaws not be reconsidered prior to August 2015. Insurers remain confident that the government will review at least some of the exceptions. Ultimately, it remains to be seen whether the Government will re-negotiate any aspects of the scheme over the course of the next year. In principle Flood Re is a positive development but Flood Re is not, nor could it ever be, the whole answer to Britain's flooding insurance problems and the scheme in its current form could cause further issues for both insurers and insured going forward.

The recent UK floods are part of a wider global trend of flooding issues facing the insurance market and given the rise of global flood catastrophic events to the industry CMS is running a special one off seminar on 13 June. See page 2 for further details.

Insurance contract law reform

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The joint review of insurance contract law, commenced in 2006, by the Law Commission and the Scottish Law Commission is drawing to a finale with draft clauses recently published for the proposed Insurance Contracts Bill and a final Bill expected by summer 2014.

Amongst other things, the Bill will close the bifurcation between the duty of disclosure in consumer and non-consumer business that has existed since the coming into force of the Consumer Insurance (Disclosure and Representations) Act 2012 on 6 April 2013.

The draft clauses for including in the Bill cover the following:
— Fair Presentation (disclosure and representations) in business insurance
— Damages for late payment of claims
— Insurers' remedies for fraudulent claims
— Good faith
— Warranties and
— Contracting out.

Duty of disclosure/ The duty of fair presentation

The current law under s.18 of the Marine Insurance Act places a duty on a prospective business insured to disclose '*every material circumstance*' that it knows or ought to know '*in the ordinary course of business*' to the insurer. There is no requirement to ask questions of the prospective insured or for the insured to indicate what it wishes to know. In the event the insured fails to disclose material circumstances, the insurer may avoid the policy, treat it as if it did not exist and refuse all claims.

The draft clauses propose that the 'duty of disclosure' be replaced with a 'duty of fair representation', bringing non-consumer business into line with the provisions of the Consumer Act. The duty of disclosure will be satisfied if all material circumstances were disclosed and/or sufficient information was provided to put the insurer on notice to make further enquiries. It is intended that disclosure should be a reciprocal process in which the insured should make a fair presentation of the risk and the insurer should communicate what it wishes to know by way of appropriate questions. If the insurer receives information that ought to prompt it to make further enquiry, but it fails to do so, the insurer will not have a remedy for non-disclosure of a fact which those enquiries would have revealed.

The proposals shift the burden on to the insurer to make proper checks at the proposal stage. The proposals will also affect the insured and brokers. Simply dumping voluminous documentation on the risk to be insured will not be accepted as having 'fairly presented the risk' to the insurer. The insurer should not be forced to sift through masses of irrelevant information. The disclosure must be '*reasonably clear, accessible*'and focused on the truly material facts.

The proposed remedies for non-disclosure reflect those of the Consumer Act. The nature of the insurer's remedy will depend on the nature of the insured's misrepresentation:
— If the insured's misrepresentation is honest and reasonable, the insurer must pay the claim
— If the insured's conduct is dishonest or fraudulent, the insurer can avoid the policy and
— In the absence of dishonest and fraudulent conduct, the remedies will be proportionate, based on what the insurer would have done had it been fully apprised of the facts at the time of placement.
  - If the insurer would not have entered into the contract, the insurer may avoid the policy but must return the premium.

- If the insurer would have entered into the contract on different terms, the insurer can require that the contract be treated as if those terms apply.
- If the insurer would have charged a higher premium, the claim should be proportionately reduced.

Damages for late payment

The Commissions propose introducing a statutory duty on insurers to pay valid claims after '*a reasonable time*'. If an insured suffers a loss because an insurer fails to do so, the insured will be able to recover contractual damages. What amounts to a reasonable time will depend on factors such as the type of insurance, the size and complexity of the claim, legal compliance and any circumstances beyond the insurer's control. The insurer will also have a defence if it can show that it had reasonable grounds for disputing the claim (e.g. suspicion of fraud or lack of detail in the claim).

Remedies for fraud

With a view to clarify the common law regime, the draft clauses introduce a default statutory regime for fraudulent claims. The Commissions made it very clear that they do not intend to define fraud or to introduce specific remedies; rather, the focus is on whether the insurer is liable. There are four main elements to the Commissions' proposals:

- A policyholder who commits a fraud should forfeit the whole claim to which the fraud relates.
- The policyholder should also forfeit any claim which arises after the date of the fraud.
- The fraud should not affect any previous valid claim.
- The insurer should have the right to claim the costs reasonably and actually incurred in investigating the claim.

The draft clauses also provide similar provisions for fraudulent claims on group insurance policies.

Utmost good faith

The draft clauses propose to amend s.17 of the MIA, such that a breach of the duty of utmost good faith will not entitle the insurer or insured to a remedy of avoidance. However, the Commissions have stressed the importance of the duty of utmost good faith as a general interpretive principle that should remain part of insurance law.

Warranties

'Basis of contract' clauses

The draft clauses abolish 'basis of contact' clauses whereby representations made by the insured during the proposal or on variation are converted into a warranty by means of a provision in the policy. This mirrors s.6 of the Consumer Insurance (Disclosure and Representations) Act 2012 and brings non-consumer insurance law in line with the consumer regime. The prohibition on using 'basis of contract' clauses will be mandatory for non-consumer insurance contracts, as it is for consumer insurance. Insurers will still be able to include warranties or other express provisions covering similar subjects to those previously discussed or asserted between the parties but these must be expressly agreed with the insured.

Breach of warranty

Breach of warranty will no longer discharge insurers' liability, rather, suspend it such that liability can be restored if and when the breach is remedied.

Terms relevant to particular descriptions of loss

If a contractual term is intended to reduce the risk of loss of a particular kind or at a particular location or time, insurer will not be able to rely on breach of the term to exclude, limit or discharge liability for loss of a different kind or at a different time or location.

Contracting out

The Law Commissions intend the non-consumer law reforms to be a 'default regime' that the parties should generally be able to contract out of and substitute their own agreed regimes. However, parties will not be able to contract out of:

- 'basis of contract' clauses or
- the provisions relating to deliberate or reckless late payment of insurance claims.

Conversely, the provisions of the Consumer Insurance (Disclosure and Representations) Act 2012 and all terms of the draft Bill in so far as they relate to consumers are mandatory.

Conclusions

If the final draft Bill mirrors in substance the draft clauses, we will see a significant change to the law relating to business insurance. The Law Commissions are clearly keen to finalise the drafting so that the final text of the Bill can be published before the summer but, given the timescale, it is perhaps unsurprising that only 38 responses were received to the first consultation on draft clauses which closed on 21 February.

The proposed legislation will have major implications for the insurance market, including amendments to proposal forms and other documentation, the policy in particular. That said, the draft clauses published on 10 March include some changes to the draft that was published for consultation in January (for instance, the new clause 11(2), which provides that a claim may be fraudulent when made, or become fraudulent as a result of a later act) and it remains to be seen whether significant changes will be made. Insurers are likely to seek to limit any claim for late payment. Insurance professionals should ensure they have suitable internal guidance, establishing how best to evidence that claims handling processes have been reasonable and kept under review.

It remains to be seen whether insurers for non-consumer lines will seek to opt out of any of the provisions and, if they do, what knock on effect this will have on both insurer's and insured's remedies.

Oiling the wheels of M&A

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Over the last decade, Warranty and Indemnity (W&I) insurance has developed from a relatively unused product to become an increasingly regular feature of the M&A landscape, both in the UK and around the globe. Its growing popularity is testament to the results it facilitates and a proven claims track record has removed some initial scepticism as to its real value. Once a time-consuming and intrusive procedure, as the product has matured, it now fits seamlessly into the transaction mechanics and it is being utilised in ever new and innovative ways. All those involved in M&A should therefore take the time to understand the product and the opportunities and solutions that it presents.

W&I insurance, or as it is sometimes known, Transactional Risk insurance, fundamentally bridges the gap between the contractual protection that a seller is willing to give in respect of a transaction and the protection that a buyer requires to do the deal. W&I insurance therefore enables parties to a transaction to achieve an outcome or position, for the relatively low cost of a premium, that would otherwise be unattainable through a more traditional negotiation process.

Will Hemsley, Senior Vice President within the Private Equity and M&A group at Marsh, has commented that '2013 was a record year for the number of transactions supported by W&I insurance', citing the private equity and corporate markets as a key driver behind this growth. The real estate and infrastructure sectors have also seen a strong uptake.

In its basic form, W&I insurance provides cover for unexpected issues arising in connection with a corporate transaction, which would give rise to a claim under the standard warranties and indemnities included as a term in the SPA. The policy can enhance the protection on offer under an SPA, which is particularly useful where a seller is unwilling or unable to offer sufficient protection. This can be in terms of scope of the warranties and indemnities on offer or in terms of quantum/time where the insurance 'tops-up' the financial cap or longstop date offered by the seller.

A policy can be purchased by either a buyer or seller to a transaction. A sell-side policy allows the seller to claim from the insurer to cover a liability it has to the buyer. By contrast, a buy-side policy, which is more common, allows the buyer to claim from the insurer in respect of its losses without recourse to the seller.

Unsurprisingly, the rationale for taking out a policy may vary depending on whether it is driven by sell-side or buy-side motivations.

Sell-side policies enable sellers to limit their liability and achieve a 'clean exit', free from a long 'warranty tail'. This may be driven by a desire to distribute sale proceeds to shareholders or wind up a fund.
Buy-side policies provide comfort for buyers doing deals in unfamiliar jurisdictions where they are uncomfortable with the enforceability of the contractual protection against the seller. They can also provide comfort as to credit risk where there are doubts as to the solvency of the seller. Where a seller remains involved with a target company post transaction, for example in the private equity sector that has been quick to embrace the product, a policy can alleviate the need to pursue a management team and potentially damage an ongoing working relationship.

W&I insurance is also becoming a frequently used strategic tool in auction processes, where the use of W&I insurance allows buyers to differentiate and enhance the attractiveness of their bid. Recent developments have seen insurers provide protection on a 'nil-recourse' basis, when no contractual protection is available from the seller, for instance in sales out of insolvency.

Generally, basic W&I policies exclude any liability arising from known risks, those identified as part of the due diligence process or disclosure exercise. It is, however, possible to gain cover for identified risks, though, unsurprisingly this will usually be more expensive and time-consuming than the basic cover. Such risks tend to be in areas of high exposure but low risk, where insurance provides an alternative to the unattractive position of having funds tied up in an escrow account for a potentially long period. Tax risks are frequently covered in this way, where the buyer is unwilling to take a view on issues identified in tax due diligence and the seller sees the risk as arising from over-enthusiastic due diligence and over-cautious advice.

The price of a W&I policy will depend on the nature of the transaction being insured. Insurers will consider factors such as the policy limit and attachment point sought, the nature of the target business (including the jurisdictions it operates in) and the breadth and duration of the warranties before setting a premium. The premium for unknown risks will typically be 1%-2% of the policy limit.

CMS is the leading adviser in the W&I insurance market, advising all key players. The firm has extensive experience advising insurers in connection with the underwriting of transactions and tax risks as well as advising numerous buyers and sellers on arranging W&I insurance for their transactions. Our global footprint enables us to advise on multi-jurisdictional transactions and provide local law advice where it is needed in connection with W&I insurance.

We recently published the CMS European M&A Study 2014. The study provides unique insights into the European as well as individual M&A markets and makes some comparisons with the US. It summarises what can be considered 'market' in European M&A and provides detailed information about deal points which are usually the subject of intensive negotiations. The Study offers a unique overview of the present 'market standard' regarding many M&A key topics, both on a pan-European level and in the different jurisdictions, including the UK. Contact **helen.johnson@cms-cmck.com** for more information.

Uncaptivated by Solvency II

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Captive insurance companies all over the world are watching the implementation of Solvency II carefully, mindful of its potentially far reaching consequences.

The current estimated implementation date of Solvency II is 1 January 2016 and in its current iteration it will apply to all EU insurers and reinsurers including EU domiciled captives. One of the aims of Solvency II is to improve insurance capital adequacy and set improved risk management standards for the insurance industry. The ongoing uncertainty over proportionality and the treatment of captives, together with the expected additional costs of running a captive under Solvency II's regulatory environment are putting off companies considering the formation of a captive insurance company, as well as forcing existing captive managers to consider what changes they may need to make as a consequence of the new regulations to ensure that running a captive as part of their risk management programme remains a worthwhile exercise.

Concerns over the implementation of Solvency II are focused on the more stringent capital requirements and the treatment of captives as regular insurance companies. Under the new regime the capital requirements might eliminate certain insurers unable to diversify their risks leading to increased prices or a shrinking of the products available on the market.

The question of how to calculate the solvency capital requirements is of particular concern as the standard model (as defined by the regulations) may be unsuitable for captives given their specialist nature, but to apply a bespoke internal model requires the approval of the relevant competent regulatory authority which will be costly and time consuming. **The European Captive Insurance and Reinsurance Owners Association believe as many as 40% of captives could be forced to close because of the capital charges imposed by Solvency II, unless the rules for captives are relaxed to reflect the fact that they are not normal insurance companies.** The price of a move from a volume based capital regime to a risk based capital regime leads to heavier overall capitalisation obligations for captives.

Smaller captives are also concerned over the more onerous reporting requirements which are designed with large multinational insurance companies in mind not captives with limited resources.

In 2012 Bermuda elected to seek third country equivalence to Solvency II and successfully lobbied the European Insurance and Occupational Pensions Authority to secure the bifurcation of its regulations. It remains to be seen whether other jurisdictions will follow suit but that appears to be unlikely at present.

At present offshore jurisdictions such as Guernsey and the Isle of Man will not be obliged to comply with Solvency II and most seem wary of voluntarily applying it given their concerns over the practical effect of its implementation.

The offshore jurisdictions point to their compliance with the International Association of Insurance Supervisors' Core Principles released in 2011. The Core Principles are said to be similar to Solvency II but more proportional. Around 140 countries under IAIS will comply with the Core Principles whether they are Solvency II equivalent or not. What is interesting is that a key aim of the Core Principles is to promote global consistency in insurance regulation which may mean that in the long term Solvency II becomes the commonly accepted standard worldwide. Anecdotal evidence suggests that fewer captives are establishing themselves in Solvency II jurisdictions instead choosing to set up offshore to avoid the additional regulatory burden. Re-domiciliation looks set to be a hot topic for consideration among captive managers looking forward.

Risk and insurance associations at a European level continue to lobby the EU over the treatment of captives and it remains to be seen whether they will be dealt with differently once Solvency II is finally implemented. It is clear that five years after its announcement significant concerns still exist within the industry and captive managers will monitor developments with interest. CMS is uniquely placed within Europe to assist in preparing for the implementation of Solvency II and the effect on the ultimate insureds as well as the captives.

Sources compliment reinsurance specialist Simon Kilgour as being a '*very astute insurance lawyer,*' who is '*extremely good - in a very competitive reinsurance market he's a top-ranked name.*'

Chambers & Partners

Filling the funding gap for infrastructure and energy – an opportunity for life insurers

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With the retrenchment of bank lending being one of the defining themes of the economic crisis, it is only a matter of time before life insurers, pension funds and specialist investment funds move into the financing gap.

As anyone who has read a newspaper in the last five years knows, banks are lending less. Not all banks, and not in all sectors, but generally the heady days of bank lending pre-credit crunch have given way to banks being more prudent to whom they extend credit. Depending on the bank, that may mean less lending to companies in different countries, less lending to large corporates and more to SMEs, less lending on riskier assets, less long-term lending, or just less lending. That covers not only new loans, but also existing ones: many banks are selling off large portfolios of operational loans, and sometimes portfolios of non-performing loans, in an effort to deleverage balance sheets and improve capital ratios.

Ready to step into this funding gap are institutional investors with capital to invest, particularly those looking to invest in fixed income offering better risk-adjusted returns than currently available on the market given the fifth anniversary of quantitative easing. These investors include life insurers and pension funds who in particular are looking for long term liability-matching assets, frequently seeking lending opportunities in sectors such as infrastructure and energy as well as certain classes of real estate, with the potential for long-term stable cashflows.

Institutional investors have of course been mainstays of the lender base for many corporate borrowers in these sectors; for example, as purchasers of bonds issued by relatively highly rated utilities, including inflation-linked issues. They also have exposure on the equity investment side, frequently via listed funds whose core strategy is in these sectors.

However, some life insurers, with or without asset management arms, now feel comfortable that they have (or retain advisers that have) specialist expertise in infrastructure and energy to directly lend into these sectors via bespoke, individually arranged projects. There are potentially suitable direct lending opportunities in the transport sector, including roads, rail, airports and ports, in renewable energy including solar farms and on-shore and off-shore wind and ‘social infrastructure’, namely hospitals, schools, social housing and the like.

However, these opportunities can occur only if they can structure investments in a manner which mitigates risks to manageable levels, particularly in relation to the revenue stream underpinning the cashflows used to repay the debt.

Investors need to know whether the project is already operational, or does an asset need to be constructed or developed first, and if so how can they be assured that this will occur. They will focus on whether the revenue stream will be determined solely by the market (eg, because the public chooses to use a particular method of transport) or by law (eg, feed-in tariffs for renewables installations) or by contract (eg, in relation to much social infrastructure under the Government's ever-evolving Private Finance Initiative), and what else can impact on those cashflows.

There are numerous other areas of risk to focus on, with the emphasis determined by the specific characteristics of the infrastructure or energy project being evaluated. Each one is different and requires careful analysis and structuring. But many have the potential to assist insurers to increase the diversification of their portfolios, particularly in sectors that are not correlated with the broader equity markets, and in a manner that potentially provides superior returns than might otherwise be achieved through more conventional routes.

> CMS Cameron McKenna 'always takes a pragmatic approach and delivers on its promise to protect the client and get the deal done.'
>
> *Legal 500*

How has TUPE changed in 2014?

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The Transfer of Undertakings (Protection of Employment Regulations) 2006 (TUPE) implement the Acquired Rights Directive into domestic legislation. The purpose of the Directive (and so TUPE) is to protect the employment of employees where the business in which they work changes hands or there is a change of provider of the services in which they work.

The Government is conducting a Parliament-long 'Employment Law Review' which, last year, included a review of TUPE. The stated aim of this review was to remove areas of 'gold plating' where the scope of TUPE goes beyond the Directive. Following the review, TUPE was amended by the Collective Redundancies and Transfer of Undertakings (Protection of Employment) (Amendment) Regulations 2014 ('the Regulations') which came into force on 31 January 2014, subject to transitional provisions.

With its aim to peel back some of the Directive's gold-plating, the review recognised one of the key areas to go further than the Directive is that of service provision change. This is the application of TUPE in situations where services are outsourced, in-sourced or there is a change in contractor. As part of its consultation on amendments to TUPE the Government indicated that it intended to repeal the service provision change element. However, following strong opposition by respondents to this part of the consultation this proposal was abandoned and in doing so the Government acknowledged that if it had repealed the service provision change element of TUPE this would have thrown TUPE back into the pre-2006 position, resulting in greater uncertainty due to reliance on old and conflicting case law. However, the Regulations do amend TUPE (in line with recent case law) to clarify that in order for there to be a service provision change the activities carried out after the transfer must be 'fundamentally the same as the activities carried out by the person who has ceased to carry them out'. This clarifies that only activities carried out by the most recent contractor can be taken into account, rather than including within its scope the activities carried out by earlier contractors.

Transfer related dismissals and changes to terms and conditions of employment

Prior to the Regulations, if an employee of the transferor or the transferee was dismissed before or after a relevant transfer, they would be regarded as having been unfairly dismissed if the sole or principal reason for their dismissal was the transfer itself or a reason connected with the transfer. The Regulations have amended this by removing the latter limb so that under new TUPE a dismissal will be automatically unfair if the sole or principal reason is the transfer. Similarly, the same amendment has been made with regard to changes to terms and conditions, which are void if the sole or principal reason is the transfer.

As under the old regime, such a dismissal or change to terms and conditions will not be unfair/void if the sole or principal reason for it was an economic technical or organisational reason (ETO) entailing changes in the workforce. The Government has acknowledged that there may be some 'short term' uncertainty over whether the sole or principal reason for a dismissal or change is the transfer.

Under TUPE, where a transfer involved or would have involved a substantial change in working conditions to the material detriment of the employee, such an employee could regard themself as having been dismissed. A stream of case law has been developing as to whether a change in an employee's place of work is a 'change in working conditions to the employee's material detriment'. In response to this TUPE has been amended to confirm that 'entailing changes in the workforce' as part of the ETO defence will include instances where the employee's place of work changes for the purposes of the definition of 'redundancy' in the Employment Rights Act 1996. This will be a welcome amendment for employers as it is not uncommon for the location of where services are provided from to change following a change in contractor.

Redundancy consultation

In a collective redundancy situation an employer should undertake a period of consultation, the length of which is determined by the number of employees that it is proposing to make redundant. The Regulations amend both TUPE and the Trade Union and Labour Relations (Consolidation) Act 1992 so that consultation by a transferee with transferring employees pre-transfer can count towards collective redundancy consultation requirements, as long as the transferor and the transferee agree this approach.

In order to take advantage of this provision the transferee must notify the transferor that it elects to do so and the transferor must agree to the election. In the event of such an election the collective redundancy consultation requirements apply from the time of that election (and continue to apply after the transfer) as if the transferee was already the employer of the transferring employees. A transferee may cancel such an election at any time (and if it does any consultation that has been carried out prior to such cancellation is void).

This provision concerning redundancy consultation goes some way to addressing the fact that, to date, some transferors and transferees have undertaken joint collective redundancy consultation pre-transfer without any legal certainty it was valid. However, the take-up of this new concept may be limited if transferor employers are reluctant to allow the transferee pre-transfer access to their employees or to provide the transferee with information to facilitate such consultation.

Collective agreements

The Regulations amend TUPE so that terms of employment derived from collective agreements will 'crystallise' at transfer so that any future amendments agreed between the transferor and a trade union will not impact on the transferee's inherited employees' terms and conditions of employment. This 'static' approach is favoured by the European Court of Justice (ECJ). The ECJ's view is that the Directive has the dual aim of ensuring a fair balance between the interests of employees and the new employer, and that this fair balance would be undermined where the new employer is unable to participate in the relevant collective bargaining.

In summary

All these changes took effect from 31 January this year, although further changes are to follow with the extension of the time limit for provision of employee liability information from 14 to 28 days coming into force from 1 May and an exclusion from the consultation obligations for micro-employers with 10 or less employees from 31 July 2014. Overall, the TUPE landscape doesn't appear substantially changed but there is some welcome clarity and flexibility for employers, particularly around dismissals and changes to terms and conditions as well as dealing with transfer/ redundancy related issues.

In a last minute twist, Ed Milliband, supported by shadow ministers, has submitted a motion to annul the Regulations. It seems unlikely that the motion will be passed, but this challenge creates a further level of complexity in an already difficult area of law.

Fund-of-fund managers face a regulatory ‘double-whammy’

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The Alternative Investment Fund Managers Directive (AIFMD) will have an extensive impact on managers of alternative investment funds. In particular, there will be a double-whammy business effect on managers of a fund-of-funds (FoF) that invest in private equity, hedge, real assets and other alternative investment funds. Many FoF managers will need to be authorised under the AIFMD by 22 July 2014, and this will combine with FoF managers having to explore operating efficiencies in monitoring the underlying alternative investment funds. Although AIFMD aims to enhance investor protection, investors in FoFs will be concerned that the greater protection will result in an erosion of investment returns.

FoF managers that are based in the EU and promote funds to or service EU investors will generally need to be authorised under AIFMD. However, many managers based outside the EU will be able to promote to investors in many EU member states through national private placement regimes, which will, in most cases, remain until 2018.

The key criteria for determining whether EU FoF managers fall within scope of AIFMD include whether:-

— The FoF is an alternative investment fund (AIF) for AIFMD purposes, defined as a ‘collective investment undertaking’ which raises capital from a number of investors with a view to investing in accordance with a defined investment policy and is not an Undertaking for Collective Investment in Transferable Securities (UCITS). An AIF may be open-ended or closed-ended and take any legal form, though a FoF managed account servicing a single investor should, generally, fall outside this definition. In addition, joint ventures or other club arrangements in which the participants are actively involved in strategic management of the arrangements are excluded.

— The FoF manager is responsible for portfolio and/or risk management of the AIF FoF.

— The assets under management exceed €100m with gearing or, for closed-ended funds, €500m without gearing (provided it has no redemption rights exercisable during a five year period following the date of initial investment). Limited grandfathering provisions apply to closed-ended FoFs and other funds which expire prior to 2016 or are fully invested by 2013.

In the case of FoF falling within the scope of the AIFMD, the FoF manager should apply to its domestic regulator and be authorised before promoting an AIF FoF, or, in any event, should be compliant by 22 July 2014. Regulators recommend submitting applications as soon as practicable to achieve authorisation. When applying, the FoF manager needs to demonstrate its capacity to comply with AIFMD requirements and this relates in part to compliance with AIFMD by the FoF's underlying fund investments (see below).

In addition, the FoF manager needs to fulfil AIFMD capital requirements: €125,000 for an externally managed FoF and €300,000 for one that is internally managed. For an externally managed FoF, these sums increase where the AIF assets under management exceed €250m when they become equal to €125,000 plus 0.02% of the amount above £250m. A FoF manager will also need to ensure it has sufficient additional funds in place to cover 'professional liability risks'.

In the context of EU FoF managers being authorised, they must focus on AIFMD compliance at FoF level and this is linked to compliance by the underlying funds. There are a number of important issues.

Each FoF will need a depositary that is responsible for safekeeping the FoF's assets, monitoring the FoF's cash flows and, in some circumstances, verifying ownership of the FoF's assets. The depositary will also oversee certain administrative functions, including the subscription and redemption of FoF units and the calculation of net asset value. In terms of verification, the FoF depositary will need to be satisfied that the FoF has good title to the underlying funds and, where underlying fund units are acquired via the secondary market, the seller provides requisite representations and warranties.

The depositary has to adopt a look through approach to the underlying funds, unless exempted (i) the funds have themselves appointed depositaries that provide ownership verification and record-keeping functions for their assets, or (ii) the FoF/FoF manager has no direct or indirect control over the underlying fund.

FoF managers should be identifying a depositary that will enable their FoFs to operate efficiently, and assess the implications of having to look through to the underlying funds. Given these implications, it may be that FoF managers will prefer to invest in funds that are capable of falling into one of the exemptions.

FoF managers are required to report specified information to FoF investors as well as providing periodic disclosures. The pre-sale disclosures include the FoF's investment strategy and objectives, latest net asset value and historic performance, as well as valuation procedure and pricing methodology. Periodic disclosures – both to investors and the regulator – include the FoF annual report, liquidity arrangements and risk profile with a particular reference to leverage. There are also disclosure requirements when the FoF manager is looking for the FoF to transact, as well as having regularly to update a business plan consistent with the duration of the fund and market conditions. FoF managers should ensure there are efficient flows of information from underlying fund managers, and this information is in a consistent and suitable form.

FoFs should identify conflicts of interests involving the FoFs and implement controls to prevent, monitor and disclose conflicts to FoF investors, including treating all investors fairly. This may impact on a FoF committing to an underlying fund which is associated with the FoF manager.

FoFs should consider the relevant remuneration provisions for their senior managers. In all cases an AIFM's senior management should be remunerated in accordance with policies consistent with the FoF's risk profile and lifecycle. The regulator will require large FoF managers to establish a remuneration committee. Some FoF managers will also be subject to tougher pay rules as individuals. Whether or not these apply principally depends (in the case of an AIFM of leveraged funds) on the AUM of the relevant AIFs exceeding £1 billion, but the structure and risk profile of the AIF and AIFM can also be relevant. If the tougher rules apply (though there are transitional provisions ensuring that only remuneration for the first full performance year after the manager is authorised as an AIFM manager is caught), at least 50% of variable pay for senior managers should normally consist of FoF units and at least 40% of variable pay must be deferred over three to five years, with claw back arrangements in place until vesting.

Non-EU FoF managers can continue until 2018 to promote AIF FoFs to EU investors under the private placement rules for each EU member state if complying with pre-sale disclosure, reporting and other transparency requirements – albeit several member states have recently tightened the rules. The private placement rules are expected to apply until 2018. Many non EU countries are now progressing negotiations and are expected by 2015 to formalise cooperation agreements with EU member states. On the basis of the cooperation agreements being formalised, the non-EU FoF managers will be entitled to promote and service EU investors in accordance with equivalent regulations to those which apply to EU FoF managers.

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