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RISK MATTERS

Highlighting topical issues for insurance sector participants
CMS Insurance Sector Group

Summer 2014

In this edition:

Reactions
LEGAL SURVEY
2014
WINNER

'CMS voted number 1 overall law firm for insurance legal work in Europe'

CMS was recently named the 'top overall law firm for all legal dealings' in the Reactions' Insurance and Reinsurance Legal Survey 2014.

The survey, conducted by industry-leading publication Reactions, asked more than 100 people from global in-house legal teams in the insurance and reinsurance market which law firms they believed were the best by region and by speciality.

By speciality we are ranked first in three categories: corporate, regulatory and insurance linked securities,and number two for litigation. By region we rank number one in three categories: Europe, the UK and London.

This survey is significant as it is based entirely on client feedback. The feedback reinforces the importance our clients place on market insight.

Our winning is testament to our continued hard work and the strength and depth of our sector knowledge and, more importantly, our clients' understanding of that.

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CMS partner, Belinda Schofield named "Best (lawyer) in insurance and reinsurance" at the fourth Euromoney Europe Women in Business Law Awards.

The awards recognise the best female business lawyers across 32 practice areas as well as those national and international firms in Europe committed to advancing women in the legal profession.

Introduction

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Reactions
LEGAL SURVEY
2014
WINNER

'Top overall law firm for all legal dealings in Europe' in the *Reactions' Insurance and Reinsurance Legal Survey 2014.*

Welcome to this summer 2014 edition of *Risk Matters*, your guide to the latest themes affecting domestic and international insurance markets. In this edition we review some decidedly delicate issues as broker conflicts hit headlines and whistle blower laws come under the microscope.

Ever since the Spitzer affair in 2004, the issue of broker compensation has received special attention. Various groups including the risk management lobby and competition authorities have attempted to push through reform making remuneration of the commercial insurance process a more transparent affair. Now with the FCA *Thematic Review into broker conflicts of interest and intermediary remuneration* the industry has received the proverbial 'wakeup call'. Maxine Cupitt explains what it will mean for brokers who now need to get their houses in order.

Meanwhile, our insight into the current status of whistle blowing law reveals a new impetus for insurance companies to consider their policies and practices and encourage genuine complainants to come forward and expose malpractice. Sarah Ozanne points out how the UK Government has recommended legislative and non-legislative actions, but stopped short of a US-style system with financial incentives for whistle blowers, preferring a cost support mechanism at tribunal.

Elsewhere across CMS, our experts have their finger on the pulse of developments in continental Europe. Ian Stevens highlights in the first of a series of articles how insurers with outsourcing arrangements will need to address those contracts in compliance with Solvency II, so that critical functions are identified, monitored and appropriately managed. In Poland, where EU membership recently passed its tenth anniversary, Warsaw-based partner Iain Batty looks at its comprehensive programme of market reforms. He explains how the Polish financial services regulator, the KNF, which has been critical of methods such as the 'group insurance model' used by insurers to sell through affinity partners like banks, energy and telecoms companies.

With 'Heartbleed' hitting UK insurers as recently as May, this vulnerability reminds us that no insurance review would be complete without a look at current cyber risk issues. Ian Stevens talks threats, protective actions and regulatory change.

Always following the upward trajectory of technology, Joanne Wheeler has played an important role in advising UK government on its space industry development. Here she reveals how a recent exemption from Insurance Premium Tax stands to benefit space and satellite investors substantially.

Back down to earth, we have two contrasting pieces; firstly Danielle Drummond-Brassington looks at the complex issue of contingent property liability and asks, when should you pay for the sins of a previous tenant? Then, we review our recent successful seminar at Lloyd's where a panel of experts reviewed the increased risk of global flooding as it produces ever more significant catastrophe losses and how modelling could help assess these exposures.

And finally, CMS was named the number 1 law firm for insurance legal work in Europe by industry trade title, Reactions, and our colleague Belinda Schofield was named "Best (lawyer) in insurance and reinsurance" at the fourth Europe Women in Business Law Awards. Please join me in congratulating Belinda and the rest of the team.

We hope you enjoy reading these insights from CMS and look forward to discussing them with you in more detail.

FCA's Thematic Review into broker conflicts of interest and intermediary remuneration

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In May, the FCA published the results of its Thematic Review into broker conflicts of interest and intermediary remuneration. The Thematic Review looked into whether insurer/ broker relationships lead, or could lead, to brokers improperly performing their duties or taking steps contrary to the insured's interests. The FCA first announced this Thematic Review in July 2013 as one of a number of FCA investigations into the general insurance market.

The financial regulator has long been intrigued by the client-broker-insurer relationship, with the Financial Services Authority's 2008 statement on "transparency, disclosure and conflicts of interest in the commercial insurance market" leading to formal industry guidance in March 2009. Despite the earlier reviews concluding that, while there were numerous potential conflicts of interest, brokers generally did not take advantage of them and overall the market worked, the FCA decided to reconsider the issues.

The regulator reviewed information from 7 large intermediaries/ intermediary groups and surveyed a sample of 1,000 UK small and medium enterprises (SMEs). While the initial spotlight of this Thematic Review is on SMEs, these probes can expand and develop over time and its outcome is likely to be relevant to all insurance brokers. It would be an unwise broker that assumes this Thematic Review does not, and cannot, apply to them.

The FCA identified the following particular concerns:

1. *Inadequate management information.*
   Systems and controls processes often had no measurable outputs impacting on competition in the market and the customer's freedom of choice. The FCA reported that firms' management were unclear:

   - Whether an insurer had been selected in advance for a particular product or whether an individual broker had selected the product for the SME concerned. In some cases there was confusion about the possibility of both models being in operation within the same intermediary.
   - What the reasoning was behind the choice of a particular market to underwrite the customer's insurance (with the lack of an audit trail to demonstrate how this would have benefited the customer);
   - How insurance policies had been sourced and placed: e.g. by open market broking, by reference to a panel or placed to a single insurer without any consideration of alternatives.

- In how many cases they acted as agent of the customer, agent of the insurer, or both;
- What work had been done to establish the suitability of any add-on insurance products sold on an advised basis; and
- In general, whether placement decisions made by a broker acting as agent of the customer were taken in the customer's best interests.

2. *Inadequate systems and control frameworks, including:*

    - A reliance on principles and company policy – and the simple belief that brokers acting as agents of the customer would always act in the customer's best interests – without any procedures or controls to ensure that these policies were followed;
    - Inadequate review processes to consider product performance from the customer's perspective; and
    - Relying on compliance with the ICOBS 4 disclosure requirements to alleviate problems of potential conflict of interest. (The FCA particularly stressed that such reliance on disclosure was wholly inadequate to comply with SYSC 10.1.7R and the requirement to maintain arrangements for taking reasonable steps to prevent conflicts of interest).

3. *Disclosure was also often generic and unclear; and, in particular, it was not always clear whether the intermediary was acting as agent of the customer or the insurer, or both.*

4. *Failure to segregate remuneration information in intermediary groups between the broking arm and the managing general agent, e.g. inadequate Chinese walls. It was also found that brokers were often more than aware of the enhanced commission that was available to them from placing certain products.*

5. *Promotional materials sent between different arms of intermediary groups concerning new insurance products sometimes focused too heavily on the commission available to the intermediary from the new product, rather than customer benefit.*

6. *Very high levels of commission being charged for:*

    - Add-on products; and
    - Products where the end cost is ultimately borne by a third party (e.g. a tenant).Particular problems arising with the supply of premium finance.

Following the publication of the results, the FCA will engage with the industry and with SMEs to enhance understanding of the issues. However, the onus is on intermediaries themselves to reflect on the findings and how they manage conflicts of interest and to make any necessary changes to ensure compliance with regulatory requirements on conflicts.

Where problems at specific firms have come to light during the course of the Thematic Review, the FCA intends to take appropriate regulatory action. The findings of this Thematic Review will also be taken into account when conducting current and future Thematic Reviews (in particular the Thematic Review into commercial claims). The Competition and Markets Authority is also involved at present in a case concerning high levels of commission for general insurance where the cost is borne by a third party (specifically, residential tenants).

Get your house in order

The results of the Thematic Review are not unexpected and should serve as notice to brokers to get their houses in order. Intermediaries should stress test their existing procedures questioning not just whether the procedures are strictly complied with but whether the overall focus is on ensuring good customer outcomes.

Senior management in particular should take heed that they are expected to set a culture of good customer outcomes from the top. As part of this, they will be expected to consider management information and whether the information provided is sufficient to enable the board to identify (and resolve) poor practice.
We anticipate that the FCA will continue to shine a bright spotlight on brokers and that broker conflicts will remain a hot topic for the foreseeable future. The wider European context of the forthcoming Insurance Mediation Directive II should also not be forgotten, with provisions for commission disclosure continuing to be debated.

Consumer Act and Business Insurance

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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 the publication of the draft Insurance Contracts Bill by the Law Commissions on 17 June 2014. Amongst other things, the draft Bill will bring insurance contract law for non-consumers insureds into line with consumer insurance, following the introduction of the Consumer Insurance (Disclosure and Representations) Act 2012, which came into force in April 2013.

The draft Bill covers changes to the duty of fair presentation in non-consumer insurance, damages for late payment of claims, fraudulent claims, utmost good faith, warranties (including 'basis of contract' clauses, breach of warranty, and terms relevant to particular descriptions of loss), and contracting out. The Law Commissions have said that most of the clauses in the draft Bill, following previous consultations, are to be regarded as settled but that two clauses are still being discussed with some stakeholders: terms relevant to particular descriptions of loss and implied terms about payment.

HM Treasury will be the sponsoring department for the Bill and are consulting on whether there is a sufficiently broad consensus of support for the draft legislation to allow the Bill to be considered under the special procedure for uncontroversial Law Commission Bills.

Use of the special procedure will allow for the Bill to be fast tracked resolving concerns that the Bill would not pass through Parliament before the next general election in 2015.

In summary, the changes are:

Duty of disclosure and remedies for breach of duty.
The draft bill replaces the insured's duty to disclose to the insurer "every material circumstance" which it knows or ought to know "in the ordinary course of business" with a duty to "make to the insurer a fair presentation of the risk". The duty to make a fair presentation will be satisfied if all material circumstances were disclosed or sufficient information was provided to put the insurer on notice to make further enquiries.

The insurer will no longer automatically have the remedy of avoidance for the breach of the duty of utmost good faith.

The insurer's remedies for breach of fair presentation will depend on whether the non-disclosure was "deliberate" or "reckless". If the breach is deliberate or reckless, the insurer would be able to avoid the insurance contract and retain the premium. The insurer's remedy for other breaches of the duty would be based upon what it would have done had a fair presentation been made.

Remedies for Fraud
The draft bill introduces 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. The insurer would remain liable for claims arising before the fraudulent act but, if the insurer elected to treat the contract as terminated, it would have no liability for future claims and would not have to return the premium.

Where fraud is committed by persons entitled to make claims under group insurance policies, the Commission propose that such polices will be treated as if the insurer and the fraudulent member had entered into a separate insurance contract.

Changes to the law on warranties
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. Insurers can still include warranties or other similar provisions but they must each be expressly agreed by the insured.

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.

Proposed reforms to business insurance contracts will have major implications for the insurance market and will see insurers seeking assistance to evaluate their internal policies and current practice. The introduction of the duty of fair presentation of risk will necessitate a review of proposal forms. Insurance policies may need amendment to seek to limit any claim for late payment, to clarify which documents will be required by insurers to carry out their investigations and to provide timescales for payment. Internal guidance will need to establish how best to evidence that claims handling processes have been reasonable and kept under review. The future proposals on opt-out provisions may also require an update of policy wordings.

A consultation has been opened to determine whether the bill is suitable for the special procedure to pass uncontroversial Law Commission Bills quickly through parliament before the next general election in May 2015. Even if this happens, further time would be required for any legislation to come into force, with the result that any changes to the law may not take effect until 2016.

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:

a) "basis of contract" clauses; or
b) the provisions relating to deliberate or reckless late payment of insurance claims.

The insurer will be required to take sufficient steps to draw the contract out provision to the insured's attention before the contract is entered into.

Implied term about late payment
The draft bill introduces an implied term in insurance contracts that the insurer will pay claims within "a reasonable time", failure to do so would give the insured the right to recover contractual damages. What is a reasonable time would depend on factors such as the type of insurance, the size and complexity of the claim, legal compliance and circumstances beyond the insurer's control. The insurer would have a defence to claim for late payment if it could show that there were reasonable grounds for disputing the claim (e.g. dispute as to quantum, events occurring abroad, failure of third party to provide information in a timely manner).

Remedies for any breach of this term, including damages, will be separate from any usual rights to enforce payment or claim interest.

Terms relevant to particular descriptions of loss
This clause concerns terms which are designed to reduce the risk of a particular type of loss, or the risk of loss at a particular time and in a particular way. In the event of breach, the insurer's liability will only be excluded for that type of loss, or at that particular time or place. For example, if the insured breaches a term requiring them to have a fire safety system, the insurer's liability for fire-related losses will be suspended but not its liability for flood or earthquake related losses. This is not limited to warranties and may also apply to, for instance, conditions precedent or exclusion clauses so long as they relate to losses of a particular type, or at a particular place or time. If the relevant term is a warranty, however, a breach would suspend liability under the whole contract, unless the warranty is caught by the particular exceptions.

If passed, the impact of the draft Bill remains to be seen. However, while there has not been a deluge of litigation stemming from the Consumer Insurance (Disclosure and Representations) Act 2012, the proposed reforms will have major implications for the insurance market. Insurers will need to understand those implications and ensure that they are compliant. For instance, the introduction of the duty of fair presentation of risk will necessitate a review of proposal forms and other documentation including cover notes. Insurance policies may need amendment to seek to limit any claim for late payment, to clarify which documents will be required by insurers to carry out their investigations and to provide timescales for payment. Internal guidance will need to establish how best to evidence that claims handling processes have been reasonable and kept under review. Insurers will also need to consider whether and, in which circumstances, they wish to opt out (noting that they will not be able to do so in all circumstances, for example, in respect of consumer contracts).

Whistleblowing under the spotlight

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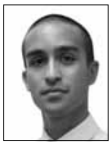

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Whistleblowing law is under the spotlight following a number of high profile press reports on issues in the NHS, financial institutions and law firms. This has resulted in a period of introspection by legislators as well as regulatory bodies including the Financial Conduct Authority.

The original statutory regime on whistleblowing was introduced by the Public Interest Disclosure Act 1998 ("PIDA"). PIDA provides a remedy for whistleblowers who disclose certain types of information, such as breaches of legal obligations or health and safety rules, and are subjected to detrimental treatment by their employers as a result. Awards of compensation for successful claims are not subject to a statutory cap.

The key elements of a potential claim under the legislation focus on whether the claimant made a protected disclosure and, if so, whether that disclosure was the cause of the claimant's dismissal and/or some other detriment. The statutory regime broadly dictates the type of disclosure and to whom it must be made for it to be a 'qualifying disclosure' and for the claimant to be eligible for recourse under the Act. PIDA does not require employers to put in place whistleblowing policies and procedures, something for which it has been the subject of criticism.

Areas of the legislation have gone through change as a result of provisions in the Enterprise and Regulatory Reform Act 2013 ("ERRA") which became effective on 25 June 2013. One such aspect is that relating to public interest. The whistleblowing regime under PIDA did not contain any requirement that the disclosure had to be in the public interest. One outcome of this being that individuals used the legislation to bring claims about breaches of their own employment contracts, leading cynical legal practitioners to believe individuals were using the law as a litigation tactic to bypass the statutory cap on compensation for unfair dismissal claims.

In response to this ERRA introduced a new test that the individual making the qualifying disclosure must have a reasonable belief that it is made in the public interest. However ERRA contains no definition of public interest and it must only be in the reasonable belief of the individual concerned. Interpretation of this is therefore subject to debate and will no doubt require some clarifying jurisprudence. ERRA also removed the requirement for disclosures to be made in good faith, but allows employment tribunals to reduce the level of compensation by up to 25% where a disclosure is not made in good faith. Further, following ERRA, employers will be vicariously liable for the actions of workers who subject a colleague to detriment for blowing the whistle except in circumstances where the employer can demonstrate that it took all reasonable steps to prevent that happening.

The law has also been changing as a result of common law and in June the Supreme Court determined that members of LLPs are workers and therefore eligible to the remedies provided by the whistleblowing legislative framework, a level of protection never afforded to such individuals before. In the judgment Lady Hale commented that such a conclusion was entirely consistent with the underlying policy of the whistleblowing provisions, which is to ensure that malpractice is exposed wherever possible.

Shortly after the introduction of ERRA the Government launched a Call for Evidence in recognition that the changes introduced by the Act might not go far enough. In particular the Government stated that the legislative framework provided a remedy, not protection, for whistleblowers and that negative cultural attitudes prevented whistleblowing working effectively. Also in November last year a report of the findings of a Whistleblowing Commission conducted by the charity, Public Concern at Work was published, which fed into the Government's considerations.

The outcome of the Government's consultation was published on 25 June and identified five common themes that reduce the effectiveness of the legislative framework. These are;

— the tension between the needs of the whistleblower and those of the employer against whom the whistle is blown
— the potential absence of whistleblowing policies, information and support provided by employers which perhaps compound a whistleblower's feelings of vulnerability
— a lack of confidence by whistleblowers in prescribed persons as the solution to the issues raised
— the fact that certain categories of worker are not covered by the legislative framework
— that cultural attitudes to whistleblowing were the root cause of many of the issues raised by stakeholders.

In an attempt to address these issues the Government identified nine recommendations which will be implemented through legislation as well as non-legislative action. The recommendations are:

— improved guidance on the regulatory framework to improve its use by whistleblowers and employers alike
— guidance on the categories of disclosure and creation of a model whistleblowing policy
— clarity on the position on costs in relevant employment tribunal claims
— a review of the current whistleblowing ET1 referral system
— update and annual review of the prescribed persons to which an external disclosure can be made
— a requirement on prescribed persons to report annually on whistleblowing
— no introduction of financial incentives
— the inclusion of student nurses (and other similar categories) within the scope of the remedies available under the legislative provisions
— identify opportunities to celebrate those organisations that embrace whistleblowing

Whilst the Government recommended some changes to the whistleblowing regime in the UK it also confirmed its position not to support other possible proposals. For example, as stated, it rejected the idea of financial incentives for whistleblowers, as exists under the US system, and instead seeks to address the negative financial impact a whistleblower might experience through costs in the tribunal system.

Many of these changes will not come into force for some time yet – the legislative ones are not expected until April next year. Whistleblowing is therefore likely to remain on the agenda for the foreseeable future with the particular focus being on tackling negative cultural attitudes and creating working environments where whistleblowers feel able to come forward. In line with this the FCA's 2014/2015 business plan identifies whistleblowing as one of its areas of focus for the year ahead, identifying trends and underrepresented sectors and carrying out work to implement and supervise changes in firms.

Organisations, particularly those in the financial services sector, should take this opportunity to review their policies and practices, not only so that they can show what steps they have taken to address whistleblowing issues but also to put in place processes that allow genuine whistleblowers to come forward to expose malpractice without fear of reprisal.

See page 23 for details of forthcoming CMS employment seminars.

There will be floods!

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On 15 June in the Old Library at Lloyd's of London before a full house, a panel of experts reviewed the increased risk of global flooding producing ever more significant catastrophe losses and how modelling developments could help assess these exposures.

Professor Tim Palmer of Oxford University, a leading climate change researcher and modeller, educated the audience on the harsh realities of the apparently irreversible warming of the Earth's average surface air temperatures. There is a broad scientific consensus that in the 21st Century this average could increase between 2°C to nearly 5°C, depending on complex variables which climate modellers monitor closely.

An increase of over 4°C would be extraordinary in the Earth's history and will be as great an increase as occurred between the last Ice Age and the end of the 20th Century. Whatever the increase, recent global flooding patterns, which are essentially chaotic and very intensive, should be expected to continue. Professor Palmer explained how increased air temperatures cause clouds to carry more moisture and how all storm events are Nature's way of trying to take heat out of an ever hotter atmosphere. Where and when extreme storms will strike is no easier to predict, however the probability of increasingly severe flooding and drought events has increased.

Philip Godwin, Senior Catastrophe Claims Coordinator at Lloyd's of London, put the risk to the reinsurance industry in context. The last 4 years had produced major flood catastrophes in Thailand, Europe, Australia and Canada totalling insured losses of USD25bn and related economic losses of over USD100bn. None of these losses had previously been modelled as either major flood PML's or events capable of producing such losses. They were examples of the severity of insured values at risk, with Thailand being the most striking example. Mr Godwin reminded the audience of the complex features of a major flooding incident in terms of scale, duration, force and the regulatory and political pressures that can quickly arise. Mobilising and synchronising global reinsurers would remain a challenge in handling major losses, but improvements can be made by investing in experts and stakeholders as well as in risk assessment and mitigation.

Dr Robert Muir-Wood, chief research officer at the leading catastrophe modelling company RMS, explained how inundation was now recognised as the dominant damage agent in remodelled hurricane or cyclone loss scenarios, reflecting the lessons learned from Katrina and Sandy. The largest PML's were associated with storm surge in locations such as the Mississippi Delta with very shallow seafloor slopes, which serve to greatly increase storm surge height. RMS has developed sophisticated frameworks for surge modelling which were examined. The inundation risk of tsunami was

acknowledged but was not examined in the time available, but Dr Muir-Wood covered the improvements in river flood modelling and how extreme precipitations can lead to damaging flash flooding in urban areas around the globe.

He also explained how Market assumptions about return periods for major flood events had been reassessed following the events in Thailand. Unfortunately, many jurisdictions do not have reliable source data on river flows and associated data to permit accurate modelling globally.

This theme was developed by Dr Jane Toothill of JBA Risk Management. She demonstrated how advanced flood hazard mapping had become; JBA's award winning river and rainfall flood models simulated how variable and localised flooding can be in urban areas and why some catchment areas require specialised modelling. She confirmed the challenges of trying to build models for countries with inadequate data, including most of South America.

Simon Kilgour of CMS reminded the audience of the foreseeable property insurance and reinsurance coverage issues that often arise with major flood events. At the direct level, causation disputes often arose where secondary perils were evident which were either excluded or were an indirect cause of loss. The efficiency of anti-concurrent causation exclusionary language and event definition was discussed. Common business interruption disputes were also examined, including wide area damage increasing the disputed loss. At the reinsurance level, causation; hours clauses, claims cooperation and follow settlements remained rife areas for dispute.

Jonathan Clark, a former executive at leading loss adjusting firms and now head of Complex Claims at SCOR, analysed the practical complications that often present themselves when a major loss occurs. Sound pre-event catastrophe planning to ensure customer satisfaction and retention was fundamental. Identifying the unique features and loss components of the flood to triage claims was a priority, enabling claims teams to focus appropriate technical resources on complex losses. Having consistent processes, open communication and a sensitivity to local legal, commercial and political issues were also key messages.

The climate science means that in the decades ahead, sea temperatures and levels are all set to rise. More erratic storms and hurricanes driving sea surge are the perennial risks. Catastrophe and hydrology models can really help underwriters evaluate the potential severity of insured loss and address some of the lessons learned from recent major flooding events, especially Thailand. Each major flooding event will have unique features but very many practical claims management and legal issues can and should be anticipated.

> The panel were all in agreement that major flood losses were set to increase in both their frequency and severity.

CEE focus: Regulation affecting insurance distribution in Poland

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The Polish insurance market has evolved rapidly since Poland began its programme of market reforms approximately 25 years ago. The vast majority of insurance companies are now controlled by international insurers whilst there is a single strong Polish "national champion". Since EU accession a number of international insurers have created branches in Poland while others have started distributing products on a freedom of services basis. At the same time, distribution has become more sophisticated. Many insurers are far less reliant than they were on traditional agent networks and are now increasingly reliant on bancassurance and on alternative distribution channels.

The Polish financial services regulator, the KNF, has been critical of methods used by insurers to distribute their products and has, in particular, been critical of the group insurance model used by many insurers. Under this model banks as well as other businesses, such as energy providers and telecoms companies, promote insurance products to their customers. The banks and other businesses are the policy holders and they, in turn, hold an insurance policy for the benefit of their customers who effectively pay a premium in order to benefit from the insurance cover. It is not unusual for tens of thousands of individuals to be beneficiaries under a single policy. Up until now one of the main criteria that has to be met in order for the group insurance model to be used is that the policyholder has some type of insurable interest. For example, banks have been deemed to have an insurable interest if they are policyholders in respect of products which cover their customers in the event that their customers are unable to repay their bank loans.

On 24 June the KNF published guidelines on distribution of insurance and in particular on bancassurance arrangements. The guidelines have been promoted as being in the interest of consumers. For the many insurers who distribute retail insurance products in Poland, the consequences are likely to be far reaching. At the moment the banks and other entities that operate the group model allegedly tend to combine the role of insurance intermediaries and policyholder. The KNF regards this as a conflict of interest. The new guidelines provide that insurance companies must put in place appropriate measures to prevent entities from combining the role of policyholder and insurance intermediary in relation to a single insurance agreement. Banks, in particular, will be required to inform clients whether they are acting as insurance agents or policyholders.

The guidelines also impose severe restrictions on the remuneration of banks and other entities that distribute insurance policies or are policyholders in the group insurance model. In future insurers will not be permitted to pay any remuneration to entities that distribute insurance products unless they are registered insurance intermediaries pursuant to the Insurance Mediation Act. In circumstances where it is permissible to pay remuneration to registered insurance intermediaries, such remuneration will in future have to be proportionate to the costs of the insurance cover. This is an attempt to address allegations that the commission paid to banks and other group policyholders and intermediaries is grossly disproportionate to the benefit received. The KNF states that any arrangements should not cause individuals to question their trust in the financial market.

Where there are bancassurance arrangements, banks may receive remuneration only from their customers who are beneficiaries under a group insurance policy. However, such costs must be commensurate with those actually incurred by the bank in the conclusion and administration of the insurance agreement. Banks will be under an obligation to agree detailed rules for their remuneration. These rules should not make the level of the bank's remuneration dependent on the level of the insurance premium.

The new guidelines also include obligations on insurers and banks to inform clients about any factors which may be relevant to their decision whether or not to conclude an insurance agreement or participate in group insurance. The KNF requires such information which is provided to clients to be reliable, unambiguous and to present both positive and negative aspects of any insurance product. This means that in the future it will be necessary to set out clearly any exclusions and other restrictions on the insurer's liability; not only in the general terms and conditions.

For providers of investment related insurance products there are even more onerous requirements. For future products they will be required to draw up product description sheets containing detailed information about the products, including the amounts and the method of calculating costs.

The KNF is also determined to prevent banks from forcing their customers to use a particular insurance product. The new guidelines, when implemented, will mean that the customer of a bank may choose any insurance product provided by any insurance company so long as it meets the criteria of the scope of insurance coverage specified by the bank. This means that banks should not use lists of approved insurers, as some of them did so far.

The new guidelines which take effect on the 31 March next year do not have the status of law but will be taken into account by the KNF when determining whether insurers are acting in a fit and proper manner.

The original draft guidelines issued by the KNF earlier in the year did not make any reference to branches of foreign insurers. Some commentators saw this as an oversight and something which meant there would not be a level playing field between domestic and foreign insurers. The final version of the guidelines attempts to remedy this by stating that the guidelines also apply to branches of foreign insurers and that the KNF has a right to do this by virtue of the general good rules. We consider this a legally questionable assertion.

Over the coming weeks and months there will be further debate as to the impact of the guidelines and there will undoubtedly be requests for the KNF to clarify some of the finer points. Regardless of this, it is clear that the guidelines will have a dramatic impact on insurers and banks who rely on such group insurance policies and will also have an impact on many other entities which distribute the benefits and insurance cover to their customers using such mechanisms. It is recommended that an analysis starts now as to which arrangements will need to be unravelled and what will need to be put in place with effect from Spring 2015 in order to comply with the new guidelines.

Iain Batty is the head of our Central and Eastern Europe commercial practice group, having worked in CEE for over sixteen years. Although based in Poland, he spends much of his time working around the region and is able to meet clients in a location convenient to them. Iain specialises in insurance, pension funds and financial service issues and has worked for many businesses in these sectors in relation to their activities in Central Europe. He has advised on entry to the markets, product development and on various issues involving regulatory bodies. He has also helped draft legislation for a number of countries in the region, including Russia, Poland, Romania, Croatia and Bulgaria.

Original tenants liability: When should you pay for the sins of a previous tenant?

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If a company or an individual held or guaranteed a lease that was entered into prior to 1 January 1996 then they will continue to be liable under the terms of the lease for the remainder of the term, notwithstanding the disposal of the property. This is known as "original tenant liability".

The problem is those same original tenants or guarantors can then find themselves years later being sued for the debts of the current defaulting tenant.

This can include a claim by the landlord requiring them to take on that lease for the remainder of the term and so the financial exposure can therefore be significant. It is possible to obtain insurance against this risk, but just because the original tenant/guarantor is faced with a claim or claims under any policy it does not necessarily follow that payment should be made.

A number of factors should be considered before making any payments.

Limitation periods

Pursuant to section 17 of the Landlord and Tenant (Covenants) Act 1995, an original tenant is only liable if the landlord has served the requisite statutory notice within six months of the debt falling due. For example, if a landlord is seeking to claimthe December quarter's rent from an original tenantguarantor, then the notice in respect of that instalment of rent should be served within six months, i.e. by the following June. If not, then there is no liability for that particular debt.

Release

When dealing with a claim against an original tenant/guarantor, a very careful review of the deeds should be undertaken. If there has been a variation to the terms of the lease to which the original tenant/guarantor were not party then this may have the effect of releasing the original tenant/guarantor or at least minimising their liability.

Further, if there have been any supplementary documents entered into, such as licences for alterations or under leases which have the potential to increase the original tenant/guarantor's liability, and which were not envisaged by the terms of the lease, then this can also have the effect of releasing the tenant. For example, if a lease contains an absolute covenant against alterations yet a landlord consents to alterations, this will release the original tenant/guarantor.

Assignment of the benefit of any covenants

Depending on the wording of any tenant covenant guarantee given, it may be possible to argue that the covenant is personal to the then landlord or for the duration of the original tenant's interest in the property. This requires a very careful examination of the terms of the leasehold documentation but it may be possible to argue that the current landlord does not have the benefit of the covenant on which it relies.
This is a very complex area of property law and fraught with difficulty. Usually Counsel's opinion will be required to reach a definitive position. However, payments should not be made until all avenues have been exhausted. Once liability has been admitted the original tenant/guarantor is potentially liable for the remainder of the term. Where there is a long term remaining the liability could be significant.

If liability is accepted, then pursuant to section 19 of the Landlord and Tenant (Covenants) Act 1995 the original tenant/guarantor has the ability to call for an overriding lease, allowing it to take a leasehold interest in the property enabling it to take control and mitigate its liability.

> The 'brilliant' Danielle Drummond-Brassington 'stands out' to sources for her application to her work and skill at "mastering the detail" of complex contracted agreements.
>
> *Chambers & Partners*

Government to Exempt Space Risk from IPT

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'Eight Great' Technologies

As one of Britain's "Eight Great" technologies, the space industry has the "potential to propel UK growth", as described by David Willetts, UK Minister for Universities and Science.

The UK Government is committed to the exciting opportunities open to the space sector and the goal of raising the UK share of the projected £400 billion global space-enabled market to 10% by 2030. As part of this objective, the Government seeks to make the UK the best place to grow existing and new space businesses and attract inward investment by providing a regulatory environment that promotes enterprise and investment in the UK.

Such a regulatory framework must also ensure that UK companies remain internationally competitive.

Insurance premium tax - exemption for space risks

Currently, UK-based satellite operators need to pay onerous and anti-competitive insurance premium tax (IPT) at 6% on general insurance premiums on satellite risks. This has until now put UK companies at a competitive disadvantage compared with those based in other space-faring nations.

IPT is a tax on premiums received under taxable insurance contracts. All types of insurance risks located within the UK are taxable unless they are made tax-exempt, with satellite risks amongst those not currently exempt from the levy.

Policies relating to the construction of a satellite, to a satellite being launched or in-orbit satellite insurance will therefore be liable to IPT if the insured party is a company in the UK to which the risk attaches. The 6% IPT currently adds approximately 0.5% to the insurance cost of a satellite. This is a significant cost to bear, which is not borne by companies located in most other countries.

IPT budget announcement

The recent news therefore that the Government will legislate to exempt space insurance from IPT was welcomed by the industry. CMS is currently working as expert adviser with the Treasury to introduce secondary legislation, after a consultation, to bring the exemption into effect by the end of 2014.

This is excellent news for UK-based satellite operators. The Government has listened to the concerns of the space sector and is taking positive action.

This legislative change is also further evidence that the Government is seeking to ensure that the UK is open for space business and is committed to attracting more investment into and in growing the UK space sector.

Joanne Wheeler "provides reflective and authorative advice" she is a recommended specialist in Satellite Communications.

Chambers & Partners

Solvency II: Time for insurers to reassess their outsourcing arrangements?

First published in Professional Outsourcing magazine – Summer 2014

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This article is part of a short series for Professional Outsourcing magazine in which Ian Stevens discusses strategies and governance issues for insurers outsourcing functions in the context of Solvency II.

Insurers and reinsurers, including Lloyd's of London syndicates, will soon face a significant change in the regulation of their outsourcing arrangements – the Solvency II Directive (2009/138/EC)[1]. As a consequence firms operating in the European Economic Area should review their outsourcing arrangements and reliance on outsourcing in the context of the new rules. They may need to amend or develop new policies, procedures and contingency plans; potentially even renegotiating terms of their agreements with service providers.

Background

Solvency II is a fundamental review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards in order to increase protection for policyholders and reduce the possibility of consumer loss or market disruption.

Insurers, friendly societies and Lloyd's managing agents are currently authorised and regulated by the Bank of England's Prudential Regulation Authority (PRA) and also regulated by the Financial Conduct Authority (FCA). As such the rules and guidance they are required to follow in relation to outsourcing are set out in the Senior Management Arrangements, Systems and Controls (SYSC) sections of the FCA and PRA Handbooks (which effectively mirror each other for these purposes).

Due to be implemented in January 2016, Solvency II will introduce a number of detailed and prescriptive requirements. The FCA and PRA intend to implement these in a new prudential sourcebook in the Handbook (SOLPRU)[2], largely replacing the currently applicable SYSC requirements. The European Insurance and Occupational Pensions Authority (EIOPA) has issued guidelines for the preparation of Solvency II. In light of this the PRA has advised that firms should use the time prior to final implementation to assess their current outsourcing arrangements and reliance on outsourcing and document their overall approach to outsourcing – including contingency plans against service provider failure. Which outsourced services will be caught in the net?

The majority of Solvency II rules will apply to critical or important outsourcings – in short those where the outsourced function or activity is essential to the operation of the firm such that without it the firm would be unable to deliver its services to policyholders. While the purchase of simple price feeds or catering services is unlikely to be caught, services involving business critical factors such as the processing or storage of policy holder data or core IT support or the outsourcing of functions such as product design, compliance, actuarial support or risk management probably will be.

Outsourcing to group members is also caught, although may be subject to a degree of flexibility. Consideration should be given to the extent to which the firm controls or has the ability to influence the actions of the service provider, the geographical locations from which services are delivered and the nature of the outsourced functions or activities.

As under the SYSC guidance, notification to the regulator will be required before outsourcing any critical or important functions or activities, or implementing any material developments or changes in relation to them.

Impact on outsourcing arrangements

Many firms will already have contracts in place designed to enable them to comply with the existing requirements of SYSC 13.9 and the Financial Services and Markets Act 2000, but these will need to be reviewed to ensure any more granular or additional requirements of Solvency II are addressed. Key rights and obligations referred to in the currently available draft Level 2 text[3], some of which overlap with the SYSC requirements, include:

— *The firm must undertake due diligence to ensure that the potential service provider has:*

- the ability and capacity and any authorisation required by law to deliver the required functions or activities satisfactorily;
- the necessary financial resources to perform the outsourced functions or activities in a proper and reliable way, and that all staff of the service provider who will be involved in providing the outsourced functions or activities are sufficiently qualified and reliable; and
- adequate contingency plans in place to deal with emergency situations or business disruptions and periodically tests backup facilities where necessary; and
- adopted all means to ensure that no explicit or potential conflict of interests with the firm impairs the needs of the outsourcing firm, (and these will typically also be reflected in contractual obligations).

— *A written agreement must be entered into with the service provider. That agreement must include provisions:*

- clearly stating the duties and responsibilities of both the service provider and the firm;
- obliging the service provider to comply with applicable laws, regulatory requirements and guidelines (e.g. compliance with data protection requirements), and relevant firm policies;
- obliging the service provider to disclose any development which may have a material impact on its ability to carry out the outsourced functions and activities effectively and in compliance with applicable laws and regulatory requirements;
- ensuring that where the service provider terminates the contract the notice period is sufficiently long to enable the firm to find and implement an alternative solution;
- allowing the firm to terminate the arrangement where necessary without detriment to the continuity and quality of its provision of services to policyholders;
- requiring the supply of information about the outsourced function or activities, including appropriate management and performance information;
- allowing the firm to issue general guidelines and individual instructions to the service provider concerning what has to be taken into account when performing the outsourced functions or activities;
- governing the protection of confidential information;
- granting the firm, its external auditor and the regulators effective access to all information relating to the outsourced functions and activities including carrying out on-site inspections of the business premises of the service provider (audit rights);
- allowing, where appropriate and necessary for the purposes of supervision, the supervisory authority to address questions directly to the service provider (which the service provider must reply to);
- regulating subcontracting and ensuring that the service provider remains responsible for the performance of its obligations under the agreement notwithstanding any subcontracting.

— *Additional 'fit and proper' personnel obligations in relation to the outsourcing of certain key functions.*

Overarching responsibility

Notwithstanding any outsourcing, firms will remain fully responsible for discharging all of their obligations under the rules and administrative requirements adopted under Solvency II. It is imperative that internal and external governance regimes, policies and management and performance information reporting are implemented and maintained and operate effectively. Risks inherent in the outsourcing of critical or important functions must be identified, monitored and appropriately mitigated and service providers properly supervised and managed.

Firms have until 1 January 2016 to become compliant with the new rules.

1. As amended by the Omnibus II Directive (2014/51/EU). It Is anticipated that the new regime will apply to all insurance firms with gross premium income/exceed ng EUR 5M or gross technical provisions in excess of EUR 25M. Some insurance firms will be out of scope depending on the amount of premiums they write, the value of technical provision, or the type of business written
2. http://www fsa gov.uk/pubs/cp/cp11_22.pdf; http://www.fsa.gov uk/static/pubs/ cpZcp12-13.pdf
3. Draft Delegated Acts Solvency II - the final version expected to be published in August.

Closing the backdoor to cyber-crime

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It seems that each week a new story relating to cyber-crime and data breaches hits the headlines and another firm adds itself to a rapidly growing list of victims to cyber-attackers, hackers, software vulnerabilities and inadvertent data losses.

Although this has resulted in increased awareness and a rapid growth in sales of cyber liability insurance, insurance firms may also need to consider addressing some of these risks themselves.

The emergence of the Heartbleed vulnerability sent shockwaves through the online community. The insurer, Aviva, is reportedly one of its most recent victims.

Heartbleed is a vulnerability in a popular cryptographic software which makes it possible for unauthorised third parties to steal the information that would ordinarily be protected by the encryption. Although it was addressed quickly by many after its discovery, it is widespread enough that it is likely that many devices, websites and servers will still be vulnerable. Attackers exploiting the vulnerability may leave no trace of their intrusion. Such a regulatory framework must also ensure that UK companies remain internationally competitive. Reports indicate that in May Aviva's bring your own device (BYOD) service, provided by a third party supplier, was attacked by a hacker that reportedly used the vulnerability to email and post messages to the devices using the service and then performed a full wipe of each device, finally bringing down the BYOD server. Fortunately for Aviva, it appears that none of its business data was accessed or lost and there were no material financial losses or repercussions.

Others have not been so lucky. The consequences of cyber incidents can be more than merely embarrassing for a business. Some recent cyber incidents have resulted in the need for large scale notifications to customers, expensive "quick fixes" to security solutions and IT infrastructure, large regulatory fines and even the resignation of CEOs.

Cyber threats

Over the past year, there has been a rapid increase in the number of cyber incidents reported in the media. Heartbleed is just one example of how anyone, or indeed anything, that is connected to the internet can be at risk. Other risks include:

— compromise of user passwords;
— Government surveillance and harvesting of company and customer data;
— disruption of business critical communications infrastructure;
— theft of valuable intellectual property and know-how;
— theft of customer information and payment details;

- leaks of commercially sensitive or personal information on illicit internet forums;
- ransom attacks (e.g. bringing down company websites using distributed denial of service (DDoS) attacks or infecting company software with viruses and asking for payment to cease the attacks or recover the data);
- hijacking of company communications media (e.g. hacktivism and hijacking of company social media accounts); and
- harm to company systems caused by trojans, spyware, viruses and an ever growing number of other malware.

While the ever increasing threat of cyber attacks, and corporate and consumer awareness of them, present opportunities for insurers to increase sales of cyber insurance products, insurers should also make sure that they themselves do not become victims of cyber incidents.

Protective action

In addition to employing their own technical and organisational measures to safeguard their data and systems, insurance firms should also look to review, monitor and manage vulnerabilities in their supply chains.

This should include a review of proposed and current contractual terms with service providers to verify that they include appropriate requirements in relation to the security and protection of business systems and data, security testing, incident reporting, business continuity and disaster recovery.

Many insurers will already focus on these areas for the purposes of ensuring compliance with data protection legislation and, where regulated, managing operational risk as required by the FCA and PRA Senior Management Arrangements, Systems and Controls (SYSC) rules and guidance. These obligations are set to be reinforced by the requirements of the Solvency II Directive (timetabled for final implementation by January 2016). As a consequence of the increasing degree of regulation, and the operational risks posed by cyber threats, firms may nonetheless need to re-evaluate their security and business continuity policies, plans and arrangements, how they profile risk and choose suppliers and service providers (particularly of ICT products and services), their minimum contractual requirements for "at risk" arrangements, the extent to which they monitor those arrangements and the sufficiency of the security in place in relation to them.

Data breach

The protection and handling of personal data by firms are under increasing scrutiny by regulators.
If an insurance company was to lose employee or customer data due to a cyber incident, data protection and/or financial services regulatory authorities may seek to take action against the firm. This could include imposing fines, requiring that affected individuals are notified, and/or specifying further technical and/or organisational measures be taken to ensure that future breaches do not occur.

Accordingly it is important to plan for breaches. The first steps to take in the event of a breach are to stem the breach and assess and limit the damage. It may be necessary to obtain advice and quickly identify: whether you are obliged to disclose details of the breach; the risks of being subject to a fine; and the potential damage to your firm's reputation. Thereafter the route cause analysis may need to be undertaken and, potentially, steps taken to review and revise internal policies, procedures and technical and organisational measures.

Regulatory change

The data protection regulatory landscape is also shifting. The draft data protection regulation currently being considered by the European Commission (EC) is set to significantly increase the compliance burden on businesses, and it is anticipated will provide for higher fines (up to 5% of global turnover) to be imposed for non-compliance. Other forthcoming or recent measures include:

- the directive to create EU-wide harmonised technical measures for information and network security proposed by the EC;
- the "Cyber Essentials" assurance framework and accreditation scheme proposed by the UK Government for firms to implement basic cyber security standards; and
- the US' Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) announcement of a Cyber Security Initiative to examine the preparedness of the securities industry in the US, further to the US' National Institute of Standards and Technology's (NIST) new framework for promoting cybersecurity, implemented in February 2014.

Against this backdrop of regulatory change and increasing cyber-related operational risks it is clear that cybercrime, and insurers' strategies in relation to it, need to be high on the corporate agenda.

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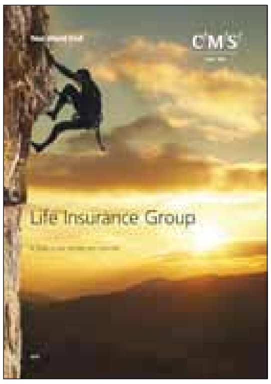

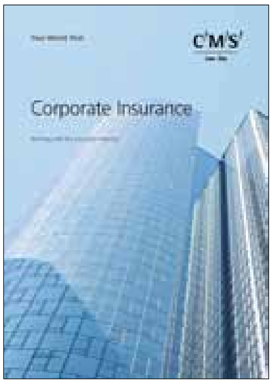

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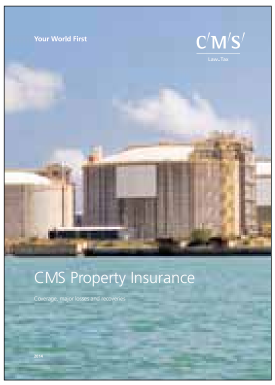

Top Scottish law firm Dundas & Wilson joins CMS

CMS and Dundas & Wilson merged in May 2014. The merger delivers many benefits to our clients. National and international insurance and reinsurance clients are able to draw on the expertise of the combined firm, which now has an unrivalled presence in the three key financial centres of London, Edinburgh and Glasgow. Existing and new clients now have access to a more flexible operating model, including a high quality near-sourcing offering that can provide cost savings and efficiencies. This means more choice regarding where work is undertaken and this in turn enables us to deliver better overall value to you.

The combination means the firm has greatly strengthened our Scottish offering – we now have more than 250 lawyers in Scotland, from a firm that is widely regarded as being the best in the market (and has more number one legal directory rankings in the past ten years than any other to prove it).

Forthcoming events

Date	Location	Seminar
17 July	Four Seasons Hotel, Canary Wharf, London	**FS Breakfast seminar - Retail Structured Products** To apply for a place please email: fs.seminars@cms-cmck.com
22 July	Lloyd's Old Library, London	**Know Your Risk: Brokers** The latest in the series of 'Know Your Risk Seminars' for brokers delivered by our award winning Insurance and Reinsurance group. To apply for a place please email: debbie.dennis@cms-cmck.com
30 July	Mitre House, London	**Employment - Fraudulent misrepresentation** Please register by 12.00 Tuesday 29 July. To apply for a place please email: caroline.humphries@cms-cmck.com
6 August	Mitre House, London	**Employment - Current employment tax issues** Please register by 12.00 Tuesday 5 August. To apply for a place please email: caroline.humphries@cms-cmck.com
27 August	Mitre House, London	**Without Prejudice update** Please register by 12.00 Tuesday 29 April. To apply for a place please email: caroline.humphries@cms-cmck.com
3 September	Mitre House, London	**Employment - Recruitment issues** Please register by 12.00 Tuesday 2 September. To apply for a place please email: caroline.humphries@cms-cmck.com
10 September	Mitre House, London	**Employment - Restrictive Covenants** Please register by 12.00 Tuesday 9 September. To apply for a place please email: caroline.humphries@cms-cmck.com
29 September	Lloyd's Old Library, London	**Know Your Risk: Construction Property** To apply for a place please email: maxine.hammersley@cms-cmck.com

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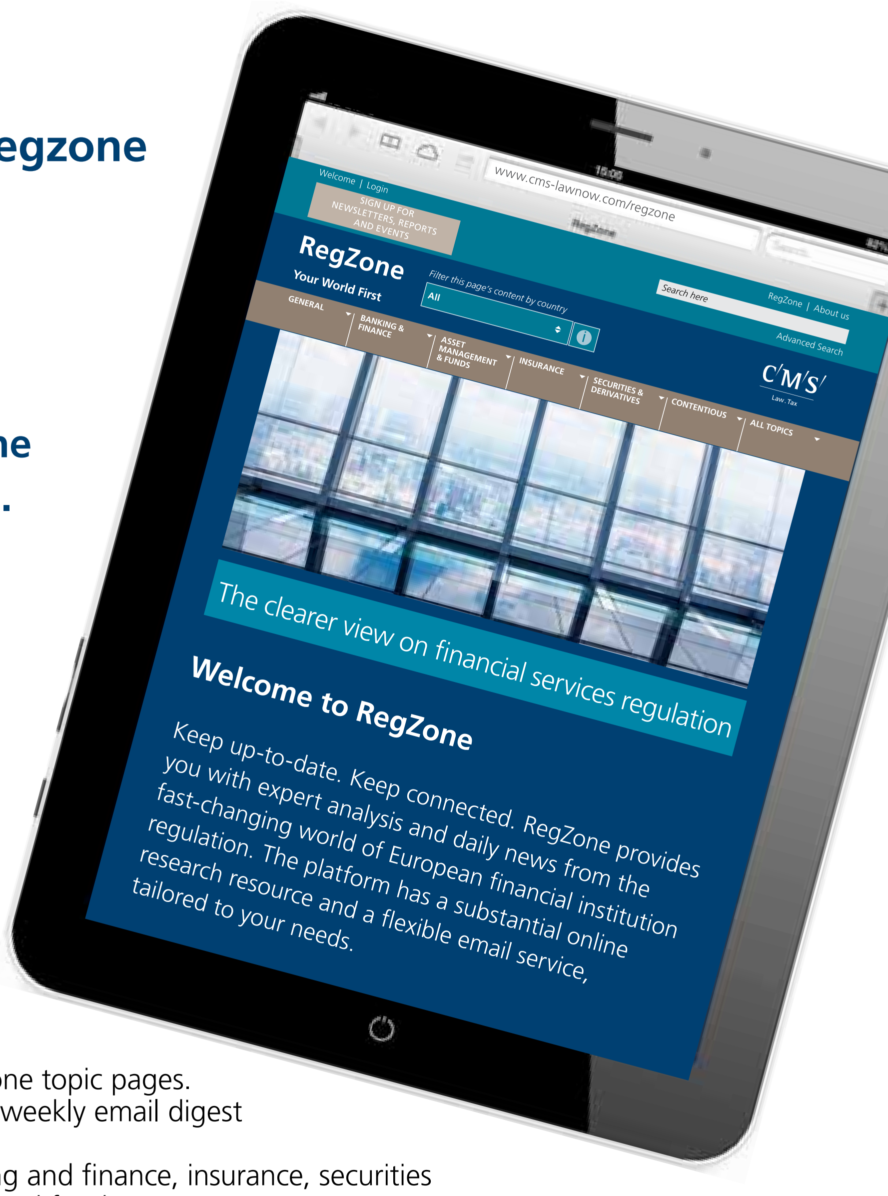

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