

In-sight

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Welcome to the latest update from Clyde & Co's corporate insurance team. This update summarises recent developments with links to further reading.

HMT Sanctions seminar

On 9 April 2014, the challenges posed by recent developments in international sanctions regimes were put into focus at a Clyde & Co seminar featuring presentations from HM Treasury (HMT), Clyde & Co US counsel and a panel discussion with representatives from the IUA, Lloyd's, KPMG and Clyde & Co.

HMT's presentation was its first to the London insurance market and comprised an overview of the sanctions regimes in operation in the UK followed by discussion of insurance specific prohibitions under the Iran and Syria sanctions regimes and how insurers and brokers can interact with HMT on sanctions issues.

HMT presentation

Engagement and dialogue

HMT were keen to emphasise the importance of engagement and dialogue over sanctions policy. HMT noted that it has to date enjoyed good relations with the insurance market and that positive engagement by market participants can be instrumental in informing policy development and implementation.

Although primary responsibility for the development of sanctions policy rests with the Foreign & Commonwealth Office (FCO), HMT plays an important role in engaging with the FCO to shape policy and streamlining policy implementation. The clear message was that market feedback on sanctions policy can make a significant contribution to this process as well as assist in the development of future policy.

Engagement with HMT is also of great importance when things "go wrong" and early discussion and analysis of issues is essential when dealing with a potential breach. HMT emphasised that, while deliberate circumvention will be met with appropriate enforcement, such a response may not be necessary in every case and that HMT has a variety of administrative and ministerial responses at its disposal.

Iran and Syria – permitted activities

HMT were interested in the market's approach to risks associated with permitted activities under the Iran and Syria regimes and presented the audience with a scenario involving the shipment of humanitarian aid.

Responses from audience members were unanimously cautious, with concerns raised about:

- The type of cover and the size of the risk
- The potential for unforeseen liability (particularly to third parties) which might generate further sanctions issues;
- The amount of due diligence required
- The risks associated with reliance on due diligence information received from lead underwriters and brokers

In short, the prevailing view seemed to be that the level of due diligence required for most policies involving Iran or Syria was simply not worth the effort.

Other factors affecting attitudes towards Iran include the disparity in application of the Joint Plan of Action between the EU and the US, with some insurers unable to participate in activities temporarily permitted under the EU regime due to the stricter approach taken by the US. There was also uncertainty as to what will happen if the current measures are not extended beyond 20 July 2014.

Panel discussion

The first topic of discussion by the panel was the rapidly evolving situation in the Ukraine. The panel recognised that Russia is a significant source of premium income for the London market and that any escalation of the sanctions regimes against Russia and the Ukraine as a result of prolonged political instability in the region would have a substantial impact.

Russia/Ukraine

In terms of the sanctions themselves, the panel recognised that the regimes imposed by the EU and the US in relation to Russia/Ukraine are likely to place a high burden on due diligence and screening processes given the breadth of the connections across business lines and customers. Responding to the fluid situation in Russia/Ukraine is likely to require a robust and proactive approach.

A question has arisen in recent weeks in relation to the status of the Russian insurer, Sogaz Insurance, which was until recently 51% owned by Bank Rossiya (a designated entity under US sanctions since 20 March 2014). Although Sogaz is not itself designated and Bank Rossiya now appears to have reduced its stake below the 50% threshold, OFAC has so far responded cautiously to requests for clarification on this issue, stating that each insurer must carry out its own due diligence to ensure that it does not breach sanctions.

Due diligence

The extent of due diligence required looks set to increase. KPMG noted that, in relation to the 63 individuals currently designated by the EU and OFAC in respect of the Ukraine, it had already identified 750 corporate entities (including entities incorporated in the UK, Germany, Austria and Finland) in which the sanctioned individuals have a potential sanctions touchpoint. This gives insight into the size of the task already facing insurers and brokers. With both the US and the EU poised to expand their respective lists of designated entities further, the challenge of ensuring compliance will only become more complex.

Lloyd's review

Lloyd's commented on its Sanctions and Financial Crime review, which has been under way for the past year. A number of high level themes coming out of the review were mentioned, including:

- The need to do more in relation to claims handling processes and training to ensure that claims are not being paid without screening
- Over-reliance on generic risk assessments and sanctions clauses rather than class/business specific risk assessment and due diligence
- The need for more guidance in relation to reliance by underwriters on due diligence carried out by third parties (i.e. lead underwriters/brokers) in the subscription market

With international sanctions in the spotlight more than ever before, insurers and brokers will need to ensure that they have robust processes in place to keep on top of the current landscape of fluid, fast moving international sanctions.



Lloyd's strategy 2014 – 2016

Lloyd's recently unveiled its strategy plan for the next three years. This plan forms part of the so-called Lloyd's Vision 2025 which was published a couple of years ago and which sets out Lloyd's key long-term objectives.

Since Vision 2025 was published, Inga Beale has been appointed as CEO of Lloyd's. This has coincided with a slight shift in emphasis in some of the content of Vision 2025, principally around international growth and diversity of capital.

Taking each of these in turn, firstly, with regard to international growth. As the strategy plan notes, expansion into developing markets remains at the heart of Vision 2025. Even though Lloyd's appreciates that in the short term, it is likely that, despite some challenging market conditions, established markets will continue to present the most profitable opportunities, there is no change to the objective of Lloyd's to be able to access all major overseas territories, including emerging markets.

However, what is now emphasised is that Lloyd's does not want this growth to be limited to growing cross-border reinsurance business, but would also like it to include increasing Lloyd's share of insurance business in developing markets.

To assist in achieving this, Lloyd's has identified the following short-term actions:

- It will continue to work with the Turkish and Indonesian governments to secure necessary legislative changes to enable trading licences to be granted
- It will conduct a feasibility study for insurance licence opportunities in Brazil
- It will conduct feasibility studies for a Lloyd's presence in Indonesia, Malaysia and South Korea, open a branch office in Beijing, investigate options in Latin America, including in particular Colombia and Mexico, and deliver plans for a new co-location office in Dubai
- It will assist brokers to build and develop relationships in developing markets

Secondly, with regard to capital, Lloyd's is keen for its capital base to become more globally diversified. As pointed out in the strategy plan, maintaining the attractiveness of Lloyd's to a range of capital providers will underpin the market's future success, as well as supporting the objective of increasing the market's access to specialist business in developing economies.

To this end, Lloyd's will continue to work with the market to facilitate the entry of new capital (with new business) from trade players in developing markets, which could take the form of new capital backing new syndicates or in support of existing businesses.

Lloyd's has identified the following short-term actions to seek to diversify its capital base:

- It will continue to build relationships which focus on increasing the understanding of potential new capital providers as to how they can participate at Lloyd's
- Whilst acknowledging and to an extent embracing the growth of non-traditional products and capital in reinsurance, Lloyd's notes that it is still a market for indemnity-based products, and Lloyd's would like to promote the benefits of indemnity (versus parametric) solutions as best meeting clients' needs

So, what are some of the key take-away messages from the strategy plan?

Well, one is that Lloyd's cannot afford to rest on its laurels. There is a recognition that the market environment is changing, and, whilst this presents challenges, there are also opportunities which Lloyd's needs to grasp. These opportunities include, in the longer term, winning new business in developing markets, and, in seeking to do so, Lloyd's appears to be flexible in terms of what business model it will adopt (be it, for example, by way of a licence or the setting up of a local establishment) taking into account local commercial and regulatory requirements.

Another is that distribution, and the role played by the brokers, remains key to delivering the Vision. Lloyd's reiterates that it is a broker market, with brokers involved in all of Lloyd's distribution channels. Indeed, Lloyd's would like to see growth in all of its existing channels (brokers, coverholders, service companies, and Lloyd's local underwriting offices). Lloyd's is also encouraging managing agents to consider new distribution options (such as joint ventures with local (re)insurers) which it will help facilitate where appropriate. It should be noted that there has been some criticism expressed by, in particular, mid-size wholesale brokers who are concerned at the prospect of local brokers being potentially able to directly access the Lloyd's market via local underwriting offices.

Finally, on an issue which has prompted quite a bit of debate recently, Lloyd's comments that it will also work with interested managing agents to develop consortia and facility arrangements where market and client demand exists, but these will need to have appropriate checks and balances on any delegation of underwriting and claims authority.

The ambition of Lloyd's which it set out originally in its long-term Vision, and which it is developing and refining by way of its shorter-term strategy plans, is clear and laudable. It will be interesting, however, to see how much progress is made over the months and years to achieve this ambition, and the extent to which there is buy-in from managing agents and brokers.

FCA business plan 2014/15

Amidst the recent furore over the FCA leaking to a journalist details of a proposed enquiry into legacy life policies, resulting in hundreds of millions of pounds being temporarily wiped off the share price of UK listed life companies, and the strong rebuke which then followed by the Chancellor, George Osborne, the FCA published its business plan for 2014/2015.

It is tempting to wonder to what extent the challenges which lie ahead for the FCA, and their approach to such challenges will be tempered, if at all, by the outcome of the inquiry into the leak. Could this recent unfortunate event result in the FCA easing up on the relentless pace which it has already set, in terms of thematic reviews, market studies and the like, and ultimately result in the adoption of a more cautious and measured approach? Only time will tell.

In the meantime, the business plan makes for some informative reading. In respect of the insurance market, the FCA has identified a number of areas of focus for it. There are three areas which we think are worth highlighting.

Firstly, the FCA is still keen to ensure that firms have the right culture. The FCA would like to see that the work which has been made to date in putting the concept of good conduct at the top of the agenda in boardrooms is pushed down throughout the firms concerned. This will involve making sure that the best interests of customers are at the heart of a firms' business model. Part of this will also involve considering the incentive structures which firms use and whether these encourage poor conduct to flourish. The spotlight will continue to fall on boards and senior people in firms who carry out significant influence functions to make sure that they continue to remain accountable, and have the right governance and risk management processes and controls in place. Particular areas of risk identified by the FCA across all sectors include the risks of cyber-attack, IT risks, and potential mis-selling risks as a result of performance of sales staff who may have sales targets to meet.

Secondly, the FCA has expressed its desire to maintain its international engagement. The FCA would like to continue to focus on establishing the FCA as a credible contributor to, and influential member of, the global regulatory community by engaging early in debates, taking the leading

role in negotiating and drafting standards, and proactively recommending areas where EU or international-level rules would be most appropriate. In our view, this is likely to become an increasing area of focus for the FCA.

Thirdly, and finally, the FCA has noted that it will carry out, and follow up on, a number of reviews including in respect of the following:

- **Commercial claims** – building on findings from current retail claims work including whether commercial customers' expectations are met in the claims process
- **Coverholders** – looking at distribution chains in firms that operate in wholesale markets, and considering the impact on retail and small commercial customers, and the way in which intermediaries identify and manage conflicts of interest
- **Premium finance** – reviewing insurers' and intermediaries' sales practices and disclosures when selling premium finance to consumers alongside general insurance products
- **Motor legal expenses and mobile phone insurance** – ensuring that firms have embedded the recommendations made in 2013
- **Protection of client money by small firms** – investigating the extent to which firms are currently holding client money without the appropriate permissions and protections (the FCA will also publish the new CASS 5A chapter replacing the existing rules covering how insurance intermediaries should deal with client money which rules will bring in new requirements around how to use and operate non-statutory trusts)
- **Legacy life products** – analysing to which life insurance firms are operating historic (ie legacy) products in a fair way and whether they have adopted strategies that are not in the best interests of existing customers

The FCA has clearly set itself a challenging agenda for the year ahead. It should be borne in mind that the issues highlighted above only relate to the insurance market! To put this into context, with effect from 1 April, the FCA also took over the regulation of the consumer credit industry which has effectively doubled the number of firms which the FCA now regulates.

The FCA will no doubt be hoping that the inquiry into the unfortunate leak will show that what happened was an isolated exception, that there will be no lasting damage to its reputation, and that it can get on with its busy agenda free from any other distraction. One thing is for sure, the next few months will probably not be dull.

How the Asia Pacific region bucks the global insurance M&A trend

With stagnant premium growth in many of the developed economies, (re)insurance players are increasingly looking at opportunities in emerging markets. This article considers what some of those opportunities might be, with a particular focus on growth by way of M&A.

While M&A in the global insurance industry has dipped, deal-making in Asia Pacific is on the rise.

The volume of M&A worldwide in 2013 fell 21% to 320 completed transactions, compared to 403 in 2012, writes Clyde & Co Singapore partner Ian Stewart.

However, the Asia Pacific region saw a 7% increase to 62 from 58 in the previous year. More significantly, its percentage share of global deal activity by region has been steadily moving upwards since the second half of 2011 – where it sat at just 9% – to 22% at the end of 2013. But just what is driving this increase, and is it sustainable?

Search for growth

In a region steeped in economic and geographical diversity, trends are not always easy to pinpoint. However, there are some common activity drivers across a number of markets. Some companies are being forced into transactional activity to alleviate financial pressure, often as part of the fallout from the global financial crisis, such as ING's sale of operations in Hong Kong, Korea and elsewhere. Others are being driven by the search for growth.

With persistent soft pricing evident in many locations around the world and opportunities in mature insurance markets difficult to come by, diversification through acquisition into new sectors or distribution channels has attracted a range of players to the Asia-Pacific region. Increasing levels of GDP and improving insurance penetration rates are delivering premium growth across the region, benefiting both domestic and international insurers.

Indeed, over the past 18 months deal-making in the region has been primarily led by Japan, with the majority of deals being outbound investments as domestic insurers explore opportunities beyond the local market. Notable acquisitions in the second half of 2013 included the

acquisition of two Indonesia targets: PT Panin Life and Avrist Assurance PT by, respectively, Japan's Dai-ichi Life Insurance Co Ltd. and Meiji Yasuda Life Insurance Co.

However, there has been activity across the region with Indonesia, South Korea, Malaysia, Taiwan, and Hong Kong all witnessing a range of domestic and cross-border transactions. In addition, China and India both saw a number of deals, although the level of activity does not reflect the size of opportunity that each market represents. While interest in the region remains keen, a number of challenges continue to apply a handbrake to M&A activity. In particular, valuation as a potential roadblock, with sellers pricing aggressively based on the future growth potential of the industry in the region. Activity is also often stymied by difficulties around finding the right targets and limitations on investments in many markets.

Regulatory drivers

These difficulties are beginning to be addressed, with regulatory reforms underway which will prove to be another key driver of transaction activity. Regulators in many markets are looking at the actions of the authorities to strengthen insurer solvency in Europe and the US, and are taking similar steps in this direction. The desire is to build businesses that understand the risks they are writing, hold the appropriate levels of capital and have strong balance sheets.

A number of insurance regulators across the Asia Pacific region have expressed the view that there are too many participants and have either indicated that new licences will not be issued, or at the very least, new entrants will be encouraged to enter local markets through acquisition rather than new start-ups. Certainly, an increasing number of new players in the region have formed the view that, notwithstanding pricing and other transaction hurdles,

acquisition is the preferred market entry method. For example, the Indonesian government took steps in the last year to tighten up regulation significantly, with new rules including a 250% increase in capital requirements for insurers by the end of 2014. Meanwhile, the regulator in Thailand has relaxed foreign ownership rules and put in place risk-based capital benchmarks to increase transparency and bolster capital strength. It is also planning to amend Thailand's insurance licensing rules to streamline the merger process and facilitate consolidation. While the specifics of regulatory developments may be local to each country, and the evaluation process for each new market entrant will depend on individual circumstances, the overall trend to fewer, stronger insurers will undoubtedly lead to continued market consolidation in many places.

Bright future

Looking ahead, in addition to Japan, other developed economies such as Hong Kong and South Korea will likely continue to explore growth and profit opportunities in emerging markets such as Malaysia and, in particular, Indonesia. Premiums in the country have been increasing

11% year-on-year – five times the growth rate of Europe or the US – and over the past 18 months the number of deals involving overseas insurers entering the market has increased, with more deals expected. Thailand is also set to take off, with current predictions suggesting growth rates of more than 10% over the next 10 years – this has led a number of international insurers to flag up Thailand as a prime target for M&A activity. China too may also look at opening up other key areas of the market, and changes around pensions, retirement products, tax incentives and health insurance could allow foreign insurers to leverage their knowledge and expertise, ultimately paving the way for more transaction activity. It is expected to be another stand-out market in the region in 2014, as we should see foreign insurers continue to increase the breadth and depth of their presence in the country.

Looking at these developments and the increasingly broad range of opportunities across the region, the future is bright for M&A activity in the Asia Pacific region.

This article was originally written by Ian Stewart, published on Globalreinsurance.com

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