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Global Insurance Focus

An overview of the latest developments in the global insurance and reinsurance industries

Issue 9: November 2019

Highlights in this issue include:

Insurance transfer schemes – Prudential – Rothesay Life

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The issues for D&O insurance introduced by the Australian Banking Executive Accountability Regime

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Insurance transfer schemes – Prudential – Rothesay Life

By Adam Levitt, UK

In June, the court (Snowden J) refused to sanction the transfer of a block of some 370,000 annuities from Prudential to Rothesay Life, the specialist annuity company. The decision is a surprise, because properly prepared transfers have generally been approved. The decision is being appealed.

The judgment sets out various factors underlying the rejection of the transfer scheme. The following themes emerge:

Reputation

Various policyholder objections seem to have been based on their having deliberately chosen Prudential because of its age and reputation. The judge considered this a rational course of conduct and pointed out the irony that Prudential's website continues to emphasise the company's heritage and trusted brand – he noted Prudential was "one of the oldest and most respected UK insurance companies".

Annuity products

It is settled law that annuities can be transferred. However, the facts that Prudential's policyholder documents indicated the product would be a "lifetime annuity with Prudential" (so did not mention the possibility of transfer), that policyholders cannot be presumed to know about an insurer's ability to effect a portfolio transfer and, finally, that annuitants were understandably extremely risk averse, were all factors that had to be considered.

Capital support

Although Rothesay's solvency capital was, according to the independent actuary, only slightly lower than Prudential's, the disparity between the external support potentially available was a material factor for the court. This point was particularly relevant here, given that the policies, being annuities, would exist for decades.

The judge distinguished Royal Sun Alliance, where David Richards J said that the court was interested in "real, as opposed to fanciful" solvency risks, given the short-term nature of the policies in that case. He also said that the existence of the Financial Services Compensation Scheme (which, under its current rules, would compensate annuitants as to 100%) was irrelevant, given that the rules of the scheme could be changed over the lifetime of the annuitants.

Reinsurance

Prudential was found to have gained most of the desired regulatory capital benefit already. This is because a reinsurance agreement covering the annuities had already been entered into with Rothesay. The agreement was designed to continue even if the court rejected the transfer scheme.

The parties could not presume the transfer scheme would be sanctioned. That Prudential would need to hold an element of regulatory capital to deal with the credit risk associated with Rothesay, and Rothesay would not have complete freedom to exploit the assets transferred to it as reinsurance premium, did not amount to "significant prejudice when set against the fundamental change in status and material disadvantage that [the parties] seek to impose" on policyholders.

Possible impact

Insurers, as a result of Snowden's judgment, may want to refer in their policy documentation to the possibility of policies being transferred. However, doing so may sit uneasily with simultaneously emphasising the benefits of contracting with them, rather than another insurer.

Also, insurers may want to re-consider whether to enter into reinsurance as a prelude to pursuing a transfer – as not doing so may make the court more cognisant of the benefit of the portfolio transfer to the parties. On the other hand, a disadvantage of this approach would be to defer most of the economic benefit of the risk transfer. For the parties to agree to enter into reinsurance if the portfolio transfer is rejected is not a complete answer, as this would need to be disclosed to the court and put the parties in an analogous situation to that of Prudential and Rothesay.

Particularly for long term policies, insurers will be less confident of being able to transfer policies to companies in weaker groups and/or those with worse reputations.

UK

Tougher UK consumer protection law enforcement on its way

By Alexi Dimitriou, UK

On 18 June 2019, the UK Government published a press release announcing "tough new powers for [the] competition watchdog to fine businesses directly who have broken consumer law". This follows a request from Lord Tyrie, Chair of the Competition and Markets Authority ("CMA"), for enhanced powers to investigate and sanction breaches of consumer law by businesses. The Government will consult on the specifics in an upcoming Consumer White Paper expected later this year.

This comes alongside proposals to increase the powers of other UK sectoral regulators in this area, in the light of recent investigations into issues such as "loyalty penalties" and the Government's recent Smart Data Review. It is currently a key area of regulatory focus in the UK, which could significantly increase compliance risk.

Key Points

- The proposed measures will increase the CMA's powers to investigate and sanction businesses for breaches of consumer protection law, and will concern all businesses, regardless of size and industry sector.
- The precise scope of the measures is currently unknown, but the Government has announced that it will enable the CMA to impose penalties on infringing businesses and could potentially also include sanctions against individual managers (e.g. director disqualification).
- This may lead to an increased number of CMA investigations into consumer law breaches, further requests for information from businesses, and additional time/resources required by management of businesses involved. Businesses might also see more complaints made to the CMA from customers and/or consumer groups regarding their consumer protection-related conduct.
- Therefore, businesses should ensure that consumer protection law compliance is sufficiently high on their board agendas, and that they have appropriate compliance policies in place.

Background

The CMA's stated aim is to make markets work well and it has a statutory duty to seek to promote competition for the benefit of consumers (Enterprise and Regulatory Reform Act 2013).

The CMA has investigated a wide range of sectors using its consumer protection law powers, and some recent examples of CMA enforcement in this area are summarised here:

Gambling firms (October 2016 – April 2019)

Issue: concerns relating to certain gaming promotions and difficulties gamblers faced withdrawing their money from online gambling firms.

Outcome: various undertakings, e.g. firms committing to being more upfront and clear about promotional terms and conditions, and making it easier and fairer for players to withdraw their cash.

Care homes (June 2017 – ongoing)

Issue: certain practices, in particular relating to self-funding residents and issues of large upfront fees, and fees charged after a resident's death.

Outcome: the CMA published two guidance documents addressing: (a) the charging of fees after a resident's death; and (b) a range of issues including the provision of upfront information, contract terms and business practices, providing services with reasonable care and skill, and complaints handling. A number of providers have entered into various undertakings (e.g. agreeing to amend certain of their terms and conditions). In February 2019, the CMA issued court proceedings against Care UK for failing to provide compensation to over 1,600 care home residents who were previously charged compulsory administration fees (in some cases, as much as £3,000).

Leasehold market (June 2019 – ongoing)

Issue: investigation into concerns regarding the fairness, clarity and presentation of certain leasehold contract terms. The CMA is examining, in particular, areas of potential:

a) mis-selling, i.e. whether leasehold purchasers fully understand the obligations they are taking on (e.g. ground rent) and their ability to buy the freehold; and

b) unfair terms, i.e. whether leaseholders are paying excessive fees on administration, services, "permission" charges and ground rents due to unfair contract terms.

Secondary ticket sales sites (September 2016 – ongoing)

Issues: concerns regarding (a) online secondary ticket sites sales were not informing their customers about certain aspects of the tickets they are buying; and (b) pressure selling, difficulties in getting money back under a website guarantee, speculative ticket selling, and whether organisers of events are selling as a primary seller directly through secondary ticket websites.

Outcome: undertakings offered by various providers. In November 2018, the CMA secured a court order against Viagogo, requiring it to overhaul the way it did business. Since then, the CMA has found that Viagogo has not fully complied with the court order, and therefore, on 4 July 2019, the CMA announced it was moving forward with legal proceedings for contempt of court.

Other recent cases include:

CASE	DATE OPENED	STATUS (AS AT 15/07/2019)
Fake and misleading online reviews	21/06/2019	Open
Online console video gaming	05/04/2019	Open
Anti-virus software	27/11/2018	Open
Apple iPhones: consumer protection case	09/08/2018	Closed (22/05/2019)
Social media endorsements	08/08/2018	Open
Online dating services	31/10/2017	Closed (06/06/2018)
Online hotel booking	27/10/2017	Open
Car rental intermediaries	19/10/2017	Closed (29/03/2018)

While these examples clearly demonstrate that the CMA has been active in using the consumer enforcement powers it currently has, the secondary ticket sales investigation in particular gives some indication of the reasons for the CMA's recent push for reform in this area, as discussed below.

This push also comes in the wake of a super-complaint made to the CMA by Citizens Advice in September 2018 concerning excessive loyalty payments in certain markets. In its response to this super-complaint, published on 19 December 2018, the CMA estimated that long standing customers who do not shop around pay more than new customers for the same service to the value of around £4 billion in total across the five markets considered (mobile, broadband, cash savings, insurance and mortgages). The CMA made a number of recommendations in order to address this issue.

Consumers: A need for reform

In August 2018, the Business Secretary, Greg Clark, requested advice from the newly appointed Chair of the CMA, Lord Andrew Tyrie, on whether legislative and institutional reforms were necessary to safeguard the interests of consumers and to improve public confidence in markets.

On 21 February 2019, Lord Tyrie responded to this request with a letter containing numerous proposals for reform. These proposals are wide-ranging, and reflect the CMA's sentiments in its 2019/2020 Annual Plan, published the week before, in which it stated that "*it is becoming evident that the competition and consumer protection regimes need to evolve further to ensure they stay effective*".

As for consumer protection, Lord Tyrie proposes that this (and the competition law regime) should be re-centred to enable the CMA to focus more directly on protecting the interests of the consumer. The letter advocates that the CMA and the courts (including the specialist competition court, the Competition Appeal Tribunal ("CAT")) should be subject to a new statutory duty to treat the economic interests of consumers, and their protection from detriment, as paramount. This would be supported by strengthening the CMA's powers to enforce consumer protection law, which Lord Tyrie describes as "*unfit for its current purpose, and far short of what would be required to enable the CMA effectively to fulfil a consumer interest duty*".

In particular, Lord Tyrie highlights that:

a) the CMA currently has no power to order businesses to stop illegal practices, but must go to court in order to obtain a binding remedy;

b) even when the CMA wins in court, no civil fines are available;

c) although the CMA can obtain undertakings from firms, it has no powers to fine firms for non-compliance with those undertakings; and

d) currently, no fines are levied on firms for failing to comply with information notices in consumer protection investigations.

In his letter, Lord Tyrie emphasises the importance of adapting to protect consumer interests, in particular given the growth of digital technology, which is creating new forms of potential consumer detriment, such as data harvesting and personalised pricing. This was also reflected in a subsequent speech he gave in May 2019, in which he made it clear that "*competition needs to be promoted not as an end in itself, but rather as a tool to serve the interests of the millions of consumers that are its intended beneficiaries...*".

Proposed changes

In light of the above, the CMA is seeking greater enforcement powers in the consumer protection context, akin to those it has under the competition law regime. In particular, in his letter, Lord Tyrie proposes that:

a) the CMA should be empowered to decide whether consumer protection law has been broken, publish this fact, require businesses to cease the relevant conduct, and impose fines (both for the infringement itself and for subsequent breach of any undertakings provided to the CMA);

b) the CMA should be able to order cessation of practices it suspects may be harming consumers on an interim basis pending the outcome of its investigation;

c) there could be reforms to improve personal responsibility for breaches of consumer protection law (e.g. director disqualifications) and potentially a requirement on companies to appoint a board director with responsibility

for assessing and reporting on risks in relation to competition and consumer law compliance; and

d) a turnover-based fines regime for non-compliance with information notices be introduced.

Next steps and potential implications

On 18 June 2019, the Department for Business, Energy & Industrial Strategy ("BEIS") confirmed in a press release that the Government intends to empower the CMA to decide whether consumer protection law has been broken and to impose fines on businesses directly for infringements. This press release includes a statement from the Prime Minister's office that "*it is high time [harmful trading practices] came to an end and … we are confirming our intention to give much stronger powers to the CMA, to strengthen the sanctions available and to give customers the protection they deserve against firms who want to rip them off*".

The Government's intention was also referred to in response to the CMA's loyalty penalty recommendations, published on 17 June 2019, in which Mr Greg Clark stated that the Government will be consulting on how best to achieve these in an upcoming Consumer White Paper, which will include the route of appeal, and the implications for the wider consumer enforcement landscape. According to a Regulation Update statement made in the House of Lords on 8 July 2019, the Consumer White Paper (which will also address other consumer-related issues) is due to be published later this year.

The details of the precise enforcement mechanisms, specific sanction levels, and indicative timings are still to be determined pending consultation. However, any implementation of these proposals can be expected to have a significant impact on the enforcement of consumer protection law in the UK. In particular, the direction of the CMA's focus is likely to lead to a greater number of CMA investigations into breaches of consumer protection law, which:

a) may include more requests for information;

b) will require more input/time from management of the businesses involved; and

c) will increase the risk of those businesses ultimately being made subject to cessation orders, undertakings and/or being fined for breaches.

In respect of potential fines, if the approach adopted follows the competition law regime, businesses could face penalties of up to 10% of global turnover for infringing consumer protection law, and so it is important that businesses are prepared.

Similarly, in addition to the powers to impose harsher sanctions on businesses for non-compliance with CMA information requests, query whether it is possible the CMA will also seek dawn raid-type powers to assist with its consumer protection law investigations.

In any event, regardless of the precise form of the ultimate proposals, this is a key area of focus for the CMA going forward. As Lord Tyrie stated in his May 2019 speech "*… these proposals will now be further developed and refined. … The task of rebuilding public trust and confidence requires much more. It requires the CMA to be a more visible and vocal consumer champion, independent of vested interests in the private sector, and of political pressures. … that will require a cultural shift.*"

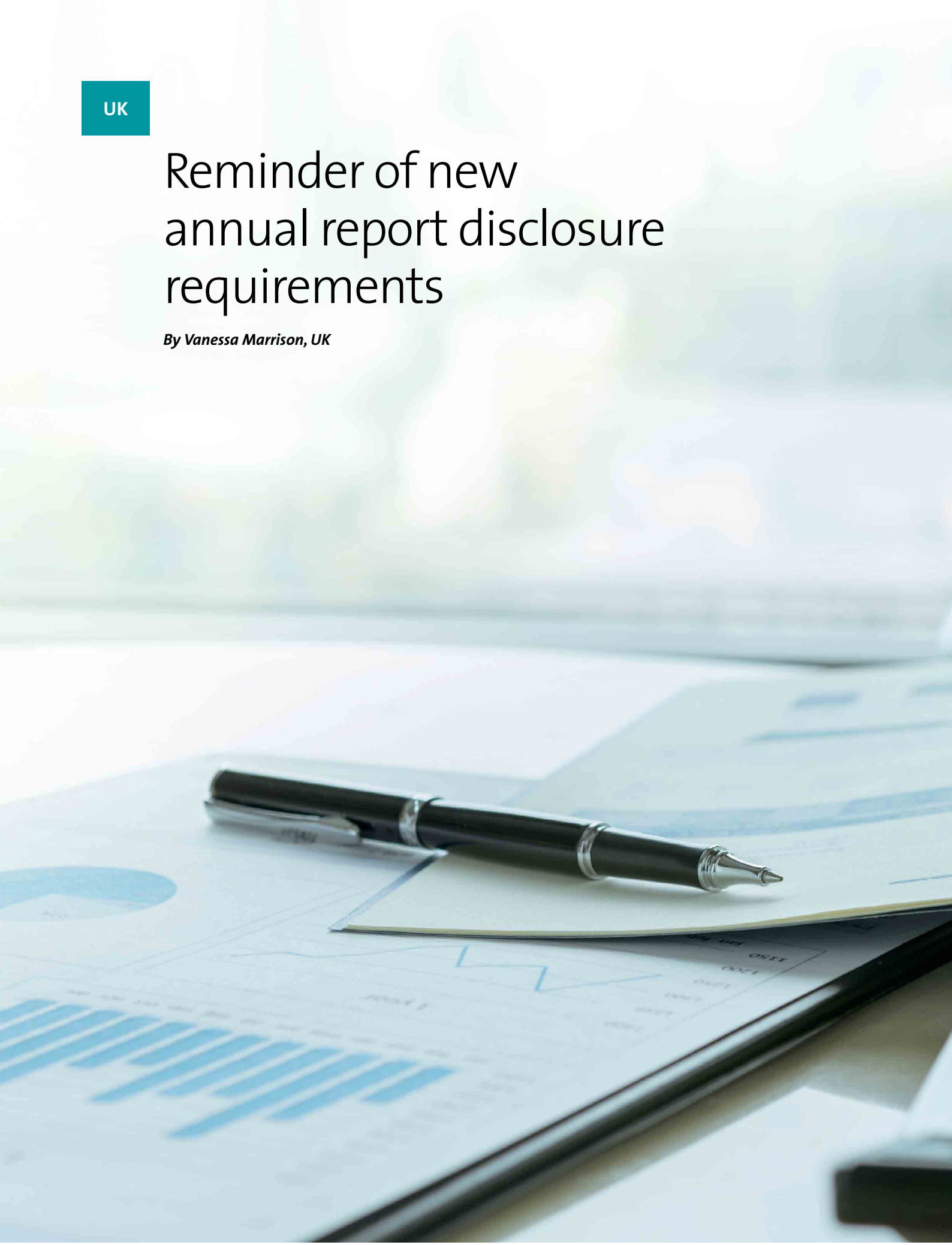
It is also noteworthy that, while Lord Tyrie's letter concerns the powers and role of the CMA in relation to consumer protection law, the Government has also proposed measures to enhance the powers of the UK sectoral regulators (which also have concurrent competition law powers) in this respect. The BEIS press release, for example, states that the Government will legislate to give regulators, such as the FCA and Ofcom, new powers to stop loyal customers being taken advantage of if their existing powers are insufficient.

Therefore, it is clear that consumer protection is a priority not just for the CMA, but also for the Government and other sectoral regulators in the UK, such as the FCA. Therefore we are likely to see significant change in this area from various parties in the foreseeable future.

UK

Reminder of new annual report disclosure requirements

By Vanessa Marrison, UK



New disclosure requirements for annual reports came into force for accounting periods beginning on or after 1 January 2019. The new disclosures will need to feature in annual reports of relevant companies that are published in 2020.

These disclosures include the new section 172(1) statement explaining how directors have had "regard" to the listed factors when promoting the success of the company and disclosures on corporate governance arrangements. They also include a higher level of reporting on culture and purpose, engagement with employees and other stakeholders, response to voting dissent, succession planning and developing a diverse management pipeline, board evaluation and directors' remuneration.

The requirements are set out in (a) the 2018 UK Corporate Governance Code, which applies to premium listed companies and (b) the Companies (Miscellaneous Reporting) Regulations 2018, which apply to large, UK companies (which can include non-listed companies). Each of the disclosure requirements of the Regulations has its own set of scope provisions, which should be applied carefully to see whether that element of reporting is required by an entity. By way of example, in relation to the new reporting on corporate governance arrangements for those companies that are not premium listed, a UK company is in scope if it has (a) more than 2000 employees or (b) a turnover of more than £200 million and a balance sheet total of more than £2 billion.

Companies caught by the new reporting requirements should consider whether extra time may be required for preparing their annual reports to be published in 2020, especially if they might need substantially to restructure their corporate governance reporting.

For more detail on these areas please see our client briefings on the 2018 Code, the miscellaneous reporting regulations and also on directors' remuneration.

UK

Superfunds

By Jasmin O'Reilly and Adam Levitt, UK

Defined benefit (DB) pension schemes are receiving increasing levels of political, legal and media scrutiny, particularly in light of recent high profile pension collapses. The fixed nature of the benefits under DB schemes and the lack of investment in many schemes mean that the majority of DB schemes run a deficit. The Pension Protection Fund's (PPF) October 2019 update estimated that 66% of eligible defined benefit schemes were in deficit and valued the total deficit of these schemes to be £265.3 billion at the end of September.

Most companies and institutions have closed their DB schemes, with the most recent analysis by The Pensions Regulator (TPR) calculating in 2018 that only 14% of defined benefit schemes in the UK were still open to new members.

Recent years have seen increasing activity in the pensions sector, with economic consolidation by bulk annuities (buy-ins and buy-outs) and (predominantly for defined contribution schemes) master trusts.

Set out below are the key differences between buy-ins and buy-outs:

BUY-IN	BUY-OUT
Policy held by the trustees as a scheme asset	Scheme's liabilities are fully transferred to the insurer
Employer's covenant remains in place	Employer's covenant extinguished
Policy often covers only a proportion of the scheme's liabilities	Policy covers the entire scheme

Continuing this trend towards consolidation of schemes, the Department of Work and Pensions (DWP) opened a consultation entitled "Consolidation of Defined Benefit Pension Schemes" in December 2018 (Consultation), following on from its 2018 White Paper: "Protecting Defined Benefit Pension Schemes".

The Consultation sets out a possible legislative framework for "superfunds": vehicles by which DB schemes could be consolidated. The key difference between superfunds and

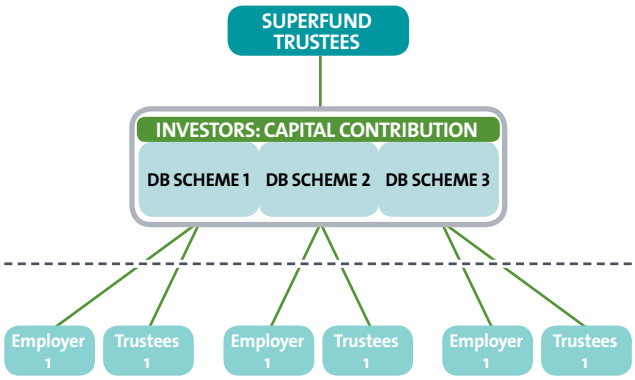
existing structures is that the employer's covenant would be replaced by third party capital other than in the form of insurance. Superfunds would be required to apply for authorisation from TPR.

The main drivers behind this proposed legislation are twofold: (a) a desire to reduce the costs associated with running DB schemes through economies of scale, and (b) a wish to establish a route for removing reliance on sponsoring employers. This second point should make defined benefit schemes less risky for members as the scheme would no longer be at risk of individual employer insolvency.

This article considers the opportunities and risks relating to superfunds.

What is a superfund?

The key feature of the superfund is the capital buffer. This would be provided by third party investors and replaces the employer's covenant — the liability of the DB scheme's employer company to ensure the scheme trustees have the money necessary to pay members' benefits. This capital buffer provides a finite amount of support to the scheme, whereas the employer's covenant is uncapped – a crucial distinction.



Profit

The incentive for the investors is the potential to profit from the performance of the superfund. While this seems straightforward conceptually, the realities of balancing the long-term interests of the scheme members against the need to provide a sufficient incentive for the investors is difficult.

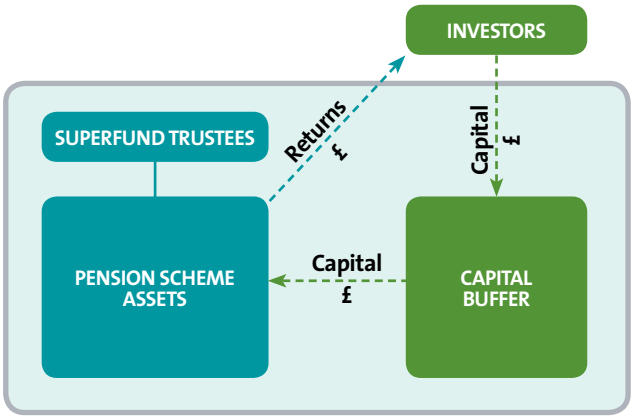
Members could be at risk if profits are taken excessively or too early. If profit is withdrawn too early, investors may be merely taking the benefit of market volatility, rather than sustained outperformance, and this would be detrimental to the members in the long term. To address this, the DWP suggested two possible options in the Consultation:

a) profits could be retained for a certain period in a separate contingency reserve; or

b) profits could only be distributed once all benefits have been paid out of the superfund.

The second option gives the greatest protection to the members. However, it would mean that investors would not see any interim returns.

Control of capital buffer



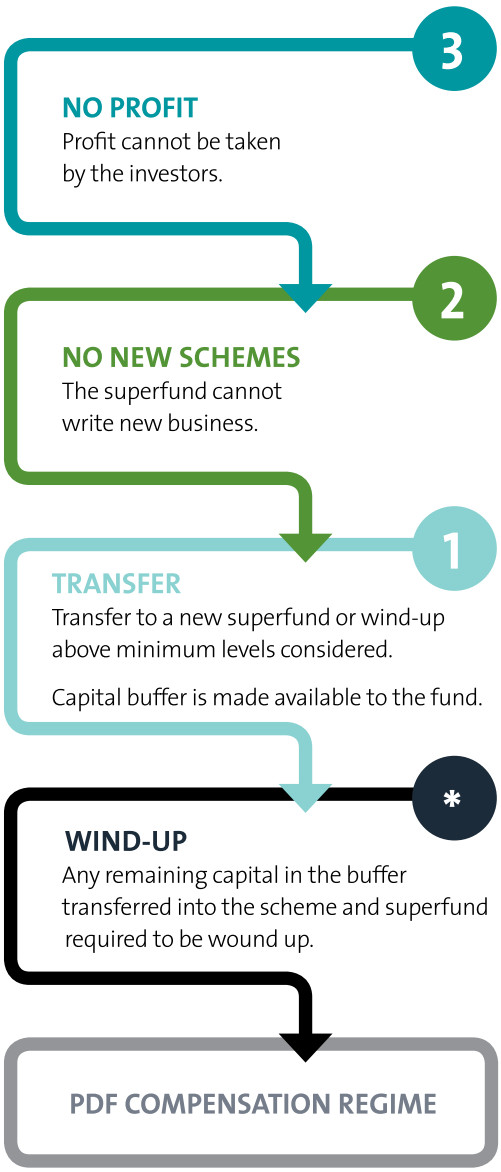
It is intended that the superfund will be an occupational pension scheme whereby the statutory employer will be a corporate entity and the employer covenant will be limited to the capital buffer. There would be a single set of trustees who would control the pension scheme assets contributed from various pension schemes in the superfund.

The Consultation sets out two possible options for transferring assets from the capital buffer into the pension scheme assets: either (a) require deficits within the scheme to be made good as they emerge; or (b) ring-fence the assets in the capital buffer. Another possible way to manage the potential transfer of the capital buffer into the assets of the superfund would be to grant security over the capital buffer in favour of the trustees. The security would only be enforceable once the superfund's funding fell below a certain threshold.

If assets from the buffer were transferred into the superfund at too early a stage, it would be difficult for the investors to reclaim the assets if the superfund's financial position improved.

Protection triggers

In addition to these protections around the capital buffer, the Consultation proposes that a series of trigger events would kick in when a superfund was beginning to fail to protect it from collapse. The detail around these trigger events has not been fully fleshed out, but the idea is that these would enable TPR to intervene. The triggers would lead to the following consequences depending on the tier reached:



Sectionalisation

Superfunds could be either sectionalised or non-sectionalised. For authorisation of a sectionalised superfund, the fund should be considered as a whole so as to avoid each section separately going through an authorisation process. However, in relation to protection triggers and general financial feasibility, each section should be considered separately so as adequately to protect members' interests.

The Pensions and Lifetime Savings Association (PLSA) notes in its response that whether a superfund should be allowed to write new business if one or more sections are inadequately funded should be decided on an individual basis: it depends on the number of sections that are underfunded, the extent to

which they are underfunded and the overall structure of the superfund.

On the other hand, non-sectionalised schemes are less expensive and more efficient to run compared to sectionalised schemes, as reporting and administration can be done for the whole pool, rather than being repeated for each section.

Capital buffer

The approach adopted for ensuring the financial adequacy of the fund needs to balance members' protection, employer affordability and investor profitability. The approach taken also depends on whether superfunds are considered more akin to insurance buy-outs or a form of pension regime. The Consultation sets outs four possible approaches: three with a pension framework and the fourth with an insurance-style framework. The insurance framework is the most stringent.

There is a significant degree of overlap between superfunds and buy-outs, as the relationship with the employer is severed and the liabilities are met by a capital fund. However, the Consultation is clear that superfunds would not be required to meet the same funding standards as insurers. If superfunds were subject to similar funding requirements as insurers, it would make superfunds less affordable and therefore no longer appropriate for those DB schemes that are currently unable to afford a bulk annuity.

The next most stringent approach set out in the Consultation is the "common long term objective and minimum standards". This approach requires stochastic modelling to be done by the fund itself to evidence a high probability of meeting its obligations; evidence that the fund would be able to meet an objective standard in relation to cash flow over the life of the fund, and further criteria to be met in relation to the capital buffer. The other two options set out in the Consultation are reduced versions of this.

The viability of superfunds depends on the effectiveness of the approach adopted and balancing the benefit of having a strong regime for financial adequacy against affordability.

How should superfunds be regulated?

The approach taken in relation to the capital buffer feeds into the bigger question of how superfunds should be regulated more broadly. The Consultation makes clear that superfunds will not be subject to the requirements of Solvency II (the solvency capital regime for insurers), and equally that the intention is not simply to create a less expensive version of the buy-out. Introducing any new regulatory regime into an already highly regulated sphere does create a risk of arbitrage, something which the Prudential Regulation Authority, which regulates insurers, emphasises in its response to the Consultation.

The Association of British Insurers (ABI) has expressed significant concern that the superfund structure could be used to circumvent the requirements of Solvency II by encouraging the transfer to superfunds of DB schemes that are close to being able to afford (perhaps with some employer help) a buy-out with an insurer.

The DWP addresses this in the Consultation by proposing a principles-based "superfund gateway", requiring schemes to evidence that the transfer would enhance members' expectations of being paid their benefits in full, but excluding schemes evaluated as being eligible for a buy-out by the trustees within the next five years. While this provides a framework of principles, it arguably does not impose any greater protection than is already provided by the requirement for the trustees to comply with their duties when deciding whether to transfer the scheme into a superfund. This has not alleviated the concerns of the ABI, which remains opposed to the introduction of superfunds.

As well as regulation to manage superfunds, there also needs to be a support regime in case of failure. The PPF's response to the Consultation expresses concern about the significant burden that could be placed on the PPF in the event of a superfund failing, given the potential number of members affected. As a result, the PPF published a possible framework to readdress the balance of risk by suggesting that more risk should be with the investors:

PPF's key aims

1	**Ensure there is a high degree of confidence that scheme benefits will be paid in full**
2	**Protect members and PPF levy payers from the potentially significant impact of "superfund" failure**
3	**Prevent ant change of control of the superfund from increasing the risk to members or the PPF, i.e. require trustee and TPR consent**
4	**Ensure further transfers into the superfund should not dilute existing members' protection**

The PPF considers a recapitalisation regime and a penalty framework to be key to achieving its aims. The PPF wants a member protection trigger requiring the superfund to be recapitalised if the investor capital has been consumed. Although understandable from the PPF's perspective, a recapitalisation regime is unlikely to be workable in practice:

METHOD OF RECAPITALISATION	OUR COMMENTARY
Recapitalisation by existing investors	This clearly puts more risk on investors and moves their position closer to that of the employer in a traditional DB scheme context. This will not be palatable to investors and could make superfunds unachievable.
Transferring into another superfund	It would be unlikely that another fund would take on the failing fund, as it would likely mean diluting the solvency of the transferee fund.
Buy-out insurance (where benefits in excess of PPF compensation could be secured)	It would in practice be difficult to pick the timing for this. The fund would not be able to afford a full buy-out by the very nature of being in financial difficulty, so it would involve making a decision to cap the level of members' benefits. While beneficial for the PPF, which won't have to pay out under the compensation regime, it will be a decision the trustees will be reluctant to make, as the trustees will hope that solvency will improve.

Who should join a superfund?

The different parties involved in the DB pension scheme and the superfund will have different perspectives and interests in deciding whether a given DB scheme should join a superfund.

Employer

The position is most straightforward for the employer. It is clearly beneficial for the employer, as the employer no longer has any liability or risk associated with the DB scheme once it has become part of a superfund. From the perspective of the employer, the position reached is equivalent to that of a buy-out.

However, the employer may be required to take additional steps; for example, providing a final top-up to the DB fund to reduce a deficit to a level acceptable to the superfund trustees and investors. The Consultation also considers the option of the employer paying a fee to the superfund. This is likely to be a one-off fee.

Ultimately, the decision to transfer the scheme is not made by the employer, but by the DB trustees and the extent to which the decision is exercised jointly with the employer will depend on the scheme rules.

DB trustees

For the outgoing DB trustees to discharge their duties, the trustees need to be confident that the superfund would be better than the current arrangement or other available options. For well-funded DB schemes, this means that a superfund is unlikely to be the appropriate choice. A buy-out remains the best option for DB schemes because it guarantees the full pay-out of members' benefits, and in the event that the insurer is unable to pay in full, the payments are guaranteed by the Financial Services Compensation Scheme (FSCS).

In contrast, under the PPF compensation regime for pensions, only those members of a scheme who have already retired at the time their scheme becomes insolvent will receive their full pay-out. The pay-out for all other members is based on 90% of what the pension was worth at the time the scheme became insolvent. The total amount that can be received by these members each year is capped by the PPF and then reduced to 90% (although the PPF notes that the majority of members are not affected by this cap). The value of the cap depends on the age at which the member retires, so that members receive the same actuarial benefit over time (i.e. a younger member will receive a lower pension per year because a younger member is expected to receive the compensation for a longer time). As an example, the current PPF cap for someone who retires aged 65 is £40,020 per annum, which when reduced to 90% is £36,018.

A potential advantage of the superfund over a buy-out is that members could benefit from the up-sharing of profit. This is not discussed in the Consultation, but one of the early entrants to the superfunds market has stated that it will share one-third of any improvement in the overall funding over 100% with the superfund trustees. This could involve giving members a one-off bonus. The remaining two-thirds would be distributed to the investors. This approach has the added benefit of aligning the interests of the members and the investors, as both are invested in the performance of the fund. Otherwise, the members are only interested in the fund reaching or maintaining 100% of the value of its liabilities, which would encourage a more conservative investment strategy compared with the profit-maximising approach that would be favoured by the investors.

Given the significance of the decision to transfer the DB scheme into a superfund, and that the transfer is without the consent of the members, DB trustees should carefully consider their decision to minimise the risk of incurring liability. As with any bulk transfer without consent, trustees should take proper advice before agreeing to the transfer, even if the legislation does not require them to do so.

Investors

Investors would need to be clear about the investment strategy of the superfund, their relationship with the superfund trustees, the terms on which the buffer was at risk and the selection process for DB schemes joining the superfund. These four factors tie into the level of risk that the investors are taking on, as they directly impact the likelihood of the investors' capital reserves being drawn. In connection with this, investors

would want to monitor compliance by superfund trustees with an agreed investment strategy (and potentially benefit from contractual recourse for non-compliance).

The selection of DB schemes is important, given the risk of the investors' capital being drawn. The effect of this is that there is likely to be only a limited range of DB schemes that will be suitable for a superfund, as the best funded schemes should opt for a buy-out, on the one hand, and investors will not want to accept poorly funded schemes, on the other.

> There has been little discussion on whether an investor would be able to act in an investment role. There does not seem to be a problem with this in principle, although, in this capacity, the investor would need to act on instruction of the trustees for the benefit of the members. By taking on such role, the investor could earn a fee, which would help mitigate the investor's risk. The superfund trustees would likely be required to re-tender for this investment role regularly, following the Competition and Markets Authority's investigation in 2018 into the investment consultancy and fiduciary management market.

Superfund trustees

The concerns of the investors are in some respects mirrored by those of would-be superfund trustees, as the superfund trustees need to be clear about their duties and to whom they are owed, particularly in instances where the interests of the members and the interests of the investors diverge.

The DWP suggests that all individuals whose actions have the potential to impact member outcomes should be subject to a fit and proper persons test. This would naturally include the superfund trustees. This test would aim to ensure that individuals are competent and will act with integrity. This seems appropriate, given equivalent requirements exist in other authorisation regimes. The PLSA rightly notes in its response to the Consultation that there needs to be a system of collaboration so that individuals who have already undergone another authorisation process elsewhere in the financial services industry do not have to repeat the process.

What are the next steps?

The Government is yet to issue its response to the Consultation, which closed on 1 February 2019 and there is no further indication as to when this response might be issued. A pensions bill was announced in the Queen's Speech on 14 October 2019, but this does not include regulation of superfunds.

However, it is possible for superfunds to apply to TPR for clearance, ahead of the Government's response to the Consultation or specific regulation being introduced, as a superfund constitutes an occupational pension scheme so can fall within existing regulation. TPR has published guidance both for trustees considering transferring to a DB superfund and for employers. The guidance for trustees tracks the key areas outlined by the Consultation and emphasises that TPR's primary aim is to ensure that members' benefits are protected. TPR states that all guidance is subject to change once the DWP publishes its response to the Consultation. TPR's guidance for employers is clear that employers are expected to provide a top-up or some other mitigation for the transfer to proceed so as to mitigate the potentially "materially detrimental" event of removing the employer's covenant.

> Two funds have applied to TPR for clearance to start their own superfunds: Clara Pensions and The Pension SuperFund. Clara Pensions seeks to create a collectively administered sectionalised scheme to be a bridge to buy-out. The Pension SuperFund aims to create a non-sectionalised scheme, whereby schemes would be accepted on a 100% prudent funded basis plus a 5% contribution to the capital buffer. It is intended that this superfund would be ongoing and self-sufficient. The Pension SuperFund has applied for regulatory approval in relation to a £10 million deal, but is said to have secured commitments for £500 million of capital from investors. TPR has said that it expects to complete its assessment of these two funds by the end of 2019.

There is still a long way to go with finalising the details of superfunds to create an adequate framework to balance the interests of investors, employers and trustees acting on behalf of members. Nonetheless, there is still a potentially significant opportunity for investors, particularly early entrants into the superfund market, given that there are 5,450 DB schemes in the UK.

EU

Recent amendments to Solvency II spread risk module

By Dr Detmar Loff and Dr Tobias Bauerfeind, Germany

Regulatory capital for (re)insurance undertakings

As with credit and financial institutions, (re)insurance undertakings must also hold regulatory capital (solvency capital requirement, SCR). For European (re)insurers, the SCR is determined primarily by the Directive 2009/138/EC ("Solvency II") and the relevant level 2 (Commission Delegated Regulation (EU) 2015/35, "DelReg (EU) 2015/35", most recently amended by the Commission Delegated Regulation (EU) 2019/981 ("Amending Regulation")) and level 3 (EIOPA Guidelines on Solvency II relating to Pillar I etc.) legislative and regulatory provisions.

Solvency capital requirement

The SCR is the amount of funds that (re)insurance companies are required to hold under Solvency II in order to have 99.5% confidence they can survive over the course of a year. In assessing this, companies can generally choose between a standard formula and an internal model approach.

One of the most relevant risk drivers for the SCR is market risk. This in turn consists of various risk components, of which spread risk (default and credit risk) is the most relevant, i.e. the sensitivity of the values of assets, liabilities and financial instruments to changes in the level, or the volatility, of credit spreads over the risk-free interest rate term structure.

New spread risk provisions

The recently adopted Amending Regulation, which concerns the existing level 2 regulation (DelReg (EU) 2015/35), includes new spread risk provisions, especially for debt positions (bonds and loans). The current Article 176 DelReg (EU) 2015/35 makes a blanket distinction between rated and unrated debt positions, the latter with and without eligible collateral. This approach is at times not very risk-sensitive.

In a little more detail:

Article 176 DelReg (EU) 2015/35 deals with the stressing of loans and bonds, i.e. the ultimate credit risk exposure. The Article differentiates between:

1) bonds or loans for which a credit assessment by a nominated ECAI is available (Article 176(3) DelReg (EU) 2015/35);

2) bonds and loans for which a credit assessment by a nominated ECAI is not available and for which debtors have not posted collateral that meets the criteria set out in Article 214 DelReg (EU) 2015/35 (Art. 176(4) DelReg (EU) 2015/35);

3) bonds and loans for which a credit assessment by a nominated ECAI is not available and for which debtors have posted collateral that meets the criteria set out in Article 214 DelReg (EU) 2015/35 (Art. 176(5) DelReg (EU) 2015/35).

The second point above (i.e. exposure that must generally be allocated to and stressed by Article 176(4) DelReg (EU) 2015/35) is amended by Article 176a of the Amending Regulation. With regard to the order of applicability, the new Article takes precedence over Article 176(4) DelReg (EU) 2015/35, provided that its requirements are fulfilled (cf. new Article 176(4a) of the amended DelReg (EU) 2015/35). The relevant requirements are contained in the first two paragraphs of Article 176a of the amended DelReg (EU) 2015/35, which read as follows:

"*1. A bond or loan for which a credit assessment by a nominated ECAI is not available and for which debtors have not posted collateral that meets the criteria set out in Article 214 may be assigned to credit quality step 2 if all of the criteria set out in paragraphs 3 and 4 are met with respect to the bond or loan.*

2. A bond or loan for which a credit assessment by a nominated ECAI is not available and for which debtors have not posted collateral that meets the criteria set out in Article 214, other than a bond or loan assigned to credit quality step 2 under paragraph 1, may be assigned to credit quality step 3 if all of the criteria set out in paragraphs 3 and 5 are met with respect to the bond or loan."

This means that, for any of these, the criteria of Article 176a(3) of the amended DelReg (EU) 2015/35 must be met and, if so, it becomes determinative whether also Article 176a(4) or (5) of the amended DelReg (EU) 2015/35 is fulfilled. If that is not the case, the default would be a fallback to Article 176(4) DelReg (EU) 2015/35. Some of these new criteria to be fulfilled relate to the internal credit assessments and procedures of the (re) insurance company, which are specified in more detail in Article 176b of the amended DelReg (EU) 2015/35.

Making use of Article 176a of the amended DelReg (EU) 2015/35 requires, for example, that no claims on the issuing company of the bond or loan rank senior to the bond or loan, and that the bond or loan provides a fixed redemption payment on or before the date of maturity, in addition to regular fixed or floating rate interest payments. Besides, the bond or loan must be issued by a company that, for example, has its head office in a country which is a member of the EEA and that has operated without any credit event over at least the previous ten years. Furthermore, there are many other (strict) requirements, such as the contractual terms of the bond or loan (cf. para. 3 of Article 176a).

Impact

(Re)insurance companies as well as asset managers aiming at a Solvency II-optimised investment should familiarise themselves in detail with the new provisions and implement the necessary processes at an early stage, as their application would result in a significant reduction in the stressing required, as the following example shows (for the standard formula):

For example (the two different duri used hereafter illustrate the significance of this variable in terms of capital adequacy and are used as examples only; they cannot replace a case-by-case assessment):

- an unrated, unsecured loan for which the criteria of Article 176a(1) in connection with (3) and (4) of the amended DelReg (EU) 2015/35 are met and which is allocated a modified duration "duri" of 1.5 years respectively 7.5 years would receive the following stressing (credit quality step 2):

duri = 1.5 years	duri = 7.5 years
1.4% x 1.5 = **2.1%**	7.0% + 0,7% * (7.5 - 5) = **8.75%**

- an unrated, unsecured loan for which the criteria of Article 176a(2) in connection with (3) and (5) of the amended DelReg (EU) 2015/35 are met and which is allocated a modified duration "duri" of 1.5 years respectively 7.5 years would receive the following stressing (credit quality step 3):

duri = 1.5 years	duri = 7.5 years
2.5% x 1.5 = **3.75%**	12.5% + 1.5% * (7.5 - 5) = **16.25%**

- If the (current) Article 176(4) DelReg (EU) 2015/35 would apply to the same unrated and unsecured loan, stressing would be calculated as follows:

duri = 1.5 years	duri = 7.5 years
3% x 1.5 = **4.5%**	15 + 1.7% * (7.5 - 5) = **19.25%**

This shows that meeting the criteria of Article 176a of the amended DelReg (EU) 2015/35 provides for a substantial decrease in stressing. Lastly, the amendments are not limited to the standard formula; Article 176c of the amended DelReg (EU) 2015/35 deals with these issues under the internal model regime.

The above could also be used to optimise investment vehicles such as funds. Their managers should carefully examine the underlying fund assets and try to fulfil the above criteria to improve the competitiveness of the fund structure from a regulatory capital perspective. This can also be done during the term of an existing fund.

Conclusion

The new provisions on spread risk for bonds and loans are extensive in some cases, but allow a much more risk-sensitive assessment of the individual debt positions compared with the previous provisions. Accordingly, a detailed examination of the new provisions is likely to be worthwhile for (re)insurers and investment fund providers.

AUSTRALIA

Will the banking executive accountability regime revive the use of premium splitting in D&O policies in Australia?

By Rehana Box and Alex Nash

BEAR obligations for "accountable persons"

The Banking Executive Accountability Regime (BEAR) was introduced into the Banking Act 1959 (Cth) (the Banking Act) in mid-2018. BEAR's intention is to increase the accountability of senior management of Authorised Deposit-taking Institutions (ADIs) for regulatory breaches and other failures by the ADI. BEAR requires banks and, importantly, certain executives (described as "accountable persons").to meet certain "accountability obligations". In response to the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry the Government has proposed to extend BEAR to all Australian Securities and Investments Commission (ASIC) licensed entities in Australia.

BEAR imposes heightened obligations on individuals with significant influence over conduct and behaviour in an ADI, who are defined as "accountable persons". An accountable person includes a board member with oversight of the ADI or a senior executive with responsibility for management or control of significant or substantial parts or aspects of the ADI group's operations.

More specifically, an accountable person is defined under BEAR by reference to a general principle and by reference to listed functions or responsibilities.

Under the principles-based element, an individual will be an accountable person if they have actual or effective senior executive responsibility for management or control of the ADI or a significant or substantial part of the ADI group's operations.

The Government has indicated that only the most senior individuals who have significant influence over conduct and behaviour, and not those who are simply in a management role, will be "accountable persons". This is reflected in the use of the term 'senior executive', which denotes an ability to create a prudential impact as a result of the individual's decisions.

Examples of "accountable persons" include, among others: non-executive directors, CEOs and Managing Directors, Chief Financial Officers, Chief Risk Officers, Chief Operations Officer, and Chief Information Officers.

Clearly, "accountable persons" include persons who would generally be defined as "insureds" under their employer's directors' and officers' liability policy (D&O policy).

Section 37CA of the Banking Act (as amended by BEAR) states that an accountable person of an ADI must conduct the responsibilities of their position as follows:

a) by acting with honesty and integrity, and with due skill, care and diligence; and

b) by dealing with Australian Prudential Regulation Authority (APRA) in an open, constructive and cooperative way; and

c) by taking reasonable steps in conducting those responsibilities to prevent matters from arising that would

adversely affect the prudential standing or prudential reputation of the ADI.

A breach of the above accountability obligations by an accountable person could result in either:

a) a decrease in that person's variable remuneration; or

b) disqualification by APRA for a period that APRA considers to be appropriate.

A brief history of the practice of "premium splitting" in Australia

A legislative restriction on a company's ability to pay a premium for certain insurance coverages for its officers has existed in Australia for decades under section 199B of the Corporations Act 2001 (Cth) (the Act) (and its predecessor acts), which states:

"*(1) A company or a related body corporate must not pay, or agree to pay, a premium for a contract insuring a person who is or has been an officer or auditor of the company against a liability (other than one for legal costs) arising out of:*

(a) conduct involving a wilful breach of duty in relation to the company; or

(b) a contravention of section 182 or 183.

This section applies to a premium whether it is paid directly or through an interposed entity.

(2) An offence based on subsection (1) is an offence of strict liability."

Sections 182 and 183 deal with misuse by an officer of information obtained as an officer or as a result of their position. Section 199C of the Act provides that a policy of insurance purchased in breach of section 199B is void to the extent section 199B is contravened.

There was concern that, on a strict interpretation of section 199B of the Act, a company which paid for a premium for a D&O policy covering an innocent director for their vicarious liability "arising out of" conduct identified in section 199B by a "guilty" director would be guilty of a strict liability offence under the Act and the policy would be void to the extent of the contravention.

The practice of "premium splitting" arose to combat this risk. Companies allocated a nominal amount (usually 1%) of the policy premium to the officers (usually just the directors on behalf of all officers) who paid that part of the premium themselves (and were not reimbursed for doing so). To be completely effective there was a view that, for "premium splitting" to be effective, the cover paid for the officers themselves also needed to be in a separate coverage section forming a separate contract between the insured persons and the insurer in the policy, so that the company could not be found to have paid any part of the premium for the relevant contract. The arbitrary allocation of 1% reflected the view that the risk of cover provided by a D&O policy coming within the restrictions imposed by section 199B was remote. The effectiveness of 'premium splitting' has not been tested before the Australian courts.

Over time, however, the practice of "premium splitting" largely died away in Australia as companies and insured persons became comfortable that the risk of vicarious liability for an innocent director arising out of conduct identified in section 199B by a "guilty" director was remote, and the view that a "guilty" director would not be covered by a typical D&O policy for liability arising from such conduct.

Time to revisit "premium splitting"?

Section 37KA of *the Banking Act* (as amended by BEAR) states that an ADI, or a related body corporate of an ADI, must not (whether by agreement or by making a payment and whether directly or through an interposed entity):

a) indemnify a person who is or was an accountable person of the ADI against the consequences of breaching a BEAR obligation; or

b) pay, or agree to pay, a premium for a contract insuring such a person against the consequences of breaching a BEAR obligation.

The section does not apply to a liability for legal costs.

The consequences of a breach of BEAR can include the imposition of a civil penalty.

Section 37KA prohibits ADIs from paying premiums for policies which cover their "accountable persons" for breaches of the BEAR regime.

Generally, where a civil penalty is imposed on an accountable person, the policy exclusion for dishonest behaviour will likely be triggered. However, the Banking Act threshold for a civil penalty to be imposed on an AP is not a breach of BEAR by the AP but rather the AP being "knowingly concerned" in a breach of BEAR by the ADI.

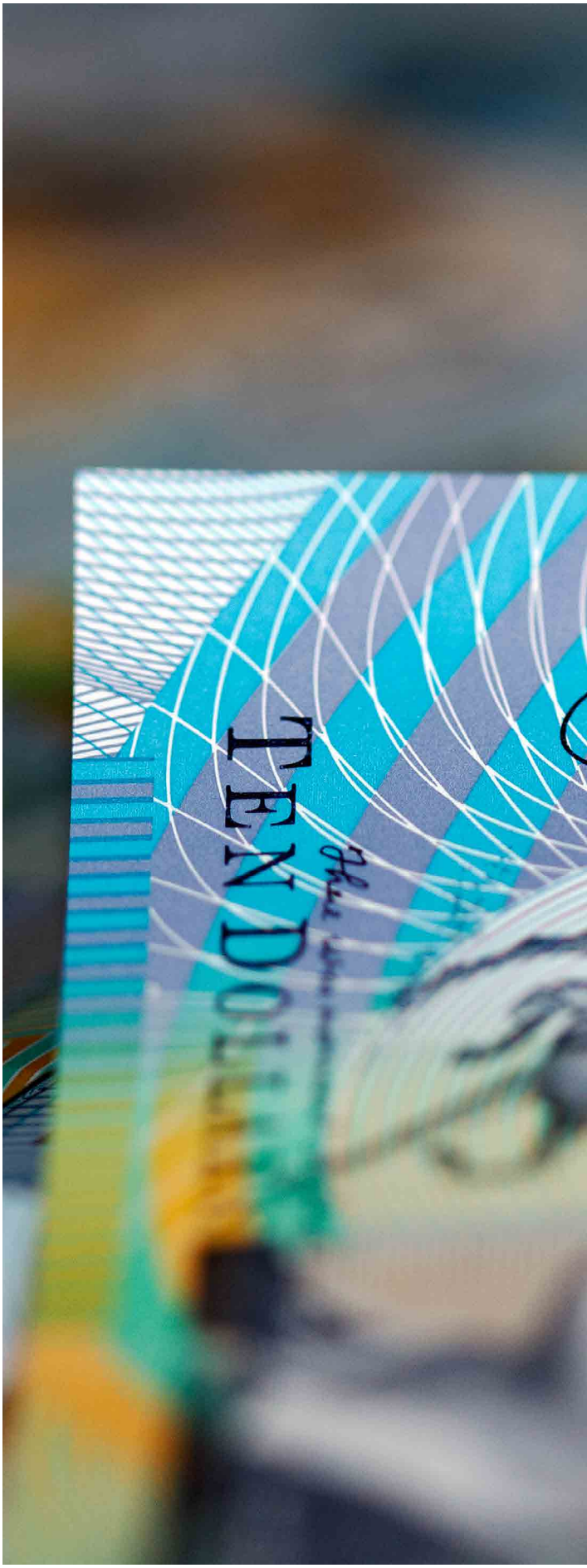
An accountable person can be liable for a civil penalty of up to AU$42 million (depending on the size of the ADI) for each breach by the ADI of BEAR where the accountable person is knowingly concerned in the ADI's breach. This does not require dishonesty on the part of the accountable person. An accountable person can be knowingly concerned in a breach by the ADI without even realising the conduct was a breach. It is important to understand that, although the risk of civil penalty does not arise from a breach of the accountability obligations by the accountable person, the civil penalty can be imposed for a breach by an ADI of its accountability obligations.

The attitude of the regulator to seeking a civil penalty in these circumstances is not currently known as this is relatively new legislation. While the risk may be remote, the consequences are high.

Absent section 37KA, a D&O policy may insure an insured person (which would include an accountable person, or should be amended to include them) for their liability for a civil penalty up to the limit (or sub-limit) of cover for such civil penalties. For this cover to be available to the accountable person, premium splitting would need to be reintroduced. The premium for this cover can be paid by anyone other than the ADI, or a related body corporate of an ADI. It can be paid by a director, officer (including an accountable person) or a shareholder that is not a related body corporate.

If 'premium splitting' is adopted, the premium paid should not be reimbursed by the ADI, or a related body corporate of an ADI, and the coverage for this risk should be in a separate coverage clause constituting a separate contract between the insured persons and the insurer in the policy for the reasons discussed above.

If premium splitting is not adopted, D&O policies may need to be amended to include an express exclusion of cover to the extent that the cover cannot be paid for by the ADI to prevent the ADI being in breach of *the Banking Act*.



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