

PROPERTY CASUALTY INSURANCE REGULATION IN THE UNITED KINGDOM

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Introduction

This article considers:

1. What activities by an overseas insurer amount to the carrying on of insurance business in the United Kingdom (“UK”) and therefore require authorisation; and
2. Authorisation routes available for insurance companies seeking to enter the UK property casualty market.

Carrying on Insurance Business in the UK

English law does not generally require an insurer to be authorised to insure or reinsure UK risks or insureds unless its activities constitute part of a business carried on in the UK.¹ The Insurance Companies Act 1982 (the “Act”), the legislation which currently governs the regulation of insurers in the UK, defines insurance business as the “effecting” and “carrying out” of various classes of insurance contracts. It has been left to the Courts to identify the factors which evidence the effecting or carrying out of insurance contracts; either “effecting” or “carrying out” contracts in the UK will require authorisation.

It has been established² that, in determining whether a person is carrying on insurance business in the UK, consideration must be given to the insurer’s business as a whole within the UK. Isolated acts may be disregarded if they do not constitute the carrying on of a business.

J. Leggatt concluded in *Stewart v. Oriental Fire & Marine Insurance Co. Lt*³ that “effecting” a contract of insurance seems to me to involve more than merely making the contract. There may also be involved . . . the offering of insurance services and the negotiation of the terms of the contract”.

In *D.R. Insurance Co. v. Seguros America Baname*⁴ it was held that the London manager of an underwriting pool acted as agent of overseas insurers which were members of the pool and was carrying on unauthorised insurance business on their behalf. The Court held that the activities of the UK agent were so extensive and important (e.g. in canvassing for business, exercising underwriting judgement and in deciding what risks to refer to the overseas insurers for decision) that the underwriting business was carried on substantially in the UK. It was not considered essential that the contracts of insurance themselves needed to be executed in the UK for the insurer to be carrying on its insurance business there.

In *Great Western*⁵ the Court of Appeal held that wholesale insurance brokers were acting as both sub-agents of retail brokers in placing insurance and as agents of the insurer in performing other activities, including advising insurers as to acceptance of risks and appropriate premium rates and settling claims. The off-shore insurers were accordingly carrying on insurance business in the UK.

An offence under the Act may be committed by the writing of a single insurance policy in the UK⁶ if it is part of a business being carried on in the UK and any directors, officers, managers or agents of insurers carrying on unauthorised insurance business in the UK may themselves be guilty of a criminal offence on the basis that they are aiding and abetting the off-shore insurers in committing a criminal offence⁷.

Guidelines

Specific legal advice will always be required but, in the light of the cases, unauthorised insurers should as a minimum adhere to the following guidelines in order not to fall foul of the Act:

- Meetings to discuss or negotiate specific risks should be convened outside the UK;
- The underwriting decision itself should be made outside the UK and should not merely be a rubber-stamping of a decision effectively made in the UK;
- The issuing of policies and other contractual documentation should take place entirely outside the UK; and
- All premiums should be received off-shore.

METHODS OF ENTRY INTO THE UK INSURANCE MARKET

There are four ways in which an insurer or reinsurer can enter the UK insurance market:

1. Establishing a UK company which obtains UK authorisation;
2. Obtaining authorisation in the UK as a branch of an overseas insurer;
3. Forming a subsidiary in a European Economic Area (“EEA”)⁸ state and then entering the UK insurance market using the cross-border authorisation directives; or
4. Establishing a Lloyd’s corporate member.

The four routes have different authorisation procedures and requirements. These are summarised below.

Establishing a UK Company

There are four key criteria which a UK company applying for authorisation must satisfy:

1. The Financial Services Authority (“FSA”) must be satisfied that the criteria of sound and prudent management will be fulfilled;
2. The FSA must be satisfied that any director, controller, manager or main agent is fit and proper to hold that position;
3. It must have adequate financial resources; and
4. It must provide the FSA with the requisite information.

Sound and Prudent Management

The criteria for sound and prudent management are set out in Schedule 2A to the Act. The criteria are:

- Integrity and skill – the business must be carried out with integrity, due care and professional skills appropriate to the nature and scale of its activities. The company must conduct its business with due regard to the interests of policyholders;
- Direction and management – the company must be directed and managed by a sufficient number of persons who are fit and proper to hold their positions; and
- The business must be conducted in a sound and prudent manner – this includes the maintenance of adequate accounting and other records and the implementation of adequate systems of control of the business and its records.

Financial Resources

There is no specific minimum capital requirement but the FSA will only grant an authorisation if it is satisfied that the company’s financial resources are adequate. Authorised insurers are required to maintain a margin of solvency as prescribed, i.e. the minimum amount by which assets exceed liabilities. The Act contains alternative premium and claims based formulae for the calculation of the required solvency margin.⁹

Information

Section 5(1) of the Act stipulates that the FSA shall not issue an authorisation unless the company has submitted proposals as to the manner in which it proposes to carry on business and financial forecasts and such other information as may be required in accordance with the regulations made under the Act. The information required by the FSA includes:

- Details of the scheme of operation including the sources of business, the basis for calculating premium tariffs and the guiding principles as to reinsurance;
- Statements showing, for each of the first three financial years, premium income both gross and net of reinsurance divided between the UK, other EEA states and elsewhere;
- Projections, for each of the first three financial years, providing estimates of income, capital expenditure, reinsurance arrangements and the financial resources intended to cover underwriting liabilities and the margin

of solvency; and

- Details of the proposed investment portfolio, reinsurance treaties, agent or brokers agreements and management agreements.

Most of the information will be set out in a three year business plan which will form the core of the application.

Establishing a Branch in the UK of a Non-EEA Insurer

The following requirements in addition to those required for authorisation of a UK company must be met:

- Maintenance of a margin of solvency in respect of the company's UK business;
- A regulatory deposit;
- Maintenance in the UK of assets of prescribed value; and
- Appointment of a general representative in the UK.

Information

The information required differs to that required for a UK company in the following respects:

- Scheme of operation – details for UK business only;
- Premium income – information in respect of the company's world-wide business;
- Projections – for both UK and non-UK business. Calculation of the company's worldwide margin of solvency is required but details of financial resources are not;
- Investment portfolio and other agreements – UK only;
- Details of non-UK risks which the company underwrites (as well as risks it proposes to underwrite in the UK); and
- Copies of the company's last three years' accounts.

The supervision of a branch of a non-EEA insurer is effectively on a worldwide basis except to the extent that the FSA gives concessions. Annual returns and solvency calculations will need to be prepared in respect of the company's worldwide business but on the basis of the UK valuation rules. In many cases it will be costly to meet this requirement, because of the complexity of developing conversion software and establishing values and processing data into UK format.

Companies Authorised in Other EEA Member States

The supervision of branches of insurers authorised to carry on direct business in another EEA member states is the responsibility of the authorities of the home member state. To gain entry to the UK market, it is necessary only for such insurers to comply with the notification requirements contained in the Act. However, the position is different for EEA pure reinsurers who will require UK authorisation if they maintain a branch or carry on business in the UK but not if they only provide insurance services into the UK on a cross-border basis.¹⁰

Timescales

Preparation of a draft authorisation application normally takes several months, depending on the level of resource devoted and the priority it is given. The FSA is legally obliged to make a decision on an application within six months from submission but the convention is to submit the application in draft and to resolve with the regulator all issues arising prior to submission of the formal application. This process can take less than six months in a straight-forward case but can take more than a year if there are significant issues.

CORPORATE PARTICIPATION AT LLOYD'S

Background

Lloyd's accounts for approximately half of all international insurance premiums in the London market and sets the rates

and terms on a large proportion of business written in London. As well as its unrivalled distribution network, attractions of Lloyd's include access to its centralised premium and claims processing and, above all, its licences in over 70 jurisdictions worldwide.

Although subject to the overall control of the FSA, which regulates Lloyd's on an overall level for solvency purposes, Lloyd's is largely self-regulatory under the Lloyd's Acts and byelaws made by the Council of Lloyds.

Structures and Routes to Corporate Participation

There are three ways in which an insurer can participate at Lloyd's:

1. Purchasing shares in a corporate vehicle listed on the London Stock Exchange or the Alternative Investment Market;
2. Quota share reinsurance of existing corporate members or syndicates; or
3. Direct participation.

This article considers the last method. Direct participation at Lloyd's can either be "passive", with no managing agent control, or "strategic" with managing agent control and substantial participation on its managed syndicate(s). Both structures require the formation of a corporate member.

Application Process

Passive structures, not involving a controlling interest in a managing agent or creation of a new corporate syndicate, will involve only corporate member approval. More complex routes will involve additional regulatory consents and it will take longer for consent to be granted. The following is a summary of the requirements applicable to corporate members:

- A corporate member must be a company that has not previously traded and must be exclusively dedicated to underwriting at Lloyd's;
- Various trust deeds (including several for US business¹¹) and the Lloyd's Membership Agreement must be executed;
- "Controllers" (see below) are required to give undertakings to Lloyd's. Special rules apply to corporate members where the controller is an insurance carrier, Lloyd's broker or a major customer of a syndicate in which the corporate member has a significant participation;
- Controllers, directors and managers have to pass "fit and proper" tests;
- Corporate candidates must appoint a sponsor, legal adviser and auditor as well as appointing a Lloyd's adviser or members' agent or obtaining a dispensation from this requirement. Each is required to give a declaration or opinion; and
- The funds at Lloyd's ("FAL") requirement (see below) must be complied with.

Control of Corporate Members

A person may not be a "controller"¹² of a corporate member without the prior written consent of the Lloyd's Council. Controllers are obliged to give undertakings and provide such additional information as Lloyd's requires; for example, if the group of a corporate member includes an insurance carrier¹³ the controllers are required to sign a "composite undertaking" to ensure that there is no influence by controllers over the day to day underwriting and reinsurance decisions of the syndicate.

Other relevant regulatory provisions include:

- Related parties relationships – Lloyd's regulates the ownership by managing agents of interests in insurance companies and the placing of syndicate reinsurance business by managing agents with insurance companies or through non-Lloyd's brokers which are, in either case, related to the managing agent; and
- Divestment – the Lloyd's Act 1982 requires the complete separation of ownership and control between managing agents and Lloyd's brokers. The principles of divestment are designed to prevent conflicts of interest between managing agents acting for their capital providers and Lloyd's brokers acting for their assureds. This is a complex issue but, potentially, anyone who has an interest in or who is involved in the

management of a managing agent or Lloyd's broker is affected by divestment.

Funds at Lloyd's

All corporate members are required to provide security to support their overall premium limit ("OPL") (i.e. the maximum amount of business which a member may underwrite) for the forthcoming year of account. This security comprises a member's FAL, which are held by Lloyd's as trustee. The level of FAL that a corporate member requires to support its underwriting depends on the class and diversification of risk of the syndicates it intends to support. The minimum FAL for corporate members (unless pure motor business is to be written) is 45% of OPL for the 2000 year of account. Lloyd's risk-based capital system may increase that percentage.

Lloyd's allows FAL to be provided in a number of forms:

- Assets including cash, short dated securities and, for FAL in excess of certain values, equities listed on various international stock exchanges; and
- Letters of credit and bank guarantees.

Timescales

Obtaining approval for a Lloyd's corporate member is straight forward and speedy (eight weeks should be sufficient). In practice, unless a corporate syndicate is also being set up, approval will need to be obtained by the Fall preceding commencement of underwriting on the subsequent 1 January. If approval is being sought at the same time for the establishing of a new managing agent and/or syndicate, the application will be significantly more complex and time consuming.

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Endnotes

1. Section 2(1) Insurance Companies Act 1982 (the "Act"). However, certain classes of compulsory insurance, the most significant of which are motor liability insurance and employer's liability insurance, must be underwritten by authorised insurers.
2. *Scher and Ackman v Policyholders Protection Board* [1994] 2 AC57.
3. [1984] 2 Lloyd's Rep 109.
4. [1993] 1 Lloyd's Rep 120.
5. *Secretary of State for Trade and Industry v. Great Western Assurance Company SA*. [1997] 6 Re L.R. 197, CA.
6. *Bedford Insurance Co. Ltd. v. Instituto de Resseguros do Brazil* [1985] QB 966.
7. Section 91 of the Act.
8. The European Economic Area comprises: the European Union members, i.e. Austria; Belgium; Denmark; Finland; France; Germany; Greece; Ireland; Italy; Luxembourg; Netherlands; Portugal; Spain; Sweden and United Kingdom; and the European Free Trade Area members, i.e. Iceland; Norway and Liechtenstein, but not Switzerland, in relation to which a special regime applies.
9. Section 32 of the Act.
10. Directive 78/473/EC.
11. In order to write US-situs business, a corporate member must complete a number of additional trust deeds to comply with Lloyd's U.S. trading arrangements, including trust deeds related to Lloyd's U.S. surplus lines and credit for reinsurance trusts.
12. "Control" as defined in various Lloyd's Byelaws (in particular the Membership Byelaw and the Underwriting Agents Byelaw). In summary a controller is any person:
 - who holds 10% of the shares or holds 10% or more of the economic or voting rights of the company whether directly or indirectly; or

- who has significant influence over the corporate member; or
- in accordance with whose directions the directors of the corporate member are accustomed to act.

13. For this purpose an insurance carrier means an insurance company but can also mean the holding company of an insurance company or a fellow subsidiary.