Financial Markets Law Committee ("FMLC")

Insurance Scoping Forum

Date: Tuesday 20 February 2018

Time: 2.00pm to 3.30pm

Location: Slaughter and May, 1 Bunhill Row, London EC1Y 8YY

In Attendance:

Beth Dobson (Chair)	Slaughter and May
Duncan Barber	Linklaters LLP
George Belcher	Skadden, Arps, Meagher & Flom LLP
Peter Bloxham	
Nick Bonsall	Slaughter and May
Nicholas Bugler	Willkie Farr & Gallagher (UK) LLP
Pollyanna Deane	Simmons & Simmons LLP
Hilary Evenett	Clifford Chance LLP
Reid Feldman	Kramer Levin Naftalis & Frankel LLP
David Kendall	Cooley (UK) LLP
Adam Levitt	Ashurst LLP
Geoffrey Maddock	Herbert Smith Freehills LLP
Steven McEwan	Hogan Lovells International LLP
James Middleton	AIG Europe Limited
Mike Munro	CMS Cameron McKenna Nabarro Olswang LLP
Jonathan Teacher	Swiss Re Management Ltd
Kees van der Klugt	Lloyd's Market Association
Michael Wainwright	Dentons UKMEA LLP
Graham White	Marine Aviation & General (London) Ltd
Venessa Parekh	FMLC
Thomas Willett	FMLC

Guest Speakers:

Marilyn Blattner-Hoyle	AIG Europe Limited
William Hogarth	Clyde & Co LLP

Regrets:

Nigel Brook	Clyde & Co LLP
Theresa Chew	Hymans Robertson LLP
Katherine Coates	Clifford Chance LLP
Jennifer Donohue	Algorithm and Extremal Consulting Limited
Matthew Griffith	RPC
Charlotte Heiss	Royal & Sun Alliance Insurance Group plc
Alison Matthews	Herbert Smith Freehills LLP
Chris Newby	AIG Europe Limited
Selina Sagayam	Gibson Dunn & Crutcher LLP
Chris Sage	Transatlantic Reinsurance Company
Manreet Sher	Lloyd's Market Association
James Smethurst	Freshfields Bruckhaus Deringer LLP
Clare Swirski	Debevoise & Plimpton LLP

Minutes:

1. Introduction.

1.1. Beth Dobson opened the meeting and delivered a brief introduction.

2. Administration: a short presentation on the FMLC Radar Function – Revisited (Venessa Parekh)[1]

2.1. Venessa Parekh outlined the remit of the FMLC, focusing on its radar function, which is the means by which the FMLC identifies appropriate issues to analyse. The function can be broken down into three initiatives: (i) scoping forums; (ii) the relationship management programme; and (iii) radar meetings. She explained that the radar programme guarantees that the FMLC addresses those issues that are of most concern to stakeholders in the financial markets, ensuring that the FMLC's work is current and has impact.[2]

[1] Please see Appendix I below.

[2] If you would like to learn more about the FMLC radar programme, or become involved in one of the three initiatives, please contact Debbie Steen at secretarial@fmlc.org.

3. The Basel Committee's finalised reforms of the trade credit insurance market (Marilyn Blattner-Hoyle)[3]

3.1. Marilyn Blattner-Hoyle began her presentation on the Basel Committee's finalised reforms of the trade credit insurance market by summarising the main changes, which included:

i. revisions to standardised approaches for calculating credit, market and operational risk;

ii. simplification of the Basel III framework; and

iii. increased ease of comparison of risk-weighted assets from bank-to-bank.

3.2. Ms Blattner-Hoyle explained the manner in which trade credit insurance provides protection from loss caused by credit risks. A Basel III-compliant insurance policy can improve capital position for the insured by replacing the obligor rating with the insurer rating. It was also highlighted that technology will play an increasingly important role in the context of these reforms, helping ensure compliance and less conditionality for the pay-out of trade credit insurance.

3.3. Ms Blattner-Hoyle then referred to the recent consultation issued by the Prudential Regulation Authority ("**PRA**") on credit risk mitigation.[4] She explained that the PRA proposed, amongst other changes, a requirement for the guarantor to be obliged, contractually, to pay out in a timely manner, i.e., within days instead of weeks or months. One participant asked what view the client banks took of this proposal. Ms Blattner-Hoyle clarified that each bank has a different approach to using trade credit insurance as a risk mitigation tool. She emphasised the time required to assess whether there has been a dispute in trade finance and that there is little evidence to suggest that payment can be made in less time.

3.4. It was also noted that the PRA's proposals were not consistent with that of the European Banking Authority ("**EBA**"), which in the Single Rulebook Q&A of Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (the "**CRR**") allowed flexibility in the understanding of the expression "timely manner".

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[3] Please see Appendix II below.

[4] PRA Consultation Paper CP6/18, Credit risk mitigation: Eligibility of guarantees as unfunded credit protection, (2018), available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2018/cp618.pdf?la=en&hash=FDC3C115AE5B423A37BAA104C02D476F8EF12057.

3.5. At this point, Michael Wainwright, who had offered to update the Forum on the PRA's consultation on credit risk mitigation, began his overview. He explained that the PRA had proposed changes to Supervisory Statement 17/13 "Credit risk mitigation"[5] to set out expectations regarding the eligibility of guarantees as unfunded credit protection under Part Three, Title II, Chapter 4 of the CRR. He emphasised that these proposals were not directly related to the insurance market and they needed to be interpreted in an insurance context to be of use. He also noted that the practical ease of enforcement had not been considered.

3.6. Forum members turned again to Ms Blattner-Hoyle's presentation. She explained that AIG's Basel III-compliant single risk trade finance insurance policy provides non-payment insurance for exposure to losses. Employing insurance policies as credit risk mitigation, however, was not explicitly addressed in the Basel Committee's finalised reforms. As such, AIG's policy utilises insurance if it fulfils operational requirements applicable to guarantees, and adheres to the requirements for use of unfunded credit protection as a risk mitigation technique under Basel III.

3.7. Concluding her talk, Ms Blattner-Hoyle outlined questions that banks and insurers will face, which included:

i. what will banks turn to as mitigants;

ii. how will the regulators vary between geographies;

iii. will there be an impact on the funded vs unfunded split of credit risk mitigation; and

iv. what will be the impact on risk-weighted asset calculations?

4. Parametric Insurance (William Hogarth)[6]

4.1. William Hogarth delivered to participants a presentation on parametric insurance. He began by explaining the ways in which parametric insurance diverges slightly from conventional indemnity insurance: payment is determined in whole or in part by the occurrence of a pre-determined trigger event or the parameter, such as earthquake magnitude, wind speed, temperature, rainfall, reaching a pre-determined level in a

[5] PRA, "Credit risk mitigations" Supervisory Statement 17/13, (2017), available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2017/ss1713update.pdf?la=en&hash=04EB5937CD84A753A205BF3494BDCEC1152C5044.

[6] Please see Appendix III below.

particular location. The amount payable is generally based on a modelled forecast of the loss that the policyholder will suffer, but the trigger event(s) and payable amounts are predetermined at the start of the policy rather than being based on a strict indemnity-based recovery of losses.

4.2. Mr Hogarth outlined the advantages of using parametric insurance including: (i) the speed of the pay-out; (ii) the certainty of timing and amount of pay-out; (iii) lower costs; and (iv) a broader range of insurable losses. He emphasised that much of the current parametric insurance has been acquired by governments and sub-sovereigns but was gaining popularity with charitable organisations, multi-nationals, small and medium-sized enterprises ("**SMEs**") and retail insurers. Factors such as technological developments and availability of data have made parametric insurance more accessible, in particular in terms of modelling and monitoring trigger events. The drive to improve resilience and close the protection gap in the developing world has also had an impact on its usage and has aided the recent acceleration in the range of products available.

4.3. Mr Hogarth then outlined the key legal and regulatory issues currently facing parametric insurance:

i. questions about whether parametric insurance can be characterised as an insurance or derivative contract;

ii. the uncertainty surrounding "insurable interest"; and

iii. issues of consumer protection.

4.4. With regards to the first issue, Mr Hogarth explained that, although this is not a new issue, the question remains unresolved especially as there is some overlap between certain derivatives and parametric insurance which can have the same practical effect and use the same modelling .

4.5. With regards to the second issue, Forum members noted that there was particular difficulty in pinpointing the "insurable interest" when third parties such a non-profit organisations ("**NGOs**") or charitable organisations purchased the insurance. Mr Hogarth gave the example of a charity which might supply a service, but does not necessarily have an insurable interest, for instance, when the relevant area is devastated by a flood or drought and the charity provides local services and supplies to ameliorate the suffering of those affected.

5. An update on the report on the Establishment of an EEA Insurer in another Member State (David Kendall)

5.1. David Kendall explained that the project on the Establishment of a European Economic Area ("**E.E.A.**") Insurer in another Member State was initiated by the FMLC. Owing to the length of the report, the Committee had requested that the paper be shortened or focused so that the Committee could review and publish it. The Working Group had published the full report with the British Insurance Law Association ("**BILA**"), and was currently working on shortening the report to focus on the complexities concerning those activities which the U.K. will be regulating, post-Brexit.

6. Any other business.

6.1. One participant asked whether the uncertainties in relation to Part VII transfers, which had been raised at a past Forum meeting, had been adopted by the Committee. Ms Parekh confirmed that the Committee had resolved to write a letter and asked Mr Maddock, who was helping draft the letter, if he would like to provide an overview of the issues. Geoffrey Maddock explained that the letter would address the following two issues:

i. the ability of the Court to effect ancillary matters, such as the splitting of inwards policies and outwards reinsurance contracts between U.K. and E.E.A. business (assuming this cannot be agreed with a policyholder/reinsurer); and

ii. the extent to which the particular circumstances of Brexit (which may require Part VII transfers to be effected if an insurer is to be permitted lawfully to service the contract, including by paying claims, after the U.K. leaves the E.U.) should be reflected in the criteria to be applied by both the PRA/Financial Conduct Authority ("**FCA**") and the Court to their assessment of a proposed transfer (e.g., what approach should be taken to issues which might normally give rise to problems in achieving an approved scheme, such as potential loss of protection for the transferring of policies under the Financial Services and Compensation Scheme).

The FMLC Radar Function: *revisited*

Venessa Parekh, Research Manager

FMLC Remit

"The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed."

FMLC Foundational Documents, September 2002

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FMLC Mission

- According to the remit, the FMLC has a tripartite mission:
  - to identify relevant issues (the **radar** function);
  - to consider such issues (the **research** function); and
  - to address such issues (the **public education** function).
- The **radar function** relies on the FMLC's **scoping forums** and other horizon-scanning, advisory bodies. It also relies on a **relationship management programme** which the FMLC Secretariat maintains with Patrons and Stakeholders.
- The **research function** is addressed by the FMLC Secretariat and by highly-focused working groups who work to draft papers and correspondence on behalf of the FMLC.
- The **public education function** is furthered when the FMLC publishes these letters and papers. It is also addressed by the regular programme of events organised by the FMLC Secretariat, including: roundtables, seminars and conferences. These feature high-profile guest speakers.

Breaking down the radar function

The FMLC's radar function is (broadly) broken down into three initiatives:

1. **Scoping forums**
2. **Relationship management programme;** and
3. **Radar meetings**

Scoping Forums

"Scoping forums serve as an avenue for the FMLC to engage with focus groups on legal issues affecting specific segments of the financial markets.

The forums serve as spaces for discussion of broader issues of legal uncertainty. Members formulate and propose to the FMLC issues considered by them to cause substantive legal uncertainty to their industry."

FMLC Brochure, January 2017

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Scoping forums in practice

- A scoping forum establishes a **pool of expertise** available to the FMLC. That pool can guide the FMLC by **recommending specific issue to the FMLC for analysis**.
- Scoping forum members can make non-binding suggestions as to the manner of the FMLC's engagement and nominate experts for working groups.
- Meetings include presentations from industry experts, individuals with first-hand experience of legal uncertainty and those at the cutting edge of their respective fields.
- Scoping forums discuss all manner of topics, issues and solutions within their sector.
- Not every issue discussed will go on to become an issue adopted by the FMLC. Scoping forums are horizon-scanning bodies and places to share and compare knowledge. They are about **learning and discovery** as much as they are about **identifying specific issues for further consideration.**
- Information about the FMLC's scoping forums—as well as the agenda and minutes of all 2017 meetings—can be found on our website at: **http://www.fmlc.org/scoping-forums.html**

Relationship management

- Another key aspect of the radar function, the FMLC's **relationship management programme**, ensures regular communication and information exchange between the FMLC Secretariat and Patrons, Members or other stakeholders.
- Relationship management calls provide a valuable opportunity for participants to highlight issues—both present and future—for the FMLC to investigate, providing the FMLC with up-to-date and market-relevant information. They also allow the FMLC Secretariat to update Patrons and stakeholders on the Committee's recent work.
- FMLC Patrons have calls monthly. We organise calls with a predetermined list of stakeholders according to their appetite for engagement.
- Monthly relationship management calls normally last around 15 minutes. If you're a Patron who'd like to participate in your firms' monthly call (as an alternate perhaps), or if you'd like to receive a stakeholder call, let us know!

Radar meetings

- FMLC Chief Executive Joanna Perkins regularly meets with financial markets participants to discuss issues of legal complexity.
- These meetings are an excellent opportunity for the exchange of information. Participants can:
  - raise issues of concern or interest in relation to legal complexity, and
  - learn about the FMLC's recent work and insights, get updates on forthcoming publications or—in the case of new contacts—learn more generally about the work and remit of the FMLC.
- Please speak to a member of the Secretariat if you are interested in arranging a meeting with your firm or organisation.

Information exchange

- The Radar programme guarantees that the FMLC addresses those issues that are of most concern to stakeholders in the financial markets, across the public and private sector.
- It also helps to ensure that the FMLC only addresses in depth issues that are material and may have an appreciable impact on the international wholesale financial markets.
- Together, these three Radar initiatives ensure our work is current and has impact.

Summary and Conclusion

To sum up…

- The FMLC is tasked with identifying, considering and addressing **legal uncertainty**…
- …which is sometimes better thought of as "legal risk".
- The **radar function** is the manner in which the FMLC identifies appropriate issues to analyse.
- The radar function is fulfilled through **scoping forums, relationship management calls,** and **radar meetings.**
- At this time, the FMLC Secretariat would be grateful for help with **assessing legal risks, identifying priorities** and **selecting issues for further work**.

FMLC Insurance Scoping Forum

The role of Trade Credit Insurance following Basel III Reforms

20 February 2018

Marilyn Blattner-Hoyle
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Basel III Reforms

Purpose of the 2017 Reforms

- Complement initial phase of 2010 reforms
- Restore credibility in the calculation of RWAs
- Improve comparability of banks' capital ratios

Summary of main changes

- Revision to standardized approaches for calculating credit, market and operational risk
- Simplification of the Basel III framework
- More robust, risk-sensitive output floor
- Increased risk-sensitive framework
- Ease of comparison of RWAs from bank-to-bank

AIG

Basel III Reforms and Trade Credit Insurance

The role of Trade Credit Insurance

- Protection from loss due to credit risks
- Less need to hold capital with a Basel III-compliant insurance policy
- Credit insurer becomes a closer partner (ongoing risk analysis and monitoring)
- Technology for Basel III-compliance, less conditionality

Basel III Compliant Insurance Policies

AIG's Basel III-Compliant Single Risk TF Insurance Policy

- Non-payment insurance for exposure to losses
- Banks can use techniques to mitigate credit risk when calculating capital requirements
- Basel III - Insurance policies as credit risk mitigation not explicitly addressed
- Insurance used if it fulfils operational requirements applicable to guarantees
- AIG policy adheres to the requirements for use of unfunded credit protection as a risk mitigation technique under Basel III

Basel III Reforms – The Impact

What next for banks and insurers?

- What will banks turn to as mitigants?
- How will the regulations vary between geographies?
- Will there be an impact on the funded vs unfunded split?
- Impact on future RWA calculations?

Questions?

Comments?

Parametric Insurance

FMLC insurance scoping forum, 20 February 2018

William Hogarth, Clyde & Co LLP
william.hogarth@clydeco.com

What is parametric insurance?

- Conventional insurance
  - Indemnifies policyholder for loss it incurs from an insured event
  - Not necessarily strict indemnity
    - valued policies
    - ‘new for old’
- Parametric or index-based insurance
  - Payment determined in whole or in part by the occurrence of a pre-determined trigger event (the parameter)
  - Amount payable is ordinarily based on a modelled forecast of the loss that the policyholder will suffer, but the trigger event(s) and payment amounts are pre-determined at the outset of the policy

Key advantages

- Speed of payout
  - No need for loss adjustment
  - Ex-ante payments
- Certainty of timing and amount of payout
  - Amount pre-agreed
  - Simplified claims process
  - Limited scope for dispute
- Lower costs
- Broadens range of insurable losses, in particular where
  - loss adjustment is not practicable or prohibitively expensive
  - losses are difficult to quantify or prove

But, basis risk

Where do we see it used?

Buyers of parametric insurance

- Governments and sub-sovereigns
- NGO and charitable organisations

- Large corporates
- SMEs
- Finance providers

- Retail consumers
- Micro/inclusive insurance

Key industries

- Property (nat cat losses)
- Renewable energy
- Agriculture
- Leisure / hospitality
- Construction
- Travel
- Transportation

And more – where ever there is a strong correlation between an index or data set and the insured's expected loss.

Why are people talking about it now?

- Recent acceleration in range of products and broadening of target markets
  - Movement away from pure nat cat risk and into mainstream insurance, SMEs and consumers
  - Linked to drive to improve resilience and close the protection gap, in particular in the developing world
- Made possible by:
  - Availability of data and improved risk modelling
  - Technological developments
    - Satellite data
    - Internet of things
    - Blockchain and smart contracts

Legal and regulatory issues

- Is it a contract of insurance?
  - Insurance contract or derivative
  - *Prudential v. Commissioners of Inland Revenue*
  - FCA Perimeter Guidance
- Insurable interest
  - Expectation of loss vs actual loss
  - Reconciling insurable interest with payments to interested third parties
  - Stretching the boundaries of traditional insurable interest
- Consumer protection issues
  - Dealing with basis risk
    - Product design and modelling
    - More accurate and granular data
    - Marketing and communicating to policyholders
  - Linkage with financing

Questions

Want to know more?

- **IAIS Issues Paper on Index Based Insurance (consultation closed, January 2018)**
  https://www.iaisweb.org/page/consultations/closed-consultations/2018/draft-issues-paper-on-index-based-insurances
- **Law Commission and Scottish Law Commission, joint review of insurance contract law: insurable interest and parametric policies (consultation closed, May 2016)**
  https://www.lawcom.gov.uk/project/insurance-contract-law-insurable-interest/
- **Parametric insurance: closing the protection gap, Clyde & Co**
  https://www.clydeco.com/resilience