

Avoiding the Global Compliance Trap

How to ensure your worldwide insurance coverage is compliant with the different regulatory and legal requirements around the globe.

By: Jonathan Post General Counsel for Global Programs, XL Insurance

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In the present turbulent financial climate, providing consistent and globally compliant risk management solutions to multinational corporations might not be first on a company's to-do list, but it is unlikely to be too far down, either. How can international corporations obtain integrated and consistent cover worldwide, while at the same time complying with local law and market practices and accessing local coverage and loss adjustment solutions? This apparent conflict can only intensify as multinationals turn to emerging markets to supply their service and manufacturing requirements, connecting on the way with unfamiliar legal systems, and regulators who may not be geared up for their needs.

Local solutions, global consistency

Local insurance policies will provide local market standard coverages and will generally be written in the local language and governed by local law. This approach gives the advantage of familiarity for local insureds, but it does not fit well with providing globally consistent coverage. So global program (GP) insurers provide additional 'wrap-around' coverage, supplementing local policies to cover the differences in conditions and limits (DIC/DIL) between those policies and the master policy.

Thus subsidiaries enjoy standard local coverages in a familiar language and terms – and, at the same time, the group's global risk manager knows that if a loss is of a kind that would be covered under the master policy, it will be covered worldwide.

So far, so good. But consider a US risk manager purchasing global program coverage for its European subsidiaries. Its insurer, a New York P&C insurer licensed across the United States, has a European affiliate which can issue integrated local policies in Europe. Problem solved? Not quite. The EU local policies are not of identical scope to the parent's master policy, and may not be issued to the same limits. As we have seen, this is where the master policy fills in

the gaps, wrapping DIC/DIL coverage around the local policies. But the US insurer issuing the master policy is unlicensed in the EU. By receiving unlicensed cover for DIC/DIL of the local policy, subsidiaries might be acting as illegally as the insurer providing it.

Until recently, this disadvantage to the GP business model was considered to be outweighed by the advantages of global reach and consistency of cover. Besides, with a few exceptions, regulators outside the EU had not necessarily appreciated, or cared, that DIC/DIL cover in excess of local policies was being given. But recently regulators have been taking greater interest in the potentially non-compliant provision of DIC/DIL cover – perhaps because they feel local tax authorities are missing out on local premium taxes. DIC/DIL coverage under an unlicensed carrier's master policy is no longer a risk-free product, whether for insurers, brokers or insureds.

With others, XL Insurance has been at the forefront of insurers' attempts to resolve this issue, which it does in the following ways:

- If we abide by certain basic principles, we may provide unlicensed cover into many countries, without falling foul of regulatory restrictions on carrying out unlicensed insurance operations in those countries.
- If unlicensed insurance cannot legally be given to a subsidiary in a particular country, then we do not insure that subsidiary.
- If we cannot legally insure a subsidiary, we insure the financial interest of the parent in its uninsured subsidiary upon the terms and conditions of the master policy.

That sounds simple enough in practice, but as ever, the “devil is in the detail”.

‘Permissible unlicensed’ cover: asking the right questions

To ask ‘do we need a license to offer insurance in Country A?’ is, generally speaking, not helpful, because as lawyers in Country A will almost invariably tell you, ‘Carrying on insurance business in Country A requires a license.’ It is much more useful to ask this: ‘Which activities by an unlicensed insurer constitute a breach of applicable law in Country A, and which do not?’ Or, put another way, ‘Can we offer cover and pay claims into Country A in such a way as not to breach the relevant laws?’

The paradigm for this approach is the United States. While individual state laws provide that only domestically registered insurers may transact the business of insurance within the state, and impose strict penalties for breach on both insurers and brokers, federal case law, binding upon all the states, provides that where an insurance transaction takes place entirely outside a state, then that state’s regulator has no jurisdiction over it. In practical terms, if the prospective insured plays no part in the placement of its insurance or, if it does, travels outside its home state to – in the jargon – ‘directly procure’ it from an ‘alien unauthorised insurer’, then its home state regulator cannot object.

For singleton insureds, the potential inconvenience of direct procurement will often mean domestic markets are the only practical choice. But a US subsidiary of a non-US parent will generally have its cover centrally negotiated and purchased by its parent’s risk manager, and does not participate in the insurance transaction. So direct procurement fits with the global program centralized purchasing model, allowing a US subsidiary to receive cover from its parent’s insurer on an unlicensed, but perfectly permissible, basis.

With the US model in mind, we wondered where else it might be possible to provide cover into a country without breaching laws applicable to insurers operating in that country. Our research into over 170 countries indicated four general categories:

- Unlicensed cover is unconditionally allowed (very rare).
- Unlicensed cover may be allowed provided the insured initiates contact with the insurer and/ or the transaction takes place outside the jurisdiction (relatively common).
- Unlicensed cover may be allowed if cover was sought from, but cannot be provided by, the domestically licensed market (relatively common).
- Unlicensed cover may be allowed if the local regulator gives advance permission (common, but in practice difficult to achieve).

These broad categories together account for a significant proportion of the countries researched. Essentially, we now know where conventional 'non-admitted' cover was actually, or potentially, compliant all along. We refer to this as 'permissible unlicensed' coverage.

Permissible unlicensed taxes

Licensing is not the only hurdle. Where we provide cover on a permissible unlicensed basis, then to achieve substantial compliance we also need to know where we or our clients face a tax obligation as a result.

For an example, let's go back to the United States. Receiving cover from an "unauthorised alien insurer" makes the US insured liable for direct procurement tax (which may or may not be the same as the "excess and surplus lines" tax) payable at state level. Rules vary from state to state, but a general principle emerges: within a certain number of days after inception of the directly procured cover, the insured must report the existence of the cover to its state insurance regulator, and pay a tax (variously rated at between 2 per cent and 4 per cent of the premium).

This pattern repeats itself across the globe: receiving cover on a permissible

unlicensed basis will sometimes expose the insured to tax. Generally (with notable exceptions – Alberta at 50%, for instance) this tax is not high; the trick is to know where it applies, and how to pay it. Our research has identified those countries where such a tax applies, and we can pass this information to our clients. Of course, verification, registration and payment itself are up to the insured and/or its local tax advisor.

Financial interest cover

Our research has also showed that there are countries where, no matter how many different ways you ask the same question, the answer will always be ‘no’. In some jurisdictions, for instance, it is illegal for persons and corporates to purchase insurance cover other than from a domestically licensed insurer. In others all insurance must be purchased through a licensed insurance broker, which may itself place risks only on the domestic market. And in others any insurance capable of responding to any loss occurring within that jurisdiction must be placed with a domestic insurer.

Where the permissible unlicensed route is barred in this way, cover provided under master policies is potentially illegal, with consequences not only for international insurers (which the local regulator will find it difficult to penalize) but also for insureds (easier to penalize, because they, by definition, will be within the jurisdiction of the offended regulator). We have set ourselves a simple rule: we will not give cover where it would be illegal to do so. But that does not necessarily prevent us from insuring our clients’ interests across their entire global operations.

How do we resolve this? We start from the proposition that the parent company of a group of companies has an economic, operational and strategic interest in the well-being of its subsidiaries, and will be adversely affected by events that adversely affect those subsidiaries. A parent that has invested time, money, intellectual capital and goodwill into establishing a global presence through its

subsidiaries may fairly be presumed to have an interest in retaining or reinstating that presence. That is an interest that can be insured. So, in cases where a parent has subsidiaries that cannot legally be covered, we do not insure those subsidiaries, but we insure the parent's financial interest in those subsidiaries.

English and some other common law systems require that a person must have an 'insurable interest' to take insurance against the possibility of an adverse event. It is the presence of that insurable interest that distinguishes a contract of insurance from a pure bet. Is financial interest coverage a bet? For the answer, we go back to classic judgments of the late 18th century; for a person to have an insurable interest in a particular thing, he or she (or it) must stand in relation to it so as to enjoy a benefit from its preservation or to be prejudiced by an adverse occurrence affecting it. We say that the parent company of a group of subsidiary entities has such an interest in its subsidiaries; that interest may arise out its ownership of those entities, but equally might arise out of the fact that those entities fulfill a certain role for, and add a certain value to, the group as a whole. If a subsidiary is adversely affected by a loss, its ability to make an operational or strategic contribution to the group is likewise affected.

Agreed valuation of financial interest loss

Except in the most straightforward of circumstances, a financial interest loss may be difficult to quantify, leading to a lack of certainty. But both insurers and insureds want consistency of cover. If clients are to be insured in respect of their uninsured subsidiaries, they want to receive the same amount in respect of the same kinds of loss as those subsidiaries would have received, if they had been insured. Likewise, insurers do not want to pay the parent where, if they had been insuring the subsidiary itself, a loss would not be covered.

We therefore need to fix the scope of coverage of the policy and the level of indemnity of the parent with sufficient precision to satisfy the need for 'contract certainty', and in such a way as to preserve global consistency of coverage and

limits. We achieve this by means of a valuation clause in the master policy. This does not simply fix the value of the insured's financial interest; it also sets out an agreed basis for calculating the insured's loss. So the parent's loss to its financial interest will be calculated on the basis of the amount that the subsidiary would have received if it could lawfully have been insured on the terms and conditions of the master policy. In this way, a group 'virtual cover' is given that will equate in monetary terms to the coverage desired.

Repatriation of claims funds

Financial interest cover is simply another cover under the master policy, so there are no issues of payment of local 'non-admitted' taxes, as with permissible unlicensed coverage. However, tax issues may arise upon "repatriation" of claims funds from the insured parent to its uninsured local subsidiary.

Remember that, where financial interest cover is given, the parent is entirely free to decide what to do with the claims proceeds it receives. It may send them to its uninsured subsidiary sustaining the original uninsured loss, but it may just as well direct those funds to a different, or a new, beneficiary, or keep them itself.

The uninsured subsidiary is dependent upon its parent's generosity. And where the parent does choose to transfer funds to its subsidiary, it will have to decide how this transfer is to be achieved. Some ways, plainly, will be more tax-efficient than others. We believe that, properly structured, such repatriation of claims proceeds may be minimized, and in certain circumstances could be tax neutral - so while taxes might be payable upon a simple 'route 1' transfer, a little care and pre-planning might mitigate, or even avoid, that liability. Of course, we advise policyholders to obtain their own advice regarding the tax implications of FI claims settlements.

Conclusion

There is no 'magic bullet' that will automatically provide a single compliant

solution to today's global programmes. Neither is there just one way of doing things. Rather, insurers and risk managers must work together, applying a suite of solutions to mitigate regulatory risk while 'leaving what ain't broke, fixed'. Permissible unlicensed cover and financial interest cover are just two of the tools we can use.

Of course, we cannot wholly guarantee compliance. It is a regulator's prerogative to move its goalposts and change the rules. But what we can say with some certainty is this: that there are challenges to address; that they are not going to go away; and that to take good-faith steps to address these challenges, will probably stand insurers, insureds and brokers alike in better stead than pretending that they do not exist.

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