Structuring Multinational Insurance Programs:

The Emerging Regulatory Challenge to Non-admitted Insurance

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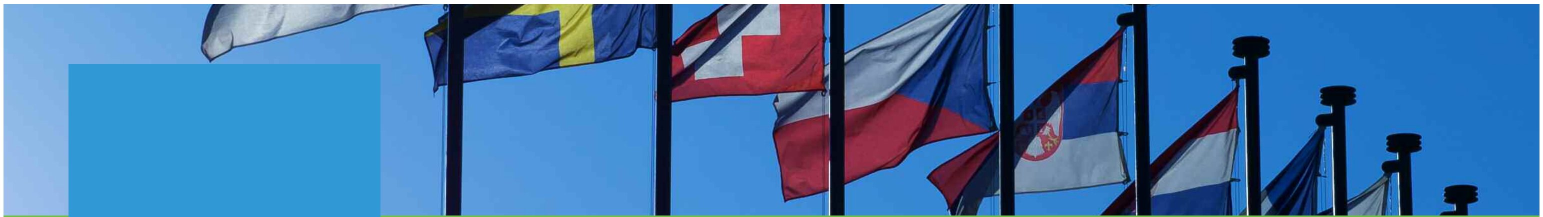

focus on:

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By Suresh Krishnan, Tracey Discepolo

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1.Introduction

Structuring an efficient, cost-effective multinational insurance program requires a close understanding of the evolving regulatory environment. Traditionally, risk managers have focused on whether a local jurisdiction permits insurance from unlicensed insurers to insure local risks, i.e., non-admitted insurance. These regulatory developments are not limited to increased scrutiny of insurance companies; they encompass both local insurance brokers and the local operations of parent company insureds. Many multinational companies are potentially unaware that their global insurance programs may be subject to compliance challenges in certain jurisdictions, and the unanticipated reputational, tax and other financial repercussions this may cause.

In this report we discuss three recent regulatory enforcement actions in Brazil, India and the United States, each of which challenges some of the assumptions behind the most common forms of non-admitted insurance. Beyond these publicly-reported enforcement actions may lie many other examples of similar enforcement actions that have been kept private for confidentiality reasons. In light of these new developments, this report urges a greater understanding of the transactional elements of cross-border insurance, emphasizes the need for increased clarity and transparency of documentation, and counsels advanced preparation to manage the execution uncertainties.

2. Non-Admitted Insurance and Local Regulation

The purpose of a multinational insurance program is to maximize global insurance capacity and minimize cost, while maintaining centralized control over risk management and risk transfer practices. Multinational insurance programs offer a consistent global approach to coverage terms, conditions and financial limits while augmenting the ability to consolidate loss information, thus enhancing loss control practices and procedures. Given the competitive nature of the global insurance business, the use of non-admitted insurance in a global insurance program presents a cost-effective alternative to local coverage. In structuring the program, global risk managers generally ascertain whether or not non-admitted insurance is permitted in countries in which it has insurable interests, e.g., a subsidiary, affiliate or joint venture. Some countries allow non-admitted insurance; others do not. In between are countries with regulations that allow the use of non-admitted insurance but subject it to certain conditions, such as prior approval from regulators, a specific registration of the existence of the insurance, and the payment of insurance premium taxes locally.

Non-admitted insurance typically is arranged in one country, often the domicile of the parent organization, to insure exposures in other countries. Often, no local policy is issued, essentially freeing the insured from paying local premium and commensurate taxes. However, many regulators across the world are beginning to view multinational insurance programs from the perspective of the local affiliated entity over which they have direct supervision, in addition to the local broker intermediating on behalf of this affiliate. This change in posture is based on a desire to enforce local insurance laws, as well as to increase taxable sources of government income, with the local affiliate of foreign companies in the cross-hairs.

Since these intensifying regulatory pressures make it progressively more difficult to insure global risks in a consistent and cost-effective manner, while raising the stakes of a costly regulatory infraction and the reputational harm that may accrue, global risk managers must enhance their due diligence prior to structuring a multinational insurance program. In the past, merely determining if non-admitted insurance was permitted in a country was considered appropriate due diligence.

No longer is this the end of the subject, however. Although regulators are concerned if insurers are transacting the business of insurance without a license in their jurisdictions, they are now equally interested in how a local broker or local insured is insuring the local risks. Consequently, risk managers must determine the conditions that must be met by the local subsidiaries or affiliates to insure local risks with an unlicensed insurer.

By upgrading their due diligence accordingly, multinational organizations will be able to assure compliance with two basic tenets of insurance regulation, one governing the transactional elements of the business of insurance, which generally regulate insurer conduct, and the other governing the location of risk, which generally regulate the conduct of the local broker and local insured. Three recent enforcement actions underscore the current and emerging concern. Not appreciating both tenets can result in consequences that are unexpected and costly.

3. Recent Noteworthy Enforcement Actions:

a. India: Challenges to Non-Admitted Insurance Architecture

A recent regulatory enforcement proceeding in India challenges the efficacy of a parent-country policy in the context of whether local coverage was adequate.

In March 2011, following a fire that damaged a warehouse in India two years earlier, the tax authority in India's Central Government announced that it would tax part of an insurance claim paid to the parent company, a leading manufacturer of sporting goods headquartered in Germany. According to The Wall Street Journal, the parent company received about $20 million in claims payments from an insurer not admitted in India, drawn from what appears to have been a global master policy. The German parent's Indian subsidiary received about $10 million of the total, drawn from what appears to be a local policy.[1] The Indian subsidiary previously had informed India's tax authority that the claim paid to its parent company was not taxable in India for two reasons—the master policy was taken out by the parent company outside India, and the claim was paid outside India. India's tax department subsequently launched an investigation.

The investigation unearthed a series of email exchanges between personnel of the parent company and the local subsidiary. These emails indicated that although the insurance claim was paid outside India, the payments were intended to benefit the Indian subsidiary. As a result, the tax authority recommended that the Indian subsidiary be taxed on the $20 million claim paid outside of India to its corporate parent.

It is noteworthy that, while the non-admitted insurer may not have carried on any class of insurance business in India (marketing, soliciting or issuing a policy in the country), the emails alluding to the use of non-admitted insurance, offered the opportunity to the Indian tax authority to challenge the basic structure of the multinational insurance program. By focusing on the local insured over which it has supervisory authority, the Indian tax authority has defined the multinational insurance program not from the perspective of how the master policy was sold to the parent, but from that of the local subsidiary, which according to the enforcement action, may have purchased non-admitted insurance to insure its local risks.

The German multinational's insurance challenges with the Indian tax authority could easily be replicated in other jurisdictions. A multinational enterprise, when questioned by local regulators, must be able to prove through contemporaneous documentation how a global insurance program excess of a local policy was purchased, including which entities are directly insured by which policies, how and to whom claims payments have been made, and where appropriate taxes have been remitted. Otherwise, regulators may be able to easily "redefine" the entire transaction as a local purchase, and impose applicable taxes, fines and other penalties on the local affiliate.

b. United States: Improper Use of Independent Procurement Authorization

Even in jurisdictions in which non-admitted insurance is permitted (however conditionally,) regulators have not hesitated to challenge what they see as abuses of the non-admitted privilege, be they from insurers, insureds, or brokers.

In the previous example, the use of non-admitted insurance and the regulatory impact on the local insured is addressed. The message from the United States, in this case New York State, presents different implications for the global risk management community—this case involves the use of a local insurance broker.

In Long Island, New York, according to press reports, a family-held insurance broker, Waldorf & Associates, used "independent procurement" to improperly sell $30 billion of property, casualty and other insurance policies issued by Lloyds of London to more than 300 Catholic universities and charities over a period of 15 years.[2] Although New York State permits a local insured to independently procure insurance from an unlicensed insurer for a risk based in New York, the placement of this insurance must take place in its entirety outside the state and not involve the services of a New York broker. The law further requires the local insured, not the broker, to remit the appropriate premium tax to state authorities. Had Lloyd's become financially impaired, the insureds would have no financial recourse to New York State's insurance guaranty fund to cover any claims. Additionally, the policyholders were not informed that the "independent procurement" policies exposed the policyholders to the risk of unpaid taxes in New York State. After an investigation, the New York State Insurance Department fined Waldorf & Associates $3.4 million and ordered it to pay back taxes on the policies, which, under New York State law, were owed by the policyholders.

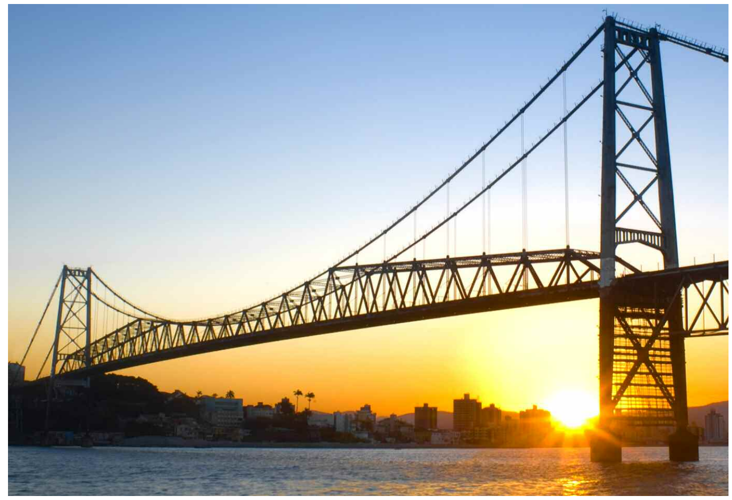
The Waldorf enforcement action reminds us that when an insurer is transacting the business of insurance in the jurisdiction where it is licensed (in this case The United Kingdom) and not at the location of risk (in this case New York State), the regulatory focus may enlarge to include the local broker and the local insured. The compliance question is not only how the unlicensed insurer sold non-admitted insurance, but also, because New York has direct jurisdiction over the local insured and the broker, whether or not the non-admitted insurance policy was procured to insure local risk in compliance with New York Law.

c. Brazil: Action Against Multinational Insurer

In the previous two examples, regulators exercised their discretion to go after local entities rather than the foreign insurer. However, in a recent enforcement proceeding in Brazil, a large international insurer was charged with conducting business in that country without a license.

In October 2011, the Brazilian national insurance regulator, Superintendencia de Seguros Privados ("SUSEP"), charged a Texas-based insurer, National Western Life Insurance Company, with illegally selling life insurance in Brazil over a period of several years. Unbeknownst to its Brazilian policyholders, National Western, which primarily sells life insurance policies and annuities, did not have a Brazilian insurance license. According to newspaper reports, SUSEP reportedly imposed a $6.2 billion fine on the insurer—the biggest fine ever imposed by Brazil's financial regulator.[3]

When an insurer is transacting the business of insurance in the jurisdiction where it is licensed and not at the location of risk, the regulatory focus may enlarge to include the local broker and the local insured.



Interestingly, National Western's conduct only came to light after a Brazilian policyholder filed a complaint over an unpaid claim. SUSEP blamed the sale of the improper insurance, in part, on what it called "irregular brokers" who themselves lacked "proper licensing to sell insurance."[4] Brazilian policyholders had no knowledge they were also committing an illegal act by purchasing insurance from a non-admitted insurer and that they may be subject to tax penalties in Brazil.[5] According to newspaper reports, the incident has led SUSEP to increase its overall supervision and policing of insurance licensing, including that of property and casualty insurers.

Had National Western sold its Brazilian life insurance policies only in the United States, SUSEP may not have had jurisdiction over the company. But, since the insurer used local Brazilian "brokers" to solicit business on its behalf from local insureds, the insurer was itself at risk of local regulatory compliance for transacting the business of insurance in Brazil without a license. The National Western case thus teaches that even where a local regulator may not otherwise have direct jurisdiction over a foreign insurer, the presence of local representatives or local dealings by the non-admitted insurer may be enough to bring the insurer into the local regulatory net.

4. Responding to the Regulatory Challenges: The Importance of Transparency

In many cases, the purchase of a master policy in the parent company's jurisdiction with Differences in Conditions or Differences in Limit (DIC-DIL) features excess of local policies offers protections against local enforcement actions. Nevertheless, there are nuances to consider. For instance, parent companies must determine whether to include certain affiliates as named insureds in the policy or solely itself as the named insured.

To assure that the master policy effectively responds to the regulatory and tax challenges in countries that either outright prohibit non-admitted insurance, or impose conditions on the procurement of such policies, risk managers should consider the following steps in addition to issuing local policies:

- Issue a master policy to the parent company as the sole insured in the parent company's jurisdiction, and exclude any of the parent company's affiliates located in countries that prohibit non-admitted insurance, or impose certain conditions on brokers and insureds that utilize non-admitted insurance.
- Insure the parent company's insurable interests in any excluded affiliates consistent with the laws of the parent company's domicile.[6] This way, the location of risk—the parent company's insurable interests—is matched with the transaction of the business of insurance, i.e., the master policy is issued by a licensed insurer in the same jurisdiction.
- Remit premium taxes on premiums paid under the master policy (if not exempted) in the parent company's jurisdiction. If the parent remits the covered claim to an affiliate, the business purpose of this remittance should be reflected in contemporaneous documents between the parent and its affiliate.
- Utilize inter-company charges and appropriate transfer-pricing documentation based on the actual experience of the multinational enterprise.[7] This way the costs and benefits of the global insurance program—both local policies and master policy—can be charged to the appropriate entities in a transparent and materially compliant manner.

5. Conclusion

This report has highlighted three specific instances where the regulatory approach to non-admitted insurance has broader consequences than is currently expected by the international risk management community. The enforcement actions introduce the potential for significant unforeseen costs and consequent reputational risks. Other countries with fast-growing economies like Brazil and India are likely to pursue a similar regulatory posture in the future.

The regulatory approach to non-admitted insurance has broader consequences than is currently expected by the international risk management community.

Preparing for these uncertainties requires a more in-depth understanding of the transactional elements of cross-border insurance, particularly as this relates to local tax and insurance regulatory requirements. As always, a multinational insurance program should carefully consider the relevant regulatory regime of each jurisdiction. With no global standard for insurance regulation or a consistent application of insurance law worldwide, a compliance analysis of local regulations governing non-admitted insurance is de rigueur. To obviate potential execution uncertainties, transaction documents must be clear and transparent.

Some specific questions to consider in preparing this analysis include:

- Do the countries in which the risk is located allow a non-admitted insurer to underwrite the risk? If the answer is yes, then what are the conditions under which a non-admitted insurer may conduct the business of insurance in that country?
- If the country permits risk to be insured by a non-admitted insurer, which entity is responsible for any applicable premium taxes and other charges?
- What are the obligations placed on a local broker or international broker with regard to non-admitted insurance? Are costs allocated to a risk in the country subject to tax and other charges?
- If there are taxes or other charges, which entity—the insurer, broker or insured—is responsible for calculating, collecting and remitting them to local authorities?

Once this analysis is completed, informed decisions coordinated among the insured, broker and insurer can follow in the structuring of the multinational insurance program.

Finally, when designing and implementing a multinational insurance program, clients, brokers and insurers should be aware of the issues introduced and analyzed in this report. Insurance brokers, risk managers and all other buyers of multinational insurance should work with a global insurer and consider whether they also need assistance from an independent financial or tax advisor. Structuring a multinational insurance program with documentation and supporting contractual arrangements fitting the specific needs and goals of multinational enterprises should result in a measurably compliant international insurance program, one that assures that the multinational program ultimately satisfies the collective objectives of the client, insurance broker and insurance carrier.

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Suresh Krishnan is General Counsel for the ACE Group's Multinational Client Group. Based in New York, Mr. Krishnan has global legal oversight for matters connected with the company's multinational products and services. With more than 19 years of experience in the insurance industry, Mr. Krishnan most recently served as general counsel of ACE USA and ACE Financial Solutions.

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Endnotes:

1 http://online.wsj.com/article/SB10001424052748704050204576218132454647812.html (last visited January 30, 2012)

2 http://www.nypost.com/p/news/business/brokers_sin_of_commission_Ljk7D2Scc1R9RXAz7FSBnJ (last visited January 30, 2012). While New York's Insurance Department could have taken action against Lloyds of London, it did not. Possibly, this was because the department may not have been able to show evidence of jurisdiction in this matter over the London-based insurer. Under New York insurance law, the state has jurisdiction over an unlicensed insurer if the unlicensed insurer transacts the business of insurance in the state, e.g., solicits or issues a policy, collects premium or pays claims in New York State. Lloyds, in this regard, appears not to fit this description.

3 http://riotimesonline.com/brazil-news/rio-business/brazil-targets-unregistered-financial-services/ (last visited January 30, 2012)

4 http://www.eiu.com/index.asp?layout=ib3Article&article_id=1148537099&pubtypeid=1132462498&country_id=1480000148&page_title=&rf=0 (last visited January 30, 2012)

5 http://translate.google.com/translate?hl=en&sl=pt&u=http://economia.estadao.com.br/noticias/economia%2Bgeral,susep-aperta-o-cerco-as-seguradoras-strangeiras,87989,0.htm&ei=EasAT4 VE8mViALyu8TNDg&sa=X&oi=translate&ct=result&resnum=1&ved=0CCwQ7gEwAA&prev=/search%3Fq%3DO%2BEstado%2Bde%2BSao %2BPaulo%2BSUSEP%2Bnational%2Bwestern%2Blife%26hl%3Den%26client%3Dsafari%26rls%3Den%26prmd%3Dimvns (last visited January 30, 2012)

6 The laws in many jurisdictions around the world recognize the principle of insurable or financial interest that a parent company has in its ownership or contractual interests in its subsidiaries, affiliates and joint ventures. This is true, for example, under English Law; the insurance laws of New York, Pennsylvania and California, the laws of most countries in continental Europe and many countries in Asia; the laws of Australia and New Zealand; as well as laws in Argentina, Brazil and Mexico. See, Beyond Non-Admitted: A Closer Look at Trends Affecting Today's Multinational Insurance Programs; Structuring Multinational Insurance Programmes: Addressing the Current Challenges in Europe; Structuring Multinational Insurance Programmes: Current Challenges in Australia, New Zealand and the Asia-Pacific Region; and Structuring Multinational Insurance Programs: Current Challenges in Argentina, Brazil and Mexico at http://gps.acegroup.com/WhitePaper_MediaCenter.html (last visited January 30, 2012).

7 See Structuring Multinational Insurance Programs: Addressing the Taxation and Transfer Pricing Challenge at http://gps.acegroup.com/WhitePaper_MediaCenter.html (last visited January 30, 2012).