Insurance & Reinsurance Law & Regulation

Jurisdictional comparisons **First edition 2014**

General Editor: Clive O'Connell
Goldberg Segalla Global LLP

THE EUROPEAN LAWYER REFERENCE

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General Editor:
Clive O'Connell

Commissioning Editor
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Forewords

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Foreword

Clive O'Connell, Goldberg Segalla Global LLP

Insurance is about the spreading of risk. Ever since Lombard merchants introduced marine insurance in 1200 or Icelandic farmers formed themselves into a mutual later that century, the risk of one has been spread across many.

Of course, sharing risk among people exposed to the same peril does not always work. Accumulation of risk in one geographic area or some other similarly exposed grouping simply magnifies the problem. It was for this reason that reinsurance was born in the fourteenth century in order to allow greater diversification of security and of risk. Risks crossed frontiers, often on a reciprocal basis. A calamity in one place was resolved from the purses and pockets of strangers from far away.

As much early insurance and reinsurance was based upon international trade, the growth of insurance and reinsurance has always been international and the geographic sharing of risk has allowed economies to flourish or, at least, has prevented them from an even earlier demise.

Insurance and reinsurance are not the sole preserves of capitalism. Socialist countries, for example, have used the world's reinsurance markets to protect their macroeconomic interests. Even North Korea used to reinsure itself around the world until sanctions denied it protection. Countries in the former Soviet bloc used reinsurance not merely to protect themselves, but as a way to earn "hard" currency. Often they did so only to find that claims had to be paid in hard currency as well.

The global economy is growing and is becoming ever more interconnected. With the growth in economies, the need for insurance grows as well. Whereas, in the early 1980s, the USA accounted for around 40 per cent of the world's insurance premiums, that figure has fallen to under 25 per cent today while, at the same time, US premiums themselves have continued to grow.

Insurers have also tended to become larger. As global enterprises have consolidated and grown, their need for ever larger insurers has increased. These larger insurers, in turn, need larger reinsurers to protect their capital.

New markets are developing around the world. As they do so, established insurers are often seeing their opportunities for growth there rather than in established and over-competitive locations.

As economies expand, insurance is required in new areas, both geographically and conceptually. New forms of risk are emerging and insurers are struggling to apply old forms of cover to them, often restricted in what they can do by regulatory regimes.

Insurance does not merely follow but can be used as a tool to assist development. Microinsurance schemes are being established, often

in conjunction with microfinance, to help create a middle class and a sustainable economy in poorer countries, and to allow them to develop beyond subsistence. Takaful is being developed to give access to risk sharing to millions of devout Muslims, who make up a significant proportion of the world's population, often in areas undergoing some of the fastest economic growth, and who would otherwise have no recourse to cover.

The insurance and reinsurance industry, however much it may be growing, is still dwarfed by the capital markets. Following the global economic downturn and the combined effects of a number of natural disasters, a need emerged for non-correlated security to protect insurers. At the same time, capital, lacking opportunity elsewhere, was available. As economies have recovered, the capital has remained, and now it is clear that insurance-linked securities are not a temporary trend but a significant change in the way that insurers protect themselves and that capital markets interact with them.

As capital markets become familiar with and develop an appetite for risk transfer, the issue arises as to what extent they will still require the intervention of insurers or whether they might be better suited to providing new solutions to those requiring protection directly. The ability of capital markets to innovate within the confines of their regulatory framework could present the greatest challenge yet to insurers.

Regulators are bound by the limits of their jurisdiction. Those that they regulate and those they protect operate on a broader, often global, scale. Cooperation between regulators is required for fear of loopholes emerging between them which could be exploited by those without good faith.

The international nature of recent developments, adding to an already global industry, presents challenges not only to regulators, but also to legal systems. Principles of insurance law, developed from cases surrounding eighteenth- and nineteenth-century ocean voyages, where cargos were carried on sailing ships, are now being asked to respond to quasi-financial instruments protecting satellite launches.

Often the transaction will be reflected in a number of documents involving parties in a variety of jurisdictions and subject to different forms of regulation.

Existing laws and regulations are being tested. It is too early to say whether they will pass these tests, but all concerned must be aware of the issues that they face.

To aid this process, we have brought together leading insurance lawyers from around the world to ponder and opine upon some of the challenges the insurers and their lawyers and regulators will face in the coming years. The questions considered in this book will be asked for many years to come.

Japan

Anderson Mōri & Tomotsune Naokuni Fukuda, with the assistance of Ryuji Kato, Tomoyuki Tanaka, Kaori Sato & William Segal

1. WHAT RISKS MUST BE INSURED?

1.1 What are the compulsory classes of insurance?

A. Compulsory classes of insurance in Japan include the following:

- *Compulsory automobile liability insurance*. Owners or users of automobiles (with certain exceptions) must purchase liability insurance covering death or bodily injury of third parties resulting from the operation thereof (Articles 3, 5 and 11 of the Automobile Liability Security Act (Act no. 97 of 1955, as amended)).
- *Nuclear energy liability insurance*. Nuclear business operators engaging in installation of nuclear reactors, processing of nuclear fuel materials or otherwise in nuclear-energy-related businesses must purchase liability insurance covering nuclear-energy-related damage to third parties resulting from the operation of such businesses (Articles 6, 7, 7-2 and 8 of the Act on Compensation for Nuclear Damage (Act no. 147 of 1961, as amended)). To cover certain events exempted under such insurance (eg earthquake and tsunami), nuclear business operators are further required to enter into nuclear energy damage compensation contracts with the government of Japan (Articles 6, 7, 7-2 and 10 of the Act on Compensation for Nuclear Damage and Articles 2 and 3 of the Act on Contracts for Indemnification of Nuclear Damage Compensation (Act no. 148 of 1961, as amended)).
- *Protection and indemnity insurance for ocean-going vessels*. Shipowners or charterers of non-tanker vessels with gross tonnage of 100 tons or more which (i) if vessels of Japanese registry, are engaged in international voyages, or (ii) if vessels of foreign registry, enter or leave Japanese ports or use mooring facilities in Japan, must purchase insurance covering (i) damages arising out of pollution resulting from leakage or discharge of bunker fuel oil loaded by such vessels and (ii) costs for removal or other necessary measures arising from abandonment of such vessels in Japanese territory due to stranding, sinking or any other reason (Articles 39-4 and 39-5 of the Act on Liability for Oil Pollution Damage (Act no. 95 of 1975, as amended)).

B. Japanese residents are required to participate in various classes of insurance comprising a social security system operated by the national and local governments, including the following:

- Owners of businesses having employees must in principle participate in the industrial accident compensation insurance system, under which insurance benefits are paid to employees in the event of job-related injury, illness, disability or death (Articles 2, 3 and 7 of the Industrial Accident Compensation Insurance Act (Act no. 50 of 1947, as amended)), as well as in the employment insurance system, under which insurance benefits are paid to employees in the event of unemployment (Articles 2, 3, 5 and 6 of the Employment Insurance Act (Act no. 116 of 1974, as amended)).
- Japanese residents must, depending on age, participate in the health insurance system, under which insurance benefits are paid in the event of illness, injury, giving birth or death (Articles 2, 3, 5 and 6 of the National Health Insurance Act (Act no. 192 of 1958, as amended)), the care insurance system, under which scaled insurance benefits are paid in respect of conditions requiring long-term care or certain other types of assistance (Articles 2, 3 and 9 of the Long-Term Care Insurance Act (Act no. 123 of 1997, as amended)), and the pension system, under which insurance benefits are paid on the basis of age, disability or death (Articles 2, 3 and 7 of the National Pension Act (Act no. 141 of 1959, as amended).

Certain other pension systems are also operated by the public sector, including the employees' pension insurance system, designed for employees under the Employees' Pension Insurance Act (Act no. 115 of 1954, as amended).

1.2 Who must they be insured with?

1.2.1 Locally admitted insurers

The compulsory classes of insurance discussed in section 1.1.A above are categorised as non-life insurance, and underwriting thereof by either Japanese or non-Japanese insurers requires a non-life insurance business licence in Japan (Articles 3 and 185 of the Insurance Business Act (Act no. 105 of 1995, as amended; the IBA)). For details of the Japanese insurance business licence regime, see section 2.1 below.

1.2.2 Foreign insurers

Foreign insurers are required to obtain non-life insurance business licences in order to underwrite the compulsory classes of insurance set forth in section 1.1.A above.

Any foreign insurer entering into an insurance contract without an insurance business licence will be punishable, in the case of an individual, by imprisonment for not more than two years or a criminal fine of not more than three million yen, or both (Article 316, item 4 of the IBA), and, if a body corporate (acting through a representative or employee), by a criminal fine of not more than three million yen (Article 321, paragraph 1, item 4 of the IBA).

2. WHO CAN INSURE NON-COMPULSORY CLASSES OF RISK?

2.1 Locally admitted insurers

A. Outline of Japanese insurance business licence regime

Underwriting insurance in Japan without first obtaining an insurance business licence is generally prohibited (Articles 3 and 185 of the IBA). This applies to both compulsory and non-compulsory classes of insurance.

Japan's licensing regime includes life insurance business licences and non-life insurance business licences, with a single entity prohibited from holding both licences simultaneously (Article 3, paragraph 3 of the IBA). Holders of a life insurance business licence may engage in underwriting of life insurance and so-called 'third sector insurance' (an expression used in Japan to refer to insurance covering illness and injury, but excluding life and non-life insurance), as well as reinsurance of life insurance and third sector insurance (Article 3, paragraph 4 of the IBA). Holders of non-life insurance business licences may underwrite non-life insurance and third sector insurance, as well as overseas travel insurance (Article 3, paragraph 5 of the IBA).

B. Japanese insurance business licences for foreign insurers

There are two ways for foreign insurers to establish an insurance business presence in Japan: (i) establish a branch office in Japan and then obtain an insurance business licence for such branch (the branch model); or (ii) incorporate a subsidiary in Japan and then cause such subsidiary to obtain an insurance business licence (the subsidiary model). The following briefly summarises both models.

(1) Branch model

In this model, a foreign insurer which seeks an insurance business licence for a branch established in Japan must nominate one or more individuals to act as its representatives in Japan, at least one of whom must be a resident of Japan.

Foreign insurers utilising this model are required to deposit 200 million yen or more (depending upon the scope of planned operations in Japan) with a governmental deposit office for the protection of policyholders, insureds, beneficiaries and other related parties in Japan (Article 190, paragraph 1 of the IBA and Article 24 of the Order for Enforcement of the Insurance Business Act (Cabinet Order no. 425 of 1995, as amended; the IBA Enforcement Order)). In addition, they must hold assets physically in Japan, either in cash or other prescribed forms, in an amount equal to the aggregate of (i) the total of policy reserve and outstanding claims and (ii) the total of deposits and stockholders' equity (Article 197 of the IBA and Article 138 of the Ordinance for Enforcement of the Insurance Business Act (Ordinance of Ministry of Finance no. 5 of 1996, as amended; the IBA Enforcement Ordinance)).

(2) Subsidiary model

A foreign insurer may establish a joint-stock corporation (*kabushiki-kaisha*) in Japan and cause it to obtain a Japanese insurance business licence. Such subsidiary is required to have:

- a board of directors;
- a board of corporate auditors (or, if the subsidiary takes the form of a corporation with statutory committees (*iinkai-secchi-kaisha*), a nominating committee, an audit committee and a compensation committee); and
- an independent accounting auditor (Article 5-2 of the IBA). Each of the board of directors and the board of corporate auditors must be composed of three or more members.

Any Japanese corporation that engages in the insurance business is required to have paid-in capital of at least one billion yen (Article 6 of the IBA and Article 2-2 of the IBA Enforcement Order).

(3) Application for licence

In either model, an applicant for an insurance business licence must file an application with the Financial Services Agency (the FSA), accompanied by the following documents:

- a statement of business procedures;
- general terms and conditions for insurance policies; and
- a statement of premium and policy reserve calculations (Articles 4 and 187 of the IBA).

2.2 Foreign insurers

As discussed in section 2.1 above, foreign insurers are in principle required to obtain insurance business licences as a condition to underwriting insurance with respect to Japanese residents or with respect to properties located in Japan. The following classes of insurance are exempted from the licensing requirement (Article 186, paragraph 1 of the IBA, Article 19 of the IBA Enforcement Order and Article 116 of the IBA Enforcement Ordinance):

- reinsurance;
- marine insurance;
- aircraft insurance;
- satellite insurance;
- international cargo insurance; and
- overseas travel insurance.

In addition, foreign insurers may, without insurance business licences, enter into insurance contracts with respect to Japanese residents or properties located in Japan if the relevant policyholder files an application with and obtains approval in advance from the FSA (Article 186, paragraphs 2 and 3 of the IBA).

2.3 Excess and surplus lines markets

We understand that a so-called 'excess and surplus lines market' system may exist in some jurisdictions, under which, if a customer is unable to

find an insurer within its local jurisdiction which offers a particular type of insurance, such customer may purchase insurance of this type from outside the local jurisdiction, even if the relevant insurer is not licensed in such local jurisdiction. There is no equivalent system in Japan; rather, subject to the exceptions mentioned in section 2.2 above, all types of insurance in Japan must be underwritten by a licensed insurer.

3. WHICH REINSURERS CAN BE USED?

3.1 Must they be locally admitted?

As discussed in section 2.2 above, an exemption to the licensing requirements under the IBA applies in respect of reinsurance. Accordingly, foreign reinsurers without insurance business licences may enter into reinsurance contracts with Japanese insurers.

3.2 If not, are security requirements imposed?

Any foreign reinsurer may enter into a reinsurance contract with Japanese insurers without an insurance business licence, as discussed in section 3.1 above, and the Japanese regulatory regime does not impose any statutory security requirements on foreign reinsurers (whether licensed or not).

As a practical matter, there is a provision that may affect the ability of foreign reinsurers to enter into reinsurance contracts with Japanese insurers. In general, Japanese insurers may deduct a portion of their insurance contracts that have been ceded to reinsurers when calculating the applicable policy reserves for such contracts. If the reinsurer is a foreign reinsurer not licensed in Japan, however, this is permitted only if the reinsurance arrangement does not threaten the operational soundness of the Japanese insurer, taking into account the status of the reinsurer's business and properties (Article 71 of the IBA Enforcement Ordinance).

In this connection, Section II-2-1-4(8) of the 'Comprehensive Guidelines for Supervision of Insurance Companies' promulgated by the FSA (the Guidelines) provides that a reinsurance arrangement with a foreign reinsurer not licensed in Japan will be deemed not threatening to the operational soundness of a Japanese insurer if (i) the reinsurance benefits payable in respect of a single loss are less than 1 per cent of the total assets of the Japanese insurer or (ii) the Japanese insurer has in the past deducted the portion ceded to the relevant foreign reinsurer in calculating its policy reserve based on a previous reinsurance arrangement (unless, in either case, the foreign reinsurer has suspended or is likely to suspend payment of reinsurance benefits generally).

4. THE TAXATION OF INSURANCE

4.1 What taxes are levied on insurance premium?

The Japanese tax regime does not levy any tax on the payment of insurance premiums, whether by individuals or bodies corporate.

Under the Japanese tax regime, insurance premiums paid by individuals in respect of certain types of social security, life and non-life insurance are deductible to some extent from income for the purpose of calculating

national and local income tax. Relevant types of life and non-life insurance include:

- ordinary life insurance;
- nursing care and medical insurance;
- individual annuities; and
- earthquake insurance.

4.2 What exceptions are there?

N/A.

5. INSURANCE REINSURANCE AND CAPITAL MARKETS

5.1 How is finite reinsurance treated?

Japanese law in general does not specifically address the concept of finite reinsurance. Use of finite reinsurance mechanisms is theoretically possible under existing Japanese law intended to apply to standard insurance/reinsurance arrangements, but the effect of such law on finite reinsurance mechanisms is uncertain. A single 2010 ruling by the Tokyo District Court and the affirmation thereof by the Tokyo High Court can be read to imply recognition of finite reinsurance mechanisms as constituting 'insurance' for Japanese law purposes, but these rulings have not to date been subject to further testing or clarification in other precedents.

It should be noted, however, that Japanese law recognises a mechanism known as 'financial reinsurance', which bears some resemblance to finite reinsurance. More specifically, under the IBA, Japanese insurers may deduct a portion of their insurance contracts that have been ceded to reinsurers when calculating the applicable policy reserves for such contracts (subject to the limitations regarding foreign reinsurers not licensed in Japan discussed in section 3.2 above). However, an additional requirement applies in respect of reinsurance under which the insurer is to receive a ceding commission from the reinsurer in an amount calculated based on estimated gain to be derived from the ceded portion of the insurance contract. In such an event, the insurer must treat such ceding commission as (i) a policy reserve in the case of types of reinsurance designated by the Commissioner of the FSA or (ii) a deposit in other cases (Article 71 of the IBA Enforcement Ordinance).

Pursuant to this provision, the Commissioner of the FSA has specified applicable requirements, including the following, with types of reinsurance which satisfy such requirements being defined as 'financial reinsurance':

- all risks in respect of the portion of the insurance contract ceded must be transferred from the insurer to the reinsurer;
- the reinsurer must be licensed to conduct reinsurance business by a Japanese or foreign regulator and be rated 'AA–', 'Aa3' or higher by a qualified rating agency as designated by the Commissioner of the FSA (provided, however, that exemption from this requirement may apply if the reinsurance arrangement does not threaten the operational soundness of the insurer, taking into account the status of the reinsurer's business and properties);

- the insurer must receive the ceding commission from the reinsurer in cash;
- the reinsurance arrangement must terminate only when all insurance contracts subject to the reinsurance arrangement have terminated or when the insurer has exercised its right to terminate the reinsurance arrangement; and
- the reinsurer must not be entitled to unilaterally terminate the reinsurance arrangement except where the insurer fails to pay the reinsurance premium.

5.1.1 What constitutes risk transfer?

As noted in section 5.1 above, Japanese law does not specifically address the concept of finite reinsurance, and accordingly the issue of risk transfer in this context also is not expressly addressed.

It is worth noting that ,in the discussions of the Tokyo District Court and the Tokyo High Court in the 2010 precedent mentioned in section 5.1 above, the Tokyo District Court appeared uncertain regarding recognition of payment of premium in an overseas finite reinsurance mechanism as constituting legitimate compensation for an authentic transfer of risk. By contrast, the Tokyo High Court appeared willing to grant such recognition. However, as noted above, these rulings have not to date been subject to further testing or clarification in other precedents.

5.2 Derivatives, ILWs and wagering agreements

A. Derivatives and ILWs

There is no provision of Japanese law which prohibits entry into either derivatives contracts or transactions or into industry loss warranty (ILW) transactions, both of which are used in the Japanese marketplace. Although there is some scholarly discussion of the issue, in general neither derivatives contracts nor ILW transactions are considered to constitute insurance arrangements as a matter of Japanese law, and accordingly neither of them is subject to the requirement for an insurable interest or the so-called 'non-profit principle', which apply to non-life insurance contracts (as discussed in section 5.2.1 below).

B. Wagering agreements

Wagering, or gambling, is prohibited under Article 185 of the Criminal Code (Act no. 45 of 1907, as amended). The Insurance Act (Act no. 56 of 2008, as amended), a special-purpose contract law enacted to regulate various aspects of insurance contracts, incorporates measures to prevent insurance contracts utilised for wagering.

In the case of non-life insurance, the Insurance Act provides for an insurable interest requirement, and insurance contracts are also subject to the so-called 'non-profit principle' (both of which are discussed more specifically in section 5.2.1 below). Both of these are intended to have the effect of preventing the use of insurance contracts for wagering purposes.

In the case of life insurance, the Insurance Act provides that a life insurance contract under which the insured is different from the policyholder will only become effective if the insured consents thereto. This requirement is also intended as a wagering prevention measure.

Wagering agreements and insurance contracts are generally differentiated, aside from the existence of insurable interests, by the general principle of whether they are socially necessary and useful. Derivatives transactions, which do not require an insurable interest, are relatively close to wagering agreements, but these two types of transaction can still be differentiated by the general principle of whether they are socially necessary and useful.

5.2.1 What constitutes insurable interest?

Under the Insurance Act, an insurance contract is defined as a contract, regardless of title, under which one party undertakes to provide a benefit to the other party in the event of certain occurrences, and such other party undertakes to pay a premium determined on the basis of the likelihood of such occurrences.

This definition indicates that the existence of an insurable interest is not an indispensable factor for all insurance contracts under the Insurance Act. In fact, three categories of insurance contracts are recognised under the Insurance Act: non-life insurance contracts, life insurance contracts and fixed-benefit accident and health insurance contracts. Of these, the existence of an insurable interest is considered to be indispensable only for non-life insurance contracts.

An interest is generally considered to constitute an insurable interest only when such interest satisfies, either expressly or by interpretation, the following requirements:

- the possibility of financial evaluation: any insurable interest must be capable of being evaluated in monetary terms;
- the certainty of existence: an interest that does not exist at the outset of an insurance contract can constitute an insurable interest if such interest will certainly occur thereafter; and
- the legality: no illegal interest may constitute an insurable interest; for example, no one may conclude a non-life insurance contract the insurable interest of which is an interest in smuggled goods, such as narcotics.

In addition to the concept of insurable interests, it is also generally understood that non-life insurance contracts are subject to a non-codified but judicially recognised ‘non-profit principle’ and that, as a result of application of the non-profit principle, the amount of insurance benefit from a non-life insurance contract must not exceed the amount of loss arising from damage to the insurable interest which is the subject of such contract.

As noted in section 5.2 above, despite some scholarly dispute, neither derivatives contracts nor ILW transactions are considered to constitute insurance arrangements as a matter of Japanese law, and accordingly neither

of them is subject to the requirement for an insurable interest or the non-profit principle.

5.3 Side cars and CAT bonds

5.3.1 To what extent are these governed by the law relating to insurance contracts?

A. Side cars

So-called 'side car' transactions are typically structured as follows: (i) an insurance company (the sponsor) establishes, together with other investors, an offshore special purpose vehicle (SPV); (ii) the SPV establishes a reinsurance company (the side car); and (iii) the sponsor enters into a reinsurance contract with the side car by which certain insurance contracts underwritten by the sponsor are ceded to the side car.

In this transaction, the contract between the sponsor and the side car, as a standard reinsurance contract, is subject to contract laws such as the Insurance Act, as well as the Commercial Code (Act no. 48 of 1899, as amended) and the Civil Code (Act no. 89 of 1896, as amended), which are general private laws that are broadly applicable to all contracts.

In addition, assuming that the sponsor is a Japanese insurer, side car transactions are regulated by the IBA and other applicable regulatory laws. Among various other requirements under the IBA and related regulations, a Japanese insurer is required to appropriately conduct risk management on a group-wide basis if it cedes insurance contracts to subsidiary insurance companies (section II-2-6-5 of the Guidelines).

The IBA provides for regulations applicable to Japanese insurers, as well as their parent companies and subsidiaries to some extent. For example, the FSA is authorised to require subsidiaries of a Japanese insurer to respond to inquiries and to provide requested information to the extent necessary to the FSA's supervision of the Japanese insurer (Article 128, paragraph 2 of the IBA).

The side car is not required to obtain an insurance business licence under the IBA as long as it is a non-Japanese company (see section 2.2 above).

B. CAT bonds

CAT bonds, or catastrophe bonds, are typically used in the following manner: (i) an insurance company (the sponsor) establishes an offshore SPV qualified to function as a reinsurance company in its home jurisdiction (the SPV); (ii) the sponsor enters into a reinsurance contract with the SPV by which certain insurance contracts underwritten by the sponsor (having exposure to catastrophe risks) are ceded to the SPV; and (iii) the SPV issues CAT bonds, the terms and conditions of which include provisions to the effect that the SPV will be entitled to redeem such bonds at amounts significantly below face value (and possibly without any payment whatsoever) in the event of a prescribed catastrophe.

CAT bonds are used in situations quite similar to those for side car transactions. Japanese contract and regulatory laws are similarly applicable.

5.4 Other ILS and ART products

ILS, or insurance linked securities, generally comprise securitisation products the underlying assets of which relate to certain occurrences that would generally be covered by insurance products. ART, or alternative risk transfer, generally refers to risk transfer or risk management mechanisms that are distinct from traditional insurance products.

While there do not appear to be many Japanese court precedents in which the nature of ILS or ART products (in particular, the difference between them and traditional insurance products) is expressly or impliedly argued, there is a recent precedent that we believe hints at the view taken by Japanese courts on ILS and ART products, as compared to traditional insurance products.

In this precedent, the plaintiff sought payment pursuant to an earthquake derivatives contract entered into with a Japanese non-life insurance company. The relevant contract was designed by the parties to provide for payment of a specified amount only upon occurrence of an earthquake of a specified intensity at a designated location, with the goal of avoiding the standard insurance contract mechanism for payment of proceeds calculated on the basis of actual loss. Despite this, the plaintiff sought payment based on a broad interpretation of the contract's trigger conditions, arguing that, because of the contract's similarity to an insurance arrangement, the benefit of broad construction should be granted to its claim.

In a 2013 judgment, the Sendai High Court discussed in detail the terms and conditions of the contract and in conclusion dismissed the claim, stating that the transaction was in fact a derivatives contract, under which the insurance company was required to make payment only in specified conditions, and was not designed to generally enable recovery of damages suffered by, or otherwise provide a remedy to, the plaintiff. It accordingly rejected the plaintiff's argument in favour of a broad construction of the contract's trigger conditions.

This ruling suggests that Japanese courts (to the extent that they follow the view of the Sendai High Court) may consider ILS and ART products, although similar in concept to insurance products, to constitute standard, contract-based arrangements rather than genuine insurance products. As a result, ILS and ART products may be considered less eligible for extraordinary consumer protection than such genuine insurance products. It should be noted, however, that the Sendai High Court decision has not to date been subject to further testing or clarification in other precedents.

6. COMMISSIONS

6.1 What commissions and brokerages are permissible? What disclosure of commissions is required?

A. Introduction

The IBA prohibits all persons other than the following from acting as agents or intermediaries with respect to entry into insurance contracts (Article 275 of the IBA):

(a) officers and employees of insurance companies;
(b) insurance agents;

(c) officers and employees of insurance agents;
(d) insurance brokers; and
(e) officers and employees of insurance brokers.

A person falling within categories (a)–(c) may act as an agent or intermediary for specific insurance companies to which such person belongs or for which such person acts as an agent, while a person falling within categories (d) and (e) may act independently from any specific insurance companies.

A person falling within categories (b)–(e) may act on a commission or brokerage basis, as discussed in the following sections.

B. Insurance agents

An insurance agent receives commissions from insurance companies in consideration for acting as an agent or intermediary for them. Such commissions are generally calculated based on the insurance premium amounts paid by policyholders. In general, no other commissions (eg those for claims handling services) are payable by insurance companies or policyholders.

Insurance agents are not required to disclose publicly or to policyholders the amounts of their commissions or the rate used for calculation thereof.

C. Insurance brokers

An insurance broker receives commissions in consideration for acting as an intermediary for conclusion of insurance contracts. Such commissions are generally calculated based on insurance premium amounts and must be paid by insurance companies; insurance brokers may receive no such commissions from policyholders (section V-4-4(1) of the Guidelines).

Insurance brokers may receive commissions from policyholders for other services, provided that the insurance brokers disclose the details of such commissions to the policyholders. Such commissions are subject to the policyholders' prior consent (section V-4-4(2) of the Guidelines).

Insurance brokers are required to submit an annual business report to the competent Local Finance Bureau setting forth, among others, the aggregate amount of intermediary commissions received from life insurance intermediary, non-life insurance intermediary and small amount and short-term insurance intermediary activities (Article 304 of the IBA and Article 238 of the IBA Enforcement Ordinance). Additionally, insurance brokers are required to disclose to policyholders, upon request, amounts of commission to be received regarding contemplated insurance contracts, the names of major insurers for which such insurance brokers act as intermediaries and the percentages of aggregate commissions received from each such major insurer (Article 297 of the IBA and Article 231, item 1 of the IBA Enforcement Ordinance). For the purpose of this requirement, the term 'major insurers' has a somewhat flexible meaning, but generally refers to the four largest insurers in terms of the amount of commissions received by the insurance broker in its two most recent fiscal years (section V-5-1 of the Guidelines).

7. HOW ARE AGENTS (BROKERS AND UNDERWRITING AGENTS AND THIRD PARTY CLAIMS ADMINISTRATORS) REGULATED?

A. Insurance brokers

To commence business as an insurance broker, the candidate must file an application for registration and be registered with the competent Local Finance Bureau (Article 287 of the IBA and Article 218 of the IBA Enforcement Ordinance). Any officer or employee may engage in insurance intermediary activities by first filing a notification of name and date of birth with the competent Local Finance Bureau (Article 302 of the IBA).

An insurance broker is additionally required to post a deposit of not less than 40 million yen with a governmental deposit office (Article 291 of the IBA and Article 41 of the IBA Enforcement Order). The required amount of deposit is expected to be reduced to 20 million yen in the near future in light of a report dated 7 June 2013 entitled 'New Insurance Products/Services and Solicitation Rules' by the Working Group on the Provision of Insurance Products/Services of the Financial System Council. (The Financial System Council is an advisory body belonging to the FSA.)

In addition to such reduction, various other changes are expected based on the report, including various amendments to the IBA which were approved by the Japanese Diet in May 2014 and will take effect within two years thereafter. Under the IBA as so amended (the Amended IBA), insurance brokers, as well as insurance agents and other categories of insurance sales forces, will be required to take necessary measures to ensure appropriate and sound insurance sales operations, including explanations to customers of important matters and appropriate handling of customer information (Article 294-3 of the Amended IBA).

Under the IBA as currently in effect and other applicable laws, insurance brokers are subject to various requirements regarding their insurance intermediary activities, including:

- indication of name, address, power and authority, and certain other information, when intermediating insurance contracts (Article 296 of the IBA);
- disclosure of commission amounts and related information upon request from customers (Article 297 of the IBA);
- preparation and delivery of closing documents when intermediated insurance contracts are concluded (Article 298 of the IBA and Article 546 of the Commercial Code);
- preparation and retention of business records (Article 547 of the Commercial Code);
- fiduciary duty in intermediating insurance contracts (Article 299 of the IBA);
- restrictions on intermediating insurance contracts if the policyholder or insured is the insurance broker itself or his or her employer (each, a 'self-insurance contract') (Article 295 of the IBA); and
- making available an alternative dispute resolution mechanism for customer use.

B. Other categories of sales forces

As discussed in section 6.1.A above, officers and employees of insurance companies, insurance agents, and officers and employees of insurance agents may engage in insurance sales activities. Among these, officers and employees of life insurance companies, life insurance agents, officers and employees of life insurance agents, and non-life insurance agents must all file applications for registration and be registered with the competent Local Finance Bureau (Article 277 of the IBA and Article 213 of the IBA Enforcement Ordinance).

Officers and employees of non-life insurance agents are merely required to file notifications of their names and dates of birth with the competent Local Finance Bureau, while officers and employees of non-life insurance companies are not required to be registered or to file notifications (Article 302 of the IBA).

Insurance sales forces (other than insurance brokers and their officers and employees) are subject to various regulations regarding their sales activities, including a requirement to inform customers of:

- their names;
- the name of the insurance company for which they act; and
- whether they act as agents or intermediaries (Article 294 of the IBA and Article 272-2 of the IBA Enforcement Ordinance).

Non-life insurance agents are prohibited from participation in sales of self-insurance contracts if the amount of premiums therefor exceeds half of the aggregate premiums for all insurance contracts sold by such agent (Article 295 of the IBA). A life insurance sales force is prohibited under industry-level self-regulation from sale of self-insurance contracts if the premiums therefor are effectively discounted or refunded.

C. Common regulations

All categories of insurance sales forces are subject to various requirements, including the obligation to provide information regarding important terms and conditions of insurance contracts, prohibition of provision of special benefit to policyholders and prohibition of solicitation by offering of conclusive judgment (Article 300 of the IBA).

D. Claims administration

It is generally understood in Japan that determination of amounts of insurance proceeds actually payable upon the occurrence of insured events is a core business of insurance companies, and may not be outsourced to third parties. As a result, Japanese insurance companies do not comprehensively outsource claims administration procedures. Partial outsourcing to third parties which provide ancillary services, such as damage investigation, does exist.

8. IS TAKAFUL POSSIBLE?

Takaful refers to certain insurance products which conform to Muslim principles. The Japanese insurance regime has no specific regulations intended to regulate insurance products falling within takaful.

Accordingly, marketing of any insurance product that is takaful will be subject to approval of general terms and conditions, a statement of business procedures, and a statement of premium and policy reserve calculations as generally required under the IBA, which will be scrutinised by the FSA in line with its general practice for insurance products marketed in Japan.

9. WHAT SCOPE IS THERE FOR MICROINSURANCE?

The Japanese insurance regime has no specific regulations addressing 'microinsurance', a general term for certain insurance products targeting lower-income households. Accordingly, insurance products purporting to constitute microinsurance will be subject to approval under the IBA as currently in effect.

In a category somewhat resembling microinsurance, relatively small-sized insurance products with terms of up to one year (or two years in the case of non-life insurance products) and with insured amounts of up to 10 million yen (or less for certain classes) may be sold under a simplified licensing system called the small amount and short-term insurance system (Articles 272–274 of the IBA).

The IBA also expressly waives the licensing requirement for certain insurance programmes, including those operated by local governments for their residents and those offered within companies, labour unions, schools or certain other closed communities (Article 2 of the IBA).

Moreover, a contractual mechanism exists in Japan with some resemblance to insurance contracts, in which a group is formed, collects small, uniform payments from all members and then makes payments of congratulatory or condolence money to members upon the occurrence of specified events and in specified amounts. Such mechanism, if individual payments do not exceed 100,000 yen, is considered not to be subject to the IBA's licensing requirement.

10. EXIT SOLUTIONS – WHAT SOLUTIONS ARE AVAILABLE AND HOW DO THEY OPERATE? HOW ARE FOREIGN SOLUTIONS RECOGNISED?

10.1 Portfolio transfer

We understand that in some jurisdictions cession of blocks of insurance policies is sometimes used to effectively 'close the books' on such policies from the perspective of the ceding insurance company, therefore constituting a form of portfolio transfer. In line with this, it is generally possible under Japanese law for an insurance company to cede a block of insurance contracts to a reinsurer and thereby transfer financial risk with respect thereto.

We understand, however, that in some jurisdictions the reinsurer, in addition to assuming the relevant financial risk, may also assume sole

responsibility for management of the portfolio following cession. In Japan, the ceding insurance company generally retains the management responsibility for such portfolio.

10.2 Statutory portfolio transfer

A. Overview

The IBA provides a portfolio transfer mechanism for licensed Japanese insurance companies to transfer insurance contracts to other licensed Japanese insurance companies (Articles 135–141 of the IBA). Under this mechanism, the transferring company may, upon mutual agreement with the transferee company, comprehensively transfer all (but not some only) of its insurance contracts for which it has calculated policy reserve on the same basis. By contrast, it is generally understood (although subject to argument among legal scholars) that transfer of individual insurance contracts is prohibited by the IBA notwithstanding agreement by all relevant parties.

It is also generally understood that an insurance company transferring its business, in whole or in part, to another company by way of business transfer must also observe the provisions of the IBA covering portfolio transfer, if insurance contracts will be transferred through such business transfer.

B. Procedures

The procedures for a statutory portfolio transfer under the IBA are as outlined below.

(a) The transferring company makes available for shareholder and policyholder inspection the transfer agreement and the balance sheets of both the transferor and transferee (Article 136-2 of the IBA).
(b) The transferor and the transferee obtain approval of transfer from their respective general shareholders' meetings (Article 136 of the IBA).
(c) The transferor gives public notice, with an objection period of one month or more, summarising the transfer agreement and the balance sheets of the transferor and transferee (Article 137, paragraphs 1 and 2 of the IBA).
(d) The transferor and transferee file an application for approval with the FSA, and obtain such approval (Article 139 of the IBA).
(e) The transferor gives public notice of the implementation of the transfer and certain other matters (Article 140 of the IBA).

If the number and the aggregate amount of receivables held by policyholders who lodge objections exceeds one-tenth (one-fifth, if the portfolio transfer will transfer all insurance contracts) of the number and aggregate amount of receivables held by all policyholders, then the contemplated portfolio transfer may not proceed (Article 137, paragraph 3 of the IBA).

Otherwise, all policyholders will be deemed to have approved the portfolio transfer – provided, however, that, with respect to any policyholders who lodge objections and demand termination of their insurance contracts upon implementation of the transfer, the relevant

insurance contracts shall be terminated and refunds paid (Article 137, paragraphs 4 and 5 of the IBA).

10.3 Novation

Novation is a contract transfer mechanism under which an individual contract is transferred based on a three-way agreement between the transferor, the transferee and the remaining party. As discussed in section 10.2.A above, it is generally understood in Japan that transfer of insurance contracts must be implemented through the statutory portfolio transfer mechanism, and transfer of individual insurance contracts is prohibited, notwithstanding the agreement of all relevant parties.

This understanding is rationalised by, among others, a principle espousing equality of treatment among policyholders. Based on this principle, if any potential inequality exists, a transfer mechanism in which individual insurance contracts are transferred based on the relevant parties' agreement (such as novation) will not be available to Japanese insurance companies.

10.4 Commutation

In the context of reinsurance, commutation is generally understood to mean a mechanism in which a reinsurance contract is terminated based on an agreement between the reinsurer and the reinsured, with outstanding receivables and payables between them, as well as liabilities for the remaining period, settled. There appears to be no particular obstacle to this mechanism under Japanese law, and Japanese insurance companies may utilise this mechanism.

Regarding insurance contracts between insurance companies and customers, Japanese insurers as a matter of practice generally accept customer requests for early termination of insurance contracts, with any premiums already paid in respect of the remaining period refunded in such circumstances. No other commutation-like mechanisms are observed in the Japanese insurance market.

10.5 Policy buy-back

Policy buy-back generally refers to insurance contract termination where negotiations are initiated by the insurer. As indicated in the second paragraph of section 10.4 above, no such mechanisms are generally used in the Japanese insurance market.

10.6 Solvent scheme

'Solvent scheme' appears to refer to a mechanism utilised in other jurisdictions in which a company negotiates with a large number of creditors and a compromise reached among them is further reviewed by the courts. There is no similar mechanism under the IBA, and it is generally understood in Japan that transfers of insurance contracts must take the form of a statutory portfolio transfer, as discussed in section 10.2 above.

10.7 Assignment

'Assignment' appears to refer to a mechanism utilised in other jurisdictions to transfer the rights of a party to an insurance contract, and a similar mechanism is available in Japan. In particular, assignment is typically used in Japan to enable an insured to grant a pledge on an insurance benefit to a third party creditor, with the right of claim over such benefit transferred from the insured to the creditor. Obviously, this is not useable as an exit solution for insurance companies.

Contact details

GENERAL EDITOR

Clive O'Connell
Goldberg Segalla Global LLP
1st Floor, 65 Leadenhall Street
London EC3A 2AD
T: +44 20 3371 5460
F: +44 20 3371 5451
E: coconnell@goldbergsegalla.com
W: www.goldbergsegalla.com

BERMUDA

Rod Attride-Stirling, Neil Horner & Kim Willey
ASW Law Limited
Crawford House
50 Cedar Avenue
Hamilton HM11
Bermuda
T: +1 441 295 6500
F: +1 441 295 6566
E: Rod.Attride-Stirling@aswlaw.com
Neil.Horner@aswlaw.com
Kim.Willey@aswlaw.com
W: www.aswlaw.com

BRAZIL

Marta Viegas
TozziniFreire Advogados
Rua Borges Lagoa, 1328
São Paulo, SP, 04038-904
T: +55 11 5086 5233
F: +55 11 5086 5555
E: mviegas@tozzinifreire.com.br
W: www.tozzinifreire.com.br

CANADA

Jeffrey S Graham & Crawford W Spratt
Borden Ladner Gervais LLP
Scotia Plaza, 40 King Street W
Toronto, ON, M5H 3Y4
T: +1 416 367 6174 (JSG direct)
+1 416 367 6318 (CWS direct)
F: +1 416 361 7377
+1 417 361 7305
E: jgraham@blg.com
cspratt@blg.com

CAYMAN ISLANDS

John Dykstra & Abraham Thoppil
Maples and Calder
PO Box 309, Ugland House
South Church Street
George Town
Grand Cayman KY1-1104
T: +1 345 949 8066
+1 345 814 5530 (JD direct)
+1 345 814 5366 (AT direct)
F: +1 345 949 8080
E: john.dykstra@maplesandcalder.com
abraham.thoppil@maplesandcalder.com
W: www.maplesandcalder.com

CHILE

Alejandro Acuña & Emilio Sahurie
Acuña, Sahurie, Hoetz & Cifuentes
Av Américo Vespucio Sur 80 2nd Floor
Las Condes
Santiago
T: +56 2 2206 4337
E: a.acuna@acuna-sahurie.com
e.sahurie@acuna-sahurie.com
W: www.acuna-sahurie.ccom

CHINA

Zhan Hao
AnJie Law Firm
26/F, Tower D, Central International Trade Center
6A Jianguomenwai Avenue
Chaoyang District
Beijing 100022
T: +86 10 8567 5988

+86 10 8567 5966 (direct)
F: +86 10 8567 5999
E: zhanhao@anjielaw.com
W: www.anjielaw.com

FRANCE

Jacques Henrot & Olivier Hubert
De Pardieu Brocas Maffei A.A.R.P.I.
57 Avenue d'Iéna – CS 11610
F-75773 Paris Cedex 16
T: +33 1 53 57 71 71
+33 1 53 57 61 75 (direct)
F: +33 1 53 57 71 70
E: hubert@de-pardieu.com
W: www.de-pardieu.com

GERMANY

Henning Schaloske & Oliver Sieg
Noerr LLP
Speditionstr. 1,
40221 Düsseldorf
T: +49 211 49986 236
E: henning.schaloske@noerr.com
oliver.sieg@noerr.com
W: www.noerr.com

GIBRALTAR

Peter Albert Isola &
Christian James Caetano
ISOLAS
Portland House
Glacis Road
Gibraltar
T: +350 200 01892
F: +350 200 78990
E: peter.isola@isolas.gi
christian.caetano@isolas.gi
W: www.gibraltarlawyers.com

GREECE

Theodore Panagos
PFG Law Firm
9, Hippocratous, Street
106 79 – Athens
T: +30 210 36 14 974-5
F: +30 210 36 14 979
E: panagos@pfglawfirm.com
W: www.pfglawfirm.com

Eleni Iacovides
Goldberg Segalla Global LLP
1st Floor, 65 Leadenhall Street
London EC3A 2AD
UK
T: +4420 3371 5470
F: +4420 3371 5451
E: eiacovides@goldbergsegalla.com
W: www.goldbergsegalla.com

GUERNSEY

Frances Watson, Amanda Mochrie &
James Cooke
Ogier
Ogier House
St Julian's Avenue
St Peter Port
Guernsey GY1 1WA
Channel Islands
T: +44 1481 721672
F: +44 1481 721575
E: Frances.Watson@ogier.com
Amanda.Mochrie@ogier.com
James.Cooke@ogier.com

IRELAND

James Grennan & Laura Mulleady
A&L Goodbody
IFSC
North Wall Quay
Dublin 1
T: +353 1 649 2000
+353 1 649 2318 (JG)
+353 1 649 2609 (LM)
F: +353 1 649 2649
E: jgrennan@algoodbody.com
lmulleady@algoodbody.com
W: www.algoodbody.com

JAPAN

Naokuni Fukuda
Anderson Mōri & Tomotsune
Akasaka K-Tower
2-7, Motoakasaka 1-chome
Minato-ku, Tokyo 107-0051

T: +81 3 6888 1195
F: +81 3 6888 3195
E: naokuni.fukuda@amt-law.com

NORWAY

Agnar Langeland
Advokatfirmaet Thommessen AS
Vestre Strømkaien 7
PO Box 43 Nygårdstangen
NO-5838 Bergen
T: +47 55 30 61 29
M: +47 93 40 32 13
E: ala@thommessen.no
W: www.thommessen.no

SPAIN

Jorge Angell
L.C. Rodrigo Abogados
Calle Lagasca 88, 4th floor,
28001 Madrid
T: +34 91 435 54 12
F: +34 91 576 67 16
E: jangell@rodrigoabogados.com
W: www.rodrigoabogados.com

SWITZERLAND

Christopher L. Bell, Lars Gerspacher
& Sara Andrea Behrend
gbf Attorneys-at-law
Hegibachstrasse 47
P.O. Box 1661
8032 Zurich
T: +41 43 500 48 50
F: +41 43 500 48 60
E: gerspacher@gbf-legal.ch
bell@gbf-legal.ch
behrend@gbf-legal.ch
W: www.gbf-legal.ch

UAE

Michael Kortbawi
Bin Shabib & Associates
Level 6, Building 3, The Gate
Precinct
Dubai International Financial Centre
P.O. Box 262, Dubai
T: +971 4 3685555
E: michael.kortbawi@bsa.ae
F: +971 4 368 5000
W: www.bsa.ae

UK

Clive O'Connell, Tanguy Le Gouellec
de Schwarz & Darren Hanison
Goldberg Segalla Global LLP
1st Floor, 65 Leadenhall Street
London EC3A 2AD
T: +44 20 3371 5460 (CO'C)
+44 20 3371 5480 (TDS)
+44 20 3371 5490 (DH)
F: +44 20 3371 5451
E: coconnell@goldbergsegalla.com
tschwarz@goldbergsegalla.com
dhanison@goldbergsegalla.com
W: www.goldbergsegalla.com

US

Helen Franzese
Goldberg Segalla Global LLP
1st Floor, 65 Leadenhall Street
London EC3A 2AD
UK
T: +44 20 3371 5454
F: +44 20 3371 5451
E: hfranzese@goldbergsegalla.com

Frederick J Pomerantz
Goldberg Segalla LLP
600 Lexington Avenue/Suite 900
New York, NY 10022
T: +1 646 292 8726
F: +1 646 292 8701
E: fpomerantz@goldbergsegalla.com

Aaron J Aisen
Goldberg Segalla LLP
665 Main Street, Suite 400
Buffalo, NY 14203-1425
T: +1 716 566 5483
F: +1 716 566 5401
E: aaisen@goldbergsegalla.com
W: www.goldbergsegalla.com