US efforts against money laundering could ensnare insurers

Recent cases against banks hint at the way insurers could be treated

Jeffrey Beatrice, Brian Egan and Jack Hayes
Steptoe & Johnson

In a warning to insurers as well as to the banks, the US Department of Justice (DOJ) and federal financial regulators announced major public enforcement actions against two large banks with significant international business dealings, resulting in a guilty plea, a deferred prosecution agreement (DPA) and near-record fines and penalties.

Both financial institutions failed to comply with Bank Secrecy Act/Anti-Money Laundering (BSA/AML) requirements. They failed – and in some instances wilfully failed – to maintain procedures reasonably designed to assure and monitor compliance with the requirements of the BSA, including detecting suspicious activity indicative of money laundering, terrorist financing, and other crimes and reporting suspicious transactions.

In some instances, these deficiencies, coupled with inadequate controls and lack of strong management and reporting structures, also led to fraudulent reporting to bank regulators regarding money laundering activity.

On February 8, Rabobank National Association (Rabobank), a California subsidiary of the Netherlands-based Rabobank UA, pleaded guilty to conspiracy to obstruct the examination of a financial institution, in violation of 18 USC § 1517 and 18 USC § 371, by obstructing Treasury's Office of the Comptroller of the Currency (OCC) in its examination of Rabobank's BSA/AML compliance programme.

In the plea agreement, the bank admitted it processed funds without adequate AML review. Due to its deficient AML programme, Rabobank allowed hundreds of millions of dollars in untraceable cash – allegedly money connected to drugs and illegal activities – to be deposited into bank branches in Imperial County, California and transferred via wire transfers, cheques and cash transactions, without notifying US federal authorities, as required.

In the second case, the DPA states that from 2009 to 2014, US Bank operated with limited compliance resources, hindering the effectiveness of its AML programme. In 2012, for instance, the bank had more than $340bn in assets and only 32 AML investigators.

US Bank also reportedly paid its investigators below-market salaries and did not provide adequate funding for computers and hardware, causing delays in necessary upgrades to their compliance software. Further, the DPA states that US Bank filled oversight positions with individuals who lacked AML experience.

The $368,701,259 fine imposed on Rabobank and the $613m fine imposed on US Bancorp are among the largest penalties financial institutions have incurred as a result of deficient AML programmes.

Financial institutions with a history of BSA/AML deficiencies are at risk of greater penalties for failing to correct AML deficiencies.

Both the Rabobank and the US Bancorp enforcement actions once again demonstrate that financial institutions continue to face scrutiny and potentially large monetary sanctions, as well as criminal charges, as a result of deficiencies in their BSA/AML compliance programmes.

We strongly advise that our financial institution clients regularly evaluate their existing BSA/AML compliance programmes, including a review of existing approaches, due diligence monitoring and alert systems, policies, and procedures. In addition, both cases serve as a stark reminder of the often-noted admonition by regulators and prosecutors that managers proceed at their own risk when they fail to value, emphasise, and adequately fund compliance programmes. A strong culture of compliance can only be achieved through a strong message from a company's board and senior management, as well as a strong reporting structure emanating from the very top of the organisation.

Finally, these cases demonstrate the importance of co-operating with regulators. In both cases, managers were in contact with relevant regulators and failed to disclose – or even acted to conceal – AML deficiencies. These actions resulted in more severe penalties and, in the case of Rabobank, provided the basis for the conspiracy charges to which Rabobank ultimately plead guilty. ■

Jeffrey Beatrice and Brian Egan are partners, and Jack Hayes of counsel at Steptoe & Johnson

Indian brokers face myriad new rules

Celia Jenkins and Priya Misra
Tuli & Co

The 2017/18 financial year has been eventful for the Indian insurance sector, with several landmark changes introduced into the regulatory framework.

Among others, the Insurance Regulatory and Development Authority of India (IRDAI) issued the IRDAI (Insurance Web Aggregators) Regulations 2017, the IRDAI (Outsourcing of Activities by Indian Insurers) Regulations 2017, the IRDAI (Appointed Actuary) Regulations 2017 and the IRDAI (Protection of Policyholders' Interests) Regulations 2017, to update the existing regulatory framework. In the middle of these landmark changes, the IRDAI released an exposure draft for revising the IRDAI (Insurance Brokers) Regulations 2013 for comments. Following various representations made by insurance brokers and other stakeholders, the IRDAI issued the IRDAI (Insurance Brokers) Regulations 2018 to repeal the erstwhile 2013 regulations.

The 2018 regulations prescribe the conditions in accordance with which an insurance broker may perform risk management services for commercial risks for a fee. The term 'risk management services' is defined to mean the provision of services such as risk assessment, risk advisory, risk mitigation or risk minimisation for the benefit of a client. Under the 2013 regulations, an insurance broker was permitted to undertake claims consultancy for claims up to Rupee10m ($153,520). This limit has been increased to Rupee100m, with regard to commercial lines of general insurance business. The insurance broker may undertake claims consultancy above the prescribed limit, with the prior IRDAI approval.

The new regulations set out express norms with respect to the outsourcing of activities. Insurance brokers are now expressly prohibited from outsourcing their functions listed in the 2018 regulations to third-party service providers.

In addition, insurance brokers are prohibited from outsourcing risk management and claims consultancy services, unless the insurance broker does not undertake this activity at all. Every insurance broker must put in place a board-approved outsourcing policy. All outsourcing arrangements where annual payment per outsourcing service provider is Rupee1m or more must be reviewed by the board of directors.

Every insurance broker must now have a board-approved policy on soliciting insurance policies including, among other things, the approach to be followed by the insurance broker regarding multiple tie-ups, types of product sold, modes of solicitation, grievance redressal mechanisms, reporting requirements and any other item with regard to different business segments. This policy must be reviewed every three years.

The 2013 regulations stipulated the norms that an insurance broker must follow to undertake online sales. In March 2017, the IRDAI released the E-commerce Guidelines and then the Web Aggregators Regulations, which prescribed additional norms applicable to insurance web aggregators for the sale and servicing of insurance products on the designated website of the insurance web aggregator.

Perhaps to ensure uniformity, the 2018 regulations stipulate that an insurance broker must comply with the E-commerce Guidelines and the Web Aggregators Regulations, with respect to the sale of insurance online by the broker. However, it is still unclear to what extent the Web Aggregators Regulations apply to insurance brokers.

Further, insurance brokers must now comply with the Web Aggregator Regulations with respect to solicitation and procurement of insurance using telemarketing and distance marketing modes. Insurance brokers are permitted to undertake outsourcing activities in the form of telemarketing and distance marketing for insurers.

The 2018 regulations now expressly clarify that an insurance broker is permitted to receive fees for undertaking services provided to the client, as permitted, including claims consultancy, risk management services or other similar services that are not a percentage of premium or claim amounts. These fees are distinct from remuneration that may be earned by the insurance broker for solicitation and procurement of insurance business.

In relation to placement of reinsurance business, the 2018 regulations stipulate that composite and reinsurance brokers must enter into a terms of business agreement with the (re)insurer, setting out the minimum terms as prescribed under the regulations. It appears that the new 2018 regulations, while increasing the compliance requirements, have also attempted to create a level playing field between brokers and web aggregators. Further, by way of the new norms, there is a distinct focus on building better controls and corporate governance. ■

Celia Jenkins is a partner and Priya Misra an associate at Tuli & Co

Insurance broker wins key VAT case

Hastings Insurance has emerged triumphant in a case with important implications for those doing business across borders

Chris Mortimer
Macfarlanes

Hastings provided broking, claims-handling and underwriting support services to Advantage, a company from Gibraltar
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Insurers and insurance brokers should take note of a recent decision that governs the way they handle VAT payments on cross-border business.

The First Tier Tribunal (FTT) recently released its decision in *Hastings Insurance Services Ltd v HMRC* [2018], concerning an arrangement whereby a UK company, Hastings, provided broking, claims-handling and underwriting support services to Advantage, a Gibraltarian company. Advantage underwrote and supplied UK motor vehicle insurance.

It was accepted by HMRC that the services provided by Hastings to Advantage and those supplied by Advantage to the insured would both qualify for VAT exemption if supplied in the UK.

However, Hastings considered that its services were supplied in Gibraltar, on the basis that this was where its customer (Advantage) belonged. Because Gibraltar is outside the EU for VAT purposes, supplies of certain VAT-exempt financial services that are made to Gibraltarian customers give the supplier the right to recover VAT on its costs – a right the supplier would not have if its customers belonged in the EU.

Advantage operated from Gibraltar, where it employed actuaries and underwriters, as well as finance and administrative staff. Advantage decided what risk to insure and for what price; set the reserving philosophy and claims-handling guidelines; and dealt with large loss claims, reinsurance, regulation and accounting, investment of funds received, the making of actuarial reserves and auditing.

HMRC argued that Advantage had a fixed establishment in the UK for VAT purposes by virtue of the nature of the activities conducted in the UK by Hastings and the extent of the control exercised by Advantage over those activities. Furthermore, HMRC argued that Hastings supplied its services to the fixed establishment of Advantage that Hastings had itself created.

HMRC placed particular emphasis on the fact that Hastings and Advantage were owned by a common parent and customer-facing functions relating to the insurance provided by Advantage were undertaken by Hastings in the UK. Also, under the long-term agreement between Hastings and Advantage, Advantage had control of the risks that could be insured, the policy wording, pricing of policies and ultimately over claims handling.

The FTT decided against HMRC, focusing in its judgment on the nature and extent of the activities conducted in Gibraltar, as well as the arm's length nature of the agreement between Advantage and Hastings and the degree of autonomy exercised by the management teams of Advantage and Hastings.

The FTT found that the agreement between Advantage and Hastings was negotiated on an arm's length basis. Hastings and Advantage was each run by its own board according to its own commercial aims and with its own profit targets and budgets.

Decisions, including as to what level of commission to charge, were taken by Hastings independently and with a view to its own interests. Hastings took its own financial risk, set its own staff levels and had autonomy as regards the day-to-day running of the functions it was engaged to undertake.

The extent of Hastings' independence meant that the UK resources of Hastings should not be taken into account in determining whether Advantage had a fixed establishment in the UK.

In any event, the FTT found that, even if the resources of Hastings were properly attributable to Advantage, Advantage would still not have a fixed establishment in the UK. To have a fixed establishment in the UK, Advantage would need to have in the UK all of the resources required to make supplies of insurance. The functions undertaken by Advantage in Gibraltar were essential to the provision of insurance and the UK resources of Hastings alone were therefore not sufficient to create a fixed establishment of Advantage.

The decision to deny input VAT recovery to Hastings represents the latest challenge by HMRC against non-EU businesses that provide VAT-exempt financial services to UK customers

The decision to deny input VAT recovery to Hastings represents the latest challenge by HMRC against non-EU businesses that provide VAT-exempt financial services to UK customers and receive related support services from UK suppliers.

'Abusive' arrangement

In *Ocean Finance* [2015], HMRC argued that an arrangement similar to that considered in *Hastings* was 'abusive', meaning the essential aim of the arrangement was to gain a tax advantage that was contrary to the purpose of the law. HMRC's arguments have so far been unsuccessful and a decision of the Court of Appeal is expected later this year.

HMRC has also consulted on the imposition of a new rule that would see advertising services being subject to UK VAT, to the extent that the advertising physically takes place in the UK, regardless of where the recipient of the service is based.

Finally, arrangements similar to those considered in *Hastings* and *Ocean Finance* will often require disclosure to HMRC under the regime for the disclosure of VAT-avoidance schemes.

If a business that purports to belong outside the EU in fact carries on its business from the UK, then a challenge from HMRC can quite rightly be expected. However, HMRC has so far been unsuccessful in its attempts to persuade the tribunals and courts that businesses that are, as a matter of fact, carried on outside the UK should be treated for VAT purposes as though they were carried on in the UK.

In *Ocean Finance*, the tribunal discussed a hypothetical scenario whereby a Jersey company set up by Jersey investors provides VAT-exempt financial services to UK customers and outsources certain functions to a UK supplier. The tribunal did not consider that the arrangement would give rise to any question of abuse.

If HMRC's reasoning in *Ocean Finance* was correct, then non-EU businesses that originated to any extent from the UK would presumably be more likely to be seen as belonging in the UK for VAT purposes than those that do not.

Aside from acting as a disadvantage to businesses originating from the UK, such an approach would require the extent to which a business originated from the UK to be measured and a tipping point to be defined, neither of which would be straightforward.

Similarly, if the approach in *Hastings* was correct, it would be extremely difficult for any non-EU business that supplies services to UK customers and also procures services from UK suppliers to determine the point at which it is deemed to belong in the UK. Unlike corporation tax, which generally requires profits to be allocated on a sliding scale, the VAT analysis is all or nothing: either the business belongs in the UK, or it does not.

Hastings acts as a reminder of the importance of ensuring that the way in which the activities of a business are characterised for VAT purposes reflects the commercial reality on the ground, as well as the importance of ensuring that the commercial reality is appropriately reflected in relevant agreements and governance structures.

HMRC may well appeal the decision but, in the meantime, it gives welcome clarity to businesses that operate across borders. ■

Chris Mortimer is head of VAT at Macfarlanes