The New Insurance Legal and Regulatory Framework in Mexico: A Year in Retrospect

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I. Introduction

Almost a year has passed since the previous General Law of Insurance Institutions and Mutual Companies (*Ley General de Instituciones y Sociedades Mutualistas de Seguros*) ("LGSIMS") was abrogated and no longer applicable in Mexico. With the legal reform driven by the new Insurance and Surety Institutions Law (*Ley de Instutuciones de Seguros y de Fianzas*) (the "LISF") and the Unified Insurance and Surety Regulations (*Circular Unica de Seguros y Fianzas*) ("CUSF") – which entered into force on April 4, 2015 – a remarkable change has occurred in the legal framework of insurance and surety in Mexico.

During 2015, most of the headlines in Mexican papers were filled with news about the privatisation of the oil and gas industry and the demise of the state-owned monopoly. The deep reforms impacting the insurance sector have received much less attention; nonetheless, the new legal environment promises to add dynamism to what has long been regarded as a lacklustre industry.

This article generally describes the new legal framework and highlights some of the structural, legal and regulatory issues that have gained relevance during the first year since the enactment of the LISF and the CUSF.

II. The New Legal Framework, Generally

The most important objective of the LISF is to implement the Solvency II framework in Mexico. Also, an important development from a structural perspective is that the regulatory and supervisory authority for the insurance and surety sector – which had been shared amongst the Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*) ("SHCP") and the National Insurance and Surety Commission (*Comisión Nacional de Seguros y Fianzas*) ("CNSF") has been consolidated into the latter. Moreover, the LISF merges two separate statutes that applied to the insurance business on the one hand and the surety business on the other: the General Law of Insurance Institutions and Mutual Companies (*Ley General de Instituciones y Sociedades Mutualistas de Seguros*) ("LGSIMS") and the Federal Surety Institutions Law (*Ley Federal de Instituciones de Fianzas*) ("LFIF").

Pursuant to its transitory provisions of the LISF and the CUSF, Pillar 2 of the Solvency II framework, which implements the Supervisory Review mechanism, entered into force on April 4, 2015. The provisions of the LISF and CUSF relating to quantitative and disclosure requirements corresponding to Pillars 1 and 3 of the Solvency II framework entered into force on January 1, 2016.

III. Unification of Regulatory Powers

The centre of gravity of insurance and surety regulation has shifted to the CNSF, which in terms of the LISF now takes responsibility for the licensing, surveillance and enforcement authority previously shared with the SHCP.

The binary system that existed until recently, where SHCP was responsible for granting, modifying and cancelling licences to insurance and surety companies (subject to the technical opinion of the CNSF), had become highly inefficient. Such system allowed a "ping-pong" bureaucracy where it was not uncommon for SHCP and CNSF to take diverging views on the same issue. This situation worsened during the transitional period of two years preceding the entry into force of the LISF, with ensuing regulatory uncertainty in the sector.

The unification powers in the CNSF now allows for a "process approach" where the same regulator follows the regulated entities from their initial licensing, accompanies them through their productive life and, as the case may be, into their mandatory or voluntary liquidation. This approach facilitates the close monitoring of compliance with Solvency II standards and the ability to take effective action upon departure from such standards by giving CNSF the ability to use a wide array of measures, ranging from the compelling to the harsh.

At the heart of such approach is the Governance Board (*Junta de Gobierno)* of the CNSF. Although the Governance Board already existed under the previous legal regime, it has now acquired particular relevance as Article 369 of the LISF lays out its ample powers, some of which correspond to the authority formerly vested on SHCP. Although SHCP still has the right to appoint four of the thirteen members of the Governance Board, the role that SHCP plays is more focused on defining policy guidelines for the sector.

From a transactional perspective, the importance of the Governance Board cannot be understated in light of the fact that it has the authority to approve mergers and acquisitions of insurance and surety companies (including indirect changes of control), as well as the transfer of policy portfolios amongst them. Because the Governance Board convenes on a bi-monthly basis, applications for such types of approvals must be complete and validated by the relevant areas of the CNSF and by a committee that prioritises and lines up the matters to be submitted to the Board's consideration. Accordingly, the right timing in the delivery of additional information requested by CNSF in connection with applications is of the essence in order to ensure the timely approval of transactions.

Another noteworthy development that occurred during 2015 was the appointment of a new Chairperson of the CNSF. Mr. Manuel

Aguilera stepped down after 17 years of serving as Chairman of the CNSF once his brainchild, the new legal and regulatory framework, was put into place. His successor, Ms. Norma Alicia Rosas, is very respected and well regarded in the insurance sector with a long history of service at senior positions with CNSF and also with a private sector perspective having served as Technical Director of Allianz in Mexico from 2012 to 2014. Ms. Rosas will have the task of seeing through the implementation of the new regime and will need to overcome the challenges of a CNSF that has grown in its responsibilities but thas not grown proportionally in its staffing and is, at times, overwhelmed with having to serve an ever more demanding and complex insurance sector that needs timely approvals and definitions.

IV. Foreign Reinsurers

As had been the case under the previous legislation, the LISF requires that foreign reinsurers be registered with the General Registry of Foreign Reinsurers (*Registro General de Reaseguradores Extranjeros*) ("RGRE") in order to assume risks from Mexican cedents. Under the LISF, the authority now in charge of maintaining the RGRE is the CNSF.

In addition to complying with existing requirements, under Chapter 34 of the CUSF, and in contrast with the requirements set forth previously in the LGSIMS, foreign reinsurers must file affidavits disclosing to the CNSF the "Patrimonial Links"[1] (*Vínculos Patrimoniales*) and "Business Links"[2] (*Vínculos de Negocios*) they have with prospective cedents and with other Foreign Reinsurers recorded with the RGRE. This new disclosure requirement relates to Rule 34.1.20 of the CUSF which reads as follows:

> "*The recording with RGRE shall not be granted or renewed with respect to foreign insurers, reinsurers or re-bonding companies or with respect to Registered Foreign Reinsurers when the majority or exclusively the operations of assumed Reinsurance or Re-Bonding have been carried out or are intended to be carried out with Institutions that have Economic Links or Business Links with them.*"

After the LISF and CUSF entered into force in April 2015, Rule 34.1.20 started raising concerns among the global insurance and reinsurance community that conducts business in Mexico. The sector's concern stemmed from the circularity and succinctness of the language of Rule 34.1.20, which allows for at least two interpretations. Rule 34.1.20 can be read in the sense of requiring that the aggregate portfolio of assumed reinsurance of a foreign reinsurer may not be conformed in its majority (i.e., more than 50%) by risks assumed from Mexican affiliate cedents. In other words, this more "businesswise" interpretation is in the sense that a reinsurers portfolio may be diversified with cedents from other jurisdictions. Furthermore, Rule 34.1.20 of the CUSF could be interpreted in a way contrary to business sense and market reality, namely that the CNSF may not grant or renew the registration with the RGRE of a foreign reinsurer that assumes reinsurance from affiliate cedents where "Mexican risks" underwritten on a direct basis by such affiliate cedents exceed the majority (i.e., more than 50%) of the reinsurer's Mexican business.

In the last few months of 2015, the conflicting interpretations of the Rule 34.1.20 of the CUSF were clarified by the CNSF, which confirmed through individual rulings issued to reinsurers on an "as requested basis" that Rule 34.1.20 will be read in accordance with the "businesswise" interpretation outlined above.

V. Cross Border Life Insurance

The new LISF contemplates a new, broader restriction applicable to non-Mexican insurers selling life insurance in Mexico.

The new LISF prohibits the sale of life insurance policies in Mexico by an insurer that is not licensed in Mexico, when the assured is present in Mexico at the time the insurance contract is entered into. Accordingly, under the LISF (as was also the case under the previous LGISMS), it is possible for Mexican and non-Mexican individuals and entities to contract life insurance abroad without contravening said prohibition, provided that the assured is not physically present in Mexico at the time the insurance is contracted (i.e., in most cases, at the time of issuance of the policy).

Under the new LISF, in addition to the restriction described above, a legal entity that contracts life insurance for an individual that is a resident of Mexico may only do so from a Mexican licensed insurer. In other words, a non-Mexican insurer that sells life insurance to a legal entity that obtains such cover on the life of an individual that is a resident of Mexico at the time of the contracting of the insurance would be in violation of the LISF; the entity contracting the insurance would also be in violation.

Accordingly, variable universal life insurance policies as private placement life insurance could be unlawful under the new framework contemplated by the LISF if contracted abroad by either Mexican or foreign legal entities when the life insured is that of a Mexican resident.

Violations to the prohibitions applicable to the cross-border sale of insurance entail harsh fines that may affect the insurer, the assured and brokers involved, as well as the risk of criminal prosecution of whoever offers and places such insurance.

VI. Surety Insurance

The LISF introduced the "surety insurance" (*seguro de caución*) as a new line of insurance business that complements the surety bond products that surety companies are authorised to issue. Article 17 of the LISF expressly provides that surety insurance shall be recognised and accepted for guaranteeing obligations assumed with the Federal and Local Governments.

This change, that would apparently open the door to unrestricted competition in the surety bond market, is curtailed by the LISF in one essential respect: insurance companies that desire to offer surety insurance must operate as mono-line insurers. The only other product that may be underwritten by mono-line surety insurance companies is credit insurance. Accordingly, existing surety companies will be protected from having to compete with property and casualty insurance companies that may discover an appetite for adding surety insurance to their product offering.

On the other hand, the LISF created an incentive for surety companies to convert into mono-line insurers. In order for a surety company to offer surety insurance in addition to surety bond products, the LISF requires that it converts into an insurance company that will receive an authorisation to underwrite both types of products (i.e., surety bonds and surety insurance). Also, there may be a more favourable tax treatment with respect to certain operational aspects of surety insurance companies as compared with the tax treatment afforded such operational aspects in surety bond companies.

VII. Conclusion

The year 2015 was crucial for the Mexican insurance and surety sector, with a number of relevant legal and regulatory issues having surfaced upon the entry into force of the LISF and CUSF on April 4. With the entry into force of Pillars 1 and 3 of the Solvency II system on January 1, 2016, the year ahead promises to be at least as eventful.

Endnotes

1. The LISF defines "Patrimonial Link" as the one that derives from pertaining to a "Consortium" or "Group of Companies" (i.e., affiliated companies).
2. The LISF defines "Business Link" as the one that derives from the execution of co-investment agreements in other companies, joint venture participation or any other type of agreement by means of which the direct or indirect control over 20% of the voting shares is attained.



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