NEW INSURANCE AND BONDING COMPANIES LAW

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I. Introduction

This article analyzes the most relevant aspects of the new Insurance and Bonding Companies Law (the "**LISF**") approved by the Mexican Congress and which will supersede both the General Insurance and Mutual Companies Law (*Ley General de Instituciones y Sociedades Mutualistas de Seguros*) (the "**LGISMS**") and the Federal Bonding Institutions Law (*Ley Federal de Instituciones de Fianzas*) (the "**LFIF**"), once it becomes effective[2].

The Bill with the LISF also includes relevant amendments to the Insurance Contract Law (*Ley sobre el Contrato de Seguro*) (the "**LCS**"), aimed to strengthen the mandatory insurance regime, regulate concurrence in liability insurance, provide specific rules for the implementation of surety insurance (*seguro de caución*) and provide rules on the exercise of rights of the insureds and beneficiaries upon entering an insurance contract.

Background

On October 25, 2012, the Senate of the Mexican Congress received the Bill with the LISF and amendments to the LCS from the President of Mexico. The purpose of the Bill was to include in a single statute the general

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[1] The authors are grateful for the support and contributions from the associates and law clerks of Nader, Hayaux & Goebel, María José Pinillos, José Andrés Rivas, Raúl Jasso, Juan Martínez del Campo, Adrián Silva and Laura Hernández, without whom, the publication of this article would not have been possible.

[2] The Transitory Articles of the LISF provide that the LISF will become effective 2 years (730 days) after its publication in the Official Gazette of the Federation, that is, on April 4, 2015. Except for the provisions regarding surety insurance (*seguro de caución*) (which will become effective on the same date in which the LISF becomes effective), the other amendments to the LCS will become effective on the next day of its publication in the Official Gazette of the Federation, that is, on April 4, 2013.

principles applicable to both insurance and bonding companies and provide such industries with a common legal framework. The Senate approved the bill on December 2012 and sent same to the Chamber of Deputies (*Cámara de Diputados*), which approved the Bill in definitive on February 28, 2013. The LISF was published in the Official Gazette of the Federation on April 4, 2013.

Notwithstanding that in our opinion it is not justified and it was not required to pass a new law to amend the legal framework applicable to insurance and bonding companies, the main reason for a new law is to incorporate all regulation applicable to insurance and bonding companies in one same law under the rationale that both financial entities share a similar legal framework, although both maintain their respective and different corporate purpose.

The LISF incorporates unto insurance and bonding companies (the "**Institutions**") some principles previously adopted by banks and broker dealers through the amendments to the Securities Market Law (*Ley del Mercado de Valores*) (the "**LMV**") in 2005 and the Banking Law (*Ley de Instituciones de Crédito*) (the "**LIC**") in 2008. In that regard, it is worth noting that the statement of purpose of the bill does not provide any explanation or clarification on the reasons why it was decided to adopt the principles established for banks and broker dealers, instead of applying principles used by other financial entities, such as per example, private pension funds managers.

The amendments to the legal framework applicable to insurance and bonding companies are also aimed to implement mechanisms similar to those that will be applicable in the European Union through Directive 2009/138/EC of the European Parliament and the Council of November 25, 2009 on taking and pursuing Insurance and Reinsurance" ("**Solvency II**"), which main pillars or basic principles are the following: **(i)** measure of assets, liabilities and capital (quantitative requirements); **(ii)** supervision (qualitative requirements); and **(iii)** disclosure, transparency and market volatility requirements. Notwithstanding that the Mexican regulator has consistently and clearly made public its decision for Mexico to adopt Solvency II principles and the fact that the legal framework has been continuously amended and adjusted for such purpose, taking such a crucial step may be premature, considering that it is not still clear under which terms and conditions Solvency II will, in its case, be adopted in Europe.

The LISF provides the basic legal framework required to implement the solvency, stability and prudential security measures to be applied under Solvency II, providing the mechanisms required by each Institution to develop their internal models to determine the solvency capital requirements pursuant to their respective risk profile, instead of a single model system determined by the regulator applicable to all Institutions. In our opinion, the legal framework being repealed was compatible with the implementation of Solvency II and, although some amendments were necessary, as previously mentioned, it was not an absolute necessity to pass a new law. In addition, the implementation of Solvency II is not limited to the LISF but will be subject to and require secondary regulations that, once the LISF becomes effective, will be issued by the National Insurance and Bonding Commission (*Comisión Nacional de Seguros y Fianzas*) ("**CNSF**").

The LISF adjust the insurance and bonding legal framework by adopting surveillance procedures similar to those established in the LMV and the LIC, as it includes a redistribution of the authorities currently granted upon the Ministry of the Treasury and Public Credit (*Secretaría de Hacienda y Crédito Público*) (the "**SHCP**") and the CNSF pursuant to the LGISMS and the LFIF. In this regard, the LISF grants specific authority on a "macro" level to the SHCP with respect to the design and operation of the insurance and bonding system, while the CNSF will have authority on all aspects related to the licensing and authorizations procedures to Institutions, going from their incorporation and operation to the revocation of their license and liquidation. Within this redistribution, the authority of the CNSF is broadened to grant such entity authority to issue general regulations aiming to regulate the Institutions, which originally resided within the SHCP. This new structure intends to standardize the legal framework of insurance and bonding companies to that of other financial entities and regulators, which, in our opinion, creates an imbalance among the traditional attribution given to the SHCP as Ministry of State and regulator of financial activities, and the attributions now granted to the CNSF under the LSIF, which from being a technical and surveillance authority becomes a much more robust regulator of the insurance and bonding sectors, with new authorities while maintaining its supervisory role.

The LISF also incorporates new corporate governance mechanisms, and reinforces those previously set forth in the LGISMS and the LISF. Among the most important changes, the LISF grants the board of directors with specific authority to determine the investment policy of the Institutions pursuant to its own risk concentration ratio. In addition, the new investment regime applicable to the Institutions provides more flexibility by allowing, in the case of investment in equity, that the Institutions invest in any security traded in regulated stock markets and, in the case of debt instruments, to invest in securities with a minimum rating to be determined by the CNSF.

Despite being a successful institution, the LISF removes the figure of the compliance officer and now will require Institutions to have an audit committee. The internal comptroller functions (*contraloría interna*) of the Institutions are now expressly recognized as such and will be required to review periodically compliance with laws and legal risks. Aligned with these measures, the LISF sets forth additional transparency measures, such as the requirement to the Institutions to hold a satisfactory credit rating and to disclose information to the public concerning its risk profile and capitalization level.

The LISF includes changes on the procedure to register insurance products, with the intent that Institutions become responsible of verifying that the documents of the insurance products are clear and comply with basic consumers' protection principles. In this regard, it is expected that the CNSF adopts a less restrictive role in the registration process of insurance products, maintaining at all times the authority to request corrective measures by means of regularization programs, when it identifies insurance products that do not comply with law and applicable regulations.

An important innovation in the LISF is that it will now allow insurance companies[3] to carry out securitizations, allowing them to transfer their insurance portfolio to a vehicle offering securities to the public-at-large.

Another relevant change and new feature of the LISF is the creation of the new "*surety insurance*" (*seguro de caución*), which will compete with bonds to secure legal or contractual obligations. The LISF provides several mechanisms aimed to guarantee that the surety insurance is accepted as a guaranty in equal conditions as those applicable to any other mechanism with similar characteristics and allows such insurance products to be offered by both insurance and bonding companies. The foregoing constitutes an interesting development, since it will allow insurance surety companies to offer bonding products (subject to some limitations) and bonding companies to be converted into insurance surety companies and, taking into consideration that the LISF will be a single law governing both insurance and bonding, makes us consider whether the traditional separation between insurance and bonding operations should be maintained having two different financial institutions or if

[3] The LISF is not clear if this kind of operations will be allowed to be carried out by bonding companies.

it is time to regulate a single institution allowing same to offer both financial products.

II. Insurance and Bonding Companies Law

1. Organization and Corporate Governance

A relevant topic of the LISF is the corporate governance of Institutions. A fundamental principal of this approach to corporate governance is the inclusion the concept of "effective corporate governance system", which consists in the observance of certain principles and policies of self-regulatory nature that the Institutions must adopt in their operation to ensure sound and prudent management of their businesses, distributing better the various functions and improving the communication with all the internal levels of governance.

Some corporate governance principles and policies had already been adopted in the current laws, in accordance with international standards. In the LISF, the lawmaker took most of the provisions of the previous regulatory framework and only amended specific provisions mostly with regard to the role of the board of directors of the Institutions, placing such board of directors as the main decision-making and internal corporate governing authority that shall be responsible to instrument and monitor the implementation of the entire corporate governance system of the Institutions under the LISF.

(a) Efficient Corporate Governance System. Pursuant to the LISF, the efficient corporate government system of the Institutions shall comply with the following requirements: **(i)** be consistent with the volume, nature and complexity of the activities and operations of the Institutions, and **(ii)** establish policies and procedures concerning integral risk management, internal control, internal audit, audit committee, actuarial activities and outsourcing controls.

The LISF only sets forth principles that will govern the corporate government system. Implementation of such policies and principles will be subject to the secondary regulation pending to be issued by the CNSF.

The principles established in the LISF include: **(i)** the creation of a specific area responsible for the integral risk management, to identify the risks to which the Institutions are subject to, including solvency matters, (**ii**) having an internal control system responsible for setting up the corrective measures and controls applicable to the Institutions regarding legal, administrative and accounting matters, (**iii**) having an independent internal audit system to verify the correct operation of the Institution and adopt the recommendation or corrective measures, when necessary, (**iv**) implementing efficient actuarial procedures and (**v**) establishing policies to guarantee that the contractual relationships with third parties comply with the applicable legal provisions.

Many of these principles and policies are currently applied by Institutions, either because they are included in the LGISMS or the LFIF and secondary regulation, or because the internal best practices of the Institutions contemplate them.

Even though no radical changes are included to the current legislation but adjustments and measures to strengthen the corporate governance around the board of directors, it will be necessary to review the secondary regulation once issued by the CNSF, to confirm whether there will be additional changes, and their impact.

(b) Board of Directors. One of the objectives of the LISF is to give Institutions more authority to self-regulate themselves, mainly with regard to the new corporate governance system and prudential norms. In this regard, the authority and liability of the board of directors is broadened compared to that currently set forth in Article 29 Bis of the LGISMS and 15 Bis of the LFIF.

Within these additional obligations, in our opinion the most important new authorities of the board of directors are: (**i**) to define and approve the corporate governance system and the mechanisms to oversee and evaluate it, (**ii**) to define and approve the asset investment policy and the mechanisms for its control; **(iii)** to establish mechanisms to control the capital solvency requirement and technical reserves, and (**iv**) to define and approve the policies concerning the disclosure of information.

Due to these amendments and the responsibility arising therefrom, the members of the board of directors will have a more active role within the operation of the Institution compared to their current role.

(c) Audit Committee. Pursuant to the LISF, the audit committee is created and established as a consulting body of the board of directors, which main purpose is to supervise the compliance of the internal regulations determined by the board of directors, including the corporate governance policies and procedures. This new corporate body will replace the compliance officer of the Institutions.

Such committee shall be comprised by at least three and no more than five members who shall be selected among the members of the board of directors based on their financial or internal audit and internal control experience. At least one of its members shall be an independent member of the board of directors and no officer or employee may be a member of such committee. In order to comply with its surveillance attributions in a more efficient manner, the audit committee shall be independent from the operations of the Institutions. The audit committee will have to meet at least on a quarterly basis.

This change is not sufficiently justified in the Bill. So far, the compliance officer has been performing its duties in a proper manner, acting as the body in charge of assuring the compliance of the internal and external regulations applicable to the Institutions. The compliance officer is a specialist involved in the day-to-day operation of Institutions which will not be the case of the audit committee since their regulatory surveillance due to its characteristics will not be as expeditious.

The fact that the audit committee is required to be comprised solely by directors will result in more responsibilities for such directors in the Institutions' surveillance duties and will require, in many cases, that the Institutions replace current board members by others that may assume their new responsibilities and have the skills, time and resources required to comply with their new responsibilities.

Additionally, the compliance officer does not have to hold meetings in order to adopt resolution and make decisions. Even if the audit committee will be meeting on a quarterly basis, and although such committee may hold more meetings, it will require calling their members and having the necessary quorum to make decisions which will undermine efficiency in performing its duties.

The substitution of the compliance officer by the audit committee constitutes a change in the lawmaker original intent to incorporate the figure of compliance officer in the LGISMS, by adopting such figure from the Pension Funds Systems Law (*Ley de los Sistemas para el Ahorro para el Retiro*) for private pension funds managers. Now the LISF adopts the model followed by banks, which never incorporated the compliance officer figure. As mentioned above, the lawmaker does not explain the rationale to substitute the compliance officer figure with an audit committee, and arguments provided to justify such change are purely formal and not of substance.

2. Activities, Operation and Prudent Rules

In general terms, the operations and activities that the Institutions may carry out are not amended in the LISF.

However, there are two significant changes in this regard. First, the prudent rules regime to which the Institutions will be subject to is amended and, second, Institutions will be authorized to carry out stock exchange operations known as "securitizations".

Additionally, the LISF makes some non-relevant revisions, consisting in precisions to the attributions of the authorities, regarding **(i)** analogous and related operations (*operaciones análogas y conexas*); **(ii)** security loan and security repurchase operations; and **(iii)** operations with derivatives.

(a) **Prudent Rules.** The LISF sets forth a new solvency regime different from the regime set forth in the LGISMS and the LFIF. This is a similar mechanism to that established in Pillar I of Solvency II (quantitative requirements), which in general terms may be considered as a "tailored suit" allowing each Institution to design an internal actuarial model to calculate its solvency capital requirement and implement internal controls to detect any change or alteration to such requirement. Notwithstanding this self-regulation right granted to Institutions by this new mechanism, the implementation of the internal actuarial model will be subject to the prior approval of the CNSF. For such Institutions that are not able or willing to implement an internal actuarial model due to their particular conditions such as size or risk profile, the CNSF will prepare and establish an actuarial model applicable to all Institutions that have not developed an internal actuarial model approved by the CNSF.

The LISF also establishes the obligation for each Institution to develop an internal policy for monitoring its solvency, operations and investments, in accordance with its risk profile. This new system will allow each Institution to select and accept those risks adequate to their particular situation.

The LISF sets forth the obligation to the Institutions to carry out stress tests on a regular basis to evaluate their capital adequacy. The results of such tests shall be reviewed by the board of directors of each Institution.

The board of directors together with the Institution's top tier officers will be responsible of approving and implementing the guidelines required for the calculation and adequacy of the capital solvency requirement and implement the necessary measures to maintain such capital adequacy, including the provision of funds in case there is a capital deficiency.

Regarding the authorities granted to the CNSF, the LISF establishes that the CNSF may determine through secondary regulations, the manner in which the Institutions will report and provide evidence of compliance with the abovementioned solvency capital requirements, as well as the manner in which the Institutions will provide the CNSF the information on the particular technical characteristics of the internal calculation model adopted by the Institutions.

(b) **Securitization of Risks.** We consider that one of the most relevant changes introduced by the LISF is the possibility for Institutions to carry out securitizations. The LISF will allow insurance companies[4] to assign or transfer a share of the technical risks accepted by insurance companies in their operations to special purpose vehicles or trusts, created with the purpose to manage such technical risk and issue securities to be placed among investors in the stock market. The foregoing will allow Institutions to receive financing arising from future flows.

The regulatory requirements to carry out these kinds of operations have not been issued, and the CNSF is granted with the authority to issue regulations in that regard. The LISF does not define the term "technical risk"; however, we consider that such term refers to the right to collect premiums under the insurance policies.

(c) **Analogous and Related Operations (*Operaciones Análogas y Conexas*).** The LISF grants authority to the Central Bank (*Banco de México*) ("**Banxico**") and the CNSF to give their opinion with regard to authorizations granted by the SHCP to Institutions to carry out analogous and related operations. These opinions are not binding and are intended to advise the SHCP regarding the operations that may be carried out by the Institutions.

(d) **Securities loan and securities repurchase operations**. Concerning securities loans and securities repurchase operations, the LISF only

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[4] It is not clear whether the bonding companies may perform these operations and we believe that this issue will be clarified once the CNSF issues the corresponding secondary regulation.

clarifies that the Institutions will carry out such activities pursuant to the regulations to be issued by Banxico and the CNSF. Pursuant to the current legal framework, securities loans and securities repurchase agreements should comply with the regulations issued by the CNSF. The LISF will standardize the insurance and bonding legal framework to the principles set forth in the LIC and the LMV, granting authority to Banxico to regulate the technical aspects and characteristics of these operations, while the authority of the CNSF will be limited to the surveillance of and establishment of prudential guidelines for such operations.

(e) <u>Derivatives</u>. The LISF provides that operations with derivatives may be carried out only for hedging purposes. Institutions will have to comply with the regulations to be issued by the CNSF on surveillance and additional regulations from Banxico in this regard.

The only change from the previous legal framework is that the LISF expressly refers to the regulation issued by Banxico, which was already observed and complied with by the Institutions in these operations.

3. <u>Procedures</u>

(a) <u>Penalty interest</u>. As well as in the LGISMS and the LFIF, the LISF establishes the right for insureds or beneficiaries to receive penalty interest from the Institutions when they fail to comply with their obligations under the insurance or bonding policies when due. The LISF establishes a separate chapter applicable to insurance and bonding regarding penalty interest. The LISF clarifies that penalty interest will be capitalized on a monthly basis. In general terms the calculation mechanism and other related provisions are similar to those established in the LGISMS and the LISF except for the following:

(i) Regarding surety insurance that warrant unpaid tax liabilities (*créditos fiscales*), the LISF establishes that the calculation of the penalty interest should be made pursuant to the applicable provisions of the Federal Tax Code (*Código Fiscal de la Federación*).

(ii) The authority currently granted to the CNSF to impose fines to those Institutions that do not pay the corresponding penalty interest, is transferred to the judge solving the dispute or to the National Commission of Financial Services' Protection and Defense (*Comisión Nacional para la*

Protección y Defensa de los Usuarios de Servicios Financieros) (**“<u>CONDUSEF</u>”**).

(iii) Regarding bonds, the LISF provides that the right to receive penalty interest will arise by the sole breach of the payment obligations under the term provided in the LISF, even if the corresponding obligation assumed in the bond has not been determined in that moment.

The LISF also includes additional provisions regarding the manner in which the Institutions will have to pay the claim and the accrued penalty interest. It is worth mentioning that the payment of the amounts due under an insurance or bonding policy and, if applicable, the accrued penalty interest shall be made in a single payment. If not paid in such manner, any partial payments should first cover the ancillary legal interest and, therefore, penalty interest will continue to be accrued on the principal amount until same is fully paid.

Likewise, the LISF provides that, in the event of a final judgment pursuant to which the Institutions have the obligation to pay any amount under the insurance or bonding policy, the accrued penalty interest due until that moment should be also included, even if a remedy provided in the LISF was filed in order to suspend the enforcement proceeding.

In case the Institution does not provide evidence that it has complied with its payment obligations within a term of 72 (seventy two) hours following to date the resolution providing such obligation was issued, the corresponding judge will have the authority to request the corresponding financial intermediary for the judicial sale of any securities owned by the Institution in order to pay any outstanding amounts to the insured, beneficiaries or any other party.

(b) **<u>Claims</u>.** With regard to the special procedure to claim the payment of bonds granted in favor of the Federation, the Federal District, the States or Municipalities (jointly the “**<u>Governmental Entities</u>**”), the LISF specifies that, due to the similarities of such financial products, such procedure will also be applicable for surety insurance (*seguro de caución*).

The LISF establishes that the Executive Power (*Ejecutivo Federal*) will issue regulations concerning surety insurance (*seguro de caución*) granted in favor of the Governmental Entities.

Additionally, the LISF sets forth that, with respect to the enforcement procedure of a surety insurance (*seguro de caución*) or bonding policy granted in favor of Governmental Entities, the payment request made by any Governmental Entity will be considered to be complied with or without further effects, by virtue of **(i)** voluntary payment by the Institution, **(ii)** payment by the Institution due to mandatory performance, **(iii)** a final judgment by the Federal Court of Tax and Administrative Justice *(Tribunal Federal de Justicia Fiscal y Administrativa)* declaring null and void the payment claim, or **(iv)** the withdrawal of the claim made by the Governmental Entity. The foregoing will not be applicable to surety insurance (*seguro de caución*) or bonding policies granted in favor of the Federation to secure tax liabilities of third parties, since in such case, the provisions of the Federal Tax Code will be applicable.

(c) **<u>Insurance Product Registration</u>**. Another amendment introduced by the LISF that will affect the day-to-day operation of insurance companies, consist in the new procedure for review and monitoring insurance products that are registered with the CNSF. With these changes, it is intended that insurance companies have a more active role and responsibility for verifying the compliance of its contractual documentation and technical notes with the applicable regulations, and that the CNSF has less burden in such review.

The CNSF will no longer have the obligation to review all insurance products that are filed for registration, nor will have 30 days to review them as provided in Article 36-D of the LGISMS. Pursuant to the LISF, the CNSF, in exercising its inspection and surveillance authorities, will review insurance products on a discretionary basis. We believe that such authority will be exercised by reviewing a sample of insurance portfolio submitted to registration and/or in the inspections carried out to the insurance companies, although the LISF does not clarify this specific matter.

In case the insurance product does not comply with the provisions of the LISF, the CNSF shall require the insurance company to submit a regularization plan to amend any breach or inconsistency. This eliminates the current process pursuant to which the insurance company could rehabilitate any insurance product by filing the revised contractual documentation and technical note, without requiring the intervention of any internal body such as the Audit Committee (see Section 5 below).

Insurance companies will no longer have the 5 (five) business days period granted by the current Insurance Regulations (*Circular Única de*

Seguros), counted from the date in which the CNSF notifies the suspension, where they can continue selling such products. As stated in the LISF, in case the CNSF requires the insurance company to submit a regularization plan for an insurance product, the insurance company shall refrain from selling the product as of the date in which the regularization plan is submitted with the CNSF.

Regarding the revocation of the registration of an insurance product, the LISF provides a shorter period to correct the insurance product to avoid its revocation, consisting in a 30 business day term starting as of the date in which the regularization plan is filed. Currently insurance companies have 60 business days to correct the insurance product counted from the date in which the insurance company receives the insurance product suspension notice from the CNSF.

The LISF grants the CNSF the authority to impose sanctions to insurance companies in case they are required to file a regularization plan.

Currently, it is uncertain whether this new procedure will ease or facilitate the registration process with the CNSF. Although the intention is to give more freedom and responsibility to the insurance companies, and impose less burden to the CNSF, the reality is that the CNSF could continue reviewing each and every one of the insurance products that are submitted for registration, with the difference that insurance companies will be required to follow a more cumbersome procedure, such as the regularization plan, to rehabilitate the insurance products that are suspended by the CNSF.

In addition to the abovementioned procedure, the LISF includes a new requirement for insurance companies in connection with its insurance products, consisting in submitting the forms of their non-negotiable insurance contracts before the CONDUSEF, for purposes of including such forms in the Non-Negotiable Contracts Registry (*Registro de Contratos de Adhesión*).

Finally, except for the above, the principles and requirements regarding the contractual documentation and technical notes required to register insurance products with the CNSF remain practically identical with no significant changes.

4. Accounting and Financial Information of the Institutions

Section Eighth of the LISF sets forth the regulatory framework applicable to accounting, financial and operative information that the Institutions should prepare. The legal provisions are similar to those established in the LGISMS and the LFIF, except for adjustments and additions to some criteria. The purpose of such adjustments provided in the LISF is to adequate the provisions to those set forth in Solvency II such as supervision procedures principles (Pillar II) and transparency in the disclosure of information (Pillar III).

(a) **Accounting Entries.** The LISF does not include the criteria adopted in the LGISMS and LFIF to calculate the assets and liabilities of the Institutions. Pursuant to the LISF, the criteria will be established by the CNSF in secondary regulations. This amendment attempts to provide a more flexible mechanisms to adjust the accounting criteria to the general accepted accounting principles and international norms and their amendments; however the fulfillment of this purpose will depend on the decisions adopted by the CNSF in this regard.

(b) **Disclosure of Information.** The LISF adjusts and provides additional obligations concerning the disclosure of information. These amendments respond to the growing interest of the markets to have more information forcing the Institutions to be transparent concerning solvency, cash sufficiency and operative security matters.

Pursuant to the new provisions, the Institutions must disclose in their financial statements information concerning **(i)** the coverage of their Investment Basis (*Base de Inversión*), **(ii)** the adequacy of the Admissible Own Funds (*Fondos Propios Admisibles*) covering the capital solvency requirement (only regarding insurance companies), and **(iii)** their risk level pursuant to the credit rating granted by a rating agency authorized by the National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*) ("**CNBV**").

The LISF grants the CNSF authority to require all corporate, financial, technical and legal information that should be disclosed to the general public.

(c) **External Financial and Actuarial Auditors.** The LISF includes all the requirements that Institutions' external financial and actuarial auditors must meet which are currently set forth in the LGISMS, the LFIF, the Insurance Regulations (*Circular Única de Seguros*) and the Bonding Regulations (*Circular Única de Fianzas*) (jointly the "**Regulations**"). The lawmaker comprised all such requirements and established them all in the LISF.

Additionally, the LISF also lists those events where the external auditors should be deemed liable before the Institutions that are currently included in the Regulations, and amends such cases only for clarification purposes. The following events are relevant: **(i)** when due to inexcusable malpractice, the report or opinion contains defects or omissions; and **(ii)** when the report or opinion intentionally, **(w)** omits relevant information, **(x)** introduces wrong or false information or in any other way alters the financial statements, **(y)** suggests carrying out operations that among the other alternatives, is the most harmful to the Institution, and **(z)** suggests, accepts, contributes or proposes that a given operation is registered in violation to the accounting principles or actuarial practices of the Institution.

5. <u>Preventive and Corrective Measures, Intervention and License Revocation</u>

The LISF reflects the clear intention of the lawmaker to continue implementing effective Institutions' self-regulatory mechanisms. In this sense, the LISF, following the provisions of the LGISMS and LFIF, provides ordinary preventive and corrective mechanisms that, in general, result in the already known procedures of regularization plans and self-correction programs.

The LISF includes provisions concerning the intervention in the administration and license revocation, which also remain similar to those provided in the LGISMS and LFIF.

It is worth mentioning the control measures that grants the CNSF with sufficient authority to carry out certain procedures intended to safeguard the Institutions' solvency and protect the rights of financial services users. As in previous procedures, these control measures were included in the LISF with some additions that will be discussed later.

(a) <u>Regularization Plans and Self-Correction Programs</u>. The LGISMS and LFIF already provided prevention and correction mechanisms similar to those established by the LISF. However, there are some non-relevant changes such as the inclusion of such mechanisms in a special section of the LISF, and correcting some omissions of previous legal regulations, such as granting the Institutions the right to be heard and contest prior to the CNSF's resolution to implement a regularization plan, and some additional requirements that such regularization plans must meet.

As a result to the changes made to the corporate governance provisions established by the LFIF and the LGISMS, the LISF establishes the obligation of the Audit Committee of the Institutions to approve the self-correction programs prior to their submission to the CNSF. Regarding regularization plans, the Audit Committee will be responsible for monitoring and informing the board of directors and the CEO of the Institutions about the progress of any implemented plans, as well as filing them with the CNSF.

(b) **Control Measures.** As part of the inspection and surveillance attributions of the CNSF, it will have the authority to deal with situations that threaten the solvency and stability of the Institutions and protect the interests of financial services' users.

The LISF establishes new scenarios to those already regulated by the LGISMS and LFIF in which the CNSF is authorized to instruct the Institutions to adopt control measures that it deems appropriate, such as the following: **(i)** failure to comply with any of the requirements to start operations, **(ii)** conduct operations other than those authorized, **(iii)** failure to meet the infrastructure requirements or internal controls necessary to carry out their operations and provide related services, **(iv)** performance of accounting or management irregularities that prevent or difficult knowing their true financial condition, and **(v)** carrying out transactions involving conflicts of interest that harm their customers.

Also, in addition to the control measures provided in the LGISMS and LFIF, the LISF provides the following: **(i)** the suspension or limitation on the issuance or retention of premiums, risks or liabilities, **(ii)** the total or partial reduction in the issuance or retention premiums, risks or liabilities, as well as the acceptance of reinsurance operations or rebonding to levels compatible with the Admissible Own Funds (*Fondos Propios Admisibles*) of the Institution, **(iii)** to instruct the investment of sufficient assets to cover its Investment Basis (*Base de Inversión*), **(iv)** to call for a meeting of the Audit Committee, the board of directors or the general shareholders of the Institution, where a person appointed by the CNSF may assist for purposes of informing the situation of the Institution, **(v)** to suspend the payment of compensations and extraordinary bonus to the CEO and staff in addition to their salary, as well as forbidding the granting to them of new and future compensation, until the Institution remedies, as determined by the CNSF, the situation that gave rise to the control measure, and **(vi)** to refrain totally or partially to sell or dispose of its assets.

(c) Intervention. As in the previous legislation, the LISF provides an administrative procedure known as management intervention (*intervención gerencial*). The provisions established by the LISF that govern this procedure are different from those of the previous laws only with respect to very specific matters and, apparently, these changes aim to clarify and limit the role of the appointed manager in the event of a situation that compromises the stability or solvency of the Institutions or the interests of policyholders and other beneficiaries.

In this regard, management intervention must be declared by the President of the CNSF with the prior approval of the CNSF's Governing Board. Nevertheless, the intervention manager may be appointed without need of the approval of the CNSF's Governing Board, and will perform its duties as intervention manager directly and under his/her own responsibility. While performing his/her duties, the intervention manager shall act based on his professional judgment and in accordance with applicable laws and insurance and bonding market practice.

The LISF also clarifies that, from the moment in which the management intervention is declared, the intervention manager shall have all the attributions and authorities of the board of directors of the Institution. The intervention manager will not be considered as representative or commissioner of the CNSF by its sole appointment.

(d) License Revocation. Regarding the license revocation, the LISF keeps a similar procedure to the current procedures and includes all license revocation causes already provided in the laws, making certain clarifications to some of them and adding new causes.

The LISF now indicates that in the event an Institution repeatedly conducts prohibited transactions or breaches a regularization plan or control measures ordered by the CNSF, it will constitute a cause for the revocation of a license.

The new LISF provides for the voluntary revocation, which consists in the approval by the general extraordinary shareholder's meeting of the Institution of an application to be filed with the CNSF requesting the revocation of its license.

In addition to the above, the LISF grants the CNSF's Governing Board authority to revoke licenses to operate as an Institution, which authority is currently conferred to the SHCP.

Neither the LGISMS nor LFIF include a specific procedure for ordering the license revocation of an Institution. The LISF provides that once the CNSF has been informed that the Institution incurred in any cause of revocation, the CNSF will give notice to such Institution the foregoing, and the Institution will have a term of 15 (fifteen) business days after such notice is received to contest and correct the alleged acts or omissions giving rise to the possible revocation. After expiration of such period, the CNSF shall resolve on the revocation, taking into account the contest of the insurance company.

If the Institution fails to correct the acts and omissions, the CNSF may resolve on the revocation of the license of the Institution; the resolution revoking the license must be published in the Daily Gazette of the Federation (*Diario Oficial de la Federación*) and in two newspapers of general circulation in Mexico.

6. Liquidation and Bankruptcy (*Concurso Mercantil*)

The LISF includes important changes to the rules concerning administrative liquidation and bankruptcy of the Institutions. The attributions that the SHCP previously had will now be vested upon the CNSF.

Regarding the administrative liquidation, additional provisions are included to the insufficient regulation that is currently available. With respect to bankruptcy, now the main rules applicable to the process are included in a single law. Currently, bankruptcy processes of the Institutions are regulated separately in the LGISMS, the LFIF and the Insolvency Act (*Ley de Concursos Mercantiles*) ("**LCM**").[5]

Likewise, as a new development, the LISF establishes the procedure for the voluntary liquidation of the Institutions. Currently, the Institutions may voluntarily start the liquidation procedure, however, such procedure is not ruled under neither the LGISMS nor the LFIF and, therefore, the provisions set forth in the General Law of Business Organizations (*Ley General de Sociedades Mercantiles*) and the criteria established by the SHCP arising from its interpretation of the LGISMS and the LFIF are applicable.

(a) Administrative Liquidation. The main amendments to the administrative liquidation of the Institutions consist in adding more

[5] The LCM includes a chapter applicable to insolvency procedures of banks which is applicable to Institutions by an express reference in the LGISMS and the LFIF.

regulations to the procedure. Among the relevant additions, the LISF provides **(i)** new requirements which shall be fulfilled by the individuals appointed as liquidator, **(ii)** that public bid procedures are deem of public interest and their purpose is to sell the assets on an economic, effective, impartial and transparent basis, **(iii)** that the Institutions will not be liable for hidden defects in the assets sold in a public bid, and **(iv)** that in case the liquidator finds a reason for not concluding the liquidation, the liquidator may appear before the competent judge (without the need to obtain prior approval from the shareholders of the Institution) to request the cancellation of the registration of the Institution before the Public Registry of Commerce.

Regarding insurance companies, the LISF establishes that once the administrative liquidation has been declared, the insurance policies, and the reinsurance and rebonding agreements shall be considered cancelled if the administrative liquidator does not assign the portfolio to another insurance company within 30 calendar days following to the date in which the license revocation is notified. Currently, the cancellation of insurance policies and reinsurance and rebonding agreements is only applicable in case of bankruptcy.

Regarding bonding companies, the LISF establishes that once declared the administrative liquidation, the clients may request the substitution of their guarantee or arrange the assignment to other bonding company as long as the bond is not due. Additionally, the assets granted to bonding institutions as counter-guarantee shall be returned once the bond has been cancelled, except if there are pending actions or rights against the parties that granted them.

(b) **Voluntary Liquidation.** Voluntary liquidation is a new procedure established in the LISF that will be applicable in two cases: **(i)** when the CNSF revokes the authorization when the Institution did not start operations within thirty days following the date in which the favorable opinion to start operations was notified, or **(ii)** when the shareholders voluntarily agree to the dissolution and liquidation of the Institution by means of an extraordinary shareholders' meeting and request the CNSF to revoke their license.

The LISF establishes that for the liquidation of an insurance company, such company will have to transfer its insurance portfolio, pay all the liabilities arising from its insurance policies and conclude its fiduciary duties. Concerning bonding companies, the liquidation would conclude if the company has no liabilities arising from bonding or rebonding policies or fiduciary duties. These requirements are currently requested in practice for the voluntary liquidation of the Institutions; however, they are not established in the LGISMS or the LFIF. The LISF provides certainty to those Institutions that start this kind of process by establishing a clear legal framework and avoiding the need to interpret other laws which have a supplementary application and pursuant to the SHCP criteria.

(c) Bankruptcy. Pursuant to the new law, the bankruptcy of Institutions will be governed mainly by the LISF since the LCM's chapter devoted to banks will no longer be applicable to Institutions.

The LISF grants the CONDUSEF the authority to represent insurance and bonding policies' creditors before the receiver.

Other relevant amendment worth mentioning is that the SHCP will no longer have the exclusive authority to request the bankruptcy of Institutions, granting such authority also to the CNSF, the intervention manager and the liquidator.

7. Other Participants of the Insurance and Bonding System

In general terms, provisions concerning consortiums (*consorcios*), insurance and bonding agents, reinsurance intermediaries and foreign reinsurers are kept in the same terms as in the current laws. As a relevant change, adjusters and self-regulatory entities are now regulated in the LISF.

(a) Foreign Reinsurers. The LISF sets forth that the General Registry of Foreign Reinsurance Companies (*Registro General de Reaseguradoras Extranjeras*) will now be maintained by the CNSF and not the SHCP as currently established.

(b) Adjusters. The LISF now defines and regulates insurance adjusters. The LISF defines insurance adjusters as the party appointed by an insurance company to evaluate the claim (casualty) and other circumstances that may affect to determine the compensation arising from the insurance policy, so the insurance company has the necessary elements to determine if the claim is covered under the insurance policy and propose the corresponding compensation.

The LISF provides that if the compensation proposal is filed with the contracting party, the insured or the beneficiary, it shall be binding to the insurance company.

Unlike the current legal framework, the LISF provides for the obligation of the insurance companies to prepare manuals setting forth the guidelines, policies and procedures to be followed by its adjusters. These manuals will need to be disclosed in the insurance companies' web page.

Additionally, the LISF provides for the creation of a national adjusters' registry appointed under the non-negotiable insurance contracts. This registry will be maintained by the CNSF and will include the adjusters registered by the insurance companies.

(c) Self-Regulatory Entities. The concept of insurance and bonding self-regulatory entities is a new concept introduced by the LISF. Self-regulatory entities are those that have as a purpose the implementation of standards for the development of either the insurance or the bonding systems.

Self-regulatory entities are described as those associations or entities which members are insurance and/or bonding companies or parties linked to the insurance and bonding activities. The CNSF will have the authority to approve the recognition of the self-regulatory entities and shall issue secondary regulations that set forth the requirements that the self-regulatory entities will need to comply.

The LISF authorizes self-regulatory entities to issue regulations concerning its operations, and policies and guidelines for its members. The main purpose of self-regulatory entities is to provide support to the adequate operation of insurance and bonding companies through developing transparency mechanism and certifying the technical capacity of their members.

8. Surety Insurance (*Seguro de Caución*)

Other of the main amendments included in the LISF and the amendments to the LCS is the creation of surety insurance. This new kind of insurance will provide an additional option in the guarantees market and provide certainty to the participants of economic activities (in particular Governmental Entities) by including a guarantee supported by the technical and administrative expertise and solvency of an insurance company.

Surety insurance will be mainly governed by the LISF (which rules the operative aspects of the surety insurance) and the LCS (by including a chapter with specific rules concerning insurance contractual documents required to issue such product).

(a) **<u>Concept</u>.** The LISF introduces and adequately classifies the insurance surety line of business within the property and casualty operation and defines it as the insurance pursuant to which an insurance company shall **(i)** pay an indemnity to the insured as compensation or penalty for damages suffered, within the terms set forth in the insurance agreement*, or* **(ii)** once the events agreed with respect to a breach of legal or contractual obligations by the contracting party occur.

The LISF excludes from the surety insurance the coverage regarding breach of obligations regarding financial agreements, since such risks are covered under credit insurance (*seguro de crédito*) agreements.

There are three participants in the surety insurance: the contracting party, the insured and the insurance company. The relationships among such parties are the following:

(i) Between the contracting party and the insured: there is a prior legal or contractual obligation to the issuance of the surety insurance, in which the contracting party or "debtor" is obligated to comply with an obligation assumed before the insured or "creditor". The contracting party enters the surety insurance for the benefit of the insured.

(ii) Between the contracting party and the insurance company: the legal relationship arises from the issuance of the surety insurance contracted by the contracting party to secure the fulfillment of the obligation, and includes payment of the premium.

(iii) The insured is the beneficiary of the compensation established in the insurance contract. In case the contracting party breaches its obligations, the insurance company shall pay the insured the agreed indemnity.

(b) **<u>Operation</u>.** In principle, insurance companies authorized to operate surety insurance may only operate this line of business and, as an exception, the credit insurance line of business. The foregoing, due to the similarities of the products and risk covered under such kinds of insurance.

The following are the main provisions set forth in the LISF and the amendments to the LCS concerning the operation of surety insurance:

(i) The claim occurs when the contracting party breaches its legal and/or contractual obligations covered by the insurance. Pursuant to the LISF, the claim occurs when the insured notifies the insurance company that a claim has occurred and requests the payment of the insured amount. The insurance company is authorized to pay without the need to obtain the approval from the contracting party or evaluate if payment is justified. The only remedy available to the contracting party in case of a wrongful claim by the insured is to request the insured the reimbursement of any undue payment once the contracting party has paid and refunded the insurance company with any amount paid under the insurance policy.

(ii) The insurance company has the right to recover any amounts paid under the insurance policy from the contracting party and, therefore, the law authorizes it to request the contracting party the required collateral to guarantee the refund. It is worth mentioning that the insurance company has the right but not the obligation to request the collateral unlike bonding institutions which are required to do so.

(c) **<u>Special Features</u>.** The LISF and the amendments to the LCS provide for the following special features applicable only to the surety insurance aimed to reinforce its character as a reliable guarantee:

(i) The lack of total or partial payment of premium shall not terminate or suspend the surety insurance's effects and will not cause its cancellation either.

(ii) The insurance company will not be able to offset the premium against the insured amount to be paid and the insurance company may not request the insured to pay the premium.

(iii) The insurance company will not have the right to oppose to the insured those defenses or exceptions it may have due to acts or omissions attributable to the contracting party.

(iv) The surety insurance may not be terminated without the express consent of the insured, except if the term for which it was granted has elapsed.

(d) **Surety Insurance and Bonds.** Notwithstanding the similarities regarding concept, operation and regulation of the surety insurance and bonds, our legal framework classifies them as two different financial products that in principle will be offered by different financial institutions. Notwithstanding the foregoing, based on the principles of risk specialization and isolation, the LISF authorizes surety insurance companies to offer bond products.

Another relevant aspect that arises from the similarities of these products which is worth mentioning is the fact that the LISF allows bond companies to request authorization to be reorganized as a surety insurance company, cancelling its bond company license.

(e) **Guarantee before the Federal Government.** One of the main supporters of including the surety insurance as a new line of business was the Federal Government. The Federal Government wanted a security mechanism that provided it with certainty in the recovery of credits as bond companies have not been able to do so.

The LISF includes special provisions standardizing surety insurance to the guarantees usually admitted by the Federal Government and granting the surety insurance the same conditions as such other guarantees.

Additionally, it is worth pointing out that pursuant to the LISF, the SHCP will determine the contractual models and insurance certificates to be accepted by the Federal Government.

9. Regulatory Authorities

The LISF grants new authorities to the CNSF, increasing the scope of its competence by transferring authorities previously granted to the SHCP, particularly regarding the granting, amendment and revocation of authorizations and the management of the General Registry of Foreign

Reinsurance Companies (*Registro General de Reaseguradoras Extranjeras*), among others.

Some of the most relevant authorities of the CNSF added in the LISF are **(i)** the granting, amendment or revocation of licenses to operate as an insurance, mutual or bonding company, **(ii)** the management of the General Registry of Foreign Reinsurance Companies, the Insurance Adjusters' Registry, the Financial Statements External Auditors' Registry, the Independent Actuaries' Registry and the Insurance Products' Registry, **(iii)** the granting of authorization for the transfer of insurance portfolio, the assignment or transfer of the rights and obligations under bonds granted by bonding companies, **(iv)** the granting of authorizations concerning the merger, spin-off, amendment or revocation of licenses set forth in the LISF, and **(v)** the participation in liquidation, as well as ample authorities for the surveillance of the liquidation, bankruptcy and management intervention including the appointment of receivers.

This new role of the CNSF is intended to provide this agency with more technical independence by granting to it attributions that were previously reserved to the SHCP under the LGISMS and the LFIF.

(a) **<u>Board of Governors</u>.** Pursuant to the LISF, the CNSF will keep an organic structure similar to that established under the LGISMS and LFIF and regulations; however, the LISF includes clearer guidelines and specific criteria for the members comprising the Board of Governors of the CNSF.

Within the relevant matters included in the LISF under this section, we point out the establishment of an authorizations committee (the "**<u>Committee</u>**"), which purpose is to review the applications requesting the authorization, amendment or revocation of licenses filed with the CNSF or those applications that, in its case, the CNSF considers necessary to be reviewed by such Committee to maintain the order and discipline within the insurance and bonding markets.

The role of the Committee is to act only as a reviewing body and once it has granted its favorable opinion, the Board of Governors will be the entity in charge of analyzing and granting the final approval to the corresponding request.

The LISF also grants additional authorities to the Board of Governors that were not included in the LGISMS and LFIF and clarifies some authorities that, although were previously granted to the Board of Governors, they were not clearly limited. Due to their importance, it is worth mentioning the following authorities granted to the Board of Governors: **(i)** to grant or revoke the recognition of self-regulatory entities as well as the veto power to the self-regulatory standards, and **(ii)** to declare and cancel the management intervention procedure and authorize the appointment of administrative liquidators, as well as participate in several stages of the management intervention, administrative liquidation and bankruptcy procedures.

(b) <u>Chairman</u>. In line with the amendments and new authorities granted to the CNSF, the LISF establishes that the Chairman of the CNSF should meet independency, impartiality and honorability requirements. Additionally the Vice-Chairmen, the proprietary and alternate members of the Board of Governors and the heads of the CNSF should also meet those requirements.

Additionally, the LISF grants new authorities to the Chairman of the CNSF as it will be responsible for carrying out of the executive tasks of the Board of Governors of the CNSF. Within such authorities, we consider relevant the followings: **(i)** the participation in management intervention procedures with management attributions including the authority to request the cease of operations of the Institutions and the appointment of intervention managers and liquidators with the prior approval of the Board of Governors; **(ii)** the management and update of the various registries that will be kept by the CNSF; and **(iii)** to issue general provisions and prudential norms to maintain the solvency, liquidity and financial stability.

(c) <u>Additional Considerations</u>. Within this section, the LISF establishes that it is forbidden to carry out operations with Institutions and other individuals and entities with preferential conditions to those offered to the public in general.

Additionally, other regulations are included to rule and limit the liability of the Mexican State regarding irregular administrative activities by any officer or body of the CNSF. Such provisions may be considered in violation of the Constitution by contravening constitutional principles for the regulation of the liability of the Mexican State set forth in Article 113 of the Mexican Political Constitution. These provisions limit in an arbitrary way the right of all private persons to be indemnified when the State carries out irregular administrative activities that harms such private person.

10. <u>Notices, Enforcement Measures and Penalties</u>

(a) **Notices.** Within the most important aspects included in Chapter XIII of the LISF, is the possibility to give notices by electronic means as long as the interested party or his/her representative has accepted it or requested it in writing to the financial authorities[6] through automatic systems and complying the security measures established for such purpose.

Regarding notices to be served in person, some requirements are established depending if the notice will be given at the offices of financial authorities, in the domicile of the interested party or its representative or in any other place in which the interested party or its representative is located.

(b) **Enforcement Measures.** Unlike the LGISMS and the LFIF, the LISF includes a chapter devoted to the regulation of enforcement measures that may be used by the SHCP and the CNSF such as warnings, fines, request the intervention of law enforcement agents or even to request the law courts to bring legal action against the individual for disobeying a legitimate order.

(c) **Penalties and Criminal Offenses.** The LISF establishes the legal framework applicable to the admission of evidence within administrative procedures to impose penalties, the kind of evidence that will be accepted and the procedure for their filing. The LISF also includes the parameters to determine if an administrative violation incurred by an Institution or any other regulated entity by the LISF may be considered as material (*grave*).

Within the most important penalties included in the LISF, it is worth mentioning the penalty that may be imposed **(i)** to the members of the committees that do not carry out their roles pursuant to the law; **(ii)** to the Institutions that do not comply with the minimum paid in capital; **(iii)** to the external auditors that audit the financial statements and to the independent actuaries that give their assessment on the situation and adequacy of the technical reserves of the Institutions, when they hide, leave out or conceal important data in their reports and assessments, as well as other professionals or experts that produce an assessment or opinion to the Institutions when such reports or assessments are not accurate due to negligence or are intentionally misleading; and **(iv)** to the representative offices of foreign reinsurers established within Mexican territory without the authorization from

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[6] Pursuant to the LISF, the SHCP, the CNSF and the Central Bank are deemed financial authorities.

the SHCP and to the insurance companies that appoint as insurance adjusters for standardized contracts persons that are not registered with the CNSF.

Violations regarding deficiencies in the Investment Basis (*Base de Inversión*) coverage as well as in the Admissible Own Funds (*Fondos Propios Admisibles*) required to support the solvency capital requirement of the Institutions will be penalized with a fine.

In the LISF, unlike in the LGISMS, individuals or entities that enter into insurance or bonds in contravention to the law will no longer be penalized with imprisonment but only with a fine that will range from 50% to 100% of the paid premiums by individuals and from 100% to 200% of the paid premiums paid by entities.

III. Insurance Contract Law

(a) Acceptance. It is provided that the insurance conditions should be included in the offer form provided by the insurance company or be sent to the proposer so that such conditions can be included in the offer, otherwise the proposer shall not be bound by his/her offer.

The insurance's company obligation to inform its acceptance to the proposer is deleted and therefore the statements signed by the insured shall be the basis for the insurance contract.

(b) Non-Negotiable Form Insurance. In case of doubt regarding the interpretation of a clause included in a non-negotiable insurance contract, the judge may request the CONDUSEF or the CNSF (in case technical actuarial matters are involved) to issue its expert's opinion to help the judge interpret the clause in dispute.

(c) Request of copies. The appointed beneficiaries under an insurance contract are allowed to request a copy of the insurance policy once the event has occurred.

(d) Premium Payment. Regarding payment of premium in installments, each of the periods shall have the same length, deleting the one day period and allowing insurance companies to determine the regularity in the installments they consider convenient.

(e) Concurrency. Concurrency may also be applicable to liability insurance in which the value of the insured interest is not determined.

Insurance companies shall be equally liable for the payment of the event. In case the limit or insured amount of any of the policies is exhausted, the excess shall be paid in equal amounts by the insurance companies with the highest limits or insured amounts, up to the top responsibility limit of each of them.

Should you have any question in connection with the new Insurance and Bonding Institutions' Law and its enforcement, please get in touch with your usual contact at Nader, Hayaux & Goebel or with any of its following partners:

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