FCA proposed guidance on Part VII insurance business transfers

May 2017

Introduction

The FCA has published a guidance consultation on its approach to the review of Part VII insurance business transfers. Although not explicitly acknowledged, the timing of the consultation is probably not coincidental as the regulators are coming under increasing pressure to review Part VII transfers in the run up to Brexit. The guidance publicises the views of the FCA on a number of commonly occurring issues, presumably in the hope that the review process can be made easier if firms take these points into account in their planning stage.

Most of the points discussed in the consultation reflect existing practice of which practitioners are likely already to be aware. It is, nevertheless, useful to have a public statement of the regulator's views and there are some particular points of interest.

It should be noted that the guidance is intended to sit alongside and not to replace existing guidance in Chapter 18 of the FCA's Supervision Manual. It also only reflects the FCA's approach. The PRA has previously published a Statement of Policy on its approach to insurance business transfers – there is no indication so far that it intends to supplement this.

Reliance on Applicants and third parties by the Independent Expert

The FCA expects the independent expert ("IE") to show in their report that their conclusions are supported by adequate evidence and that the IE has properly challenged and assessed the information on which the report is based. This is a theme throughout chapter 6 of the guidance. The FCA comments that:

> "We often find that IE reports lack detailed analysis, critical review or reasoning to support a conclusion that there is likely to be no material adverse effect on Policyholder groups".

Importantly, as well as looking at the possible impact on reasonable benefit expectations, the FCA expects the IE to consider type and level of service, such as claims handling, and administration and governance arrangements pre and post transfer.

Where the IE has relied on assessments provided to it by the Applicants the FCA expects the IE to show that they have questioned the adequacy of the assessments and asked for further evidence where appropriate. In some cases it may be necessary for the IE to review underlying material independently.

Previous Schemes

The FCA emphasizes the need for firms to comply with current regulatory requirements and comments that it does not expect these to be over-ridden by the Court. This may, in particular, affect firms which have entered into previous schemes in connection with the same book of business. COBS contains transitional provisions which allow firms to disregard certain provisions of COBS 20 if they are inconsistent with an arrangement formally approved by a court of competent jurisdiction before a certain date (COBS TP 2). The FCA may not allow these to be carried over into a new scheme before the Court.

> "We will challenge charges to with-profits funds which are inconsistent with COBS 20, even if these charges were permitted under a prior Scheme sanctioned before COBS 20 came into force".

This approach is potentially problematic. It could prevent a fund from being operated in the same manner after a transfer as it had been before, even where the entire fund is being transferred and none of the underlying commercial practicalities have changed. There may be valid reasons associated with the fund structure for some historic requirements to continue to apply. The extent to which this approach impacts firms in practice may depend on how flexibly the FCA applies their policy.

Identifying the transferring liabilities

The FCA makes some interesting (although not entirely consistent) comments about responsibility for liabilities which don't arise "under" the transferring policies but which are connected with them. It emphasizes that there should be clarity around what liabilities are being transferred, for example who is to be responsible for liabilities in connection with:

- lapsed matured, surrendered and expired policies
- quotations not proceeded with due to an administrative or processing error
- reinstated policies
- complaints made to the Financial Ombudsman Service after the transfer.

There seems to be some confusion around mis-selling liabilities, which the FCA appears to suggest arise under the policy. In fact, liabilities for mis-selling arise separately from the policy and should therefore be clearly identified in the scheme document if they are being transferred under the scheme. This was confirmed in the recent case of PA(GI) Limited v GICL 2013 Limited and another [2015] EWHC 1556 (Ch), in which the judge commented that it was "plain that liability for mis-selling would not arise 'under' the contract of insurance" and that "a liability 'attaching to' a contract would be understood as a reference to a liability that is directly connected with, or emanates from, the contract itself, arising after that contract has come into existence. It would not readily be understood as referring to a liability for an actionable wrong which preceded or gave rise to the contract".

Compensation schemes

For cross-border transfers, the FCA considers that the availability or otherwise of a compensation scheme in the transferee's jurisdiction should be considered by the IE, regardless of the perceived solvency of the firm. Curiously, this seems to particularly be a concern in the case of transfers of general rather than life business, although it is not clear why this should be the case. The FCA comments that to deal with this point, the IE may suggest that the Applicants implement some form of mitigation, such as notifying policyholders that they have the option to switch providers at no cost if they want to continue to have insurance with FSCS cover.

This is obviously a particular issue to be considered in the context of Brexit-driven insurance business transfers, as the UK is relatively unusual in providing a comprehensive compensation scheme.

Waiver of notification requirements

The FCA view is that there should be a starting assumption that all policyholders are entitled to be notified and that it is for them to decide whether they are interested in the proposals. Arguments that a group of policyholders would not find the information useful or of interest would therefore need to be supported by a strong case and accompanying evidence.

The FCA does not consider to be sufficient justification for a waiver any of the following in isolation (although they could be combined with other arguments):

- the IE having concluded that there is likely to be no material impact to a particular group of policyholders
- a suggestion that notification would confuse policyholders and/ or that they wouldn't understand the complexities of the transfer
- individual policyholders having stated that they only want to receive targeted communications
- a claim that the costs of notification are disproportionate where not accompanied by reasonable estimates of the costs of notification.

In general insurance cases, if a waiver is sought on the grounds of low probability of claims from certain policyholders then thorough analysis and supporting evidence will be required to demonstrate this.

It should be noted that, although the views of the regulators are influential, it is ultimately for the Court to decide on the question of any waivers of notification requirements. The Court will not necessarily always concur with the views of the regulators. For example, in *Re Combined Insurance Company of America* [2012] EWHC 632 (Ch), the Court declined an application by the FSA for the Court to direct the transferor to give notice to former policyholders who might be affected by the outcome of an ongoing past business review.

Other issues

Changing the effective date	It is quite common to include flexibility within the scheme document to change the effective date of the scheme without the approval of the Court. The FCA acknowledges this but is concerned to ensure there are some parameters within which this flexibility can be applied. In particular, if the delay is more than a short period – 2 months or less – notifications to policyholders may become out of date and will need to be refreshed. There is some ambiguity in the draft guidance regarding the position where the delay is less than two months. There is a suggestion that policyholders will in any event need to be notified of the new effective date, but it is not clear whether this is a pre- or post- effective date requirement.
Definition of policyholder	In considering who must be notified of a Part VII transfer, the FCA confirms in the draft guidance that it takes a broad view of the definition of "policyholder" in FSMA and the relevant regulations made under it. The FCA's view is that this should include, for example, beneficiaries under pension schemes and other trusts, and employees under employer's liability policies or group pension schemes. The FCA acknowledges that Applicants do not always agree with its interpretation of the legal position on this point. It suggests that a compromise may be found by Applicants applying for notification dispensations to achieve the same outcome (which the FCA will, presumably, consider on their merits).
Connected transfers	The FCA expects to receive full information about any other transfers which are connected with the proposed Part VII, including any proposed subsequent transfer of the business. In general, the existence of a proposed subsequent transfer will be relevant information which will need to be provided to the regulators and the Court. In principle there might be occasions where it is possible to argue from a legal perspective that disclosure is not needed, perhaps where there is a high degree of uncertainty regarding whether the possible subsequent transfer will proceed. It appears from the FCA guidance that it will expect disclosure even in these cases.
Supplemental reports	The FCA confirms in the draft guidance that it expects a supplementary independent expert's report to be produced on all transfers, whether or not there are any changes to the scheme or to the IE's conclusions. This is not explicitly required by SUP 18. The FCA expects the supplementary report to reiterate the main points of the original report as well as confirming or updating the IE's conclusions. Where there are material changes in the IE's conclusions, firms should notify policyholders of the issues in good time as well as making the report available.
Outsourcing and reinsurance	Firms will sometimes put in place outsourcing and/ or reinsurance arrangements with a proposed transferee in advance of commencing a Part VII process. The FCA has expressed some concerns about these arrangements in the past on the basis that they can appear to pre-empt regulatory scrutiny of the Part VII process. In the draft guidance, the FCA suggests that the IE should consider the position of policyholders in the absence of the reinsurance or outsourcing arrangement against the post-transfer position as part of its analysis.

What next?

The consultation period runs until 15 August. Firms should consider whether there are any aspects of the guidance which they would like to see changed or clarified. In the mean-time, although still in draft it would be advisable to take the FCA's points discussed in the consultation into account in any new or ongoing Part VII transfers.

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