SLAUGHTER AND MAY

Insurance newsletter

September 2019

High Court declines to sanction Part VII transfer

On 16 August Mr Justice Snowden gave his judgment on a proposed transfer of annuity business from Prudential Assurance Company (PAC) to Rothesay Life under Part VII of FSMA. In an almost unprecedented move, he refused to sanction the transfer notwithstanding the fact that all procedural requirements had been met and there was no objection from either of the regulators. The judgement is to be appealed with a hearing of the Court of Appeal expected to be in the first half of next year.

The judgment

The key points which Snowden, J. cited as the basis for his refusing to the sanction the transfer were:

- some policyholders had objected to the transfer claiming that they had an expectation PAC would remain the provider of their annuity for the duration of the policy. The judge considered that this was a relevant factor given PAC's established reputation and the anticipated wider financial support of the Prudential group. By comparison, Rothesay Life is a relatively new entrant into the market without the backing of a large corporate group – although the evidence before the court was that Rothesay Life had a higher solvency ratio than PAC

- the judge disagreed with the parties, the Independent Expert and the PRA, who all took the view that only the relative financial strengths of the transferor and transferee was relevant as the likelihood of external support being required was remote. Snowden, J. commented "*I cannot dismiss as fanciful the possibility that such support may be required over the very long duration of these policies*"

- the policies being transferred were life annuities, which were therefore of a long-term nature and not transferable by the policyholder

- Prudential's commercial objective was (in the judge's view) already largely satisfied via a reinsurance agreement put in place between the parties and its further commercial interests were therefore outweighed by the interests of the objecting policyholders. The reinsurance agreement was drafted in such a way as to survive a failure of the scheme to receive approval.

Comment

Mr Justice Snowden's decision not to sanction the scheme has wider implications for future Part VII transfer schemes. In particular it raises questions as to how difficult it will be in the future for well established insurers to transfer long-term liabilities and for comparatively new entrants to the market to have such books of business transferred to them. We discuss the wider implications in more detail in our longer note on the case *Prudential Assurance Company and Rothesay Life*.

In the immediate term the judgment does not appear to have had an adverse impact on Rothesay Life's business. On 26 and 27 September it announced two new major pension derisking transactions – the largest full pension scheme buy-out ever undertaken in the UK, with telent, and the largest buy-in ever to cover deferred members, with Allied Domecq. It also announced that shareholders had contributed a further £200 million of new equity to help fund these and future deals. This follows on from a further £500 million of new equity and a £400 million bond issue raised a few weeks ago to support its growth.

Our recent work in this area includes advising Prudential, Aviva and Standard Life on their Brexit-related Part VII transfers, Legal & General on the proposed transfer of its mature savings business to ReAssure and Canada Life on a proposed transfer of policies from MGM Advantage to Canada Life

Proposed guidance on the Prudent Person Principle

On 18 September the PRA published a consultation on a proposed supervisory statement on the Prudent Person Principle (**CP22/19**).

Much of the guidance reflects risk management and governance arrangements which insurers are likely to already have in place. There may, however, be a need for increased documentation of processes, in particular the setting of internal quantitative investment limits in respect of some areas.

Some key points in the draft supervisory statement are:

- firms should be able to demonstrate compliance with the Investments Part of the Rulebook and to provide evidence of compliance to the PRA on request (para 2.3)
- for investment in structures where the risk exposure is dependent on the performance of underlying assets, firms should include the risks of the underlying assets within the scope of their investment risk management framework (para 3.4)
- firms are expected to consider stress scenarios in relation to investment risks and the potential impact on their solvency position, including considering possible management actions (para 3.5). There is an element of overlap here with the existing requirements for calculating the SCR and the ORSA
- firms should set internal quantitative limits for assets and exposures encompassing at least asset class, geographic, single-name, sector and off-balance sheet exposures (para 3.11)
- the PRA emphasizes that requirements relating to avoiding excessive risk concentration and excessive reliance on particular assets and issuers (paras 3.17 and 3.19) and keeping investments in non-traded assets to prudent levels (para 5.9) are "objective standards". The precise nature of the objective standard is not specified, however. Firms will presumably need to consider what the PRA would "objectively" think is excessive or imprudent in the circumstances
- firms are specifically required to consider excessive accumulation of financial risks arising from climate change (para 3.23)
- there are separate sections on exposure to non-traded assets and valuation uncertainty in relation to those assets, which are particular areas of concern for the PRA at present. Amongst other things, the PRA emphasizes that firms must be able to demonstrate that key persons have sufficient experience and expertise to be able to understand and manage the risks involved in holding such assets (para 5.8)
- there is a section of guidance on intra-group loans and participations, which the PRA considers to constitute intra-group assets (section 7). The PRA's primary concern in respect of these assets is the potential for conflicts of interest between shareholders and policyholders. In general, the PRA considers that because of this potential conflict intra-group assets are unlikely to be appropriate for covering technical provisions. Although not explicitly stated, the use of intra-group assets to cover the SCR is presumably permissible.

Changes to rules for subordinated debt capital

Recent changes and proposed future changes to the rules on subordinated debt capital have in the first case made life easier for insurers issuing subordinated debt capital and in the second case threatened to make it harder for that capital to be used for group solvency purposes.

Changes to the Delegated Regulation - early redemption

In July 2019 the Level 2 Delegated Regulation was amended to (among other things) allow own fund items to include provision for early redemption in the event of a change in regulatory classification or tax treatment. This is intended to create a more level playing field with other financial institutions for issues of subordinated debt by insurers. It is also more in line with the position in the UK prior to the introduction of Solvency II.

CP16/19 – Group availability of subordinated liabilities and preference shares

Meanwhile, recent PRA proposed guidance may make it more difficult for groups to use subordinated debt to meet the group SCR. On 22 July the PRA published **CP16/19**, which proposes changes to the guidance set out in SS9/15 – Solvency II: Group supervision. The proposals would mean that in order for subordinated liabilities and preference shares to be considered as available to count towards group own funds two tests would need to be met:

(i) each (re)insurance undertaking in the group must have the right to claim against the issuer if that undertaking is wound up and there is a shortfall for policyholders and beneficiaries; and

(ii) the legal obligation of the issuer to the holders of the instruments, including coupon payments, must be subordinated to any claims made by related (re)insurance undertakings that are being wound up.

In principle the second test can be met by including appropriate wording in the terms and conditions for subordinated debt issues. Existing subordinated debt issues, however, are unlikely to contain such wording and it is unclear what the position will be for these issuances. The consultation paper states that the proposals will only apply to future determinations of the availability of subordinated debt. As, however, availability of own funds is assessed on an ongoing basis the proposed new guidance has the potential to catch existing sub debt issues. It will be important that this point is clarified in the final supervisory statement if the proposals go ahead.

The first test is more problematic. The PRA comments that the rights of group undertakings against the issuer should not significantly increase group risks and, in addition, that intra-group guarantees would usually have precisely that effect. It is therefore not entirely clear what mechanism should be used.

The proposals have come as something of a surprise. We are not aware of the PRA specifically raising these points with insurers issuing subordinated debt prior to publication of the consultation, although we understand that the points have been raised on proposed issuances post publication. Insurance groups have typically treated subordinated liabilities as available to contribute towards group own funds and there may therefore be some push back on the proposals.

Our recent work in this area includes advising Pension Insurance Corporation on its debut issuance of Restricted Tier 1 Capital and Prudential on its issue of Resettable Dated Tier 2 Notes.

Fair pricing in financial services

In July the FCA published a feedback statement to its October 2018 discussion paper on fair pricing in financial services – **FS19/4**. As highlighted in the feedback statement, this is part of a broader piece of work which includes looking at the balance of responsibilities between consumers and providers of financial services products.

The discussion paper and feedback statement focus on a proposed framework for the FCA to assess whether it has concerns about the fairness of a particular pricing practice, the wider effects of the practice and the appropriate intervention (if any) for the FCA to make. The FCA concludes that the use of prescriptive rules to apply the framework is unlikely to be sufficient. It therefore intends to consider how its work on fair pricing can be incorporated into its upcoming review of the Principles for Businesses. This review will also draw on the work the FCA has undertaken recently considering a possible duty of care for financial services firms.

Next steps:

- the framework will be used as part of the General Insurance Pricing Practices Market Study – findings to be published in H2 2019
- a discussion or consultation paper on a possible duty of care for financial services firms – to be published in autumn 2019
- a discussion paper on the review of the FCA's Principles for Businesses – to be published in Q4 2019 or 2020.

SELECTED RECENT WORK

We have recently advised:

- **Legal & General** on the proposed transfer of its mature savings business to ReAssure by way of Part VII transfer
- **Prudential** on the proposed demerger of its UK & Europe business (M&G Prudential)
- **Standard Life Aberdeen** on a contractual dispute with Lloyds Banking Group / Scottish Widows in relation to the termination of a series of investment management agreements
- **management** on the sale of the **Barbican Insurance Group** to Arch Capital
- **Pension Insurance Corporation** on its debut issuance of Restricted Tier 1 capital
- **Athora** on the proposed acquisition of VIVAT's life and asset management business
- **Allianz** on the acquisition of the general insurance business of Legal & General
- **Legal & General** on a further derisking of The Pearson Pension Plan
- **Prudential** on its regional bancassurance arrangement with United Overseas Bank, covering Singapore, Indonesia, Malaysia, Thailand and Vietnam
- the **Quartz insurance group** on a minority investment into the group by Inflexion Private Equity Partners
- **Zurich Insurance** on the transfer of its pre-2007 UK legacy employers' liability portfolio to Catalina.

On 6 November we are hosting a client seminar jointly with our Best Friends insurance group. The seminar will take place in Frankfurt and will cover topics including life insurance run-off, the professionalization of asset management and the digitisation of insurance.

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Dated September 2019