The City of London Law Society

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RESPONSE BY THE INSURANCE COMMITTEE OF THE CITY OF LONDON LAW SOCIETY TO HM TREASURY'S CONSULTATION ON PROPOSALS TO STRENGHTEN THE ADMINISTRATION REGIME FOR INSURERS

The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the captioned subject has been prepared by the CLLS Insurance Committee. The Committee's purpose is to represent the interests of those members of the CLLS involved in the insurance industry.

Introduction

The Government's proposals seek to refine the administration regime for insurers, primarily with the objective of ensuring continuity of payments and protection for policyholders should an insurer go into administration. The underlying aim of the proposals, which is emphasised throughout the consultation, is to preserve continuity of treatment of policyholders, particularly in the case of life insurers.

For some time, insolvencies in the life and non-life sectors have been dealt with along different lines. This note will first make some general observations on the development of the insolvency regime for insurance companies and then comment on the specific consultation questions raised in the Treasury paper.

The development of the insolvency regime for insurance companies

Before administration became available to insurance companies in 2002, insurance companies in financial difficulty had only two options – go into liquidation or enter into a scheme of arrangement. It has long been generally

recognised that it is by far preferable for an insurer in financial difficulties to endeavour to continue the business wherever possible than to cease the business and attempt to place a value on policyholders' unexpired claims and pay them out a dividend as part of an insolvency process. This is why, historically, schemes of arrangement were the preferred insolvency process within the insurance industry, particularly for general insurers.

Many of the earliest schemes of arrangement, in the 19th century, concerned life companies in liquidation. However the scheme process was resurrected as a tool for dealing with general insurer insolvencies in the late 1980s, and most, if not all, insolvencies in the general sector since then have used, or in the more recent cases are expected to use, the scheme process in order to make payments to creditors.

As companies negotiating a scheme of arrangement had no right to a moratorium on hostile action by creditors, the practice in the 1980s and 1990s was to apply to the court for the appointment of a provisional liquidator, so as to bring about a moratorium. With the moratorium in place, the company was free to explore the possibility of putting a scheme of arrangement in place after any preliminary issues had been resolved. Distributions to creditors were in all cases under the umbrella of a scheme of arrangement.

Extension of administration to insurance companies

Since the administration procedure was extended to insurance companies by the Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2002 (**AORI Order**), there have been only two insolvencies, both involving general insurers, in which administration was used. This may suggest that people are still fighting shy of administration as a means of resolving the financial problems of an insurance company, or it may mean that fewer general insurers have experienced extreme financial difficulties.

The problem in arranging a rescue of a general insurer is that it is rarely possible, particularly in the early days of an insolvency, to estimate what the ultimate total liabilities will be. In relation to the Barings crisis, the Governor of the Bank of England remarked that when somebody knows what the bill is, it is likely that somebody can be found to pick it up, but where nobody can tell what the bill will be, this is not possible. This remains true of insolvent general insurers. The rules of the game are different for life companies where actuarial techniques make it possible to estimate the total liabilities with much greater certainty than in non-life cases. Therefore, it may well be possible to organise a rescue or a takeover.

In a general insurer insolvency, the best that can be hoped for is to maximise both the realisation of the remaining assets (of which the largest is likely to be reinsurances to which claims that have not yet been settled will give rise) and the consequential return to creditors at the end of the day. If the business is not in run-of when insolvency occurs and is profitable or has a value, it is likely that the right to renewals will be sold.

Although administration is an attractive option because of the statutory moratorium, it is likely that distributions in insolvencies of general insurers will continue to be dealt with under a scheme of arrangement. The reason for this is that although paragraph 65 of Schedule B1 to the Insolvency Act 1986 contains a power for the administrator to make a distribution to a creditor, with the permission of the Court, it is generally considered that this does not extend to making a series of distributions to creditors generally. In a normal case an initial payment percentage will be set, once the scheme is in operation, and this will be increased over the years as the ultimate total of the liabilities becomes clearer and further assets (mainly reinsurance recoveries) are realised out of which to make payments to creditors.

For life companies, because, as mentioned above, there is a higher possibility of organising a rescue or takeover, in most cases policyholders' best interests will be served by keeping the business going in run-off rather than putting it into liquidation or administration and attempting to value policyholders' claims and pay them a lump sum, which will rarely be adequate to purchase a replacement policy. In such cases, keeping continuing contracts in place will be key. This will involve continuing to receive payments of premiums and to pay out under policies which were already in payment or subsequently mature for payment.

The comments which follow are all made in the context of the foregoing.

Commentary on Treasury Consultation

It may be useful for the provisions relating to the valuation of claims in a winding up to be permitted to be used in the administration of insurers. We expect that in practice administrators are already heavily guided by the claims quantification under the Insurers (Winding Up) Rules 2001 (**Winding Up Rules**). This is because, under paragraph 8(2) of the AORI Order, "*any payments to a creditor...must not exceed, in aggregate, the amount which the administrator reasonably considers that the creditor would be entitled to receive on a distribution of the insurer's assets in a winding up*".

However, we do not think that application of the valuation rules should be compulsory in the case of general insurer insolvencies. As mentioned above, it

is likely that a scheme of arrangement will continue to be the insolvency process of choice for general insurers. What happens under the scheme will be governed by the provisions of the scheme. In our opinion it is undesirable for the hands of those promoting the scheme to be tied in this respect.

In most cases administration of a general insurer will come to an end when the scheme of arrangement becomes effective. In some cases it may be more appropriate for administration to continue, to deal with certain matters, primarily pursuing claims against third parties, outside the scheme, using Insolvency Act powers.

It has been suggested that, in line with the spirit of paragraph 8(2) of the AORI Order, any new regulations adopted following the consultation should clarify that policyholders' claims rank, in an administration, before claims of ordinary unsecured creditors. We would not object to this, provided that it is not mandatory, but is capable of being varied by the terms of a scheme of arrangement. It seems preferable to preserve flexibility. In any case, those promoting the scheme would be aware that policyholders have priority in a liquidation, and in all likelihood, this would have to be given some recognition in designing the scheme.

It has also been suggested that the law should be amended to support the orderly run-off of an insurance business in financial difficulties to a greater extent than it does at present. For example, in the Winding Up Rules, where a general insurance policy is expressed to run from one definite date to another or may be terminated by any of the parties with effect from a definite date, the liquidator is required to attribute a value to liabilities under such policy equal to such proportion of the last premium paid as is proportionate to the unexpired portion of the period in respect of which that premium was paid. This provision was criticised for being prejudicial to policyholders, especially in the situation where the risk or cost has increased since the policyholder took out the policy, such that there is little prospect of the policyholder obtaining the same cover for the balance of the period, using the pro-rated premium. Nevertheless we consider that this is simply one of the unavoidable consequences of the insurer's insolvency.

Where there are current policies, we believe that it is important that, like a liquidator, the administrator of a general insurance company should have the ability to terminate current policies, giving rise to the right to a return of the portion of the premium attributable to the unexpired period of the policy, whether or not the contract so provides, if the administrator considers that this would be in the best interests of creditors as a whole. We believe these conditions will

temper the potential for policyholders to be prejudiced in the manner highlighted above.

We agree that, whether or not a scheme of arrangement will be, or is likely to be, proposed in a non-life insurance administration, the administrator should be under an obligation to render assistance to the FSCS.

Response to questions in Treasury Consultation

Turning now to the numbered questions in the consultation paper, our views are as follows:

1. We agree that the valuation rules should apply to insurance companies in administration provided that they are capable of being varied by the terms of a scheme of arrangement.

2. We agree that the administrator should have a duty to provide assistance to the FSCS to enable it to administer the compensation scheme in all cases.

3. We agree that the administrator should have a duty to provide assistance to the FSCS to enable it to secure continuity on long term insurance contracts.

4. We do not agree that the same duty should apply in relation to general insurance contracts. The duty to provide assistance to the FSCS to enable it to administer the scheme would be sufficient in non-life cases.

5. We agree that the administrator should be required to maintain contracts of long term insurance.

6. We agree that an administrator should be permitted to enter into new contracts of long term insurance where they relate to existing policyholders and arrangements in place. This question expressly does not apply to general business.

7. We agree that the administrator should have a power to agree to a variation of contracts in force, so long as he does not have to exercise such power and his hands are not tied with regard to the terms of a scheme of arrangement.

8. We agree that the administrator should have the same power as a liquidator to apply for the appointment of a special manager, although we consider it unlikely that such power would be used by an administrator of a non-life company. It has been common for provisional liquidators to

appoint run-off managers to manage the run-off of general insurers. We see no reason why an administrator should not have the same power, and we believe that he already has such power under Schedule B1 to the Insolvency Act 1986. The run-off manager will almost invariably be not a human person but either a company specialising and experienced in the management of run-off or a company specially formed to employ such of the staff of the now insolvent company, who have been managing the business of that company, as are to be retained.

9. We agree that the power to reduce the value of contracts and appoint an independent actuary is desirable in the administration of a life insurer but do not consider it necessary for a general insurer.

Richard Spiller and Glen James

THE CITY OF LONDON LAW SOCIETY
INSURANCE COMMITTEE

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