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Insurance Law Committee response to PRA Consultation Paper "*Schemes of arrangement by general insurance firms*" (CP6/13)

The City of London Law Society ("CLLS") represents approximately 15,000 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 19 specialist committees. This response in respect of PRA Consultation Paper "*Schemes of arrangement by general insurance firms*" (CP6/13) has been prepared by the CLLS Insurance Law Committee.

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1. Departure from PRA Policy

1.1 The Consultation Paper ("CP") states that the approach to schemes of arrangement is reflective of the PRA's policy on insurance supervision as set out in the PRA Approach Document[1]. It appears that in a number of respects, however, the CP is not consistent with the stated policy.

A Tailored Approach

1.2 It appears that there is a distinction between the PRA's policy in the CP, which adopts a "one size fits all" approach to solvent schemes regardless of the line of business or type of insurer proposing the scheme, and the Approach Document, which adopts a more nuanced approach to the supervision of insurers generally. In particular, the Approach Document states that:

(a) the PRA's approach to protecting policyholders will "*vary according to the significance to the policyholder of the risk insured and the potential for significant adverse effects on policyholders if cover were to be*

[1]Para 2.1

withdrawn or obligations not paid"[2] and, as a result, it may take a different approach to lines of business that are key to financial stability or compulsory, such as employers' liability insurance and life insurance compared to other lines of business; and

(b) the PRA is responsible for supervising a diverse range of insurers, including Lloyd's, "low potential impact insurers", reinsurers, mutual insurers etc and that its approach will be tailored to each type of insurer.[3]

1.3 It would be helpful if the PRA could explain to the market the reasons for this apparent shift in approach. It seems that there is a clear basis for a policy approach which takes account of distinctions such as type of firm and line of business, for example:

(a) where a scheme relates to insurance rather than reinsurance business;

(b) where only a book of business is to be schemed rather than the whole of the business;

(c) the business is personal lines or SME business;

(d) the scheme involves a pool;

(e) the firm is a mutual; or

(f) whether the firm is a member of an insurance group which includes other insurance companies or is a solo firm.

1.4 It is unclear whether the draft supervisory statement will apply to life insurers. The heading of the draft supervisory statement restricts its application to "general insurance firms" but the statement itself does not limit its scope to general insurers. The PRA should clarify its position in relation to schemes proposed by life insurers.

Continuity of Cover

1.5 The CP states that the PRA policy view is that the use of a scheme by a solvent insurer is unlikely to be compatible with its statutory objectives unless there are safeguards in place "*to ensure an acceptable level of continuity of cover for dissenting policyholders*" and that the PRA "*has explained in its Approach Document that it wishes to ensure that firms are able to exit the market in an orderly manner, but in such circumstances, it wishes to ensure that policyholders have an acceptable degree of continuity of cover against insured risks.*"

[2] Para 12.
[3] Paras 199 to 217.

1.6 First, this does not seem to be consistent with the Approach Document, which states that the PRA's focus on ensuring that policyholders have an appropriate degree of continuity of cover is achieved broadly in two ways:

(a) through ensuring that insurers are sufficiently financially sound to avoid failure and thus able to meet claims when they fall due; and

(b) that continuity of cover is, in certain circumstances, available on the *failure* of a firm to help prevent significant disruption to critical financial services (*emphasis added*).

The Approach Document does not state that the PRA's statutory objective is to be achieved by ensuring that *solvent* insurers maintain continuity of cover for a group of policyholders.

1.7 Secondly, the Approach Document refers to a firm "exiting" the market in an orderly way in the context of the failure of that firm[4] but does not address solvent firms exiting the market. The Approach Document does not say that a solvent firm exiting the market must ensure continuity of cover for its policyholders.

1.8 We note that Julian Adams' recent speech[5] followed the policy approach set out in the Approach Document, where he stated, in the context of the PRA approach to reducing the likelihood of firm failures, that "*within insurance, one aspect of this is a much greater focus on ensuring policyholders can have an appropriate degree of continuity of cover in the event of firm failure and have recently published two consultation papers which illustrate this in the particular context of general insurance...*" (*emphasis added*).

1.9 The CP suggests[6] that continuity of cover may not be required in the case of an insolvent scheme and that the PRA will consider the extent to which policyholders can be protected within the context of that scheme. Again, this does not seem to be consistent with the Approach Document, which focuses on securing continuity of cover in the event of a failure of a firm. On the other hand, the CP expects continuity of cover to be secured in the event of a solvent scheme.

1.10 We consider that there is a sound basis on which to treat solvent schemes differently from insolvent schemes in respect of the securing of continuity of cover. Given that in a solvent scheme, policyholders should receive full value for their policies in any event, that sum may be capable of being used to obtain alternative and identical cover, albeit it may well be the case that

[4] See paragraphs 23 and 24 of the Approach Document.
[5] Given on 2 October 2013 at the Insurance Institute of London, available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech684.pdf
[6] Para 2.9b.

alternative cover is not available either on the same terms or at all. However, there are also issues around the accuracy of the valuation of IBNR claims, particularly long tail liabilities on policies written on an occurrence basis. Furthermore, there are cases where alternative cover is not available. Clearly, where full value is not payable due to insolvency, the position will differ.

1.11 It would, therefore, be helpful if the PRA could explain to stakeholders:

(a) whether the policy in the Approach Document regarding continuity of cover in a failing firm has been extended to cover solvent schemes; and

(b) the position regarding requiring continuity of cover in the case of an insolvent scheme. We consider that this clarification would be helpful given that there are already rules in place enabling the FSCS to take steps to ensure continuity of cover, for example, in life insurance.

2. **Continuity of Cover**

2.1 The CP refers to the ensuring of an appropriate degree of continuity of cover for policyholders generally and also, in the case of solvent schemes, to an acceptable level of continuity of cover for dissenting policyholders[7]. In any event, whether the scheme is a solvent or insolvent scheme, it is not clear what is intended by "appropriate degree" or "acceptable level" in the view of the PRA.

2.2 The PRA should clarify to stakeholders whether it expects continuity of cover to be provided only for dissenting policyholders or also for non-voting policyholders. In this regard, the PRA should also clarify if it has a view on the proposed treatment of untraceable policyholders.

2.3 The CP does not make it clear how the appropriate or adequate continuity of cover should be achieved. Continuity of cover is usually achieved through a Part VII transfer. However, from a firm perspective, a simple termination and replacement mechanism would usually be the most straightforward, timely and cost effective means of achieving continuity of cover. In the latter case;

(a) there is no independent expert to consider the status of the new provider, as would be the case in a Part VII transfer and it is not clear whether the PRA would expect the Court to consider the proposal as part of the Scheme process (nor indeed whether the Court would consider it had the statutory authority or responsibility to do so in such circumstances);

[7] Para 2.9.

(b) replacement cover may not necessarily mean equivalent or identical cover, and it may not be possible to source such cover in the market at the time.

2.4 Furthermore, there is a risk that the termination and replacement of a number of policies may trigger Part VII of FSMA in any event as Part VII triggers automatically on the transfer of all or part of a business[8]. If a firm were to opt to terminate and replace in lieu of implementing a Part VII, it would be open to scrutiny and challenge from both the regulator and policyholders. Whilst a firm may, of course, take its own legal advice on this issue, it seems appropriate in the circumstances for the PRA to set out its views clearly as to its expectations in respect of the process by which firms can or should achieve the desired continuity of cover and the interplay with Part VII FSMA in this regard.

3. Insolvency

3.1 The CP appears to draw a line between the treatment of proposed schemes in the event of an insolvent firm as opposed to a solvent firm. Whilst the CP refers to "*other doubts...whether sufficient assets will remain available*", it is not always clear as to the point at which the PRA will consider a firm to be insolvent for these purposes, bearing in mind the various regulatory capital thresholds which may apply to a firm and also corporate insolvency thresholds. The glide path to insolvency may not always be predictable and that it may be appropriate to implement a scheme where the firm remains solvent and is not at a critical stage in the PRA's ladder of intervention.

3.2 There is no reference in the CP to the impact of Solvency II on the PRA's policy approach. Although Solvency II has been delayed once more, given its significance for all firms, including for firms in the run off sector, it would be helpful for stakeholders to understand the PRA's views on its impact on the PRA's policy in this area.

4. Exercise of PRA powers

4.1 The PRA focuses in the CP on its obligation to pursue its statutory objective of "*contributing to the securing of an appropriate degree of protection for policyholders*" and states, in particular, that a solvent scheme is unlikely to be compatible with this objective *"other than where there are compelling reasons to take a different approach in order to secure an appropriate degree of policyholder protection*". We have identified a number of issues that we believe are relevant to this approach:

(a) the PRA's predecessor, the FSA, also had a statutory objective of achieving an appropriate degree of protection for policyholders[9] but

[8] Section 105(2)(a) of FSMA
[9] Section 5 of FSMA (now repealed)

did not, apparently, consider that continuity of cover in solvent schemes was necessary in order for this objective to be achieved in any case. It would be helpful if clarification were provided as to the basis of the apparent change in approach; we note that there has been no evidence provided in the CP of policyholder detriment resulting from the approach of the FSA in solvent or insolvent situations;

(b) the statutory objective requires an "appropriate" degree of protection rather than "absolute" protection. We consider that the approach in the CP leans towards the latter interpretation, whereas the achieving of an "appropriate" degree of protection permits a more nuanced approach, which also recognises and anticipates a balancing of different interests. It would be helpful for the PRA to explain what may be considered to be "compelling reasons" for an approach which does not include an offer of continuity of cover in the case of a solvent scheme. Some examples or further guidance as to the PRA's thinking would perhaps shed some light on this statement, particularly given that the pursuit of a higher level of protection than that set out in statute may leave the PRA open to a challenge by way of judicial review.

5. **Statutory Authority**

5.1 The CP acknowledges that schemes of arrangement are governed by the Companies Act[10] but does not explain the relationship between the role of the Court as overseer of schemes of arrangement and the role of the PRA under FSMA.

5.2 We consider that there is a robust procedure under the Companies Act, which is designed to ensure fairness to policyholders and offers them protection by requiring that a scheme be sanctioned by the High Court, at its discretion.

5.3 However, the PRA's approach indicates that it does not believe that the procedure set out in the Companies Act provides sufficient safeguards to meet the PRA's statutory objectives (set out above) and that the PRA will object to the Court in cases, for example, where its expectations as to continuity of cover for policyholders are not satisfied.

5.4 We are not aware of any suggestion that Parliament considers that the Companies Act scheme procedure is inherently unfair or inappropriate for insurance firms or that the financial services regulators should be awarded a specific statutory role in the process. If this were the case, we consider that the necessary amendments to FSMA (and the Companies Act) could have been implemented as part of the regulatory reform programme.

[10] Para 2.4

5.5 Schemes of arrangement have been available to companies since 1870 and there is long line of judicial decisions which have developed that focus on protecting the interests of creditors, and in particular those minority creditors that do not support a scheme proposal. In summary, the Court will only sanction a scheme where the creditor classes are properly constituted, the effects of the scheme have been sufficiently explained to creditors and it is fair to creditors generally. The courts have applied these protections robustly to solvent schemes – see for instance *Re British Aviation Insurance Co Ltd* [2006] BCC 14, *Re Sovereign Marine & General Insurance Co Ltd and other companies* [2006] EWHC 1335 (Ch) and *The Scottish Lion Insurance Company Limited v Goodrich Corporation And Others* [2011] CSIH 18.

5.6 There is an argument that the PRA would be acting outside its statutory powers by implementing the changes set out above. Whether the High Court would refuse to sanction a scheme of arrangement solely on the basis of a PRA objection, in pursuit of its statutory objectives under FSMA, that insufficient steps had been taken to protect the minority, dissenting policyholders, in circumstances where all of the requirements of the Companies Act process have been met, is a matter for further debate and, ultimately, a matter for the High Court to determine.

6. **FCA**

6.1 The CP notes that the FCA may also have its own views on proposed schemes of arrangement. Given the interplay between the prudential aspects of a scheme of arrangement and the conduct elements concerning the impact on policyholders, it would be helpful for stakeholders to be given a clear statement as to how the regulators will work together on schemes of arrangement in future.

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THE CITY OF LONDON LAW SOCIETY
INSURANCE LAW COMMITTEE

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