MILLIMAN BRIEFING

Final Guidance on the FCA's approach to the review of Part VII insurance business transfers

July 2018

Introduction

On 29 May 2018, the Financial Conduct Authority (**FCA**) published final guidance[1] on its approach to the review of Part VII insurance business transfers[2]. This follows a year after it published a guidance consultation paper on the subject[3], of which Milliman provided a summary in January 2018[4].

The FCA received 22 responses to the consultation from a range of industry participants and also provided a summary of the feedback received[5]. In light of this feedback, it made a number of updates in the final guidance, primarily in the following areas:

- The purpose of the guidance;
- Changes to the Scheme;
- The Independent Expert's (**IE's**)[6] reliance on the work of other experts;
- Competition considerations;
- Changes to Financial Ombudsman Service (**FOS**) and Financial Services Compensation Scheme (**FSCS**) coverage;
- The definition of policyholder; and,
- Identifying and tracing policyholders.

The FCA also commented that there were some areas where requests from respondents to the consultation were considered beyond the scope of the guidance. For example, requests for:

- The guidance to be more prescriptive;
- Guidance on detailed EU withdrawal-specific arrangements;
- Changes to the twin-peaks regulatory framework[7] and the coordination between the FCA and the PRA; and,
- The creation of various tools and standards to help firms in preparing for the Part VII process.

The FCA has not made any changes in respect of such requests but has said it may take some of these suggestions forward as separate process improvement initiatives.

This paper provides an update to our previous summary of the FCA's approach by describing those areas where the final guidance differs relative to the initial guidance consultation. There have not been many material changes to the guidance, rather, the updates are largely clarification points and further illustrative examples provided by the FCA. To help firms to quickly identify and familiarise themselves with the important points, we have therefore grouped the changes into 'significant' and 'other' updates, and have not described minor updates. We have also included our observations and comments in blue text.

Significant updates

THE PURPOSE OF THE GUIDANCE

The FCA has amended the introductory statement to clarify the purpose of the guidance. It explains that the aim is to help **Applicants** (i.e. those firms proposing a Part VII transfer) to identify early in the process those areas of the transfer that differ from the FCA's expectations, and hence avoid delays closer to the scheduled Court dates. It does not wish for the guidance to be viewed as the adoption of a 'comply or explain' approach, which could potentially lead to a more costly or onerous process.

Despite this clarification, the final guidance requires Applicants to confirm that the proposed transfer satisfies the expectations set out in the guidance or else explain any divergence from it.

FUTURE CHANGES TO THE SCHEME

Respondents to the consultation raised a number of points in relation to the FCA's guidance on clauses in Scheme documents that allow for future changes to the Scheme. In particular, they sought clarification on which types of changes would trigger specific requirements, the expectations for the IE (where one is required) and the involvement of the Regulators (i.e. the Prudential Regulation Authority (**PRA**) and FCA) and Courts based on the nature of the changes.

[1] FG18/14: The FCA's approach to the review of Part VII insurance business transfers.
[2] A transfer of part or all of the insurance business from a UK insurer to another insurer is governed by Part VII of the Financial Services and Markets Act 2000, and is referred to as a 'Part VII transfer'.
[3] GC17/5: Proposed guidance on the FCA's approach to the review of Part VII insurance business transfers.
[4] Milliman Briefing: Part VII transfers and the FCA's approach to the review.
[5] Summary of feedback received.
[6] The role of the Independent Expert is to assess the impact of the transfer on policyholders and report on this to the Court.
[7] Under the twin peaks regulatory system, banks and insurers are subject to supervision by the PRA for prudential issues and the FCA for conduct issues.

Below we have set out the FCA's updates to the final guidance relating to clauses that:

- Allow for future minor or technical changes without the need for Court approval;
- Allow for future changes subject to Court approval, but include certain provisions that the FCA may challenge (though the FCA acknowledges that ultimately it is for the Court to decide); and,
- Allow for changes to be made in very specific circumstances, subject to non-objection from the Regulators.

Minor or technical changes not requiring Court approval

In relation to clauses in Scheme documents that allow for minor or technical changes to be made without returning to Court, the FCA states that such changes are in fact likely to require Court approval where a level of discretion may be exercised by the firm. Alongside its original example of changes prompted by changes in management practices, it provides an example of changes prompted by actuarial practice where different approaches are permitted.

Changes requiring Court approval

In relation to clauses in Scheme documents that allow for future changes subject to Court approval:

- The FCA specifies that, where a change is eventually proposed that relies on section 112(d) of the Financial Services and Markets Act (**FSMA**)[8] (incidental, consequential and supplementary matters) and is not necessary to give full effect to the Scheme, it will consider the potential for harm to occur when assessing whether or not to object at the time of the proposed change.
- For any significant change proposed, the FCA would expect this to be accompanied by an updated IE report or IE certificate. In this case, the FCA states that the IE's considerations should extend to all possible impacts of the change beyond policyholders' benefit expectations and to all policyholders groups. The IE should also be the same as the IE on the original Scheme where possible.
- Within the Scheme document, the FCA would like to see provisions which prompt firms to apply for a change to the Scheme to cover future incidences where there have been unintended impacts on policyholders relative to what was communicated to them in the policyholder notification (for example, as a result of EU withdrawal).

Timelines for notifying the FCA

The FCA states that it should be given sufficient time to object to proposed changes. It specifies:

- For minor or technical changes not requiring Court approval, at least (rather than ideally) 28 days from the date that its Part VII team acknowledges notice of the proposed change; and,
- For changes requiring Court approval, at least six weeks or a 'reasonable period'.

Changes in specific circumstances

In relation to clauses in Scheme documents that allow for changes to be made in very specific circumstances, the FCA previously provided an example of where the Transferee expects to need to merge, close or split funds, usually with-profits or unit-linked. The FCA retains this example in its final guidance; however, it removes its previous reference to unit-linked funds.

The FCA states that it expects to see confirmation that the proposed action is permitted by the terms of the policies and does not make those terms more restrictive in a way that could adversely affect policyholders' interests. If, however, there is ambiguity regarding whether the action is permitted, the FCA would expect any resulting amendment to policy terms to be in the interests of, and clearly and prominently communicated to, policyholders.

In our previous summary, we noted that it would be helpful if the FCA indicated whether it would be considered sufficient for such a change to have no effect on policyholders' interests, giving the example of where a fund merger has sound financial objectives due to diminishing fund size but does not benefit policyholders who are subject to fixed charges.

The FCA has elaborated on this matter in its final guidance by stating that, in such instances, it would question why some of the financial benefits of the merger are not passed on to policyholders, directly or indirectly.

*We would note that, in the case of with-profits funds subject to fixed charges, the purpose of such a merger would be to reduce the fixed costs borne by shareholders, for example, by allowing multiple funds to be managed in accordance with a single Principles and Practices of Financial Management (**PPFM**)[9]. Policyholders would therefore be unlikely to directly benefit from the merger; however, they would be expected to indirectly*

[8] Section 112 of FSMA – Effect of order sanctioning business transfer scheme.

[9] A PPFM is a document that defines the Principles and Practices that a company follows when managing its with-profits business.

benefit from the increased benefit security afforded by a reduction in shareholder costs and associated increase in shareholder capital available to support the business.

The FCA states that Applicants should consider whether the original IE report has provided full commentary on all potential impacts and adverse effects of such future changes on policyholders.

In practice, all potential future outcomes may not be realistically identifiable or measurable at the time the original IE report is written. What is more important, however, is ensuring that appropriate governance will be applied to protect policyholders' interests at the time of the change.

The FCA suggests it may also be appropriate to require an IE's review at the time the change is effected to ensure the interests of policyholders are sufficiently protected, particularly where the **Transferee** (i.e. the firm which is receiving the transferring business) is afforded significant discretion by the Scheme and the implications for policyholders are potentially significant.

The need for appropriate controls at the time of the change is not something new – we would already expect to see this. Requiring a review by an IE is only one of the possible options, however. For example, for changes affecting with-profits policyholders, an alternative might be a review by the with-profits actuary, an independent member of the with-profits committee or the with-profits committee as a whole.

CHANGES TO THE 'EFFECTIVE DATE' OF THE SCHEME

Where Scheme documents permit the flexibility to change the effective date of the Scheme without returning to Court, the FCA has increased the deferral period for which it would typically expect firms to refresh policyholder notifications (and potentially seek Court approval for the delay) from two to three months. This follows from consultation feedback that established industry practice currently uses three months.

However, the FCA explains that this serves as a guideline only - in practice, it will consider what is proportionate in light of the particular transaction. Regardless of the length of the delay period, this might be re-notification but equally there may be alternative proportionate methods of informing policyholders of the new effective date. In any case, the FCA expects firms to give appropriate consideration to whether the information provided in policyholder notifications has changed in a way that could affect a policyholder's decision significantly.

CHANGES INVOLVING ANCILLARY ORDERS[10]

Respondents to the consultation requested further clarification on the circumstances that would cause the FCA to consider objecting to requests to change the Scheme where such requests involve the Court exercising its ancillary orders powers. In response, the FCA:

- Explains that, where proposed changes involving ancillary orders are demonstrably for the benefit of policyholders, though not obviously necessary for the Part VII transfer, it will leave the question for the Court;
- Will expect that any changes are clearly and prominently notified to policyholders such that they are able to assess the impact on them; and,
- States that, for cases where the purpose of the transfer is primarily for commercial reasons and to the benefit of the Applicants, it will check that appropriate mitigations are in place to protect policyholders against any adverse changes in terms.

THE IE'S RELIANCE ON THE WORK OF OTHER EXPERTS

The FCA clarifies that only relevant and significant legal advice given to the Applicants need be obtained by IE, and that this should be subject to appropriate arrangements to safeguard any legal professional privilege.

Also, to address feedback from respondents to the consultation, the FCA has expanded its guidance in relation to the IE's use of a legal opinion on whether a transfer involving overseas policyholders will be recognised in non-EEA jurisdictions.

The FCA's guidance consultation paper referred to an IE's reliance on the work of overseas legal advisors and we mentioned in our previous summary that, due to potentially limited legal and actuarial resources in overseas jurisdictions, using overseas advisors may result in a trade-off between expertise and independence. In the final guidance, however, this no longer appears to be an issue - the FCA now refers only to 'a legal opinion' (not necessarily one from an overseas advisor), suggesting that seeking advice from a domestic advisor would also be appropriate.

The FCA now states that, where there is material doubt as to whether a court would adopt the approach set out in the advice received, the IE should not use such advice as the sole basis of their conclusion. Further, the legal advice itself should address,

[10] Ancillary orders are orders issued by the Court, which are supplementary to or support the Court order sanctioning the Scheme. An example is an order that makes provision for the transfer of property or liabilities which would not otherwise be capable of being transferred or assigned to the Transferee.

and suggest ways of mitigating, the risk that the relevant court takes a different position.

Where the **Transferor's** (i.e. the firm which the insurance business is being transferred from) authorisations are to be cancelled and it is likely to be wound up, the FCA clarifies that it is unlikely that treating policies that cannot be legally transferred as excluded policies which remain with the Transferor is itself an adequate mitigation. In addition, the FCA states that the IE should assess any material possibility of the Transferee successfully denying its liability in respect of excluded policies that were to be transferred but in practice were left with the Transferor.

Where the Transferor is expected to remain in existence post transfer, the FCA believes there is less risk to policyholders as they will still be able to claim against the Transferor as an excluded policy. Nonetheless, the FCA would expect the IE to examine potential adverse impacts and determine appropriate mitigations. It provides an example of delays / changes in approach to claims handling if the Transferor is uncertain about indemnity arrangements.

Other updates

COMPETITION CONSIDERATIONS

This section of the guidance was challenged by a number of respondents to the consultation, with the point raised that IEs typically specialise in actuarial, rather than competition, matters.

The FCA has now clarified that it does not expect the IE to be a competition expert but that the IE should highlight any matters that could affect policyholders.

CHANGES TO FOS AND FSCS COVERAGE

Respondents to the consultation sought clarity over the FCA's expectations for the analysis of regulatory protections post-transfer relative to pre-transfer, in particular, how these expectations might be met given the UK's withdrawal from the EU.

For cross-border transfers, the FCA states that it expects Applicants to aim to preserve the FOS insofar as possible, with some firms being able to continue servicing contracts from UK branches to preserve continuity. Post EU withdrawal, the FCA says it is likely to accept proportionate approaches to comparing conduct of business rules regimes, focusing on the key protections.

Where there is no comparable compensation scheme in the jurisdiction to which the business is being transferred, including where firms have taken a commercial decision to switch to a jurisdiction without FSCS cover, the FCA expects this to be clearly communicated to all types of policyholders, not just those with general insurance policies. The option of moving, at no cost, to an insurer with FSCS or other compensation scheme cover should also be communicated if a policyholder considers this to be a significant issue. This applies where the firm has taken a commercial decision to switch to a jurisdiction without FSCS cover.

We can see how the latter part of this guidance, relating to the option of moving at no additional cost, would work for short-term general insurance business. However, for long-term insurance business (particularly business with no surrender value, for example, annuities), it is not clear how Applicants would carry out and fund such transfers in practice.

THE DEFINITION OF POLICYHOLDER

The FCA extends its definition of policyholder to include any potential claimant under a policy (rather than just those where the possibility of claiming is remote).

It acknowledges that there are compelling different views on some of the categories of policyholders described in the guidance. However, rather than accepting the arguments from respondents to the consultation that its definition is too broad, the FCA states that it is open to firms applying for dispensations. It also states that approval of dispensations would usually be on the grounds of proportionality or impracticality.

IDENTIFYING AND TRACING POLICYHOLDERS

In relation to documenting the various classes of policyholders that are encompassed by the definition of policyholder under FSMA, the FCA advises that this information should be set out within the witness statement(s)[11] (but not necessarily within the Scheme document). It also confirms that Applicants' efforts to identify, trace and contact policyholders should be in addition to their business-as-usual activities.

Where third party arrangements restrict Applicants' ability to request necessary policyholder information or to assist third parties in making notifications on their behalf and, as a result, Applicants cannot comply with relevant regulatory requirements, the FCA states that it may take separate supervisory action to address this. In any case, the FCA would expect the Applicants themselves to take action to change their contractual

[11] Witness statements are evidence submitted to the Court by the Applicants. For the first Court Hearing, they provide information on the Scheme background, history of the companies involved, contracts being transferred, policyholder notification plan, draft policyholder communications pack and proposals for any overseas business. For the final Court Hearing, they provide details of actual notifications, of resulting policyholder contacts, and a summary of all policyholder objections.

arrangements to remove the issue.

The FCA highlights a specific example where this may be an issue. For applications for dispensations where brokers have refused to facilitate the notification process / withheld policyholder information from the Applicants, the FCA clarifies that it expects the Applicants to demonstrate that they have considered all reasonable options to make the brokers notify the policyholders and any alternative methods for undertaking notification.

The FCA also states that it would expect brokers and other authorised third parties to help to facilitate the notification process. Arguments relating to data protection concerns will not generally be accepted.

How Milliman can help

Milliman is a market leader in the provision of IE services for insurance business transfers. Milliman consultants have acted as IE for a large number of life and non-life transfers over many years for small and large insurers and friendly societies, and we have a supporting team of consultants who have a track record of delivering these complex and lengthy projects to a high quality, and who keep up to date with emerging regulations and best practice for such assignments.

If you have any questions or comments on this paper or any other aspect of insurance business transfers, please contact any of the consultants listed below or your usual Milliman consultant.

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