Milliman Briefing: Insurance Business Transfers

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WHAT IS AN INSURANCE BUSINESS TRANSFER?

An insurance business transfer is the transfer of some or all of the insurance business of one insurer to another. Transfers from UK insurance companies or underwriting members of Lloyd's are governed by Part VII of the Financial Services and Markets Act 2000, and such transfers are commonly known as 'Part VII transfers'. Part VII transfers require sanction from the High Court to come in to effect. Transfers from friendly societies are covered by Section 88 of the Friendly Societies Act 1992 and require sanction by the Prudential Regulation Authority ('PRA') after consultation with the Financial Conduct Authority ('FCA'). This paper considers some of the issues associated with insurance business transfers.

Transfers often take place for one or more of the following reasons:

- In order to provide finality for insurers running off a portfolio.
- In order to formalise a transfer of economic risk that has already taken place.
- In order to rationalise legal entities within the same group, often following an acquisition.
- In order to take credit for diversification benefits between the risks within an insurance group within capital requirements and to ensure that capital is not trapped in a subsidiary.
- In order to remediate retrospectively any issues that may have emerged, such as misclassified business that has been written without the relevant authorisation.

Under a Part VII transfer, the firms in question must appoint an Independent Expert ('IE') who will assess the terms of the proposed Scheme[1] and related documents, consider the impact on policyholders and prepare a report for the Court. Policyholders have the right to submit objections or representations to the Court, and both the PRA and the FCA may file reports with the Court providing their view as to the appropriateness of the transfer (although neither policyholders nor the regulators are able to veto the transfer). It is therefore vital for companies undertaking a Part VII transfer to maintain dialogue with the regulators and to communicate appropriately and effectively with affected policyholders.

INVOLVING THE REGULATORS

The PRA formally leads the regulatory side of the transfer process, with the FCA also taking an active role. Both regulators have statutory objectives to ensure policyholders are appropriately protected and that there is effective competition in the market. The PRA focuses on the prudential and solvency aspects of the proposed transfer in order to promote the safety and soundness of insurers, whilst the FCA looks to protect the integrity of the industry, for example by considering the quality of communications with policyholders and other aspects of the transfer potentially having a bearing on their fair treatment. In terms of guidance from the regulators, the FCA has recently published a consultation paper on its proposed guidance[2] regarding its expectations in relation to insurance business transfers, and in 2015 the PRA published a Statement of Policy[3] setting out its approach with regard to insurance business transfers.

We would highly recommend that the PRA and the FCA ('the regulators') be proactively involved at each stage of the process, including the planning stages, and to highlight any unusual aspects of the transfer or any areas of concern to them at the earliest opportunity. They typically require a minimum of 6 to 8 weeks to review documents, with the review period being proportionate to the size and complexity of the transfer. The regulators will also expect the timetable to allow policyholders a reasonable time within which to consider the information mailed to them. The PRA's 2015 Statement of Policy states that they expect at least 6 weeks from the time the last policyholder receives their mailing to the final Court hearing. This will again be proportionate to the complexity of the transfer and may be extended if, for example, the period runs over the Christmas holidays. For transfers involving changes to principles within the relevant Principles and Practices of Financial Management, a longer period may be required.

A balance needs to be struck between having long enough to get everything done and the timeline not being so protracted that financial information and any conclusions become outdated by the time that the reports are published. It is important for firms involved in a transfer to confirm which

[1] This is the document that, following sanction by the Court and implementation by the relevant parties, will effect the transfer and govern aspects of the operation of the transferred business thereafter.

[2] https://www.fca.org.uk/publications/guidance-consultations/gc17-5-review-part-vii-insurance-business-transfers

[3] http://www.bankofengland.co.uk/pra/Pages/publications/sop/2015/ibt.aspx

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financial results they plan to use with the PRA during the planning stages, and to consider potential ways of ensuring that the information provided is current, such as the provision of interim or estimated financial results to assess the impact of post-balance sheet events.

TWO-WAY CHALLENGE

The FCA states in its proposed guidance that the relationship between the IE and the firms should involve a two way challenge. Not only should the IE be analysing and challenging the firms' work, but the firms should be ready and willing to challenge the IE, for example if the firm does not consider that the IE has sufficiently analysed the information provided or if the IE has simply accepted and replicated a conclusion from one of the firm's actuarial reports without sufficient independent analysis. The FCA states that it will require the firms to evidence that they have provided such challenge to the IE.

REINSURANCE AGREEMENTS

It has become common for firms intending to undertake a Part VII transfer to enter into a reinsurance agreement covering the relevant liabilities in advance of the transfer. This has the benefit of immediately transferring much of the risk from the transferor to the transferee in anticipation of the transfer process.

It is a common policyholder concern that transfers where such arrangements are already in place are effectively a 'done deal'. The FCA's recent proposed guidance instructs the IE to consider carefully the context of any reinsurance agreements. Firms should be aware that when the IE compares the pre- and post-Scheme positions, they may deem it appropriate to also give consideration to the pre-Scheme position without the reinsurance being in place. This is especially the case if, in the event that the Scheme is not sanctioned, the expectation is that the reinsurance agreement will be terminated.

The FCA's position on pre-arranged outsourcing arrangements in anticipation of the transfer is similar. The FCA states that it would expect to see a comparison of the pre- and post-outsourcing administration arrangements so that the IE can clearly review any changes to service standards.

CHALLENGES UNDER SOLVENCY II

Solvency II has introduced many additional challenges for firms undertaking a Part VII transfer, with the current solvency coverage ratio becoming less definitive as a measure of the security currently enjoyed by policyholders.

The transitional measure on technical provisions ('TMTP') reduces a life insurer's best estimate liabilities but could be considered to not be a tangible asset to the company in the same way that, for example, a government bond is. It therefore arguably does not contribute to policyholder security in the same way. Consider, for example, policies being transferred from a company with no TMTP to a company with the same solvency coverage ratio but with a large TMTP. The transferee may have the same solvency coverage ratio but may provide less security for policyholders, as in reality it has fewer realisable assets available to provide resilience against adverse events. Whilst this does not preclude the transfer from taking place, it is important for firms to be able to demonstrate that the TMTP will continue to be supportable throughout its full run-off.

If policies (either life or non-life) are being transferred from a firm with an internal model to a firm which uses the Solvency II Standard Formula, or vice versa, the firms' capital requirements may be calculated using very different parameters and with differing methodologies. Firms are likely to be required to demonstrate the relative volatility of their solvency cover, for example by providing the IE with the results of the sensitivity tests on their balance sheets, in particular for material market risks.

Additionally, for a Standard Formula firm the calculation of the solvency capital requirement is audited, but this is not the case for firms using an internal model. If business is being transferred to an internal model firm, the firm must be able to demonstrate to the IE that their capital requirements have been calculated appropriately and that he or she can rely on the solvency figures provided by the firm.

There is also a question of how the firms should allow for pending regulatory approvals, for example, applications to the PRA for changes to internal models, in the financial information that is included in the IE's report. The PRA is understandably uncomfortable with firms assuming that such applications will meet with approval, but the assumption of non-approval may also be inappropriate. This can result in the firm producing financial results based on a number of scenarios, which can be time-consuming and burdensome.

Solvency II has renewed focus on governance and capital management and this is an aspect to which the PRA is particularly attentive. The IE will consider the relative strength of the firms' capital policies; not just not just the target solvency ratios but also the way capital is managed, the governance structure that surrounds the policies, the actions that will be taken on breach of the policy and the process that would need to be undertaken for these policies to be altered following the proposed transfer.

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POLICYHOLDER COMMUNICATIONS AND DISPENSATIONS

Firms must contact all policyholders to notify them of the transfer. It is worth bearing in mind that the regulators have a broad definition of whom they consider to be policyholders. Dispensations can be applied for and granted by the Court; these waive the requirement to contact certain groups of policyholders, but the proposed FCA guidance states that such applications must be rigorously justified and backed up with evidence.

For example, applications to not contact 'gone away' policyholders must be backed up by evidence that reasonable efforts have been made to trace policyholders via a range of channels. Beginning to trace such policyholders ahead of the transfer process is looked on favourably by the regulators and is likely to help to justify an application for dispensation on these grounds. In 2016, the FCA conducted a review[4] which included their expectations regarding treatment of 'gone away' policyholders.

Similarly, applications on the grounds of proportionality must be backed up with reasonable cost estimates associated with notifying relevant policyholders, which should ideally be prepared in advance of the process.

The PRA's Statement of Policy states that it is sensible to consult the PRA on its views about which waivers might be appropriate and substitute arrangements that might be made. Additionally, depending on the type of transfer and the policies in question, the FCA's proposed guidance suggests that, while additional advertising is not sufficient on its own to meet the need for notification, such a method may be used to support applications for dispensations that are made on grounds such as impracticability or proportionality.

Applications solely on the grounds that the information will not be of use to certain policyholders are likely to be challenged, as the FCA's view is that this is for the policyholders themselves to decide. The FCA have also stated that firms intending to request that brokers or trustees relay information to their clients/policyholders must oversee and contribute to the financial costs of the onward communication.

POLICYHOLDER OBJECTIONS

Even the most straightforward transfers will usually elicit a number of objections from affected policyholders. While some of these objections arise from a misunderstanding by the policyholder of the transfer and the Court process, there are typically some objections that require serious consideration by the firms and, in some cases, by the IE. Some of the most common policyholder objections that we have seen in recent transfers cover areas such as:

- Holders of annuities sometimes express frustration at their inability to surrender their policy if it is subject to a transfer, and often believe that this is an option that is being denied to them by the firm rather than by UK pension legislation. This is in contrast to transfers of types of policy where an option to surrender or lapse does exist.
- The policyholder may object to being transferred from a firm that they have consciously chosen and are comfortable with to a firm they have not necessarily heard of.
- The policyholder's policy may have been subject to previous transfers of business, and the policyholder objects to being passed "from pillar to post" as a result of a number of successive transfers.
- The transfer from a UK insurer into a non-UK insurer or an insurance group that is headquartered outside the UK (even where the transfer is into a UK-domiciled subsidiary of that group) can elicit objections from policyholders.
- The loss of "double protection"[5] when the transferring business is already reinsured from the transferor to the transferee has been the subject of objections.
- Some policyholders object to the use of language by the IE such as "no material adverse effect", and challenge why it is necessary to qualify the opinion with the word "material".
- With-profits policyholders sometimes express concerns around the likely level of their future bonuses, particularly where bonuses have historically been below their expectations.

[4] https://www.fca.org.uk/publication/thematic-reviews/tr16-02.pdf, p49

[5] The protection provided by both the insurer and the reinsurer.

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CROSS-BORDER TRANSFERS

Given the potential loss of passporting rights as a result of Brexit, many firms are beginning to consider cross-border transfers of non-UK business into subsidiaries domiciled in the EU but outside of the UK. The FCA has highlighted two areas that it may be particularly beneficial to consider in advance of the transfer process:

- *How does the regulatory environment of the new firm compare to that of the current firm – in particular, has the new country been granted Solvency II equivalence (if outside of the EU)?*

  The UK's regulatory regime is arguably stronger in some respects than that in many other EU countries. For example, the last liquid point of the Solvency II discount curve is 50 years for the UK but 20 years for many European countries, resulting in the Euro discount curve starting to move upwards to the Ultimate Forward Rate much earlier than the GBP discount curve. A higher discount rate results, all else being equal, in a lower liability being held.

  On transfer out of the UK to an EU company, the firms will need to consider how to satisfy the IE that the transferring policyholders will continue to be protected to a materially similar extent under a regulatory regime that potentially has fewer protections for policyholders, for example by strengthening capital policies and continuing to comply with relevant UK-specific regulations, such as the UK's Conduct of Business rules.

- *How do protections such as compensation and complaint bodies compare between the two countries?*

  For transfers out of the UK, will policyholders have access to arrangements comparable to the Financial Ombudsman Service and Financial Services Compensation Scheme after the transfer?

  For example, policyholders of German insurers only have access to the German Insurance Ombudsman if the insurer is a member of the related association.

CONCLUSION

Part VII transfers require a lot of time, resource and planning but if this is given due consideration and an experienced IE is appointed, the process does not need to be unduly demanding. It is important to remember that the Courts are not there to prevent transfers from taking place but are principally there to ensure that policyholders are protected. An experienced IE will be able to guide you through the transfer process and provide input into the steps you need to take to ensure your application clears the relevant hurdles in relation to policyholder considerations.

MILLIMAN'S EXPERIENCE OF TRANSFERS

Milliman is a market leader in the provision of Independent Expert services for insurance business transfers. Milliman consultants in the UK have acted as Independent Expert for approximately 30 life and non-life transfers over the past 5 years, for small and large insurers and friendly societies. 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.

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

Milliman maintains a strong and growing presence in Europe with 250 professional consultants serving clients from offices in Amsterdam, Brussels, Bucharest, Dublin, Dusseldorf, London, Madrid, Milan, Munich, Paris, Stockholm, Warsaw, and Zurich.

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