

Run off update

September 2007

1) The FSA invites comments on new arrangements for Part VII transfers

Part VII of the Financial Services and Markets Act 2000 ("FSMA") requires an application made to court for an order sanctioning an insurance business transfer scheme to be accompanied by a report by an independent expert on the terms of the scheme. The FSA also has the right to participate in the proceedings.

In June 2007, the FSA agreed with the Chancellor of the High Court to provide an additional report to the court setting out the most significant issues in a Part VII transfer and the basis on which it does, or does not, object to a particular transfer. Reports have now been provided in six cases heard between June and August 2007 (the FSA also instructed Counsel to represent it at the hearings of these cases). In each case, the report was finalised after the FSA had seen the report of the independent expert and any written representations from policyholders. A draft copy of the FSA's report was also provided to the transferor and transferee prior to the court hearing. In an email sent out by the FSA on 22 August, the FSA advises that in the cases in which it has filed a report, no particular difficulties were encountered and the court has responded positively. Nevertheless, the FSA is considering holding a round table discussion with professional advisers and others typically involved in Part VII transfers (including the court) to discuss the form and function of its report and to obtain views as to how the new arrangement might be improved (see further below).

The FSA has also asked the court to agree that the standard form of notice to policyholders (as sanctioned by the court at the hearing for directions) will include a request that they send any representations/objections to the FSA (as well as the firm concerned) not less than two weeks prior to the hearing date. The FSA believes that once the new arrangement is fully in place, it will be able to substantially complete its provisional report before reaching a decision on whether or not to object to the transfer. This provisional report would then be sent to policyholders and other affected persons at the same time as they are sent notice of the application for the proposed transfer. After considering any representations/objections, the FSA would then finalise its report before the sanction hearing. A case-by-case decision will be made by the FSA as to whether Counsel will be instructed to appear on its behalf at the hearing.

Some potential issues identified by the FSA include:

- How, if at all, will the independent expert's report address the FSA's report?
- At what point should the FSA's report be made available to the applicant firm and the independent expert, as well as to the policyholders and other affected persons?
- Will court hearings take place well before the proposed effective date of transfer schemes, in order to allow for adjournments for further consideration of objections in person, if necessary?

We have been invited by the FSA to identify any significant potential issues with the operation of the new arrangement and to advise whether we believe a round table discussion would be an appropriate forum for discussion. We will be making a submission and if any reader would like to see the consultation paper and/or let us have any comments on the proposals for possible inclusion in our submission, please contact Glynis Masters, whose email address is glynis.masters@clydeco.com



2) House of Lords case results in significant developments on the right to claim interest

The House of Lords has made a recent ruling in the case of *Sempra Metals Ltd v Revenue & Anor* [2007] UKHL 34 has provided a significant boost to cedants facing delayed payments from reinsurers: recalcitrant reinsurers may now be obliged to pay compound, rather than simple, interest where payment of claims is delayed.

The case concerned a test case against HMRC following a decision of the European Court of Justice on the payment of Advance Corporation Tax by UK subsidiaries of foreign parent companies. It was agreed that HMRC was obliged to repay tax to such subsidiaries, but not the amount of interest to be paid for the period when HMRC was wrongly in receipt of funds.

Sempra brought a test case against HMRC in which they reclaimed interest on the sums paid by way of restitution, claiming the time value of the money by which HMRC was unjustly enriched. The House of Lords held that such a claim was recoverable, and they recognised that compound interest was now a fact of commercial life. They unanimously held that a claim for restitution could include a claim for compound interest and that simple interest was no longer consistent with commercial reality.

Lord Nicholls went further and criticised the anachronistic and restrictive common law rules for the award of interest on a debt. The existing rules allow the Court discretion to award interest to a Claimant in debt or damages actions under s.35A Supreme Court Act 1981. The maximum period is from the date upon which the cause of action arose until judgment and simple, rather than compound interest is usually awarded. There is no provision entitling the court to consider a claim for interest where debts are paid late, but before the commencement of proceedings for their recovery. In those cases, even if the debt was paid many years late, the creditor could not commence proceedings solely for recovery of interest on the debt. Lord Nicholls called for the House to hold that "in principle, it is always open to a claimant to plead and prove his actual interest losses caused by late payment of a debt. These losses will be recoverable, subject to the principles governing all claims for damages for breach of contract, such as remoteness, failure to mitigate and so forth".

This Judgment provides an important development in the right of parties to claim compound interest on their debts. It also signals a move by the Courts to allow Claimants to claim interest as damages where actual interest losses can be pleaded and proved as a separate item of loss. Claims for compound interest are now likely to become more standard in the industry, and cedants should take steps to record any actual losses caused by late payment as suggested by Lord Nicholls. Reinsurers may need to increase reserves where they dispute claims and note that they may be exposed to a claim for compound interest, even where they make payment of the full claim amount prior to commencement of proceedings.

3) The FSA issues a process guide to decision making on Schemes of Arrangement for insurance firms

Schemes of arrangement are governed by the Companies Act 1985, rather than the Financial Services and Markets Act 2000, so the procedural rules relating to scheme do not expressly require the involvement of the FSA. However, schemes clearly give rise to regulatory issues, given their impact on policyholders and the potential reputational issues for the particular insurer and the market as a whole that may arise. An insurer proposing such a scheme is obliged to inform the FSA of the proposals, as a result of its obligation under Principal 11 to deal with the FSA in an open and cooperative way and to disclose to the FSA anything relating to the insurer of which the FSA would reasonably expect notice. As a result, in practice the FSA is always consulted in relation to a scheme, and the court always expects to be informed that the FSA does not object to the scheme proposals.

Given the increasing number of schemes being proposed in the London market, the FSA has set up a specialist committee whose role is to review draft schemes of arrangement submitted to the FSA. It has also issued a process guide explaining its process for reviewing schemes and the factors it will take into account in considering them. The process guide is in the main a summary of the established practice that has grown up over the last 10 years. Schemes must be submitted to the insurer's usual supervisor and to the

schemes contact in the Wholesale Insurance Run-Off team. The documentation will then be reviewed by the specialist committee, any questions and comments resolved with the insurer, and a non-objection letter sent once the FSA is happy with the proposals. Factors to be taken into account in reviewing the scheme are the types of policyholder subject to the scheme, the degree of solvency of the insurer and the type and age of the business written. Essentially, the FSA will want to be satisfied that the scheme treats policyholders fairly, bearing in mind the resources available to the insurer.

A new aspect to the process however is the proposal in the process guide for the appointment of a policyholder advocate where the scheme affects the interests of private retail or small commercial policyholders, or is likely to be complex or controversial. The concept of a policyholder advocate is a familiar one in the case of life insurance companies seeking to redefine the rights or interest of with-profits policyholders in an inherited estate, but is new in the context of schemes. The FSA envisages that the policyholder advocate would advise policyholders on issues such as the method of valuation of their claims under the scheme, and would negotiate with the insurer to ensure that the benefits offered under the scheme constitute adequate compensation for the rights policyholders are giving up. In practice, the role is only likely to be relevant in insolvent cases, since solvent schemes are rarely if ever proposed to small commercial or retail policyholders.

The process guide is not a formal consultation document, but the FSA has indicated that it would welcome comments on the decision criteria set out in it. If any reader would like a copy of the process guide please contact Glynis Masters whose email address is glynis.masters@clydeco.com.

4) HM Treasury consults on proposals to implement the provisions of the Reinsurance Directive relating to passporting and portfolio transfers

The Reinsurance Directive (the "RID") introduces a new Europe-wide system for the regulation of reinsurance, and extends to reinsurance the concepts of home state regulation and mutual recognition of authorisation that apply in the case of direct insurance. The RID affects pure reinsurers and the reinsurance activities of companies that write both insurance and reinsurance business. The prudential requirements of the RID were consulted on by the FSA in 2006, and the resulting rule changes came into force on 31 December 2006. The Treasury is consulting on its proposals for implementing the remaining provisions of the RID, relating to passporting and portfolio transfers. In this context, passporting means the process under which a firm's authorisation in an EEA state in which it has its head office permits it to establish branches or provide services in other member states.

The passporting process under the RID and reflected in the Treasury's proposed amendments is very simple. Once those amendments are in force, pure reinsurers authorised in the EEA state where they have their head office will have permission to carry on in the UK the reinsurance activities for which they are authorised by their home member state, without any other formality. In addition, UK pure reinsurers wishing to passport into other EEA states will not have to comply with the consent procedure applying to direct insurers or those who carry out both direct and reinsurance business.

As is the case with direct insurance, passporting rights do not extend to pure reinsurers whose head office is outside the EEA. Such reinsurers will still have to be authorised in each member state in which they wish to take up reinsurance business in accordance with local rules.

In relation to portfolio transfers, the RID imposes a similar requirement to that in the direct insurance directives that member states introduce a procedure for the transfer of reinsurance portfolios by pure reinsurers with head offices within their territory, and for mutual recognition of such transfers by member states.

The business transfer process under Part VII of FSMA already allows for the transfer of reinsurance business. However, the RID requires transfers by EEA pure reinsurers to be authorised by the authorities in their home member states. The Treasury is therefore proposing to amend Part VII to remove provisions allowing EEA pure reinsurers to use Part

VII to transfer reinsurance business carried on by them through a branch in the UK, and allowing UK pure reinsurers to use any procedure other than Part VII to transfer business carried on in the EEA or relating to EEA risks.

The Treasury is also proposing to relax, in the case of transfers of reinsurance, the notification and publication requirements applying to Part VII transfers; and is proposing a "Part VII-lite" procedure for such transfers which would make court sanction optional, and require only a solvency certificate from the transferee's regulator. At the moment, these proposals would only apply in cases where all reinsurance policyholders affected by the transfer had consented to it. Given the difficulties encountered in most cases in identifying let alone locating policyholders, this is unlikely to be of much practical use. In circumstances where recognition of the transfer outside the EEA is an issue, a court sanctioned transfer may in any event be preferable. The Treasury is inviting suggestions as to other circumstances in which the Part VII lite process might apply.

The Treasury has not taken the opportunity to propose changes to Part VII which would allow for transfers of insurance and reinsurance business to insurers in Gibraltar, which remain problematic. However, it is proposing to make the amendments necessary to allow pure reinsurers established in Gibraltar to passport into the UK, as direct insurers are currently able to do.

The Treasury's consultation document is available via the following link: http://www.hm-treasury.gov.uk/consultations_and_legislation/reinsurance_directive/consult_reinsurance_directive.cfm

We will be responding to the Consultation and if any reader would like to let us have comments on the proposals for possible inclusion in our response, please contact Glynis Masters whose email address is glynis.masters@clydeco.com

Further information

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