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In this Insurance Bulletin:

REGULATORY

- PRA consults on substantial Solvency II reforms
- Sanctions systems and controls – the good news and the bad news

DISPUTES

- Court considers extent of principal's responsibility for acts of an appointed representative
- Law Commission publishes final proposals for reforms to the English Arbitration Act 1996
- The Policyholder Protection Rules – Costs will not be Compensated
- Insurers: Do you know what you know?

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REGULATORY

PRA consults on substantial Solvency II reforms

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"The PRA proposes that the IM provisions will be reduced and that it will retain a smaller number of more principles-based requirements that will allow greater flexibility and facilitate more suitable modelling techniques."

Following the UK's exit from the EU, the Government has been taking steps to put into place a new regulatory framework for financial services in the UK, one of the aims of which is to bolster UK competitiveness. As part of this process, the PRA published its first consultation in July, CP12/23 – Review of Solvency II: Adapting to the UK insurance market. In this article we summarise and consider some of the proposals within it.

Background

The Financial Services and Markets Act 2023, enacted in June, contains new powers that allow for the revocation and reform of the existing Solvency II regime to create Solvency UK[1] . The stated aim of Solvency UK is to create a more competitive insurance sector, and to support insurance firms to provide long-term capital for growth.

The reforms will:

- Reduce the risk margin[2] for long term life insurance by around 65% and for general insurance by 30%;
- Maintain the existing methodology and calibration of the fundamental spread[3] while allowing for notched ratings; and
- Broaden the matching adjustment[4] eligibility criteria to include assets with highly predictable cash-flows.

Some of the amendments will be implemented directly via legislation and for other reforms the government will legislate to enable the PRA to make the necessary changes to its rules and other policy materials including repealing relevant areas of retained EU law. The Treasury has published draft Statutory Instruments which are available here.

The aim is to move from the EU to the UK model of regulation, ie whereby the overarching framework is in legislation but detailed rules are made by regulators. A new section 138BA of the Financial Services and Markets Act 2000 (FSMA) gives greater powers to the PRA to modify rules.

As set out above, the PRA published a consultation on proposed changes to its rules, which relate to a number of areas not covered by legislation. Not all necessary changes are included in this consultation, and a further consultation will be published in September (not yet published at the time of writing) relating to proposals for life insurers on investment flexibility and the matching adjustment.

Details of the PRA consultation

Some of the key proposed changes are as follows.

Transitional measures on technical provisions (TMTP) and the risk-free interest rate

Firms are required to hold technical provisions to cover all of their future expected insurance contractual liabilities, and transitional measures were introduced to phase in any increase arising from the introduction of Solvency II relating to business written before 1 January 2016.

There are a number of changes proposed, including introducing a new simplified measure for calculating the TMTP; allowing some firms to continue to use the old approach ("the legacy approach"); and removing the financial resources requirement (FRR) test (intended to ensure firms do not claim more TMTP than is necessary to transition).

The new calculation method will allow the TMTP to be simplified in

1 The PRA has said it will continue to refer to the regime as Solvency II whilst the reforms are still being consulted on and implemented in stages and until all references to Solvency II can be amended across all relevant materials.

2 The amount, in addition to the best estimate of liabilities, that an insurer is required to hold on its balance sheet, representing the theoretical amount that a third party would require to accept the transfer of the insurer's insurance obligations.

3 Essentially the credit risk of an asset

4 This allows insurers to reduce the amount of assets required to be held against certain long-term liabilities, where the liabilities have a predictable cash-flow and the assets have the same predictable cash flow.

order to reduce costs for the firm and the PRA when considering queries.

The aim of the new TMTP is to reduce cost and increase consistency, rather than materially altering the ongoing amount, and therefore if firms would suffer operational impacts they can apply to vary their TMTP permission to continue the existing approach with some modifications (to be submitted at least six months before the proposed implementation date of 31 December 2024).

Insurance business transfers and 100% reinsurance transactions can result in significant changes to the liabilities subject to TMTP, and it is proposed that under the new method firms will have two months after the transaction to adjust their calculation approaches within two months of any transfer, subject to a requirement that no additional TMTP is generated overall between the two parties. The PRA notes that business transfers and 100% reinsurance contracts are designed for the purpose of transferring the full economic risk, which is why the latter are a proposed "transfer event", but the PRA expects the impact on TMTP of less material reinsurance arrangements would not be recognised in the firm's usual TMTP calculation and therefore would not require a methodology update and would not be a "transfer event". The proposal not to allow new TMTP would prevent new TMTP relief being claimed as a result of a business transfer.

The ability for third-country branches to use TMTP or TMIR (transitional measures on the risk-free interest rate) will be removed – the PRA says that since 2016 no branch has applied to use either measure.

Internal models

Under Solvency II, the Solvency Capital Requirement (SCR)[5] is calculated using a standard formula or an internal model (IM) approved by the PRA or a combination of the two.

The remaining retained EU law in this area will be revoked[6] and a new IM framework implemented, which aims to streamline the tests and standards (T&S) required to be met for IMs and increase flexibility. Under the proposed new framework, rather than approving an IM the PRA would grant permission to modify its rules on the calculation of the SCR to allow the use of an IM. This is described as a change in the legal mechanism rather than a substantive change in the way the PRA currently engages with firms in considering applications to use IMs under the existing framework.

Firms with existing IMs approved before these proposed reforms will not need to be granted new permissions, although they should consider whether consequential changes are needed as a result of these proposals[7].

The PRA proposes that the IM provisions will be reduced and that it will retain a smaller number of more principles-based requirements that will allow greater flexibility and facilitate more suitable modelling techniques.

Currently, firms can receive IM approval or be rejected on a binary basis. The PRA proposes that in addition it be able to grant permission to use an IM that has some residual model limitations (RMLs) with safeguards to mitigate or correct the limitations. Safeguards proposed are: an RML capital add-on (RML CAO), and a requirement safeguard – a qualitative requirement that would apply to a firm's business practices or IM use. The PRA would only grant a permission where the firm complies with the calibration standards (the IM on its own or with an RML CAO safeguard).

The PRA will also update its approach to the review and assessment of ongoing compliance with the IM requirements and will introduce a proposed IMOR framework.

The chapter indicates that the PRA may consider further aspects relating to the use of the new permissions power under s138BA FSMA in the future.

Capital add-ons

A capital add-on is the amount by which the SCR of a Solvency II firm or group is increased by the PRA in a number of circumstances such as: where there is a significant deviation in the risk profile of a firm from the assumptions underlying the SCR; where the firm's system of governance deviates significantly from the relevant requirements, or where there is a significant deviation from assumptions underlying the matching adjustment, volatility adjustment, TMIR or TMTP.

The PRA's approach for setting capital add-ons will broadly reflect current retained EU law. Any changes are intended to support the flexible approach on internal models.

Flexibility in calculating the group SCR

The proposal is that the PRA may grant temporary permission to a group temporarily to add the results of two or more different calculation approaches when calculating the consolidated group SCR, to allow greater flexibility in some scenarios, such as where a firm or group with IM permission is acquired by another group. It is also proposed that an application may be made for a UK group's overseas sub-group SCR to be included in consolidated group SCR under method 2[8] (for which the PRA can grant permission using s138BA FSMA). Currently, groups using method 2 cannot add overseas sub-groups to the overall group SCR. A group would be able to apply for this measure to apply method 2 to the overseas sub-group where that sub-group is subject to equivalent group supervision, to ensure firms are not incentivised to offshore UK risks to an overseas sub-group.

Finally, the PRA proposes to transfer and restate certain group supervision regulations from the SII CDR and the Solvency 2 Regulations 2015 that will be revoked under the Financial Services and Markets Act 2023 into the Glossary and Group Supervision Part of the Rulebook and a proposed new Statement of Policy.

5 The minimum level of capital that insurers and reinsurers are required to maintain.

6 Including on-shored Commission Implementing Regulation (EU) 2015/2012 and the SII CDR.

7 A transitional rule, Solvency Capital Requirement – Internal Model 6.6 will apply to firms that apply model limitation adjustments (MLAs), allowing two years from the date of the final rules to make consequential changes to their IM change policies to reflect MLAs.

8 The deduction and aggregation method for calculating group solvency described in Group Supervision 12.1.

requested. The PRA considers that a 12 month timeframe is appropriate (although a firm may exit in less) but, if there are exceptional circumstances outside a firm's control that affect its ability to exit in 12 months, this can be discussed with the PRA.

Third-country branches

The PRA proposes to remove the rules that require international insurers operating in the UK via a branch to calculate and report the branch SCR and branch minimum capital requirement (MCR), collectively the "branch capital requirements". As a result, it is also proposed that the SCR localisation requirement for third-country branch undertakings will be removed, together with the requirement to establish and report a branch RM. This reflects the PRA's approach to authorisation and supervision of branches as set out in SS2/18 which emphasises the overall "supervisability" of a firm. The PRA expects the whole firm to meet the Threshold conditions and relevant PRA rules, and to have sufficient financial resources.

The PRA considers that existing branch capital requirements offer limited protection (as a branch cannot fail alone) and create a burden.

Mobilisation

The PRA proposes a new optional mobilisation regime for new insurers that will be time-limited and apply from the point of authorisation.

Under this regime, the PRA will authorise firms with business restrictions at an earlier stage of maturity and they will have a period of up to 12 months to finish building out their business. The aim is to facilitate start-ups in particular, which may otherwise find it difficult to secure all capital, infrastructure and resources needed for authorisation. It may be suitable for firms that have a list of activities to complete before they can meet regulatory requirements: such as filling senior management positions, developing IT systems and controls or securing more capital. (It is unlikely to be suitable for a well-established insurance group seeking to establish a UK subsidiary which would have sufficient resources to establish themselves on day one.) Firms that wish to utilise this regime would need to submit a mobilisation plan before being accepted.

The nature, scale and complexity of the business will be restricted by the PRA during mobilisation, utilising Part 4A of FSMA, and the PRA would not expect firms to write a material amount of business if any[9]. Generally, restrictions would mean firms could only ever write short term policies of short-tail risks (on a claims-made basis and no liability insurance) producing a cumulative net exposure below a maximum limit (total net exposure below an aggregate sum insured of £50,000).

Firms in mobilisation will need to meet the Threshold Conditions and applicable standards in the PRA and FCA Handbooks, but regulatory requirements will remain proportionate and the minimum capital requirement (MCR) floor will generally be lowered to £1 million. Consent to authorisation will still be needed from the FCA (which might also impose restrictions).

To exit mobilisation, firms would need to apply for a variation of permission and to have completed all mobilisation actions as well as addressing anything the PRA has requested.

Thresholds

The PRA proposes to increase the size thresholds that determine whether a firm is regulated under Solvency UK or the non-Directive firm (NDF) rules and redenominate them from EUR to GBP as follows:

- a firm's gross written premium income threshold would change in the PRA Rulebook from €5 million to £15 million.
- firm and group technical provision thresholds would change in the PRA Rulebook from €25 million to £50 million.

Timetable

The consultation period ended at the start of September. The PRA intends to publish final policy around the end of the year, with expected implementation for most of the reforms of 31 December 2024.

Going forward, the PRA is taking the necessary steps to align the PRA Rulebook with implementation of the Treasury's risk margin reforms by 31 December 2023, and is planning to have final policy in place on the matching adjustment to enable implementation of the Treasury's matching adjustment provisions by the end of June 2024, with all other changes taking effect on 31 December 2024.

The PRA will consult in early 2024 on transferring any remaining firm-facing Solvency II requirements from retained EU law into the Rulebook and policy materials, although does not expect to make substantive changes to requirements at that time.

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9 If it does propose to write business the PRA would expect a full credible plan for how it will be serviced and for run-off if operations are discontinued.

Sanctions systems and controls – the good news and the bad news

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Against the backdrop of the Russian invasion of Ukraine, the FCA has stepped up its focus on sanctions compliance and has carried out a programme of assessing systems and controls for 90 regulated firms across a range of sectors, including insurance. The FCA found examples of good and bad practice, and in this article we summarise the key findings.

Many of these findings are directly relevant to insurers, reinsurers, brokers and other sectors.

They provide a useful overview of the policies, procedures and approaches which constitute good practice and therefore enable organisations in the sector to benchmark their own approach.

Equally, in the event of sanctions non-compliance, organisations may find that regulators use this report as an indicator of minimum standards, and seek to enforce more aggressively against those who do not meet these minimum standards.

Good practice

The FCA identified good practice in the following areas:

- A number of firms had taken a proactive approach in conducting risk exposure assessments and scenario planning prior to the Russian invasion, which left them better placed to manage the unprecedented level of sanctions we have seen since that time. The FCA states that firms should also conduct "lessons learned" exercises to improve readiness for any future events.
- Several firms could clearly demonstrate that their sanctions screening tools had been adequately calibrated, and had controls in place to measure the effectiveness of sanctions systems, thresholds and parameters.
- Finally, most firms were able to show that sanctions screening systems had fuzzy logic built in to help identify name variations for sanctioned entities and individuals.

Areas for improvement

The FCA indicated the following areas that need improvement:

- There were instances where senior management were not given enough management information (MI) to enable them to discharge responsibilities appropriately, including where multinational firms sought to rely on systems and processes used in other jurisdictions. In other cases, MI lacked basic metrics.
- In some firms, global policies were not aligned with the UK sanctions regime. For example, some firms had focussed on US sanctions and had applied insufficient focus to the UK regime. There were also instances of poor communication between global and regional sanctions teams.
- There was some over-reliance on third party sanctions screening tools, where firms lacked understanding of how the tools were calibrated and when lists were updated.
- Many firms had significant backlogs in the assessment, escalation and reporting of alerts from screening, which affected firms' ability to promptly identify and report exposures. This was often compounded by a lack of governance and appropriate internal service level agreements. Some firms did not have adequate internal expertise for effective timely screening.
- Some firms had effective control mechanisms to measure the efficiency of system thresholds and parameters, including testing and tuning, but in some cases calibration had not been adequately tuned, so that it caused a high number of false positives, or it was not sensitive enough, leading to minor variations in names and meaning sanctioned individuals were not detected.
- The FCA was concerned with the low quality of customer due diligence (CDD) and know your customer (KYC) assessments,

"In some firms, global policies were not aligned with the UK sanctions regime."

such as CDD that did not articulate full ownership structures risking inadequate screening of relevant parties.

- There was inconsistency in reporting, with some firms taking months to report a sanctions breach to the FCA. Others took remediation action before reporting, or did not report at all.

Next steps

The FCA flags up a number of resources to which firms should have regard, including the Financial Crime Guide (Chapter 7 in particular), SYSC 6.3 of the Handbook (to understand Money Laundering Regulations) and UK sanctions regimes, and relevant guidance including the OFSI UK Financial Sanctions general guidance and the JMLSG guidance. Firms should consider how its findings may be applicable to its own systems and controls, and be prepared to engage with the FCA about its testing programme. The FCA has indicated that it will continue its supervisory focus on sanctions. In its recent Dear CEO letter outlining its insurance market priorities for 2023-2025, the FCA set out that it continues to see financial crime problems across the wholesale insurance market, and that insurers with poor sanction controls increase this risk.

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DISPUTES

Court considers extent of principal's responsibility for acts of an appointed representative

In *KVB Consultants Limited & Ors v Jacob Hopkins McKenzie Limited & Ors,*[1] the High Court considered the extent to which a principal can limit its responsibility for the acts of an appointed representative (AR). The Court's approach to the application of section 39 of the Financial Services and Markets Act 2000 (FSMA) will be of particular interest to principals, particularly those with a number of ARs. The decision highlights the importance of ensuring, first, that the scope of any AR agreement is clearly defined at the outset of the relationship, and secondly that ARs are properly supervised throughout.

The facts

The claimants comprised a number of companies and individuals who, between October 2015 and March 2019, had invested a total of approximately £1.7 million in eight investment schemes. Those schemes were devised, managed, and promoted through a company known as Jacob Hopkins McKenzie Limited (**JHM**). The schemes were designed to allow investment in property development opportunities, which would be developed (or partly developed) and sold at a profit, to be split between the investors and JHM. The ventures failed, with half of the properties being repossessed by lenders.

JHM was acting as the AR of Kession Capital Limited (**KCL**). Under the AR agreement between JHM and KCL (**the Agreement**), the "Relevant Business" that JHM was permitted by KCL to undertake was defined as:

> *"… regulated activities which the [Appointed Representative] is permitted to carry out under this Agreement which are subject to the limitations of the Appointer's part IV permission… for the avoidance of doubt, the AR is not permitted to carry out any investment management activities…*
>
> *The Appointer acknowledges that the [Appointed Representative] will offer advisory and arranging services to third party investors with regard to residential property investment. There is no pooling of capital and no CIS"*

CIS means a collective investment scheme, an arrangement that enables investors to contribute to, and effectively 'pool' their respective assets within, a fund scheme and have these managed by a separate person or entity.[2] Additionally, the Agreement provided that JHM would only market and provide its services to professional and sophisticated clients and would not be permitted to conduct business with retail clients. Notably, KCL did not have authorisation to operate, promote or approve CISs, nor was it authorised to provide advice to any retail clients.

The claim

The claimants made an application for summary judgment against KCL (which by that point was the only remaining active defendant), arguing that KCL's liability for their losses was so clear that KCL could have no realistic prospect of defending the claims.

The claimants advanced arguments under three separate heads:

1. KCL had accepted responsibility for JHM's conduct and was therefore liable, under section 39 of FSMA as principal, for any losses caused by JHM's conduct in relation to CISs.
2. KCL's failure to properly supervise its appointed representative was otherwise a breach of the FCA SUP rules.
3. KCL had unlawfully approved promotions so as to become liable to the claimants under section 241 of FSMA.

1 [2023] EWHC 1686 (Comm).

2 The full definition of a CIS is set out in section 235 of FSMA.

KCL argued that it had only been prepared to appoint JHM on the strict understanding that there would be no CISs; given that the Agreement excluded such schemes from the ambit of "Relevant Business", they were not something for which KCL had accepted responsibility. Additionally, KCL noted that the claimants' case was that they were retail investors, and the terms of appointment expressly prohibited JHM from dealing with them. Whatever was done, therefore, was outside the terms of KCL's acceptance of responsibility and so not subject to section 39 of FSMA.

As the judge noted, working out whether a given set of arrangements amounts to a CIS is not always simple. However, in this case it was not disputed that each scheme was a CIS within the meaning of section 235 of FSMA and it was beyond doubt that they were.

Additionally, it was clear that the first seven of the eight schemes were unlawful. Nobody involved in them had any authorisation to operate them, and there was no lawful route by which they could be promoted or marketed. However, it was not clear that the eighth scheme was not lawfully operated, given that an appropriately authorised firm had been recruited to operate it. The claimants contended that the eighth scheme remained unlawful because the purported operator did not in fact function as operator, and that in fact it was JHM who operated it.

The Court's decision

Whether KCL had 'accepted responsibility' for JHM's actions

The bulk of the judgment focused on the application of section 39 of FSMA. As set out above, this provides that an AR is exempt from the general prohibition on carrying out a regulated activity comprised in the carrying on of business for which his principal has accepted responsibility. 39(3) of FSMA provides that:

> *"The principal of an appointed representative is responsible, to the same extent as if he had expressly permitted it, for anything done or omitted by the representative in carrying on the business for which he has accepted responsibility."*

In considering the application of section 39, the Court considered separately: (i) the operation by JHM of the CISs and (ii) JHM's promotion and marketing of those schemes.

It was held by the Court of Appeal in *Anderson v Sense Networks Ltd*[3] that the exemption and liability in section 39 FSMA are co-extensive so that a claimant cannot use section 39 to hold a firm liable for activities of ARs which are outside the scope of the business for which responsibility was assumed. It was held that the *Anderson* decision shows that it would be wrong to apply section 39 with the single-minded objective of imposing the broadest liability on the principal (as that would entail the broadest exemption) but it was also necessary not to dissect the appointment divorced from commercial reality. The Court should not take an artificially narrow view or assist principals in drafting away responsibility for business that in commercial reality falls within the appointment.

The Court found that KCL had not accepted responsibility for the operation by JHM of CISs, on the basis that the operation of such schemes was outside the scope of the activities for which KCL had accepted responsibility under the Agreement. Additionally, under section 39(1) of FSMA one of the requirements for a valid exemption is that the business to which the agreement relates and in relation to which responsibility is accepted should be "prescribed". The prescribed categories are specified in the Financial Services and Markets Act 2000 (Appointed Representatives) Regulations 2001. They do not include the activity of operating a CIS. It therefore followed that even if the operation of CISs had been included within the scope of the activities for which KCL had purported to accept responsibility under the Agreement, this would not have been sufficient to exempt JHM from the need for FCA authorisation, and KCL could not be taken to have accepted responsibility for JHM's actions.

The Court did, however, find that KCL had accepted responsibility for the promotion and marketing of the schemes by JHM. Those activities

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> **"In setting out its decision, the Court highlighted the importance of a principal thoroughly exploring all aspects of an AR's activities, and how the exemption it is going to confer will be used by that AR."**

3 [2019] EWCA Civ 1395.

were within the prescribed categories within which ARs could be appointed, and fell within the activities that KCL was authorised itself to conduct. The Court rejected KCL's argument that it had not accepted responsibility for the promotion and marketing of the schemes because the claimants were retail investors, and the Agreement prohibited JHM from dealing with them. In doing so, the judge pointed to the distinction drawn in *Anderson* between what an AR is permitted to do and how it should do it. Stipulating the type of clients that JHM was entitled to deal with was a requirement as to *how* JHM should go about matters, rather than what it was permitted to do under the Agreement.

Further, the fact that the schemes were identified after the event as CISs did not absolve KCL of responsibility. Even though the agreement had referred to *"no pooling of capital or CIS"* it was beyond doubt that the parties intended the marketing of schemes structured as these ones were to be "Relevant Business", regardless of whether the parties were proceeding under a legal misapprehension about their nature.

The Court went on to consider the issue of liability, given that section 39 deals with responsibility only. The judge found that, after July 2016, JHM had realised that there was at least sufficient uncertainty about the status of the schemes to suspend marketing them. Despite having told KCL that all marketing activity was on hold, JHM continued to accept investments after this point. The Court therefore granted summary judgment in relation to the period after July 2016.

Arguments as to supervision and the approval of promotions

The Court was not prepared to grant summary judgment on the claimants' supervisory claim. KCL had a "long shot" of establishing that it was reasonable to rely on assurances that the schemes were not CISs.

Likewise, the judge would not have been prepared to grant summary judgment in relation to the claimants' arguments on approval of promotions. The point was academic given the judge's views on the application of section 39 of FSMA, however this aspect of the claimants' case was not clearly pleaded or sufficiently evidenced.

Comment

In setting out its decision, the Court highlighted the importance of a principal thoroughly exploring all aspects of an AR's activities, and how the exemption it is going to confer will be used by that AR.

It is also abundantly clear that the Court will take a pragmatic approach to construing AR agreements. In such circumstances, the Court's principal focus will be on *"defining 'what' the appointor accepted authority for, approaching that question with a broad eye for commercial reality, and alert to the fact that terms defining how the appointor is to conduct the business are not to be taken as circumscribing it."*

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Law Commission publishes final proposals for reforms to the English Arbitration Act 1996

After two years and two consultations, the Law Commission's Report and Recommendations on the reform of the Arbitration Act 1996 have been published, together with a draft Bill.

Nicola Gare, our Disputes Knowledge Counsel, will be producing a detailed briefing, but in the meantime the Bill includes the following proposals:

1. **Arbitrator disclosure.** A new codification of the statutory duty of disclosure of circumstances that might reasonably give rise to justifiable doubts over impartiality extending to pre as well as post-appointment;
2. **Arbitrator immunity.** Arbitrator protected from liability unless their resignation is unreasonable;
3. **Summary disposal.** Aligning arbitration with litigation and enabling tribunals to issue summary awards, unless parties agree otherwise;
4. **Substantive jurisdiction.** Amendments to reflect the approach taken on s69 challenges;
5. **Governing law.** Addressing the Supreme Court's decision in Enka v Chubb, the recommendation is for a new rule providing that the law governing the agreement is as expressed by the parties failing which the law of the seat; and
6. **Emergency arbitrators.** Clarification of court powers in support of arbitral proceedings, and in support of emergency arbitrators.

A notable exception in the list is confidentiality. The Law Commission determined that confidentiality should not be a mandatory or default position in arbitration, preferring to leave it to the parties to agree to this provision.

The Policyholder Protection Rules – Costs will not be compensated

The Financial Services Compensation Scheme (the "FSCS") has successfully appealed a High Court decision to grant an application for judicial review following the FSCS's refusal to compensate policyholders for legal costs and statutory interest due to them under a court judgment against an insurer in administration.

Background

The policyholders purchased long leases in a property development. Upon purchase of the leases the policyholders were issued with an insurance policy intended to cover structural defects. The development suffered serious defects but the policyholders' insurance claim was declined. The claim proceeded to trial where the policyholders were successful and the policyholders received payment of the judgment sum of the base amount due under the policy. However, the defendant insurer, East West Insurance Company Ltd, went into administration before it had paid the policyholders the VAT, interest and costs due to them. The FSCS agreed to pay the outstanding VAT under the Policyholder Protection Rules (PPR) but declined to pay the interest and legal costs owed to the policyholders such that they were £4m short.

The Policyholder Protection Rules

The PPR[1] are a set of rules dealing with insurance-related compensation. In short, the FSCS administers a compensation scheme intended to respond where eligible claimants make a claim in respect of a "protected claim" (i.e. claims under qualifying insurance policies) and where the insurer is unable to pay. The PPR contains detailed provisions determining the timing and amount of any compensation. Rule 3.1(2) provides that the FSCS may pay compensation to an eligible claimant if it is satisfied that the claim is *"in respect of a protected claim"*.

High Court Decision

The policyholders successfully argued that their claim for interest and costs fell within the PPR because it was a claim "in respect of" a protected claim i.e. the claim for interest and costs was made in connection with a qualifying insurance claim arising from structural defects at the development.

Court of Appeal Decision

The FSCS appealed the decision of the High Court and relied on the following grounds:

Ground 1: the term *"in respect of"* had been interpreted incorrectly. The FSCS argued that this can only be interpreted as meaning making a claim *"for"* or *"for payment of"* a protected claim.

Ground 2: a claim for costs and interest does not fall within the scope of a *"protected claim"*.

Ground 3: the costs and interest could not be said to be owed "under a contract of insurance".

The Court of Appeal upheld the FSCS's appeal and considered the three grounds in reverse order:

Ground 3: costs and interest were owed pursuant to a court order and statute. They were not owed under the terms of an insurance contract.

Ground 2: a claim for costs and interest was not a "protected claim" as costs and interest were not owed under the terms of the insurance contract. Instead, the claim was derived from a court order and statute.

Ground 1: a narrow interpretation should be given to the words *"in respect of a protected claim"*. When reading the PPR as a whole, the phrase *"in respect of a protected claim"* should be properly interpreted as meaning *"for"* or *"for the payment of"* a protected claim.

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"The judgment will be unwelcome for policyholders as it limits the recourse available to claimants who are successful in legal proceedings"

1 Prudential Regulation Authority Rulebook, SII Firms, Policyholder Protection

Comment

The Court of Appeal's judgment serves as a reminder that regulatory instruments, such as the PPR, should be interpreted with regard to the natural and ordinary meaning of the words used, read in the context of the regulatory regime within which they sit and with reference to the intended purpose of the provisions.

More practically, the judgment will be unwelcome for policyholders as it limits the recourse available to claimants who are successful in legal proceedings but who are unable to realise their rights to interest and costs in circumstances where their insurer is unable to pay.

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Insurers: Do you know what you know?

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The Commercial Court has delivered a noteworthy decision which deals with, among other things, whether "knowledge" held by a claims team can also be said to be in the "knowledge" of the relevant underwriters.

The judgment considered this in the context of policy construction and potential rectification of the definition of "Insured" in a policy wording, and the case provides a useful discussion of estoppel by convention. The decision is also of interest in the context of the duty of fair presentation under the Insurance Act 2015.

The case provides an important reminder that there must be a clear dialogue between underwriting and claims teams regarding insureds, including where external claims handlers/loss adjusters are employed as their agents.

We discuss the case in more detail in our briefing here.

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