PRUDENTIAL AND ROTHESAY: HAS POPULISM REACHED PART VIIS?

Much has been written in recent weeks about Lord Snowden's decision, in a somewhat emotive judgment[1], to block the Part VII transfer of the Prudential Assurance Company's (PAC) annuity book to Rothesay Life. But what does it really mean for the market and for future Part VIIs?

Some have observed that Lord Snowden was persuaded by the objections of the policyholders, notwithstanding the views of the IE, regulators and the parties, and that the decision is a clear signal to the market that the courts are more than willing to exercise their discretion broadly. Others have suggested that the decision can be distinguished as applicable only to transfers of annuity books.

1. The Prudential Assurance Company Limited and Rothesay Life plc [2019] EWHC 22455 (Ch)

General Principles

The law applicable to all Part VII Transfers, with which Lord Snowden agreed and which has not changed.

Availability of Part VII for all types of insurance business	Transfers of annuity business are within the scope of Part VII. The operation of Part VII cannot be prevented by contract, so even if PAC had contracted with policyholders not to enter a Part VII, this would not override the availability of the statutory process (although it is fair to assume such provision would be a relevant factor for the regulators and the Court in their considerations of the proposed transfer particularly involving retail business).
The Court is the ultimate arbiter	FSMA, which provides that the Court must consider whether "in all the circumstances of the case, it is appropriate to sanction the scheme" makes clear that the Court has a broad discretion which empowers it to consider factors beyond those relevant under Solvency II or presented by the IE or the regulators. This must be correct in order to ensure that the Court's discretion remains, in Lord Snowden's words, one of "real importance" and not a "rubber stamp".
Exercise of Court's discretion is not wholly unfettered	The Court's discretion is not wholly unfettered: • it must be exercised by giving due recognition to the commercial judgement of the directors of the commercial parties • The Court's role is not to produce the best possible scheme, nor to amend the proposed scheme nor indeed to challenge the validity of the parties' purpose in seeking to implement the scheme. Rather, its concerns are: – Whether a policyholder, employee or other interested person or any group of them will be adversely affected by the scheme (and just because some are, it does not follow that the scheme must be rejected) – Whether the scheme as a whole is fair. • The Court will pay close attention to views of the IE and regulators – the IE's actuarial judgement requires a comparison of the security and reasonable expectations of policyholders before the Part VII as compared to after it.
Security and reasonable expectations of policyholders	Security and reasonable expectations encompass security of benefits and relate to how an insurer will perform its obligations and service standards, in the case of general business.
No Policyholder veto	Policyholders do not have a veto over what the commercial parties wish to do – they just have to be treated properly.

However, whilst some parts of the decision clearly focused on the particular nature of annuity policies, the principles are capable of a much broader application, particularly to long tail business and so to the run off sector. It would be foolish to conclude at this stage that Lord Snowden's analysis will not be taken into account by the courts in other types of Part VII in the future.

Of course, we must not overlook the position of the regulators and the Independent Expert (IE). Regardless of the approach adopted by future judges, the PRA, FCA and IEs must inevitably pay careful consideration to Lord Snowden's position, the particular factors he considered relevant and to any implicit criticism of the approach of the regulators and IEs to Part VII transfers. Indeed, it is already apparent that the regulators' approach is shifting in response to the judgment.

However, whilst agreeing with the general principles, Lord Snowden also added some additional factors to be taken into account when making his decision. Therefore the following questions arise:

1. what other factors should the Court properly consider as relevant to the exercise of its discretion?; and

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2. how should the Court give appropriate weight to those factors, as against the settled general principles, the Solvency II Directive provisions on portfolio transfers (which focus on SCR), the overriding objectives of Part VII as a statutory process for the transfer of policies and the evidence submitted by the parties, the IE and the regulators?

"Relevant Factors"

Lord Snowden appears to have been persuaded by the submissions of the policyholders and their assumptions about the policies they were buying and did not fully explain how these applied alongside the agreed general principles. It is not clearly explained why the policyholders' position was so significant that the Scheme as a whole was not fair, and in terms of whether it adversely affected policyholders, it appears that the only substantial relevant factor considered was the mismatch in potential parental support. The particular "relevant factors" considered by Lord Snowden were:

The nature of annuity policies

Unlike many general insurance policyholders who purchase annual short tail cover, an annuitant is locked in to its contract to receive payments over many years. Therefore, the reputation and financial standing of the insurer are arguably of particular concern to an annuitant. Lord Snowden considered that this represented a "material difference" between the two types of policies. Yet he also acknowledges that all policyholders are entitled to rely on the fact that their insurer complies with the regulatory capital framework and so will be able to pay claims. The Solvency II Framework is there to ensure a robust financial positon is maintained by all insurers, whether of general business or annuity business. It is worth noting in this context that even the most solid of reputations can be tarnished, and that Prudential's reputation has suffered in recent weeks as the FCA has levied a fine of £23,875,000 for failures relating to the sale of non-advised annuities – failures described by Mark Steward, FCA Executive Director of Enforcement and Market Oversight as "very serious breaches that caused harm to those customers"[2].

On the one hand, drawing a distinction between annuity books and general business helps to narrow the potential impact of this judgment. However, if the courts follow this view and continue to apply significant weight to the nature of annuity business, it inevitably places a high hurdle on any firms seeking to transfer long term business.

Furthermore, as a matter of principle, it cannot be said that general insurance policyholders do not take into account the financial standing and reputation of their insurer, not least where their policies also have a long tail either in terms of potential claims or long term payments, such as EL and PPO claims.

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Policyholder expectations

Whilst Snowden says it wouldn't assist to ask whether policyholders have a "reasonable expectation" that their insurer would not seek to transfer their policy, his judgment steps into new territory. Lord Snowden felt that there was considerable force in the policyholders' submission that they had a "reasonable expectation" that their policy remain with PAC because:

- The literature did not indicate that such a future transfer to another party was a possibility, and the Court found it unrealistic to

2. https://www.fca.org.uk/news/press-releases/fca-fines-prudential-failures-relating-non-advised-annuities-sales

assume an average person would have any knowledge of such a mechanism;

- The literature was such that they could reasonably expect that, having chosen PAC for life, it would be the contracting party for the entire period.

These additional considerations as to policyholders' "expectations" are open to challenge. As Lord Snowden notes, the average policyholder would not be expected to know of the availability of the Part VII process. This argument applies equally to every policyholder across all types of policy; annuitants are in no better or worse position than anyone else. The fact that they hold such an assumption may be reasonable but it doesn't follow that this is then a factor to be given such considerable weight by the Court in its consideration of a Part VII transfer, where that process is designed to achieve a transfer without the consent of the policyholders.

> Lord Snowden's approach raises the possibility of the primacy of policyholder consent (whether implicit or explicit) in a way which is contrary to the objectives of the Part VII process.

Current SCR metrics and availability of parental or group support

Notwithstanding a robust European wide regulatory framework, which focuses strongly on ensuring sufficient capital at insurer level to support its business to finality, Lord Snowden in effect determined that the actuarial and regulatory assessments on SCR metrics (and in line with the provisions Solvency II on portfolio transfers) were insufficient. Again, drawing attention to the long tail nature of the business, he concluded that the risk of a need for capital support over the annuity period was real rather than fanciful Accordingly, it was appropriate to consider the relative positions of the parties, notwithstanding that this was at odds with the IE position.

One view of the position would be that it effectively drives a coach and horses though the Solvency II regime as a robust capital framework. In addition, however, Lord Snowden essentially accepted that Prudential would support PAC come what may, principally on reputational grounds, but not that Rothesay's shareholders – comprising pre-eminent financial services investors from private equity, sovereign wealth and US life mutual – would do the same. He appears to disregard the fact that Rothesay's shareholders have equally significant reputational concerns and the same regulators oversee them (as controllers of regulated firms) and any future controllers, focusing instead on "strong likelihood" of ongoing support on the one side as against relative "uncertainty" on the other.

This allowed him to conclude that policyholders did not have "equivalent comfort" that capital support would be forthcoming in Rothesay as it would in PAC. It has never previously been contemplated that "equivalent comfort" as regards group capital support forms part of the matrix when considering a Part VII. It does not reflect the established general principles and it was not the test applied by the IE in this case. If Lord Snowden's position holds, this is a high bar indeed, particularly for new or smaller acquirers in the market.

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> In any event, it seems clear that IEs and the regulators will need to address this point in future transfers and seek to distinguish or rebut any presumption that a Part VII transfer should not be sanctioned on the basis that the standing of the parties is not "equivalent" in respect of both SCR, capital management and potential group support. This is likely to apply beyond the narrow scope of annuity business.

Age and reputation of transferor vs transferee

Here, Lord Snowden rejected the previous position, namely that age was not a relevant factor but that financial strength, record and expectations were relevant. This ensured that the courts did not make decisions that effectively barred new entrants or aggregators to the market. This is naturally of particular significance in the life and run off markets. Lord Snowden simply concluded that the age and reputation of PAC was a factor in the policyholders' decision to purchase their policies and that the Court should "give some weight to their exercise of contractual choice". Again, we see the concept of policyholder consent creeping in as a relevant factor.

Although Snowden maintains this doesn't prejudice future acquisitions by Rothesay or other new entrants it seems difficult to see how it would not do so in practice. This comparison of PAC vs Rothesay creates concerns for the life and run off market, where smaller, run off aggregators frequently acquire books of business from larger insurers, and those books of business often include long tail business. Applying these factors to such transfers will weigh unduly heavily on the run off market. Even if the regulators and courts maintain a distinction, the doors are now open to objecting policyholders to have their say in court. The same arguments can be made by any policyholder or claimant who can expect to have long term claims triggers or payments from their insurer.

Commercial objectives

Agreeing that the Court should exercise its discretion, whilst leaving the commercial decisions to the respective boards, Lord Snowden expands the previous position by stating that "the appropriate balance" has to be struck between the interests of policyholders and the commercial parties. This is, of course, what the Part VII process with its layers of protection for policyholders was designed to do. However, he then goes on to say that "it must be for the commercial parties…to satisfy the Court that in all the circumstances of the case, it is appropriate to sanction a change to the contractual status of the policyholders".

The language in FSMA makes clear it is simply for the Court to determine whether it is appropriate in all the circumstances to approve the transfer. Established caselaw makes clear that the Court, in exercising its discretion, gives due weight to the judgement of the directors of the commercial parties. But here, the language and tone almost suggests a presumption against a Part VII transfer unless the commercial parties can satisfy the Court otherwise. Indeed, the judgment clearly takes into account the commercial objectives of PAC and the fact that those objectives had been met by the LPT, which ultimately does not change the "contractual status" of policyholders. It is not difficult to make the leap to conclude that, in other circumstances, the commercial objective could be achieved by another mechanism like an LPT, without the need for a Part VII.

This approach increases the burden of proof on the commercial parties and shifts the weight in favour of policyholders, in circumstances where the Court has recognised that they have an expectation that, having carefully chosen their insurer, they will continue to be paid their claims by that insurer. Again, this is potentially at odds with the Part VII process, which is there to facilitate transfers without consent and where the Court does not involve itself in the commercial merits of a particular transfer.

It is questionable whether the Court's discretion extends to consideration of the venerability of the parties' commercial aims and the decision to apply Part VII to achieve them. In any event, parties should now consider how they can demonstrate that they have considered alternate structures to achieve their aims and the overall impact on policyholders of the available options – a process not dissimilar to the one applied by the PRA to firms proposing a scheme of arrangement. Parties must also ensure that their commercial agreements set out clearly what will happen should a Part VII transfer be rejected.

Practical steps

In view of the points raised in Lord Snowden's judgment, we would advise parties considering Part VII transfer as follows:

- address some of the key points raised by Lord Snowden, in discussions with regulators, in witness statements and in the IE report and ensure they are appropriately managed, rebutted or evidenced as inappropriate/irrelevant to the case at hand. In other words, distinguish it! In particular, consideration should be given to:
  - The potential strength of policyholder opposition to the proposals
  - The market reputations of the parties involved
  - Capital management policies and the likelihood of discretionary group capital support
  - The type of policies being transferred, whether they share comparative characteristics with annuity policies
  - The basis upon which an independent expert reaches his conclusion. Even if an outcome is found to be extremely unlikely it does not mean its possible occurrence will not be scrutinised by the Court.
- consider the legal rights and obligations of the parties should the Part VII not be sanctioned. For example, if the LPT had terminated on a rejection of the Part VII, then the economic objectives of PAC would not have been met - the neutrality of the Part VII from an economic perspective was a relevant factor for Lord Snowden
- Amend policyholder literature and online materials to bring to policyholders' attention that the statutory Part VII process applies and is open to all insurers in the market. Accordingly, their insurer is at liberty to seek to utilize it and their policy may at some point in the future be subject to a transfer application and the scrutiny of the PRA, FCA, IE and Court.

What's next?

PAC and Rothesay have announced that they will jointly appeal the ruling on the basis that Lord Snowden's judgment in the High Court "contains material errors of law". It is unlikely that this will be considered at the Court of Appeal until spring 2020.

Comparison - PAC vs Rothesay

PAC	Rothesay Life
Long history as a leading UK insurer	Relatively recent market entrant
Large entity	Relatively small entity
Member of a large insurance group	Not part of large, established group
Diverse book of business	Monoline aggregator
Strong likelihood of parental support	Relative uncertainty of parental support
Favourable SCR	
Service standard maintained	
Construction of transfer payments	
UK regulated funding	

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