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"Operational disruption has been a focus of the FCA, and minimising its impact is one of the FCA's commitments"

REGULATORY

FCA publishes insights into firms' work on operational resilience rules

The FCA has recently published its observations on the work firms have undertaken so far to comply with the operational resilience rules which were introduced on 31 March 2022. This article looks at some of the insights from the FCA.

Background

In the aftermath of the disruption caused by Covid-19, the rules were developed to prevent harm to consumers and instability within the financial services sector due to operational disruption. Firms are currently within a transitional period and have until 31 March 2025 to comply with the rules.

Operational disruption has been a focus of the FCA, and minimising its impact is one of the FCA's commitments in its 2024/2025 business plan. The operational resilience rules are just one part of the wider work that the FCA has been undertaking on operational resilience. It has also recently consulted, in conjunction with the Bank of England and the PRA, on proposed rules for the oversight of providers of critical third-party services. For more information on that consultation please see our Bulletin article here.

The rules

The operational resilience rules apply to all Solvency II insurers. Insurance intermediaries may also be in scope where they are enhanced scope SM&CR firms.

Under the rules a firm must:

1. identify its important business services;
2. set impact tolerances for each of those services;
3. use mapping to identify and document the people, processes, technology, facilities, and information necessary to deliver each of its important business services;
4. using severe but plausible disruption scenarios, identify vulnerabilities which may result in it failing to remain within its impact tolerances; and
5. develop testing plans that detail how it can remain within its impact tolerances.

Operational resilience is defined as the ability of firms, and the financial sector as a whole, to prevent, adapt, respond to, recover and learn from operational disruptions. The rules ask firms to assume that major operational disruptions will occur and have in place robust and reliable policies and procedures to deal with those disruptions within specific impact tolerances.

Business services will qualify as important under the rules where a firm provides services to an external end user and failure of those services could, among other things, threaten policyholder protection or cause intolerable levels of harm to consumers, market participants or market integrity.

Insights

Some of the observations that the FCA has made in its recent publication include that:

1. firms must be able to justify the services they have identified as important but equally must consider the rationale and justification for not identifying a service as important;
2. rationales for impact tolerances should be sufficiently detailed so that the FCA can fully understand how those tolerances have been set. Senior management must also be able to understand the tolerances that a firm has set and why;
3. some firms have shown limited:
    a. evidence of testing response plans; and
    b. understanding of whether they can remain within their impact tolerances,
4. the most effective operational resilience frameworks are embedded within firms' overarching risk frameworks, including playing a part in a firm's change management and strategic planning.

The high-level message from the FCA is that firms need to be working on embedding compliance with the rules into overall firm culture. The FCA has reminded firms that, whilst 31 March 2025 marks the end of the transitional period, the requirement to be operationally resilient is not a tick-box exercise.

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UK: Third-country insurance branches – PRA publishes feedback and updated policy

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"The PRA has also clarified the application of its key function holder requirements to third-country branches"

The PRA published in May a Policy Statement (PS 8/24) on its updated policy in respect of authorising and supervising insurance branches. Although the Policy Statement largely consolidates the PRA's existing approach, it includes various clarifications, including on branch reporting and SM&CR requirements.

Background

In 2023, the PRA consulted on its proposals to consolidate and formalise existing PRA policy on overseas insurers that write business in the UK through the establishment of a third-country branch, and to offer more clarity on its expectations in respect of those third-country branches. The PRA proposed to make these changes in light of its experience of authorising and supervising third-country insurance branches following the UK's withdrawal from the EU.

In response to the feedback it received, the PRA has now published Policy Statement PS 8/24, which sets out the final relevant policy and provides various further explanations and clarifications. The Policy Statement includes the final version of a new statement of policy on the PRA's approach to insurance branch authorisation and supervision.

Branch reporting – ORSA

In particular, the PRA has clarified that branches can submit either a standalone branch own risk solvency assessment (**ORSA**) for the branch, or a legal entity ORSA. Any submitted ORSA must cover at minimum the requirements set out in paragraph 9.3 and 9.5 of the updated SS 44/15, which is also included in the Policy Statement. SS 44/15 will be updated again in December 2024 to incorporate changes arising from the Solvency UK reforms.

The PRA has confirmed that it does not require notification from firms on their intended approach.

In respect of third-country branches incoming from non-Solvency II jurisdictions, the PRA considers that ORSA-equivalent reports may be sufficient subject to conversations with the firm's PRA supervisor.

SM&CR – key function holders

The PRA has also clarified the application of its key function holder requirements to third-country branches. The PRA requires third country branch undertakings to establish the four minimum key functions (risk management, compliance, internal audit and actuarial) in respect of the branch's operations, and the relevant individuals responsible for these key functions to be notified to the PRA for an assessment of their fit and proper status if they will not directly be in either a PRA SMF or FCA controlled function.

The PRA has further clarified that where a third-country branch undertaking has a key function holder acting as Chief Finance Officer, Chief Risk Officer, Chief Actuary, Chief Underwriting Officer or Head of Internal Audit functions and that person's role is solely dedicated to the branch, then it would expect the firm to apply for approval for the relevant functions. Conversely, where that individual's role is not wholly dedicated to the branch, the PRA would not expect them to apply for approval, but they should still notify the PRA of their identity and provide relevant personal information as appropriate. The third-country branch undertaking should assess whether that individual is carrying out the role of a Group Entity Senior Manager (SMF 7), in which case they must apply for PRA approval.

Other clarifications

The Policy Statement sets out some additional clarifications, including those summarised below:

1. **Notifications** – in the updated SS 44/15, the PRA sets out some examples of circumstances in which it would expect notification from third-country branches in line with its Fundamental Rule 7.
2. **Outwards reinsurance arrangements of the third-country branch and third-country branch undertaking** – the PRA's approach to assessing intra-group reinsurance arrangements focusses on risks to branch supervisability and independence, where the third-country branch undertaking may become operationally heavily dependent on an intra-group entity. In assessing outwards reinsurance arrangements of a third-country branch and a third-country branch undertaking, the PRA will take into account the views of the firm's home supervisor.
3. **Resolution** – the PRA has set out its assessment criteria for considering UK policyholder protection and fairness of treatment of UK policyholders in insolvency and winding up, as well as expectations regarding availability of assets in winding up.
4. **Pure reinsurance branches** – the PRA has confirmed that it does not require pure reinsurance branches to hold assets in the UK to cover the solvency capital requirement (**SCR**), nor to hold assets on deposit as security. The PRA has also highlighted that in the interim period before implementation of the new Solvency UK rules on 31 December 2024 (which set out fewer reporting requirements for pure reinsurance branches), it offers a Modification by Consent for pure reinsurance branches which waives rules relating to branch capital requirements and some other reporting.
5. **Financial Services Compensation Scheme (FSCS) subsidiarisation threshold** – the PRA has outlined its approach to assessing the scale of UK branch activity covered by the FSCS, including its expectation for third-country branches to have under £500 million of insurance liabilities covered by the FSCS.
6. **Waivers and Modifications by Consent** – the PRA has reiterated that waiver applications can be submitted for any PRA reporting requirements, including those proposed under its Solvency UK reforms.
7. **Re-domiciliation** – the PRA has set out its proposed approach to re-domiciliation, outlining its expectations in cases where a third-country branch undertaking that is authorised to operate as a third-country branch re-domiciles to another home jurisdiction.
8. **Size of the branch vs legal entity** – the PRA has confirmed that it considers the relative size of the UK branch's operations (e.g. total premiums and liabilities) as a proportion of the operations of the whole third-country branch undertaking to be an important factor in assessing the supervisability of the third-country branch.
9. **Equivalence of home state supervision and supervisory cooperation** – the PRA will only authorise third-country branches from "broadly equivalent" jurisdictions, which the PRA has confirmed is different from the concept of Solvency II equivalence. The PRA outlines in Chapter 2 of the Statement of Policy the criteria it uses to assess whether there is sufficient supervisory cooperation with the home supervisor, by setting out the high-level outcomes the PRA would expect to see, as well as its approach to memoranda of understanding and split of responsibilities agreements. However, the PRA has clarified that a signed memorandum of understanding does not necessarily translate to a jurisdiction being considered as broadly equivalent. The PRA will not publish the results of its equivalence assessments.

Implementation timetable

The PRA has confirmed that the new policy (including the current updated version of SS 44/15) came into force on 23 May 2024. The implementation date of the future version of SS 44/15 is 31 December 2024.

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Solvency UK Provisions Delayed by Election

One of the less thought about consequences of the snap general election is the effect it has on legislation that has been laid before Parliament but has yet to come into force.

This is of particular relevance at the moment, given the swathe of Brexit-related revocations of EU-retained law, which will take effect on their given dates irrespective of whether a replacement or transitional provision has been enacted. More information is available here.

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DISPUTES

WELCAR wording appeal

On 9 May 2024, the Court of Appeal handed down judgment in *Technip Saudi Arabia Limited (Technip) v The Mediterranean & Gulf Insurance and Reinsurance Co*[1], dismissing an appeal against a decision of Jacobs J[2] in which he had denied a claim brought by Technip against Medgulf on the basis of a policy exclusion in an Existing Property Endorsement.

Background

The Appellant, Technip, was the principal contractor on an offshore construction project in the Khafji Field, offshore Saudi Arabia. Medgulf underwrote a policy of offshore construction all risks insurance on the WELCAR 2001 form in connection with the project. The policy named both Technip and the field operator as Principal Insureds. Technip time-chartered a vessel to assist in the performance of certain of the contract works. On 16 August 2015, the vessel was returning to port when it allided with an unmanned wellhead platform. Technip claimed an indemnity under the policy in respect of its liability for the allision.

At first instance, the Judge held that Technip's claim was excluded by the Existing Property Endorsement in the policy which defines the scope of cover for damage to existing property. The Endorsement excludes cover for property owned by "the Principal Insured". The Judge held that this applied because the platform was owned by the field operator, a Principal Assured. The Judge granted permission to appeal on the proper construction of the Endorsement.

Appeal judgment

On appeal, Technip argued that the reference in the Endorsement to "the Principal Assured" in a contract of insurance where there is a single contracting party (that being the consequence of the composite nature of the policy) should be read as a reference to the Principal Assured that is claiming an indemnity under the policy. As a result, the exclusion did not apply because the damaged platform was not owned by Technip but by another Principal Insured. Technip believed that the effect of the Judge's construction was to deprive Technip of any, or a very substantial part of any, effective property liability insurance.

The Court of Appeal dismissed Technip's appeal and upheld the first instance Judge's decision. Sir Geoffrey Vos MR, with whom Lewison LJ and Arnold LJ agreed, held that the exclusion in the Endorsement is to be properly interpreted as excluding claims for damage to property owned by any of the Principal Insureds named in the policy. This includes Technip's claims for damage to the platform which was not scheduled in the Endorsement. The first instance Judge's construction accorded with the natural and ordinary meaning of the Endorsement and its commercial rationale. The composite nature of the policy was irrelevant.

Comment

This finding leaves contractors (when they, as opposed to the project owner, are the principal insured, who arranged the insurance – not the traditional scenario but not uncommon in some regions) in an awkward position. Without a crystal ball, it is difficult for a contractor to know what assets between a project site and the ports might be (or during the project become) owned by one of the other principal insureds. In a case like this the liability cover would not respond. This does leave, for the contractor, a potential gap in cover for damage to any property which is not scheduled. There are sound commercial reasons for this for insurers but the converse could also be argued from a contractors' perspective.

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"This finding leaves contractors (when they, as opposed to the project owner, are the principal insured, who arranged the insurance – not the traditional scenario but not uncommon in some regions) in an awkward position."

1 [2024] EWCA Civ 481

2 [2023] EWHC 1859 (Comm)

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Court considers meaning of "seizure" in policy wording

The Court has handed down judgment in *Hamilton Corporate v Afghan Global* relating to reinsurance of a warehouse in Afghanistan and the AFB political violence wording.

It held that an exclusion for seizure applied to the facts of the case, and that *"seizure"* was not restricted to action by governments. The Court also considered arguments on the distinction between Political Violence and Political Risk insurance.

In this article we set out further detail.

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Court revisits application of causation and loss of chance principles in no-insurance claim against broker

In the matter of *Norman Hay*, the Commercial Court applied loss of a chance principles to a professional negligence claim against an insurance broker, in the context of a strike out application.

Specifically, the judge found that where a claimant had no insurance policy in place at all, due to alleged negligence of the broker, the measure of loss will be the claimant's loss of a chance to recover under the hypothetical policy.

This means that the claimant may recover in full if it can establish that there would certainly have been cover that would have paid out. If, on the other hand, it can show that there would have been an opportunity to settle at a discount, notwithstanding a coverage defence, it may be entitled to recover damages on that lost chance to settle for a lower sum.

More information is available here.

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