Part VII portfolio transfers: Designing the Scheme - the legal perspective

Katherine Coates
6 July 2007

Part VII Portfolio Transfers

- Topics covered:
  - Legal effect of a portfolio transfer Scheme
  - Types of portfolio transfer
  - Outline of the process
  - Key factors underpinning a successful Scheme
  - Outline of the Scheme document
  - Key design issues
  - Current legal developments

What is a portfolio transfer Scheme in legal terms?

- Statutory novation of liabilities and transfer of assets effected through a Court Order under s111 FSMA
- The terms of the transfer are set out in the Scheme document which is sanctioned by the Court
- The process is compulsory for the transfer of all or part of an insurance business within the EU and will shortly be compulsory for reinsurance business

What is a portfolio transfer Scheme in legal terms?

- The court can make ancillary Orders under s112 FSMA
  - transferring the undertaking and any properties or liabilities
  - causing the allotment of shares
  - permitting the continuation of legal proceedings by or against the transferee
  - regarding other incidental, consequential and supplementary matters
  - The court Order overrides the requirement for third party consent to the transfer of assets or liabilities and any lack of capacity at least as a matter of English law.

When may portfolio transfers be beneficial?

- Group reorganisations (general and life)
  - Capital, accounting and administrative efficiency
  - Cross-border restructuring
- Mergers and acquisitions (general and life)
  - An assets sale
  - Flexibility of transferring all or part of the business
  - Tax structured deal advantages
- Demutualisations
  - Assets and liabilities of mutual company are sold to a new shareholder owned company
  - Transfers can be made to more than one transferee

When may portfolio transfers be beneficial? (continued)

- Closed funds and bulk annuity transactions (life assurance)
  - Cost efficiency through amalgamation
  - Release of capital
  - Avoids long term reinsurance
- Insurance securitisations (general and life)
  - Repackaging of portfolio/assets to be securitised
  - Benefits of segregation
- Reattribution of inherited estate (life)
  - Establishment of separate funds
  - Additional complexity of policyholder advocate negotiations

When may portfolio transfers be beneficial? (continued)

- Lloyd's – (general and life)
  - Alternative to reinsurance-to-close
- Changing policy terms (general and life)
  - As part of a business transfer
  - Ancillary to the Scheme
- Converting ("unitising") with-profits policies (life)
  - Potential alternative to a Companies Act scheme of arrangement

Outline of the process

- Draft Scheme
- Consult with the FSA
- Report by actuarial functionholder of transferor and transferee and if relevant with profits actuary
- Report by an independent expert
- Court hearing for directions
  - Claim form and affidavit
  - Notices and Scheme summary
  - Advertisement
- Consultation with relevant EU regulators
- Final Court hearing and Order
- Effective Date

Key factors underpinning a successful scheme

- A Part VII Scheme is scrutinised by:
  - FSA
  - High Court
  - Independent Expert
  - Actuarial Functionholder of transferor and transferee
  - With profits Actuary (if applicable)
  - Legal advisers/counsel
  - Policyholders, reinsurers and their advisers
- Key determinants for obtaining sanction will be:-
  - The effect of the Scheme on the security of affected policyholders
  - The effect of the Scheme on the benefit expectations/contractual entitlements of affected policyholders
  - Fairness and transparency for policyholders
  - All aspects of the Scheme must be within the Court's jurisdiction
    - territorial
    - impact on contractual rights

Key factors underpinning a successful scheme

- The Court must consider that, in all the circumstances of the case, it is appropriate to sanction the Scheme (s111(3) FSMA)
  - Not necessarily the best possible Scheme
  - Is the Scheme as a whole fair between different classes of policyholders? (Re London Life 1989)
- In designing the Scheme compliance with these principles will be critical

The Scheme document in outline

- Whether the Scheme concerns general or life business it will usually include the following:-
  - Identification of transferring business, transferring assets, transferring policies and transferring liabilities
  - Operative provisions effecting the transfer of assets and liabilities by virtue of the Court Order
  - Transfer of mandates or other bank instructions in relation to premium payments

The Scheme document in outline

- Provisions regarding residual policies, assets and liabilities which cannot pass to the transferee on the Effective Date for legal or regulatory reasons.
- Provisions enabling the continuation of proceedings by or against the transferee
- Conditions to the Scheme becoming effective including tax clearances
- Variation of the provisions of the Scheme either before or after the Court Order

The Scheme document in outline

- Other common terms in life assurance schemes will include:-
  - Valuation provisions
  - Establishment of sub-funds for different blocks of business
  - Requirements for management of with profits funds
  - Restrictions on charges and expenses
  - Establishment and operation of unit linked funds
  - Internal reinsurance/capital support
  - Amendment of policies

Key design issues

- Identification of the assets and liabilities to be transferred
  - Clarity of definition is critical
  - Particular issues arise with contracts governed by laws other than English law or assets requiring particular formalities to be observed before transfer is effected
    - consider trust arrangements and indemnities
    - subsequent transfer once formalities completed
    - exclusion of assets/liabilities which are outside the jurisdiction of the Court
    - temporary reinsurance

Key design issues

- Effective transfer of the benefit of reinsurance/retrocession contracts
  - Reinsurance/retrocession contracts are a key asset of the business
  - Insurance Companies Act portfolio transfers of general business did not novate reinsurance
  - Section 112(2)FSMA envisages novation
  - WASA International case (December 2002) confirmed novation effective
  - Split portfolios – particular issues

Key design issues

- Valuation issues
  - Valuation issues arise where there are multiple transferees, multiple transferee funds or only part of the business is being transferred
  - The methodology for splitting assets and liabilities and allocating any surplus must be clearly defined and capable of practical application
  - It may be necessary to carry out valuation calculations after the effective date of transfer
  - Consider which assets transfer to which fund or whether pooling is appropriate

Key design issues

- Governance and Ongoing Management of the Transferred Business
  - In the case of portfolio transfers of long term business, particularly with profits, the ongoing financial management of the business is key to policyholder security and benefit expectations
  - FSA and the Independent Expert will take a keen interest in the proposals
  - Key areas to be considered include:-
    - Bonus policy
    - Investment policy
    - Application of surplus assets
    - Capital management
    - Charges and expenses
    - Management actions

Key Design Issues – Governance and Ongoing Management of the Transferred Business (cont)

- Pre introduction of Principles and Practices of Financial Management ("PPFM's") Schemes often contained detailed and often quite prescriptive provisions regarding the management of with profits funds
- PPFM's now set out in the principles to be followed in the management of a with profits fund making it unnecessary to repeat these principles in the Scheme
- The principles required in the Scheme itself are now typically
  - Principles governing the relationship between different funds
    - allocation of expenses
    - parallel investment and bonus policy
  - Principles which are intended to be set in stone
    - limitations on charges for guarantees
    - allocation of distributions
  - Principles relating to non profit business

Key design issues

- Alterations to Policies
  - As part of a portfolio transfer Scheme it may be desirable to amend the terms of some of the transferred policies, e.g:
    - to rationalise charges between different blocks of business
    - to improve administrative efficiency
    - to amend linked funds arrangements
    - to allow different risks to be insured by different transferees
    - to exclude any right to participate in distributions of inherited estate
    - to convert a with profits policy into a unit linked policy
  - Section 112 FSMA ancillary Orders. Key questions for the Court will be:-
    - Have the policyholders been given adequate information?
    - Are the proposed changes fair?
    - Are they necessary or incidental to give effect to the Scheme?
    - Scheme or Ancillary Order?

Current Legal Developments

- Proposed amendments to Part VII FSMA and related regulations to clarify:
  - Outwards reinsurance and other contracts relating to the transferring business may be transferred by Court Order
  - Power of the Court to override certain contractual non-transfer provisions
  - Obligation to notify reinsurers (but not other counterparties)

Current Legal Developments

- Transfer of reinsurance business under Part VII FSMA
  - Scope (Article 18 of the RID):
    - a transfer
    - by a reinsurance undertaking with its head office within the territory of a Member State
    - of all or part of its portfolio
    - to a transferee established within the EC
  - Amendments to FSMA to abolish distinctions between insurance and reinsurance under Part VII FSMA
  - Implementation required by 31 December 2007

Conclusions

- A Part VII Portfolio Transfer is an important and flexible tool to transfer and/or rationalise insurance business
- They can be complex arrangements particularly in the life sector
- Good scheme design is critical
  - to obtain court sanction
  - to enable effective operation of the business after the transfer
- Successful Scheme design involves close co-operation between business executives, actuaries and lawyers

Part VII portfolio transfers: Designing the Scheme - the legal perspective

www.cliffordchance.com