Prudential plc and Rothesay Submit Their Appeal on the Blocked £12 Billion Part VII Transfer

16 October 2019

On Friday 27 September 2019, Prudential plc ("Prudential") and Rothesay Life plc ("Rothesay") announced that they had filed an appeal against the controversial decision of Snowden J, blocking Prudential's proposed transfer of annuity policies under Part VII of the Financial Services and Markets Act ("FSMA") to Rothesay. The decision, handed down on 16 August 2019, adopts an interventionist approach for courts to follow when considering whether to sanction a proposed Part VII transfer. Although few details of the specifics of the appeal are available, we understand it challenges the judgment on the basis of material errors of law.[1]

While this case is of general importance to the insurance industry, particularly with the significant numbers of Part VII transfers still being proposed in anticipation of Brexit, the judgment is of particular importance to potential acquirers and sellers of annuities.

Background

Prudential announced its intention to divide the Prudential group into two separate parts ((i) European and (ii) Asian/American businesses respectively) in March 2018. In preparation for the demerger process, The Prudential Assurance Company Limited ("PAC"), M&G Prudential's UK-regulated insurance entity, transferred two of its own Hong Kong subsidiaries, one of which had made substantial contributions of excess capital to PAC's Solvency II capital position, to Prudential Corporation Asia Limited. As a result, it was necessary for PAC to reduce its solvency capital requirement. Therefore, immediately prior to the announcement of the demerger, PAC entered into agreements with Rothesay for Rothesay to reinsure around 400,000 retail and bulk annuity policies (constituting around £12.9 billion of liabilities) and both parties agreed to cooperate to transfer the business under a Part VII transfer scheme.

The independent expert (appointed to report to the High Court on the proposed scheme), the UK's Prudential Regulation Authority and the Financial Conduct

[1] https://www.pru.co.uk/annuitytransfer/.

Authority all approved the proposed scheme, which did not propose any changes to the terms and conditions of the transferring policies, including to the amounts payable to policyholders. In particular, the independent expert's overall conclusion was that the scheme would not have a material effect on (i) the security of the benefits, (ii) the reasonable benefit expectations of the policyholders or (iii) service standards and governance.

Although the proposed transfer was notable for its size, there was nothing else particularly unusual about the proposed transfer and, as has been noted in various commentaries, although the High Court has generally considered policyholders' objections in the past, it has not rejected a scheme on the basis of these.

Elements of the Decision

Snowden J refused to sanction the proposed scheme, citing the role of the High Court as not being just as a "rubber stamp". While this update does not seek to summarise the entire decision, the following key elements can be highlighted:

- Scope of judicial discretion: s. 111(3) FSMA requires the High Court to consider whether it is "appropriate" to sanction the scheme and that in doing so the High Court should take account of "all the circumstances of the case". This was described as a "very broad discretion". While the subjective likes and dislikes of the policyholders should carry little weight, the High Court is not constrained by the actuarial analysis and regulatory criteria (in particular those derived from Solvency II) to which the independent expert and regulators must pay regard.

- Balance between the parties: An appropriate balance must be reached between the interests of the policyholders and the commercial parties. As part of his decision, the following aspects were taken into account:

    - Annuities: Snowden J accepted that annuities are capable of being transferred by means of a Part VII transfer. However, the peculiarities of annuities, including the length of these policies, the inability of policyholders to switch provider and the financial importance attached to them by the policyholders, mean that additional considerations should be applied.

    - Age and reputation: Where policyholders have taken account of unique factors in making their decision, including the age and reputation of the insurer, the court may also take these factors into account. Snowden J did not find it unreasonable

or irrational that these would be considered by policyholders when selecting an annuity.

- Reinsurance: Snowden J also noted that the commercial purpose of the scheme (i.e., to reduce PAC's regulatory capital requirements) had been achieved by way of the reinsurance agreement.

- Reputation: A distinction was drawn between large insurance groups and specialist run-off acquirers, particularly on the basis that (i) a smaller, relatively new entrant would have less available group capital to draw upon and (ii) Prudential would be reputationally, and to a certain degree legally (pursuant to a capital support arrangement), required to stand behind PAC in the event of insolvency, but Rothesay's shareholders would have less of an obligation or incentive to do so.

- Theoretical risks: The High Court is required to take account of material adverse effects. This does not include theoretical or fanciful risks. Snowden J determined that it was not fanciful that PAC or Rothesay might require external financial support during the lifetime of the annuities and that in such circumstances PAC would be more likely to be supported (see above).

The Appeal

Prudential and Rothesay made clear immediately that they would seek to appeal the judgment—a move that was widely expected and supported throughout the insurance sector. While we are not aware of the specifics of Prudential and Rothesay's appeal, it would not be unreasonable to suggest that it might take account of the following issues:

- The way the decision in this case was reached in the light of the previous body of case law on Part VII transfers;

- The scope of judicial discretion to take account of subjective issues beyond the realms of regulatory criteria and actuarial analysis, such as reputational issues and what might happen sometime in the future;

- The extent of the "very broad discretion" granted to the courts and, in particular, the concept of whether the scheme is "appropriate";

- How the balance between the parties is achieved and the weight that should be given to a small percentage of objectors from the policyholder population as a whole;

- The extent to which the High Court can take into account a policyholder's choice of provider given the purpose of Part VII transfers or decide on whether the "commercial purpose" of the transaction between the parties has been sufficiently achieved; and

- The extent to which the possibility of requiring external financial support and that being available at some point in the future fall within the realm of the hypothetical rather than the material.

Wider Implications

This decision is undoubtedly of interest to insurers and industry participants, particularly those planning to transfer, acquire or sell closed book/run-off insurance policies. The exercise of the High Court's discretion under FSMA casts doubt on the previous industry assumption that consent would likely follow the support of the independent expert and the UK regulators. For future Part VII transfers, insurers and reinsurers may need to take into account factors beyond the requirements under Solvency II and the current Part VII provisions. Particular focus may need to be paid to considerations other than actuarial matters that may be considered important by customers.

It is possible that the decision in this case may be limited to transfers of annuity books as a significant long-term investment where policyholders do not have the opportunity themselves to switch provider. Snowden J acknowledged that the treatment of such policies will be different from the treatment of general insurance policies. It is not clear that the same level of scrutiny of and dissent from the decision of the directors of the companies proposing the scheme would have been made had this been a transfer of general policies.

Conclusion

Prudential has indicated that it does not expect this case to come before the Court of Appeal before Spring 2020 and so the industry may need to wait several months before finding out whether a new approach to judicial discretion is in the process of gestation.[2] However, current proposed transfer schemes may wish to pay attention to wider factors when considering their analysis and drafting of scheme documents.

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[2] https://www.pru.co.uk/annuitytransfer/.

In the meantime, the Prudential demerger is expected to continue, with closing expected before the end of 2019.[3]

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Please do not hesitate to contact us with any questions.

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[3] https://www.ftadviser.com/pensions/2019/08/19/high-court-blocks-prudential-annuity-sale/.