

Statement of Policy

# Policyholder protection

April 2015



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY



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## Introduction

1. This statement of policy is addressed to the Financial Services Compensation Scheme (FSCS) Limited in respect of its role as scheme manager of the policyholder protection scheme. This statement may also be of interest to insurance firms, successors (where applicable), the Society of Lloyd's (Society) and policyholders.
2. The purpose of this statement is to set out the expectations of the Prudential Regulation Authority (PRA), with regard to the FSCS's general duties. By providing further information clarifying the PRA's expectations in respect of the administration of the scheme, this statement of policy should help to ensure an effective policyholder protection scheme which advances the safety and soundness of firms, and contributes to securing an appropriate degree of protection for those who are or may become policyholders.
3. This statement of policy is intended to be read together with the insurance specific rules set out in the Policyholder Protection Part and the Lloyd's Part, which are relevant to the FSCS, insurers, successors (where applicable) and the Society. The funding section of the Policyholder Protection Part is also intended to be read together with the FSCS Management Expenses Levy Limit and Base Costs Part and the Management Expenses in respect of Relevant Schemes Part, which apply to the FSCS, insurers, and the Society.

## Background

4. The PRA expects the FSCS to exercise the functions that are conferred on the scheme manager by Part XV of the Financial Services and Markets Act 2000 (FSMA) as amended by the Financial Services (Banking Reform) Act 2013.
5. The PRA is required under section 213 of FSMA to make rules establishing a compensation scheme (the compensation scheme). The PRA expects that the FSCS will only pay claims if a firm is unable or likely to be unable to meet claims against it because of its financial circumstances. If a firm is still trading and has sufficient financial resources to satisfy a claim, the firm will be expected to meet the claim itself.
6. FSMA confers certain powers upon the FSCS, such as the power under section 219 of FSMA (Scheme Manager's powers to require information) to require persons to provide information.
7. In addition to rules made by the PRA, other aspects of the operation of the FSCS are dealt with through powers under company law (such as the power to borrow, to take on premises etc) and through rules made by the Financial Conduct Authority (FCA).

## Applications of rules to the Society

8. The Society is the society incorporated by Lloyd's Act 1871, by the name of Lloyd's.
9. With effect from 15 October 2003, the PRA's predecessor exercised its power under section 316 of FSMA (Direction by a regulator) to direct in Rule 3.1 of the Lloyd's Part that certain core provisions in FSMA should apply to members of the Society (an insurance market direction). The effect of the insurance market direction is that the PRA may in relation to members, and in respect of insurance market activities carried on by them, exercise any of the statutory powers conferred by the provisions which are applied by the direction. Those include the powers in Part 9A to make general rules and give guidance and also the powers in Part XV to make rules for the establishment and operation of a compensation scheme.
10. If the FSCS levies the Society, the PRA expects the FSCS to apply the rules in the Policyholder Protection Part which makes provision for the payment of compensation by the FSCS in certain cases arising from insurance business carried on by members and apply the rules in Chapter 21, the FSCS Management Expenses Levy Limit and Base Costs Part and the Management Expenses in respect of Relevant Schemes Part which make provision for raising levies on the Society.
11. The effect of Rules 2.7(4) and 14.5 of the Policyholder Protection Part (which are subject to Rule 14.4) is to set out the PRA's expectation of how recoveries are paid in respect of the Society. Any recovery obtained by the FSCS is retained by the FSCS up to an amount equal to the cost to the FSCS of paying compensation. To the extent that the Society is entitled to any part of the recovery (for example, by agreement with the FSCS), it is only paid out of any excess up to a maximum amount equal to that paid out of the Central Fund. Any recovery in excess of the compensation (including payment from the Central Fund) received by the claimant from the FSCS is paid to the claimant regardless of whether the Society receives the full amount paid from the Central Fund.
12. The insurance market direction in the Lloyd's Part is intended to set out the PRA's expectation of how the FSCS should protect the interests of policyholders and potential policyholders by:
  - (a) providing for the application of the Policyholder Protection Part in respect of contracts of insurance issued by members (or where applicable, members that are successors) or a managing agent on its behalf; and
  - (b) providing for the application of such other provisions of FSMA as will enable the application of the Policyholder Protection Part to be effective in relation to insurance market activities carried on by members.

13. Section 317(2) of FSMA (The core provisions) provides that references in an applied core provision to an authorised person are to be read as references to a person in the class to which the insurance market direction applies. With effect from 15 October 2003, references to a relevant person in Part XV of FSMA include a person who was a member at the time the act or omission giving rise to the claim against a member took place. See Rule 3.1 of the Lloyd's Part.

14. The PRA does not expect the FSCS to compensate members or former members (or where applicable, members that are successors) if firms are unable to satisfy claims made in connection with regulated activities relating to their participation in Lloyd's syndicates. The PRA expects the arrangements, referred to in Rule 4.1 of the Lloyd's Part, to have a governance structure that is operationally independent from the Society but which is nevertheless accountable to the Society for the proper administration of the compensation arrangements.

## Duties of the FSCS

### Administering the compensation scheme

15. The PRA expects the FSCS to:

- (a) pay compensation to eligible claimants, secure continuity of insurance, meet claims for benefits falling due or take such measures it considers appropriate to safeguard the rights of eligible claimants, when a relevant person (or where relevant in respect of compensation payments only, a successor), is unable or likely to be unable to meet claims against it in accordance with the Policyholder Protection Part; and
- (b) make levies on participant firms, in accordance with Chapter 21 of the Policyholder Protection Part, to enable it to pay compensation, secure continuity of insurance, or take such measures it considers appropriate to safeguard the rights of eligible claimants and meet the costs of discharging its functions under the Policyholder Protection Part.

## Securing continuity, measures taken in financial difficulty and paying compensation

### Securing continuity of long-term insurance cover

16. The PRA expects that the FSCS will first consider the merits of seeking to secure continuity of cover for claimants of long-term insurance contracts, subject to the FSCS being satisfied the criteria set out in Rule 4.1(1)–(4) of the Policyholder Protection Part are met, before taking such measures it considers appropriate under Chapter 5 of the Policyholder Protection Part, or any determination that compensation is payable under Chapter 18, of the Policyholder Protection Part.

### Relevant person in financial difficulty

17. The PRA expects the FSCS to take such measures it considers appropriate for the purposes of safeguarding the rights of eligible claims under protected long-term or general contracts of insurance when the insurer is in financial difficulties, subject to the FSCS being satisfied the criteria set out in Rule 5.1 of the Policyholder Protection Part are met.

### Claims on behalf of another person

18. Rule 3.3 of the Policyholder Protection Part gives the FSCS the option to pay compensation (and any recovery or other amount payable by the FSCS to the claimant) to a person who makes a claim on behalf of another person, subject to the FSCS being satisfied the criteria in Rule 3.3(1)–(2) are met. The PRA expects Rule 3.3 of the Policyholder Protection Part may be applied, but not limited to, the following circumstances:

- (a) when a personal representative makes a claim on behalf of the deceased;
- (b) when trustees make a claim on behalf of beneficiaries (for further provisions relating to claims by trustees, see Rules 20.10 to 20.16 of the Policyholder Protection Part);
- (c) when the donee of an enduring power of attorney or a lasting power of attorney makes a claim on behalf of the donor of the power;
- (d) when the Court of Protection makes a claim on behalf of a person incapable by reason of mental disorder of managing and administering his property and affairs; and
- (e) when a policyholder dies before receiving compensation.

### Relevant persons in default

19. The FSCS may determine a relevant person in default under Rule 10.2 of the Policyholder Protection Part. A relevant person is a person who was a participant firm at the time the act or omission giving rise to the claim against it took place. As such, the PRA expects an insurer to be authorised for the purposes of FSMA and the Policyholder Protection Part, at the time the insured event that gave rise to the claim occurred or is notified to the insurer. The PRA expects that the insured event is the earliest date on which the act or omission giving rise to the claim against an insurer might occur.

### Successors in default

20. The FSCS may also determine a successor to be in default under Rule 11.3 of the Policyholder Protection Part. A successor is a person who has assumed responsibility for liabilities arising from acts or omissions of a relevant person. All claims that arise (whether reported or unreported) against the predecessor relevant person before the assumption of liabilities by a successor (ie in circumstances where the insured



event occurred before the transfer) fall under the successor rules. All claims that arise (whether reported or unreported) after the assumption of liabilities by a successor (ie the insured event occurred after the transfer), will not be covered by the successor rules. However if the successor is a relevant person in its own right, the claim will fall under the relevant person rules.

### Members in default and the Central Fund of the Society

21. The PRA expects that if a member (or where applicable, a member that is a successor) is unable to meet protected claims against it in full, then, in the first instance, any shortfall will be met by payments made by the Society from the assets of the Central Fund. The FSCS will not consider claims for compensation unless it is satisfied that the amounts which the Society will make available from the Central Fund are, or are likely to be, insufficient to ensure that claims against the member (or where applicable, a member that is a successor) under a protected contract of insurance will be met to the level of protection which would otherwise be available under the Policyholder Protection Part. The amount which the FSCS may pay in respect of any such claim, will be limited to the difference between the amount which the claimant will receive or is expected to receive, from the member and the Society together and the maximum amount of compensation payable in accordance with Chapters 17 and 19 of the Policyholder Protection Part.

### Assignment and subrogation

22. The PRA expectation is that upon the payment of compensation, the FSCS will determine that any such payment has the effect of either automatically subrogating the FSCS to the claimant's rights against a relevant person (or where applicable, a successor) and/or any third party; or, has the effect of automatically assigning the FSCS to the claimant's rights against a relevant person (or where applicable, a successor) and/or any third party. The FSCS will determine the most appropriate method to use in the specific circumstances. The PRA also expects that the FSCS may (and in some cases must) make an offer of compensation conditional on the assignment or subrogation of rights to it by a claimant.

### Recoveries

23. Under Rule 19.5 of the Policyholder Protection Part, the PRA expects the FSCS to take into account any payments made to the claimant by the relevant person (or where applicable, the successor), the FSCS (including amounts recovered by the FSCS on behalf of the claimant) or by any other person, to ensure that the claimant does not suffer any disadvantage arising from his prompt acceptance of the FSCS's offer of compensation compared with what might have been the position had he delayed his acceptance.

24. The PRA expects the FSCS to pay recoveries to claimants in cases where the FSCS has been subrogated or has taken assignment (automatic, electronic or otherwise) or transfers of rights from claimants and makes payments of compensation, but then makes recoveries from the relevant person (or where applicable, the successor) or any third party that are greater than the amount paid to claimants. The PRA does not expect the FSCS to pay recoveries unless there has been a payment of compensation under Chapter 18 of the Policyholder Protection Part.

### Paying claimants

25. The PRA expects that the FSCS will usually pay compensation direct to the policyholder, but in certain circumstances it may be appropriate for the FSCS to pay compensation to someone other than the policyholder. Rule 3.3 and Chapter 18 of the Policyholder Protection Part sets out when those circumstances arise.

### Reduced or interim payments

26. Rule 18.4 of the Policyholder Protection Part applies to compensation payable in connection with any protected claim. The PRA would expect this to apply, for example, to a situation where the FSCS considers it imprudent to make a payment in full because of uncertainty as to the value a court might attribute to a bonus provided for under a long-term insurance contract. In such circumstances, the FSCS may make payment of compensation on account to the policyholder in respect of those benefits under the contract of which the value is certain.

27. Factors the PRA expects the FSCS to take into account when considering taking the approach in Rules 18.8(1) and 18.8(2) of the Policyholder Protection Part include:

- (a) whether the amount of claimants' overall claims are likely to be assessed within a reasonable time frame;
- (b) the circumstances of the claimants;
- (c) the circumstances of the claims; and
- (d) the nature of the products to which the claims relate.

## Funding of the FSCS

### Legislation around funding

28. Section 213(3)(b) of FSMA requires the PRA to make rules to enable the FSCS to impose levies on authorised persons (or any class of authorised persons) in order to meet its expenses. These expenses include in particular expenses incurred, or expected to be incurred, in paying compensation, borrowing or insuring risks.

29. Section 224F of FSMA enables the PRA to make rules to enable the FSCS to impose levies on authorised persons (or any class of authorised persons) in order to meet its management expenses incurred if, under Part 15A of FSMA, it is required by HM Treasury to act in relation to relevant schemes. These rules are set out in the Management Expenses in respect of Relevant Schemes Part.

30. Section 223 of FSMA prevents the FSCS from recovering, through a levy, any management expenses attributable to a particular period in excess of the limit set in the Management Expenses Levy Limit and Base Costs Part and FCA rules as applicable to that period. These rules are set out in the Policyholder Protection Part and Management Expenses Levy Limit and Base Costs Part.

### Application to the Society

31. Although a member is a participant firm for the purposes of most provisions of the Policyholder Protection Part, the PRA expects a member to be excluded from the definition of participant firm for the purposes of Chapter 21, and transitional provision Rule 22.6–22.8 in Chapter 22, the Management Expenses Levy Limit and Base Costs Part and the Management Expenses in respect of Relevant Schemes Part. This is because the fees levied in relation to the carrying on of insurance market activities by members will be imposed on the Society rather than individually on each member.

### Levies on Class B1 and Class C1

32. The PRA's rules enable the FSCS to impose levies on participant firms. The PRA has given the FSCS discretion to apply levies on the general insurance provision class (Class B1) and the life and pensions provision class (Class C1). The FSCS may impose three types of levy on the insurance classes Class B1 and Class C1: a management expenses levy (consisting of a base costs levy and a specific costs levy), a compensation costs levy and a management expenses levy in respect of relevant schemes levy (ie a levy to meet the management expenses incurred by the FSCS under FSMA Part 15A). The FSCS has discretion as to the amount and timing of the levies imposed.

33. The PRA expects that in calculating a compensation costs levy, the FSCS may include up to the greater of one third of the compensation costs expected in the 36-month period following the date of the levy, or the compensation costs expected in the twelve months following that date.

34. In order to allocate a share of the amount of specific costs and compensation costs to be funded by an individual participant firm, the funding arrangements are split between the two PRA insurance classes, Class B1 and Class C1.

35. The Policyholder Protection Part, which requires the FSCS to allocate levies to classes up to its levy limit, meets a

requirement of section 213(5) of FSMA that the PRA make rules to enable the FSCS to impose levies that must take account of the desirability of ensuring that the amount of the levies imposed on a particular class of authorised person reflects, so far as practicable, the amount of claims made, or likely to be made, in respect of that class of person.

### Management expenses levy

36. The PRA expects the FSCS to collect a management expenses levy. A management expenses levy may consist of two elements. The first is a base costs levy for the base costs of running the compensation scheme in a financial year. This includes costs that are not dependent upon the level of activity of the compensation scheme and which therefore are not attributable to any specific class. Included in this category are items such as the salary of the members of the board of the FSCS, the costs of the premises which the FSCS occupies, and its audit fees. It would also likely include the cost of any insurance cover secured by the FSCS against the risk of it paying claims out in circumstances where the levy limit of the particular class to which the claim would otherwise be attributable has exceeded its levy limit for the year. This is because the insurance cover is likely to benefit each class which may have costs allocated to the other if the levy limit of the other class is breached. The amount that each participant firm pays towards a base costs levy is calculated by reference to the regulatory costs paid by the firm. All participant firms are liable to contribute towards a base costs levy.

37. The second element of a management expenses levy is a specific costs levy for the 'specific costs' of running the compensation scheme in a financial year. These costs are attributable to a class and include the salary costs of certain staff of the FSCS and claims handling and legal and other professional fees. It also may include the cost of any insurance cover that the FSCS secures against the risk of the FSCS paying out claims above a given level in any particular class (but below the levy limit for that class for the year). The specific costs are attributed to the class which is responsible for those costs. When the FSCS imposes a specific costs levy, the levy is allocated to the class which is responsible for those costs up to the relevant levy limits. The FSCS may include in a specific costs levy the specific costs that the FSCS expects to incur (including in respect of defaults not yet declared at the date of the levy) during the financial year of the compensation scheme to which the levy relates. The amount that each participant firm pays towards the specific costs levy is calculated by reference to the amount of business conducted by the firm in the class to which the FSCS has allocated specific costs. Each class has a separate 'tariff base' for this purpose, set out in Annex 2 of the Policyholder Protection Part. Participant firms may be exempt from contributing to the specific costs levy.



38. The PRA and FCA will consult on the limit on the management expenses attributable to the forthcoming financial year of the FSCS in January each year.

### Compensation costs

39. Insurance compensation costs are attributed to the general insurance provision (Class B1) or the life and pensions provision (Class C1). The PRA expects that, when the FSCS imposes an insurance compensation costs levy, the levy is allocated to Class B1 or Class C1 up to its levy limit.

40. The PRA does not consider that the use made by the FSCS of borrowing facilities to provide liquidity until the next levy should affect the attribution of compensation costs, nor the allocation of compensation cost levies. This is because the allocation of a compensation costs levy occurs at the time that the FSCS imposes a levy.

### Participant firms that are members of more than one class

41. The PRA expects that if a participant firm is a member of more than one class, the total compensation costs levy and specific costs levy for that firm in a particular year will be the aggregate of the individual levies calculated for the firm in respect of each of the insurance classes for that year. Each class has a levy limit which is the maximum amount which may be allocated to that particular class in a financial year for the purposes of the levy.

### Exemption

42. A participant firm to which the conditions in Rule 21.5 of the Policyholder Protection Part no longer apply will then become subject to levies in accordance with Rules 21.7 to 21.9 of the Policyholder Protection Part and the Management Expenses Levy Limit and Base Costs Part, as applicable.

43. If a firm fails to notify the FSCS of an exemption under Rule 21.5 of the Policyholder Protection Part by 31 March, the PRA expects that it will be treated as non-exempt for the whole of the next financial year.

44. The PRA expects that the FSCS will usually levy once in each financial year to meet expected expenditure. For compensation costs, the PRA expects the FSCS will levy for the greater of the period of twelve months of expected

expenditure or, one third of the expected expenditure in the period of 36 months following 1 July in that year, if greater. However, if the compensation costs or specific costs incurred, or expected to be incurred, exceed the amounts held or reasonably expected to be held to meet those costs, the FSCS may, at any time during the financial year, do one or more of the following:

- (a) impose an interim compensation costs levy or management expenses levy; or
- (b) borrow, including from the National Loans Fund; or
- (c) utilise money collected from firms.

45. The FSCS will generally impose a levy rather than borrow or utilise funds as described in (c), unless the latter options appear to it to be preferable in the specific circumstances prevailing at the relevant time; for example, to address short-term liquidity issues or in order to deal with a significant failure without having to wait for a levy to be imposed or collected.

### Recovery of fees

46. Paragraphs 31(7) and 35 of Schedule 1ZB of FSMA permit the PRA to recover fees and section 213(6) of FSMA permits the FSCS to recover shares of the FSCS levy payable, as a debt owed to the PRA and the FSCS respectively. The PRA and the FSCS, as relevant, will consider taking action for recovery (including interest) through the civil courts.

47. The PRA may also take regulatory action in relation to the non-payment of a share of the FSCS levy, after reference of the matter to the PRA by the FSCS. What action (if any) is taken by the PRA will be decided upon in the light of the particular circumstances of the case.

### Remission of fees and levies

48. The PRA does not expect that a poor estimate or forecast by a fee or levy payer, when providing information relevant to an applicable tariff base, is likely, of itself to, amount to an exceptional circumstance for the purposes of Rules 21.2 or 21.3 of the Policyholder Protection Part. By contrast, a mistake of fact or law by a fee or levy payer may give rise to such a claim.