

# Final Regulatory Impact Assessment

## Purpose and intended effect

1. The Insurers' Reorganisation and Winding-Up Directive (2001/17/EC) creates unified proceedings for EU insurance undertakings that are subject to reorganisation measures or being wound-up. The Directive provides that proceedings may be opened only in the home Member State of an insurance undertaking and that those proceedings will have effect throughout the EU.

2. The principle purposes of the directive are:

- To simplify proceedings when an EU insurance undertaking is in financial difficulties, enabling efficient reorganisation or distribution of assets;
- To co-ordinate reorganisation and winding-up arrangements across Member States through mutual recognition; and
- To ensure that all EU creditors are treated equally.

3. The provisions of this Directive are intended to apply to reorganisation measures affecting, or to a winding-up of, "the association of underwriters known as Lloyd's".

4. The Directive was implemented in respect of all other insurers in the UK by the Insurers' (Reorganisation and Winding-up) Regulations 2003 and 2004<sup>1</sup> ('the principal regulations'), which came into force on 20 April 2003 following consultation ('the main consultation'). In order to complete the implementation of the Directive the Government needs to make provision in relation to the Lloyd's market that will have an equivalent effect to that of the principal regulations<sup>2</sup> so far as that is possible given the particular characteristics of the Lloyd's market.

5. Not implementing the Directive would put the UK in breach of EU Treaty obligations and would mean that reorganisations and winding-ups within the Lloyd's context would not be co-ordinated and would be susceptible to high levels of litigation. This could result in fewer funds being available to meet the claims of insurance creditors following the payment of legal expenses.

6. Reorganisation measures and winding-up or bankruptcy procedures already apply to members of Lloyd's on a member by member basis. By contrast, there is no legal mechanism for the co-ordinated application of reorganisation measures and winding-up procedures to the Lloyd's market as a whole. The regulated 'insurance undertaking' for the purposes of the

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<sup>1</sup> SI 2003/1102 and 2004/353: regulation 3 removes Lloyd's from the scope of the Regulations

<sup>2</sup> Insurers' (Reorganisation and Winding-Up) Regulations 2004

insurance directives, the “association of underwriters known as Lloyd’s”, has no legal personality.

7. In order to implement the Winding-up Directive, ensuring that any reorganisation or winding-up of the market as a whole could be achieved efficiently and effectively, arrangements are necessary which address the potential global scale of a reorganisation or winding-up, while also facilitating the application of existing insolvency procedures at the individual member level.

8. In implementing the Winding-up Directive in relation to Lloyd’s, the Government also has to have regard to the Insolvency Regulation<sup>1</sup>. Both the Insolvency Regulation and the Directive are intended to deal with the cross-border effects of insolvency proceedings in the European Economic Area. The intention is that there should be a single set of rules for determining which State has jurisdiction in insolvency matters, and therefore which insolvency law applies, affecting both persons and businesses where assets or liabilities are present in more than one Member State.

9. The Insolvency Regulation applies to all businesses and individuals in the EU, with the exception of insurance undertakings, certain investment undertakings and credit institutions. In Community law terms, that means the Regulation does not apply to “the association of underwriters known as Lloyd’s”. But, on the face of it, the Regulation does seem to apply to the underwriting members considered individually (as the members are not themselves insurance undertakings).

10. For the UK to implement the Winding-up Directive effectively in relation to Lloyd’s, it is therefore necessary to provide that in certain circumstances the insolvency of an underwriting member is to be treated as falling within the ambit of the Winding-up Directive.

## **Options**

11. There are three options for implementing the Directive

### **Option 1 – Do nothing**

12. Existing UK insolvency law already applies to members of Lloyd’s on a member by member basis. In the extreme circumstance of the actual or impending deficits among the underwriting members being so great that the difficulties run deep into the market, the FSA could use its powers to reorganise the Lloyd’s market.

13. With this approach there would be the risk that it would be much more difficult to co-ordinate reorganisations and windings-ups within the Lloyd’s context than under the other options. There is also an increased risk of high

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<sup>1</sup> (Council Regulation (EC) No. 1346/2000 of 29 May 2000 on Insolvency Procedures” OJ. L. 160, 30.6.2000, p.1.).

levels of litigation resulting in less funds being available to meet the claims of insurance creditors following the payment of legal expenses. Doing nothing would also put the UK in breach of EU Treaty obligations for implementing EU directives and leave the UK Government exposed to potential fines and actions for damages.

## **Option 2 – Use existing insolvency law in a new procedure**

14. Under this option, the UK would retain its existing insolvency laws with the relevant case law and experience that already applies to members of Lloyd's on a member by member basis.

15. There would then be the scope for the court to order a new procedure, which would enable the necessary amendments to existing UK insolvency law to be made in the circumstances necessary for compliance with the Directive.

16. To identify the circumstances when the necessary changes should be made, and ensure compliance with the policy of the Directive, there would be:

- A court ordered procedure available where regulatory solvency requirements applicable to the market are not, or may not, be met. The objectives of such a procedure would be to preserve or restore the financial situation of, or market confidence in, 'the association' in order to facilitate the carrying on of insurance business at Lloyd's or to assist in achieving an outcome that is in the interests of creditors of members and insurance creditors in particular;
- A moratorium or stay of unilateral action by creditors and in respect of all litigation against members, managing agents, the Society and others including for the appointment of a liquidator, administrator or trustee in bankruptcy so that reorganisation can take place in an orderly manner, with the funds available for each member used to the maximum extent possible to pay the members' policyholders;
- A court appointment of a Lloyd's market reorganisation controller, whose role will be to find out the extent and have an overview of the difficulties and to seek to identify ways of meeting the objectives of the Lloyd's market reorganisation order by, amongst other things, agreeing a reorganisation plan with the Financial Services Authority (FSA);
- A requirement, once a reorganisation order has been made, that any bankruptcy or winding up proceedings, and other insolvency measures affecting members, be notified to the FSA and the reorganisation controller.
- A requirement that, while the order is in force, the member will be treated as if it were an UK insurer for the purpose of insolvency proceedings unless the Court is satisfied that it is likely that the insurance market debts of the member will be satisfied. This will mean

that the members are treated in accordance with the Directive rather than the Insolvency Regulation.

17. This appears to be the means of achieving the policy of the Directive with the minimum disruption to the market both now and in the event that it needs to be used.

### **Option 3 – Establish new insolvency procedures**

18. Under this option, HM Treasury would establish new insolvency procedures for the members of Lloyd's and the market to meet the Directive's requirements.

19. To do so, UK insolvency law would need to be rewritten for members of Lloyd's and the market. Such a rewrite would also need to identify the circumstances when it was necessary to apply the provisions of the Directive to insolvency procedures. Thus, many of the characteristics of the court ordered procedure in option 2 would be needed.

20. In addition, insolvency law provisions would also be needed. There is a risk that the wholesale rewrite of insolvency law would not better achieve the policy of the Directive as it might lose the benefits of existing law as developed through case law and applied through experience. This option would be very complex and difficult to achieve in practice.

### **Costs**

#### **Option 1 – Do nothing**

21. The European Court of Justice found on November 2004 that the UK was in breach of its obligations under the Directive in that it had not implemented with regard to Lloyd's. Since then, infraction proceedings against the UK have begun and there is now a further substantial risk of a fine being proposed by the Commission and confirmed by the ECJ. Ongoing non-compliance would lead to substantial and escalating costs.

22. In the event that the market needed to be reorganised and participants wound-up, further costs could arise in respect of litigation. Not implementing the Directive would mean that reorganisations and winding-ups within the Lloyd's context would not be co-ordinated and would be susceptible to high levels of litigation which could result in fewer funds being available to meet the claims of insurance creditors following the payment of legal expenses.

23. There is also the risk that holders of direct policies at Lloyd's would not receive preference of their claim over other general creditors, as is required by the Directive.

#### **Option 2 – Use existing insolvency procedures**

24. Generally, the provisions of the Directive affect the association of underwriters known as Lloyd's when the market as a whole fails to meet the regulatory solvency tests.

25. To maintain existing insolvency procedures to meet the requirements of the Directive, it would be necessary to create a new Court-controlled procedure within which existing insolvency law would operate subject to any necessary amendments (for which the procedure will make provision).

26. The Directive requires that direct insurance creditors be given priority over other creditors of an insurer in the event of a winding-up procedure. Some natural persons underwrite insurance at Lloyd's and they do so with unlimited liability. This means that all their assets may be required to pay their insurance creditors.

27. To comply with this Directive requirement, when a natural member cannot pay his insurance creditors, the insolvency law which prescribes the treatment of the assets of natural persons will need to be amended to ensure that insurance creditors have priority over other unsecured creditors. The Regulations would prescribe this.

28. In general, there should be no or very little direct and immediate cost to adopting this option. The requirements of the Directive relate to co-ordinating a possible future event.

29. The Directive's requirements (however they are implemented) may impose some additional costs on natural Names in their dealings outside the Lloyd's market because of the priority their insurance creditors will be given over other unsecured creditors in insolvency proceedings. Natural Names may be able to mitigate this cost on the advice of their member's agent.

30. The requirement of the Directive to enable creditors from other Member States to lodge claims and for them to be kept informed of the progress of the reorganisation or winding-up measures may impose additional costs (principally due to the translation requirements). It is not possible to quantify the likely additional costs.

32. This procedure should reduce legal costs overall. The Court-controlled nature of the procedure will provide order in a very difficult situation and restrict the legal proceedings to those which are strictly necessary.

### **Option 3 – Establish new insolvency procedures**

33. Any direct or immediate costs should be similar to those in option 2.

34. It is likely that costs would be higher than for option 2 in the event that the market needed to be reorganised and participants wound-up because insolvency practitioners would be working with new, previously unused procedures, resulting in fewer funds being available to meet the claims of insurance creditors following the payment of fees.

## **Benefits**

### **Option 1 – Do nothing**

35. The benefits of the Directive would not be achieved and the UK would be subject to infraction proceedings and the risk of action for damages. There are no benefits to not implementing the Directive.

### **Option 2 – Use existing insolvency procedures**

36. The principal benefits of the Directive achieved by this option are:

- The costs of reorganisations and winding-ups should be reduced due to:
  - The avoidance of multiple separate proceedings in different Member States; and
  - The ability of officials acting in insolvency proceedings to have automatic recognition as regards the enforcement of the proceedings and their effects throughout the EU without the need to make applications to courts in other Member States.
- It will be possible to take action more quickly and effectively to protect the interests of policy holders and other creditors if Lloyd's syndicates were to get into serious financial difficulties; and
- A single set of proceedings for Lloyd's will ensure that policy holders and other creditors are treated equitably.

37. Through adopting this option, there is the additional benefit that insolvency practitioners would be using processes with which they are generally familiar

38. We envisage that this option would result in the most funds being available to meet insurance and other related debts rather than legal or other fees.

39. Given the complex contingent nature of these provisions, it has not been possible to quantify these benefits

### **Option 3 – Establish new insolvency procedures**

40. This option should have the general benefits of the Directive and have similar benefits to option 2.

## **Consultation**

41. HM Treasury published consultation proposals with draft regulations on 7 December 2004. The three-month consultation closed on 11 March 2005.

42. We received nine responses to the consultation. Four of those responses were from natural names or those specifically representing natural names; of these, three did not address the individual questions posed by the consultation document. Rather, they sought clarification on the scope of the Regulations, and the proposal for prioritisation of insurance creditors. None of these three respondents expressed a view generally on the proposals. The other six respondents were broadly supportive of the proposals and commented on the specific questions posed in the consultation document.

43. In the light of the consultation responses, four small amendments have been made to the Regulations, two in relation to the role of the reorganisation controller in the event that a Lloyd's Market Reorganisation Order were made by the Court, one in relation to the time allowed for drawing up a reorganisation plan, and one relating to differing insolvency provisions in Scotland.

44. The first concern raised was that the draft Regulations included no mechanism to ensure that the reorganisation controller would be remunerated accordingly. Such provision has now been made in Regulation 12.

45. The second point made was that, given the high concentration of expertise amongst those specialising in the subject of insurance insolvency and the consequent limited field for possible candidates for this role, there might be a danger that the individual appointed could suffer from a conflict of interests in some circumstances. It was suggested that this could be addressed by providing for the appointment of one *or more* reorganisation controllers within the Regulations. Provision is made for this in Regulation 9 (3).

46. The third modification made to the Regulations was as a result of differing insolvency laws in Scotland for natural persons. These Regulations now place the legal obligation at all times on all debtors to inform trustees for creditors in Scotland if they are a member or former member of Lloyd's, in order that insolvency practitioners are advised accordingly in the event that a Lloyd's Market Reorganisation Order were made. This provision is reflected in Regulation 17.

47. The final alteration to the draft Regulations relates to the period of one month for agreeing a reorganisation plan. It was suggested that this period may in some circumstances be too short. Given the time urgency in such a scenario, the Treasury remain of the view that this time restriction should still be set at one month. However, the Regulations now reflect a new provision for the relevant party (FSA or reorganisation controller) to apply to the Court for one extension of a further month, should the necessity arise. This provision is reflected in Regulation 11 (2).

48. None of these first three amendments has any additional cost implications. The fourth might result in additional court costs but these would be relatively small.

49. The remaining views expressed in the responses have been duly noted and considered accordingly. The Treasury have concluded however that no further changes were required pursuant to them.

50. Some respondents requested further clarification on certain points, and the Treasury intend to address these issues shortly in the form of a feedback statement.

### **Business sectors affected**

51. We have been unable to identify any negative impacts on small firms as a result of the proposals and therefore do not intend to carry out stage one of the small firms' impact test. This approach has been agreed with the Small Business Service.

### **Competition Assessment**

52. The Treasury have applied the competition filter and are satisfied that the proposals do not raise competition concerns.

53. There are currently 66 insurance underwriting syndicates writing business at Lloyd's with over two thousands members participating in the market through these syndicates. The market is therefore diverse and competitive.

54. Implementing the Directive should not affect the market structure nor should it impact upon some members and syndicates more than others.

55. It is not expected that the Directive would give rise to higher costs (either set-up or ongoing) for new members entering the market as opposed to established members.

56. The Directive will not restrict the ability of firms to choose the price, quality range or location of their products.

### **Enforcement and Sanctions**

57. Should it be necessary to use the legislation, the FSA will enforce the procedures set out to comply with the Directive. The enforcement would be in line with the FSA's current powers under the Financial Services and Markets Act 2000. The FSA's role in any court-ordered procedure would be consistent with its current powers.

58. The FSA are content to enforce the proposed procedures and, given the current enforcement responsibilities it already carries out, there is no reason to believe that any new procedures would not be appropriately enforced.

## **Guidance**

59. An explanatory memorandum will be accompanying the legislation through Parliament. Its purpose is to give an overview of the motivation behind and the objectives of the Regulations.

## **Monitoring and Review**

60. The UK Government has recently undertaken to monitor and review all new legislation after a period of two years. The Treasury will conduct such a review of the Winding-Up Regulations for Lloyd's in two years' time.

## **Recommendation**

61. Option 2 is the preferable approach. It makes the benefits of the Directive available to the market using existing insolvency procedures, which have already been tried and tested. It should also allow for the maximum possible funds to be available to meet liabilities.

## **Ministerial Sign-Off**

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

A handwritten signature in black ink, appearing to read 'Ivan Lewis', is positioned above the typed name and title.

**Ivan Lewis MP**  
**Economic Secretary to the Treasury**  
**July 2005**

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