ISLE OF MAN
FINANCIAL SERVICES AUTHORITY

Lught-Reill Shirveishyn Argidoil Ellan Vannin

Report to the Isle of Man Treasury Minister following the Independent Review of the role of the Insurance and Pensions Authority in relation to the failure of Powerhouse Insurance Limited

30 June 2017

CONTENTS

IMPORTANT NOTE FOR READERS

This is a highly complex case in which the material events occurred between 13 and 20 years ago.

The reader's attention is drawn to the note on confidentiality at Section 6 of this Report.

It is a criminal offence for the Isle of Man Financial Services Authority to disclose information it receives in the course of fulfilling its functions ('restricted information'), except where it is statutorily able to do so, such as when the information has been available to the public from other sources.

This case has been the subject of much public scrutiny and important information which may provide an alternative perspective to the views expressed in public are not featured in this report because that information is not public and it is a criminal offence for the Authority to disclose it.

1 Executive Summary

1. This report presents the key findings of the independent review of Mr Charles Flint QC on the role of the Insurance and Pensions Authority in relation to the failure of Powerhouse Insurance Limited (the 'Flint Report'). This report, entitled the 'Treasury Report', sets out the key findings of the Flint Report along with the response of the Isle of Man Financial Services Authority (the 'Authority') to the conclusions set out in the Flint Report including, where appropriate, highlighting the regulatory and supervisory developments undertaken since 2003 (or which are currently in progress) which address the matters observed.

2. This is a complex case involving a number of parties acting under advice in which the material events occurred between 13 and 20 years ago.

3. An overview of the history of Powerhouse Insurance Limited ('PIL'), an Isle of Man authorised insurer, is provided within Section 3 of this report. Essentially, PIL insured the warranty cash back liabilities of two entities, London General Insurance Company Limited ('LGI') (a UK authorised insurer) and PowerPlan Company Limited ('PPCL') (an unregulated Isle of Man company). The warranties issued by LGI and PPCL were to customers of Scottish Power UK plc ('Scottish Power') in respect of electrical goods sold through Scottish Power's UK based retail stores. In 2003 the structure set up to pay for the cash back claims collapsed, which in turn resulted in PPCL being placed into administration.

4. Douglas MacDonald of The MacDonald Partnership ('TMP'), the administrator (and subsequently liquidator) of PPCL undertook two investigations into the matter. Following the first investigation in 2004, a number of settlement agreements between the various parties were entered into under which Scottish Power agreed to pay up to £6.575 million towards cashback claims and costs ('the 2004 settlement'). With all parties in agreement to the terms, the matter was considered by the Insurance and Pensions Authority ('IPA') to be resolved and PIL subsequently surrendered its authorisation.

5. Six years later, in 2010[1], TMP commenced a second investigation, which concluded three years after that in 2013. The liquidator of PPCL claimed he had been misled into agreeing to the 2004 settlement and that, in his opinion, the case involved other very serious wrongdoing, including fraud, on the part of Scottish Power and PIL.

6. The very serious and public allegations made by the liquidator of PPCL and the liquidators of PIL (KSA Group) have called into question the actions of Scottish Power, PIL as an authorised insurer and the directors of PIL as well as numerous regulators and law enforcement agencies throughout the UK and the Isle of Man including the IPA.

7. The Authority engaged Mr Flint QC to undertake an independent review of the role of the IPA in relation to the failure of PIL[2] and his summary of findings is reproduced in full in Appendix B to this report. In relation to the allegations made by the liquidators, Mr Flint QC concludes:

   a) *There is no evidence that the affairs of PIL were mismanaged by Scottish Power.* [316]

[1] There is some doubt as to when the second investigation commenced, paragraph 2.5 of liquidator's fifth annual progress report - https://pplaninadmin.files.wordpress.com/2011/02/uk-liquidators-fifth-annual-progress-report-february-2016.pdf states that the investigation commenced in 2010, whereas paragraph 51 of the Published TMP Report states that the investigation commenced in 2011. For the purposes of this report, we have assumed the earlier date.

[2] Full terms of reference are detailed at Appendix A

b) *The very serious allegations of impropriety made by the liquidators of PPCL and PIL against the directors of PIL are baseless.* [323]

c) *There are grounds for serious criticism of the decisions made by the board of PIL in relation to the financing advanced to the Powerhouse Group [of Companies], but the evidence would not support any application to the court for a directors' disqualification order, or any other regulatory action against the former directors.* [324]

d) *The evidence available to this review does not give any grounds to criticise the conduct of the managers, auditors and legal advisers to PIL with respect to the treatment of cashback liabilities.* [325]

e) *The regulatory failings identified are unlikely to have made any difference to the demise of PIL.* [329]

f) *There are no further steps which are required to be taken by the FSA arising out of the conduct of those concerned in the affairs of PIL.* [325]

8. Both the Authority and Mr Flint QC have had the opportunity to review the case with the benefit of all the relevant facts available to the Authority including information that is restricted under the Insurance Act 2008. The Flint Report is drawn up on this basis and for the reasons set out in Section 6, the Authority is statutorily prohibited from sharing that report in full. Recognising the public interest in this matter and the calls of individual members of Tynwald for the conclusions of the report to be made public, the Authority is providing the Treasury Minister, as a primary recipient of restricted information under the Insurance Act 2008, a full copy of the Flint Report which accompanies this Treasury Report. The information so disclosed continues to remain restricted when in the possession of Treasury. Further, the Authority has received legal advice from the Attorney General's Chambers ('AGC'), and on the basis of that advice the Authority concludes that it is able to publish the unabridged summary of findings of Mr Flint QC set out in Chapter 10 of the Flint Report (Appendix B to this report).

9. The terms of reference of Mr Flint QC specifically excluded any consideration by Mr Flint QC of the allegations by TMP of mis-selling by Scottish Power in relation to the extended warranty contracts sold to the customers of Scottish Power. The investigation of mis-selling by a UK plc to the general public of the UK is a matter which rightly sits within the remit of the UK authorities and is outside the scope of any function of the Isle of Man Financial Services Authority or IPA.

10. In 2003 the UK Office of Fair Trading assessed the terms and conditions of the warranty cashback scheme for unfairness under the provisions of the Unfair Terms in Consumer Contracts Regulations 1999.

11. To date, as far as the Authority is aware, no UK authority has instigated any proceedings, nor have TMP or KSA Group, as liquidators of PPCL and PIL respectively, instigated legal proceedings against any of the parties alleged of wrongdoing.

12. Following due consideration of the conclusions of Mr Flint QC the Authority has determined that there are insufficient grounds to support regulatory action against the directors of PIL and confirms that, as at the date of this Treasury Report and on the basis of the information in its possession, the Authority does not intend to take any regulatory action against PIL's former directors nor against Scottish Power as a former controller of PIL in relation to the affairs of PIL (being the only capacity for which the Authority has the vires to consider action against Scottish Power).

13. The board and management of regulated entities, such as PIL, are responsible for managing the risks within their business. It is the role of the regulator to advance a regulatory framework that promotes effective controls, good risk management and suitable disclosure. The insurance regulatory framework was assessed in 2003 by the International Monetary Fund ('IMF') under the Offshore Financial Centre Assessment Programme[3] and the IMF concluded that the "*financial and supervisory system of the Isle of Man complied well with the assessed international standards*[4]*"*.

14. Mr Flint QC concludes that the regulatory regime at the time was *"unlikely to have made any difference to the demise of PIL* [329]" and was therefore not the cause of the companies' failures, which he states *"were a combination of :*

- *the decisions of the directors to advance unsecured financing of £36.5 million to the Powerhouse Group [of Companies], which it proved not to be in a position to repay,*
- *the White Summit transaction which had the effect of removing from PIL any prospect of meeting cashback liabilities from its own resources, namely the excess reserves on the repair warranty business, and*
- *the insolvency of Powerhouse Retail Limited ('PRL') which lawfully entitled Scottish Power to terminate the Cashback Funding Agreement*" [322].

15. Whilst the regime in place at the time "*achieved a high degree of compliance with the IAIS Principles"*[5] Mr Flint QC identifies a number of areas for improvement within the insurance framework and the approach taken by the IPA in the supervision of that framework. Examples include improvements to regulatory guidance, the need to introduce a risk based capital and solvency assessment reflective of incidence of claims and quality of assets; implementing changes to reflect risks arising from large intra-group exposures; better processes by which to determine applications for a change of controller, and the introduction of a requirement on directors to disclose material matters to the IPA as well as the need for supervisory officers to be more cognisant of the risks. These matters are broadly accepted and have already been, or are in the process of being, addressed as more fully described in Section 4 of this report.

16. International standards themselves have developed significantly since the relevant period of material events (2001 - August 2003) with standards undergoing major enhancements in October 2003 and again in October 2011. The IPA (and latterly the Authority) has developed, and continues to develop, its insurance framework in line and in keeping with the developing international standards by way of the:

- enactment of the Insurance (Amendment) Bill in 2004 (a Bill which was progressing through the branches of Tynwald throughout 2003),
- the Corporate Governance Code of Practice for Regulated Insurance Entities ('CGC'), issued in 2010, which codified the expectations of the IPA in respect of corporate governance and risk management systems of an authorised insurer; and

[3] Executive Summary of the Assessment of the Supervision and Regulation of the Financial Sector - Issued by the IMF and dated 25 November 2003.
[4] The assessed international standards applicable were the Insurance Core Principles issued and adopted by the International Association of Insurance Supervisors ('IAIS') in October 2000.
[5] Paragraph 16 of the Assessment of the Supervision and Regulation of the Financial Sector - Issued by the IMF and dated 25 November 2003.

- the initiation in 2012 of the 'ICP project' to introduce a risk-based insurance regulatory regime, consistent with the 2011 revised international standards issued in October 2011.

17. Recognising this Mr Flint QC concludes that the regulatory regime has substantially changed since 2003 and that "*the board of the Authority is in the best position to decide, taking into account its regulatory objectives and priorities, whether any further adjustments to the prudential supervision of general liability insurers are required in the light of the findings set out in this Report*" .[330]

18. The Authority is committed to maintaining appropriate standards of regulation for the general insurance sector of the Isle of Man. International regulatory standards for insurance continue to develop in response to changes in the economic environment, moving increasingly towards risk sensitive capital frameworks, complemented by robust risk management and governance requirements, as well as transparency in respect of reporting to supervisory authorities and to the public.

19. The Authority considers developments to its own framework to be consistent with its aims of ensuring that the Island has a proportionate regime for the regulation and supervision of insurance business which is robust and which maintains the Island's reputation as a responsible international jurisdiction.

2 Glossary

[XXX]	Paragraph numbered XXX within chapter 10 of the Flint Report.
2004 settlement	A series of settlement agreements, dated 9 December 2004, between the various parties, including TMP (as the administrator of PPCL) under which Scottish Power agreed, in consideration of a release from all claims, to pay £6.575 million towards cashback claims and costs and through which the administrator of PPCL acquired control of PIL.
AGC	Attorney General's Chambers.
APPG Report	Report entitled 'ScottishPower's Cashback Mis-selling Corporate dishonesty and regulatory failure. How 625,000 UK consumers lost out on the PowerPlan Cashback Promise' issued by a UK All-Party Parliamentary Group, un-dated but issued in April 2016.
Authority	Isle of Man Financial Services Authority, a statutory board created on 1 November 2015 as a result of the merger of the FSC and IPA.
Cashback Funding Agreement	An agreement dated 17 June 2004 between PHL, PRL, PIL and Scottish Power.
CGC	Corporate Governance Code of Practice for Regulated Insurance Entities, issued in 2010.
Controller	A defined term within section 54 of the Insurance Act 2008, but essentially the person who owns or controls an insurance entity regulated by the Authority.
Draft TMP Report	Report entitled 'PowerPlan Company Limited (in liquidation), Report by the Liquidator to the Regulatory Authorities raising concerns in relation to the conduct of Scottish Power UK plc', dated 6 February 2012.
Flint Report	Report entitled: 'Independent review of the role of the Isle of Man Insurance and Pensions Authority in relation to the failure of Powerhouse Insurance Limited', dated 24 February 2017.
FSA	The Authority.
FSC	Financial Supervision Commission, a statutory board which merged with the IPA in 2015 to form the Authority.
IAIS	International Association of Insurance Supervisors.
ICP Project	A multi-year project, commenced by the IPA in 2012 to update the insurance regulatory framework in order to complete the move to a risk-based insurance regulatory regime.
ICPs	Insurance Core Principles issued by the IAIS.
IMF	International Monetary Fund.
IPA	Insurance and Pensions Authority, a statutory board which merged with the FSC in 2015 to form the Authority.

KSA Group	Keith Steven and Eric Walls of the KSA Group, joint liquidators of PIL.
KSA Report	Report entitled 'Powerhouse Insurance Limited (in liquidation), Report by the Liquidators to the Regulatory Authorities', dated 3 March 2014.
LGI	London General Insurance Company Limited, a UK insurer that issued insurance warranty contracts with cashback features to the customers of Scottish Power between 1997 and 1998.
TMP	Douglas MacDonald of The MacDonald Partnership, the administrator and subsequently the liquidator of PPCL.
ORSA	Own risk solvency assessment.
PIL	Powerhouse Insurance Limited, an Isle of Man registered company, number 048577C.
PHL	Powerhouse Holdings Limited, a company registered in England and Wales – company registered number 03151872, the controller of PIL from 2001 to 2004.
PIGL	Powerhouse Insurance Guernsey Limited, an insurance company incorporated in Guernsey which, as part of the White Summit transaction, purchased the extended warranty business, excluding cashback liabilities from PIL.
PPCL	PowerPlan Company Limited, an Isle of Man registered company, number 090015C, that issued service warranty contracts with cashback features to the customers of Scottish Power between 1998 and 2001 and controller of PIL from 2004.
PRL	Powerhouse Retail Limited, a company registered in England and Wales – company registered number 03123741.
Published TMP Report	Report entitled 'PowerPlan Company Limited (in liquidation), Report by the Liquidator to the Regulatory Authorities raising concerns in relation to the conduct of Scottish Power UK plc and the Directors of its former subsidiary Powerhouse Insurance Limited (in liquidation)', dated 7 February 2014.
Relevant period of material events	Between 2001 and August 2003.
Relevant period of the review	Between 1997 and 2010.
Scottish Power	Scottish Power UK plc, a UK public listed company listed on the London and New York Stock Exchanges and controller of PIL from 1996 to 2001.
SCR	The solvency capital requirement, being the proposed new prescribed solvency requirement in respect of authorised insurers which is currently under development as part of the ICP Project.
SPA	Sale and purchase agreement dated 31 July 2001 by which Scottish Power sold its electrical retail business (including PIL) to PHL.

The Supervisor	A statutory role under the Insurance Act 2008, in practice carried out by the Chief Executive of the IPA, in whom the administration of the Act and certain statutory functions and responsibilities of the Act rested.
Treasury Report	This report, entitled 'Report to the Isle of Man Treasury Minister following the Independent Review of the role of the Insurance and Pensions Authority in relation to the failure of Powerhouse Insurance Limited', issued by the Isle of Man Financial Services Authority and dated 30 June 2017.
White Summit	White Summit Holdings Limited, a company incorporated in the British Virgin Islands and controller of PIL for a short period in August 2003 in order to give effect to a transaction which resulted in PIL's non-cashback warranty business being transferred to PIGL and the indebtedness of PHL to PIL in excess of £32 million being substantially extinguished.

3 Background

20. Powerhouse Insurance Limited ('PIL') was authorised on 23 March 1990 by the IPA to carry on insurance business. Originally authorised to undertake business within class 12, which restricted its insurance business to insurance or reinsurance of related parties, in 1998 that restriction was removed and PIL was authorised to carry on insurance under classes 3 to 9 which allowed it to insure or reinsure third parties. PIL surrendered its authorisation on 1 April 2010.

21. In 1996 PIL was acquired by Scottish Power, a major energy and retail supplier based in the UK.

22. Between 1997 and 2001 extended warranties were offered by Scottish Power to consumers who purchased electrical goods sold through Scottish Power's UK consumer outlets. The warranties ran for periods up to 5 years and included a guarantee that the premium paid for the warranty would be refunded to the customer if the customer did not make a warranty claim (i.e. a claim for repair or replacement) within the warranty period and complied with some further conditions. The average cost of the contracts sold, and therefore the amount of cash back potentially reclaimable, was approximately £140.

23. Between 1997 and 1998 the customer's warranty was insured by LGI, a UK authorised insurer and a leader in the field of warranty insurance at that time. 95% of LGI's liability to Scottish Power's customers was in turn reinsured by PIL with the remaining 5% being retained by LGI.

24. In 1998 the structure of the Scottish Power warranty arrangements was changed from an insurance scheme provided by LGI to a service contract scheme provided by PPCL, an unregulated Isle of Man company. Similar to the LGI insurance scheme the service contracts provided by PPCL to the consumers of Scottish Power also guaranteed to return the cost of the service contract if no claim was made in the warranty period and some further conditions were complied with. PPCL insured 95% of its liability with PIL.

25. In 2001, Scottish Power sold its retail business, including its stores and warranty business together with the shareholding in PIL to Powerhouse Holdings Limited ('PHL').

26. In August 2003 PHL and PRL were placed into administration and as a result the structure set up to pay for the cash back claims collapsed.

27. Following an investigation by TMP, the administrator entered into the 2004 settlements between the various parties, including TMP (as the administrator of PPCL), under which Scottish Power agreed, in consideration of a release from all claims, to pay up to £6.575 million towards cashback claims and costs, and the administrator of PPCL acquired control of PIL.

28. With effect from the date of the 2004 settlement, with all parties in agreement to the terms, the matter was considered by the IPA to be resolved. Following a release of its insurance liabilities by PPCL on 10 March 2010, PIL completed its administrative wind down and surrendered its authorisation on 1 April 2010.

29. On 9 December 2004 PPCL (in administration) acquired PIL. PPCL, in effect, had access to the information in the files and records of PIL with effect from that date. Six years after acquiring that information a second investigation by TMP was commenced in 2010[6]. The IPA was informed in

[6] There is some doubt as to when the second investigation commenced, paragraph 2.5 of liquidator's fifth annual progress report - https://pplaninadmin.files.wordpress.com/2011/02/uk-liquidators-fifth-annual-progress-report-february-2016.pdf states that the investigation commenced in 2010, whereas paragraph 51 of the Published TMP Report states that the investigation commenced in 2011. For the purposes of this report, we have assumed the earlier date.

December 2011 by a director of PPCL that a second investigation was underway. At the conclusion of the investigation in 2013, the now liquidator of PPCL claimed he had been misled into agreeing to the 2004 settlement and that, in the opinion of the liquidator, the case involved other very serious wrongdoing, including fraud, on the part of Scottish Power and PIL.

30. In February 2013 the IPA received from Keith Steven and Eric Walls of the KSA Group (the joint liquidators of PIL) a copy of the PPCL liquidator's report to the regulators[7] (the 'Draft TMP Report') and the IPA was advised by the KSA Group that the KSA Group was going to commence its own investigation into the affairs and conduct of PIL (as liquidators of a former insurer authorised by the IPA).

31. In March 2014 the IPA received a copy of the interim report of the PIL liquidators[8] upon the conclusion of that investigation. A final version of the report was received in May 2014.

32. On or before April 2015 an updated version of the confidential report of the liquidator of PPCL to the regulatory authorities[9] (the 'Published TMP Report') was published on a campaign website[10] calling for compensation for Scottish Power's consumers. In that report, as with the Draft TMP Report and KSA report, a number of serious allegations were made against PIL, its directors and Scottish Power.

33. The IPA commenced an internal review to investigate the allegations made by both the KSA Group and TMP upon receipt of the Draft TMP report in February 2013. That review considered the IPA's files, the various reports received from the liquidators and documents supplied to the IPA in support of those reports. It also took into account legal advice received from Mr Keiron Murray (the then Government Advocate, who remains with AGC), and experienced English counsel[11], as well as liaison and communications with the Enforcement Division of the Financial Supervision Commission.

34. In addition, in order to assist the liquidators of PIL to discharge his functions under enactments in relation to insolvency, bankruptcy or the winding up of companies and considering it appropriate to use the statutory disclosure gateways, the IPA provided the liquidators of PIL with copies of all correspondence received from and sent to PIL over the course of its authorisation whilst PIL was under the control of Scottish Power or PHL.

35. At its meeting of 3 July 2015, the IPA resolved to '*liaise with the appropriate parties with a view to appointing external resource to carry out the detailed case review*'. This position was reaffirmed by the IPA's successor organisation the Authority at its meeting of 26 November 2015 where it was noted that the Executive was seeking '*to engage an independent third party, via the Attorney General's Chambers, to carry out a thorough review of the IPA's actions and processes in this case which could provide context and further understanding regarding the steps taken over the period by the regulator*'.

36. Mr Flint QC was engaged on 11 March 2016 to carry out an independent review of the regulation of PIL by the IPA, between 1997 and 2010 (being the date of surrender of authorisation by PIL),

[7] Report entitled: PowerPlan Company Limited (in liquidation), Report by the Liquidator to the Regulatory Authorities raising concerns in relation to the conduct of Scottish Power UK plc, dated 6 February 2012. Whilst the report states it is to 'the regulators', the report does not specify which regulators the report is addressed to.
[8] Report entitled: Powerhouse Insurance Limited (in liquidation), Report by the Liquidators to the Regulatory Authorities, dated 3 March 2014.
[9] PowerPlan Company Limited (in liquidation), Report by the Liquidator to the Regulatory Authorities raising concerns in relation to the conduct of Scottish Power UK plc and the Directors of its former subsidiary Powerhouse Insurance Limited (in liquidation), dated 7 February 2014.
[10] www.scottiskpowerbrokenpromises.co.uk – this website was taken down on or after August 2016, as a result of publication of the Published TMP Report through this website, the confidential report had been in the public domain and referenced by numerous press articles and social media for at least 16 months and is still available today through document archives on the internet.
[11] For the avoidance of doubt, the experienced English counsel is independent of Mr Flint QC.

based on all relevant documents available to the IPA, and subsequently to the Authority, including, for the avoidance of doubt, all information supplied to the IPA and Authority by TMP and the KSA Group subsequent to those dates. Mr Flint QC was assisted in this engagement by Mazars, an independent professional firm of accountants and issued his findings to the Authority on 24 February 2017.

4 Regulatory developments undertaken which address the matters raised by Mr Flint QC

The regulatory regime

37. Mr Flint QC considers that the regulatory regime at the time was *"unlikely to have made any difference to the demise of PIL* [329]" and was therefore not the cause of the company's failures.

38. Notwithstanding the above, as detailed in the Executive Summary Mr Flint QC expressed his views that the regulatory regime between 2001 and 2003 required further development to cover the prudential risk of a non-life insurer failure. Improvements were suggested in relation to regulatory guidance; the need to introduce a risk based capital and solvency assessment reflective of incidence of claims and quality of assets; implementing changes to reflect risks arising from large intra-group exposures; better processes by which to determine applications for a change of controller, the introduction of a requirement on directors to disclose material matters to the IPA, and the need for supervisory officers to be more cognisant of the risks. As more fully detailed below these matters are broadly accepted and have already been, or are in the process of being, addressed.

The basis of Mr Flint QC's review

39. The Flint Report is an independent review, based on all relevant documents available to the Authority, of the regulation by the IPA of PIL between 1997 and 2010. The lines of enquiry and the conclusions of Mr Flint QC were not the subject of prior discussion with, nor were they influenced by, the Authority. A final draft of the Flint Report was provided to the Authority for the correction of factual errors, but that necessary step did not affect the principle that the Flint Report should represent the independent opinion of Mr Flint QC.

Regulatory guidance

Observation

40. In the Flint Report, Mr Flint QC concludes that over the relevant period of material events there were no guidelines in place for officers of the IPA regarding how they should exercise the Supervisor's functions under the Insurance Act 1986 (the Act). In particular, there were no guidelines on how the business of regulated insurers should be monitored once authorised.

41. Mr Flint QC notes that the regulatory objectives of the IPA were subsequently introduced under the Insurance (Amendment) Act 2004 and were to :

    a) Secure an appropriate degree of protection for policyholders;

    b) Maintain confidence in the Island's insurance industry; and

    c) Reduce in the extent to which it is possible for any insurance business to be used for a purpose connected with financial crime.

Response of the Authority

Building on the introduction of the regulatory objectives in 2004, the IPA's expectations of corporate governance standards for insurers were published in 2010.

As the Authority continues to develop and refine its supervisory approach it continues to update its policies and procedures.

Paragraphs 42 and 43 provide further detail in this regard.

The CGC

42. In 2010 the IPA introduced the CGC which codified the IPA's expectations of an insurer's corporate governance, including risk management and capital adequacy. The CGC also provides a common frame of reference on governance matters and a mechanism for IPA officers to make consistent and transparent decisions. Therefore, in addition to providing industry guidance, the CGC also provides internal regulatory guidance for risk-based regulatory enquiry pursuant to the regulatory objectives.

Regulatory policies and procedures

43. In order to help ensure appropriate implementation of the Authority's evolving regulatory approach and framework, the Authority's policies and procedures continue to be reviewed to take account of change.

Solvency margin requirement as a measure of capital adequacy

Observation

44. Mr Flint QC was critical of the basis of calculation of the minimum margin of solvency set out in regulation 13 of the Insurance Regulations 1986, in that it was measured by reference only to premiums written and did not include reference to claims made or anticipated. As a result, Mr Flint QC observes, an insurer which enters run off and ceases to write new business is able to reduce its required solvency margin, although the risk inherent in the policies remains the same, and as a result the required solvency margin cannot be risk sensitive.

45. Mr Flint QC notes that the requirement under regulation 13 of the Insurance Regulations 1986 did not properly reflect the risk incurred by an insurer where reserves were inadequate and there is a worsening of claims experience, nor does the calculation consider the risks arising in the event of a reorganisation of the business.

46. The Flint Report considers the Island's solvency margin requirements against the Solvency regime applicable in the UK at that time (Solvency I). As a result the minimum margin of solvency in the UK would have been much higher than that required in the Isle of Man. In addition UK regulation considered average gross claims incurred and adopted a more stringent approach to unsecured loans made in considering the inadmissibility of assets.

47. Mr Flint QC concludes that the regulatory regime for assessing the solvency of non-life insurance companies was not adequate at the material time. It did not provide a sufficiently rigorous supervisory system to provide an appropriate level of protection for the policyholders of PIL (being LGI and PPCL). In particular the minimum solvency margin required under regulation 13 was set at an inadequate level, did not properly take into account the incidence of claims, and did not take into account the quality of assets held by the insurer.

Response of the Authority

The insurance and regulatory framework at the time of the material events "*achieved a high degree of compliance with the IAIS Principles*[12] "

As international standards have enhanced so too has the Island's insurance framework. In pursuit of its regulatory objectives in 2008 the IPA commenced its work to develop the Island's insurance regulatory regime to one that is more risk-based using the ICPs issued by the IAIS to inform that process.

The Authority, through the ICP project and working with the insurance industry, is completing the change to a risk-based solvency and capital regime with supporting risk management requirements.

Paragraphs 48 to 65 provide further detail in this regard.

The Island's policy to comply with international standards

48. In 2003, the prevailing aim of the Isle of Man Government was of '*constructive engagement on matters of international standards whilst defending the economic interests of the Isle of Man*'[13]. The Authority recognises that the insurance regime within the UK is perceived as being a forerunner in regulatory developments, often preceding changes to international standards. As a result comparisons held out in the Flint Report between the historic UK and Isle of Man regimes may not be appropriate.

Ongoing development of risk-based supervisory approach

49. In pursuit of its regulatory objectives, the IPA undertook to develop the Island's insurance regulatory regime to one that is more risk-based and the IPA used the Insurance Core Principles ('ICPs') issued by the IAIS to inform that process.

50. As standards have enhanced so too has the Island's insurance framework. In pursuit of its regulatory objectives the IPA commenced in 2008 its work to develop the Island's insurance regulatory regime to one that is more risk-based using the ICPs issued by the IAIS to inform that process resulting in the following relevant updates:

- In 2010 the IPA introduced the CGC which was a significant step in the process of the Island adopting a risk-based insurance regulatory regime.

- In 2013 the IPA began the ICP project to move to a proportionate risk-based insurance regulatory regime. The Authority is continuing that project which is anticipated to be legislatively completed in 2018/19; but may take additional time to be fully implemented.

51. A risk-based regulatory regime requires two complimentary components, a risk-based framework and the application of a risk-based approach. Thus the IPA's, and now the Authority's, supervisory approach has been developing alongside its regulatory framework. This includes since 2010, with the support of the CGC, the Authority requiring authorised insurers to be able to demonstrate to the satisfaction of the Authority the risk profile of the insurer, its risk management processes and for insurers to determine and maintain an appropriate level of capital adequate to meet its liabilities that might reasonably be expected to arise out of the risks to which it is exposed. In addition the Authority requires insurers to demonstrate to the Authority an understanding of its ability to meet its obligations under various adverse economic and business scenarios.

[12] Paragraph 16 of the Assessment of the Supervision and Regulation of the Financial Sector - Issued by the IMF and dated 25 November 2003.
[13] Tynwald Hansard of 22 October 2003, extract from the presentation by the Treasury Minister of the Economic Strategy Report

The introduction of capital adequacy

52. In 2010 the IPA introduced the concept of 'capital adequacy' under the CGC, removing the previous sole reliance on the minimum margin of solvency as a means of protection against unforeseen losses.

53. This capital adequacy requirement is supported by other provisions in the CGC which require adequate, appropriate and effective risk management systems which enable the board of a regulated entity to properly assess the adequacy of its capital and other financial resources for its specific risk profile.

Minimum margin of solvency

54. The current minimum margin of solvency is in the process of being updated as part of the ICP project to become more risk-based providing a more consistent level of protection for policyholders. The proposed new solvency capital requirement ('SCR') will take into account:

- the uncertainty relating to claims reserves estimates;
- the quality and form of assets held;

as well as the uncertainty relating to the pricing of insurance contracts, market risk and operational risk.

55. The SCR has been the subject of a number of testing processes and meetings with the insurance industry and is close to being ready for final consultation.

56. As an industry-wide requirement, the SCR's calculation is based on market-wide experience by significant line of business. The approach is significantly more sophisticated than the current minimum margin of solvency and will result in a solvency capital requirement that more appropriately reflects the risk profile of individual non-life insurers.

Enterprise risk management (including own risk solvency assessment) for solvency purposes

57. Insurers are required to have in place a robust risk management system. Enterprise risk management ('ERM') is the process by which an organisation assesses, controls and monitors risks from all sources that may affect the company and to provide reasonable assurance regarding the achievement of entity objectives. Insurers must be able to demonstrate the robustness of their risk management systems.

58. The ICP project will introduce the formal requirement for an ORSA. This is a well-accepted component of modern regulatory frameworks. ORSA formalises a process that aims to assess, in a continuous and prospective manner, the overall solvency needs related to the risk profile of the insurer. Through the ORSA process insurers must be able to demonstrate that consideration of risk is at the heart of decision making and that both the control framework and capital resources are adequate for the insurers risk profile.

Target level of protection for policyholders

59. Consistent with other regulatory authorities, the Authority recognises that regulated entities operate in a competitive environment and will take appropriate, reasoned risks. As such, regulated entities can experience financial difficulties that could lead to their failure. An appropriate insurance risk based regulatory regime must be proportionate and balance its requirements to give an appropriate degree of protection to policyholders as well as allow insurers to operate with reasonable efficiency.

60. The objective of a risk based supervisory regime is to identify potential threats to the continued viability of a regulated entity early enough so that corrective and timely action can be initiated or orderly exit achieved, thereby reducing the impact of such threats.

61. An insurance regime with a 'zero failure' tolerance level would be considered excessively onerous from an insurer efficiency perspective, whereas an overly permissive regime would be inadequate to protect policyholders. An appropriate balance has to be struck.

62. Views on the degree of protection versus permissiveness vary over time and, in relation to the PIL case, it can be seen that in 1997 to 2004 the Island's regulatory regime which, although considered to be appropriate at the time and consistent with international standards, was more permissive than might be appropriate today.

63. From today's perspective the level of protection included in recent quantitative impact studies carried out with industry in respect of the proposed new solvency regime is a 1 in 200 confidence level for conventional insurers[14] and a 1 in 10 confidence level for an insurer which only insures the risks of the group to which it belongs[15], with potentially other types of insurer having a level in between the two depending on the risks they pose.

64. The 1 in 200 confidence level means that the insurer involved must have no more than a 1 in 200 chance of financial failure in the next 12 months. The 1 in 10 confidence level would involve no more than a 1 in 10 chance of financial failure in the next 12 months.

65. Once sold to Powerhouse in 2001, PIL was a conventional class 3-9 general insurer insuring the risks of PPCL, an unrelated party. If the current proposed regime had been in place in 2001 to 2003, PIL would have been required to hold sufficient capital of appropriate quality to satisfy the 1 in 200 confidence level requirement.

Consideration of intra-group risk

Observation

66. In his report, Mr Flint QC concludes that the IPA did not consider the risks arising from the large exposure in respect of financing advanced to the Powerhouse Group, adding that the failure to consider the risks to the business of PIL, and thus the risks to its policyholders, arose from a highly restrictive regulatory approach which concentrated solely on compliance with the solvency margin and which did not include any general consideration, beyond the letter of the regulations, of the risks to which the insurer was actually exposed.

67. A reasonably prudent and inquisitive regulator, Mr Flint QC reports, would have noted the large exposure of PIL to PHL, which made the solvency of the subsidiary wholly dependent on the solvency of PHL and PRL, and ought to have raised questions as to the insurer's assessment of the risks of the intra-group lending.

Response of the Authority

The new risk-based solvency regime will require insurers to manage the risks arising from an insurer lending to its associates.

[14] A confidence level adopted by many regimes throughout the world including the UK and the EU under the Solvency II Directive.
[15] This level of confidence is consistent with a number of competitive regimes with significant markets in the insurance sector where the insurer only insures the risks of the group to which it belongs.

Paragraphs 68 to 73 provide further detail in this regard.

Background to the regulatory culture over the relevant period of material events

68. Throughout the relevant period of material events the IPA was also developing the reforms to the insurance framework in place that would form the Insurance (Amendment) Act 2004, introducing amendments to the Insurance Act 1986, including in relation to the following areas:

- Clarification of the respective roles of the board of the IPA and the Supervisor with the effect that the board has a clearer responsibility to oversee the actions of the Supervisor.
- Introduction of the regulatory objectives of the IPA, providing an important reference framework for decisions.
- Changes to the 'fit and proper regime', including in relation to controllers.
- A strengthening in the remedial powers, including the ability to issue directions and to issue civil penalties.
- A strengthening of the powers to inspect the records and investigate the affairs of a regulated entity.
- A widening and strengthening of the powers to request information from a regulated entity.
- A widening of the statutory gateways through which restricted information may be disclosed.
- The introduction of the ability to use the powers of inspection and investigation for the benefit of other authorities.
- An overhaul of the appeals process.

Limitations in the powers available

69. In considering the powers available to the Supervisor and IPA at the time, which might have been used to limit the credit risk exposure of PIL to its parent group, it is the view of the Authority that there were potentially two statutory powers which could have been contemplated. The first was to make the authorisation subject to conditions, the second was to withdraw the authorisation completely.

70. It is the Authority's view that, in the absence of guiding principles, such as the regulatory objective to protect policyholders which was introduced in 2004, the exercise of either power to require the company to limit its exposure to the group would have been considered to be an inappropriate use of that power. This is because the then regulations implicitly permitted an insurer to issue loans provided that a proportion of the value of loans granted was excluded from the assets as part of the prescribed solvency calculation. Thus the power would be exercised contrary to an explicit regulation that implicitly permitted insurers to make such loans.

Ongoing development of risk-based supervisory approach

71. Today, the supervisory approach adopted by the Authority seeks to better understand the business of, and risks posed by, regulated entities and uses the CGC for particulars in this regard.

72. Under current requirements within the CGC that was introduced in 2010, all relevant and material risks faced by an insurer (including any arising from loans or other financing of associates) are

required to be identified, assessed, measured, monitored and controlled and, where appropriate, mitigated. The insurer is required to have adequate financial resources for any such risks it retains.

73. Under current proposals for the SCR, an insurer, such as PIL, writing significant third party risks will be required to hold capital in respect of any risks it faces arising from loans or other financing of associates (e.g. credit default, concentration or spread risk). In cases where there are no mitigating factors (such as diversification of counterparties or credit ratings applicable to counterparties) it is proposed that the capital required could be as high as 100% of the loan or other financing involved.

Process to assess a change of controller

Observation

74. Mr Flint QC reports that the IPA failed to make any enquiry in July 2003 as to the purpose and effect of the White Summit transaction and approved the change of control without any knowledge or understanding of the risks posed by that transaction.

75. Mr Flint QC considers that the information required by regulations to be submitted to the Supervisor as notice of the change in controller was limited and the questions were insufficiently demanding, with the effect of the approval by the IPA of White Summit as the controller without any understanding of its fitness and propriety to fulfil that role.

76. He goes on to conclude that the regulatory culture evident from the manner in which the IPA dealt with the approval of change of control in relation to the White Summit transaction, failed to make any enquiry about the large exposure of PIL to its associate and did not consider the overall risks to PIL's business.

Response of the Authority

In 2003 the IPA did not have the power to prevent a person from becoming a controller. The power to approve a proposed new controller in advance of the transaction was introduced in 2004.

Paragraphs 77 to 80 provide further detail in this regard.

Changes introduced by the Insurance (Amendment) Act 2004

77. In the relevant period of material events, under the Insurance Act 1986, the regime relied upon 'no objection'. An insurer could appoint a person as a director, chief executive or manager, or a person could become a controller of an authorised insurer, with only a notification to the Supervisor, who then had a period of eight weeks to object to the appointment.

78. As a result, the Insurance (Amendment) Act 2004 introduced a number of changes, including the specific provision requiring advance notice of a change of controller. These changes are now included in section 29 and parts of section 53 of the Insurance Act 2008. The changes include –

a) that the Authority must be given 28 days prior notice of a proposed change (including change of controller), or shorter notice period if agreed by the Authority;

b) powers for the Authority to direct that any person (corporate or individual), who does not appear to the Authority to be fit and proper for the position in question, must not be appointed or must not continue in an appointment without the consent of the Authority;

c) that the Authority may make its consent subject to conditions;

d) that a person directed by the Authority must comply with the direction; and

e) that failure to comply with a direction of the Authority is an offence.

Ongoing development of risk-based supervisory approach

79. As detailed in paragraphs 71 to 73 above, under the CGC all relevant and material risks faced by an insurer (including any arising from changes to the ownership of the insurer) are required to be identified, assessed, measured, monitored and controlled and, where appropriate, mitigated and the insurer is required to maintain adequate and appropriate financial resources for any such risks it retains.

80. In considering applications for a change in control today, the Authority would seek to understand the implications of the proposal before determining the application.

Disclosure of material matters

Observation

81. In his report Mr Flint QC notes that the regulatory regime applicable in 2003 imposed no positive requirement on directors of regulated insurers to disclose material matters to the IPA.

82. Mr Flint QC further reports that in general PIL complied with its regulatory duty to provide regular accounting information and solvency margin calculations to the IPA. He states that PIL's statutory and management accounts from November 2002 onwards were not prepared on a proper basis in that the balance sheet did not disclose the gross amount of all estimated outstanding cashback liabilities, together with the amounts recoverable to meet such liabilities from reinsurers and Scottish Power. Mr Flint QC concludes that error of approach did not affect the reported solvency of the company but it did have the effect that the scale of the cashback liabilities and the extent of reliance on the Scottish Power indemnity was not disclosed to the IPA. Mr Flint QC further notes that the loans made to PHL were properly disclosed in the accounting information provided to the IPA.

Response of the Authority

New proposed requirements under the CGC will explicitly require insurers to disclose material matters to the Authority.

Additionally, the regulatory framework currently under development will specifically require claims and recoverable amounts to be shown separately and gross within the SCR calculation.

Paragraphs 83 to 86 provide further detail in this regard.

Accounting methodology adopted by PIL

83. The Authority notes that the statutory financial statements of PIL had been subject to an independent audit without qualification.

Ongoing development of risk-based supervisory approach

84. The proposed SCR, as referred to in more detail above, will not allow claims to be shown net of recoverable amounts and therefore the SCR contains requirements independent of accounting standards which mitigate the risk that the level of gross claims and/or amount of reliance on recoveries may not be apparent to the Authority.

85. As detailed in the response of the Authority above, current proposals for changes to the CGC which will be subject to consultation over the coming months will include a requirement for insurers to report to the Authority any material changes in their circumstances which have occurred or are likely to occur. It will also include a requirement for the insurer to provide the background to the change and, where relevant, what corresponding actions the insurer has taken or will take.

86. This requirement is anticipated to help ensure better awareness of the Authority of changes potentially requiring its attention and to trigger timely interaction between insurers and the Authority at those times. Other enhancements such as the ORSA will provide a common frame of reference for further investigation of the potential implications of material changes affecting insurers.

Other considerations – Crisis management

Observation

87. Mr Flint QC noted that the insolvency of PHL and PRL, and hence PIL, was sudden and unexpected and the regulator adopted a proper approach in managing the ensuing crisis in the affairs of PIL from August 2003 onwards.

Response of the Authority

The Authority is pleased to note that Mr Flint QC considers that the approach adopted by the IPA in managing the issues following the collapse of PHL and PRL was appropriate.

5 Independence

88. None of its current Members of the Authority, including the Chief Executive, nor the officers of the Authority were involved in the key events (between 1997 and 2004) relating to the PIL case. The current board of the Authority maintains general oversight of the PIL case and a subcommittee of the board more directly oversaw the determination of the terms of reference for the Flint Report, the Authority's internal assessment and the drafting of this Report.

6 A note on the limitations of this Treasury Report

Confidentiality: (prohibition against disclosure of restricted information)

89. Information that is obtained by the Authority, its Members or any officer or servant of the Authority (the 'primary recipient') in the course of that person's functions under the Insurance Act 2008 or any public document made under that Act is restricted information under paragraph 1 of Schedule 6 to that Act. As a primary recipient, it is a criminal offence for the Authority to disclose information that is restricted.

90. Paragraph 2 of Schedule 6 sets out a number of permissible disclosures ('gateways'), through which the Authority may, if it considers it proportionate to achievement of its regulatory objectives, disclose information that is restricted. These gateways are generally for the purposes of assisting appropriate authorities in performing their statutory functions. The Authority is not prohibited from disclosing information that is or has been available to the public from other sources.

91. There has been much information already made available to the public from other sources in relation to this case, through the media, social networks and more widely through the internet with a particular focus on the alleged mis-selling by Scottish Power of the warranty products to the UK public. This public information originates in the main from a campaign website set up by a former director of PPCL through which a number of documents were published including the Published Reports. These reports have weight in the public arena as they are written by the liquidator of PPCL (the Published TMP Report) and an independent group of UK Members of Parliament (the APPG Report), together known as the published reports.

92. In some areas the conclusions of the Authority differ to the various opinions provided in the public arena. Importantly, whilst the Authority is able, in limited circumstances, to provide an alternative conclusion it is in many instances prohibited by law from disclosing why and how it has reached that conclusion. This is because the information it would need to disclose to do so is restricted information under the Act and the Authority would be committing a criminal offence in so doing.

93. There are 8 different reports issued by various individuals, organisations and groups in relation to this case:

The Treasury Report – This report, entitled '*Report to the Isle of Man Treasury Minister following The Independent Review of the role of the Insurance and Pensions Authority in relation to the failure of Powerhouse Insurance Limited*', issued by the Isle of Man Financial Services Authority and dated 30 June 2017. This report is addressed to the Treasury Minister of the Isle of Man Government and does not contain any information that is restricted under the Insurance Act 2008. It is the intention of the Authority to publish the report in full following the consideration of it by the Treasury. **NOT RESTRICTED INFORMATION**

The Flint Report – Entitled '*Independent review of the role of the Isle of Man Insurance and Pensions Authority in relation to the failure of Powerhouse Insurance Limited*', issued by Mr Flint QC and dated 24 February 2017. The Flint Report is an independent review of the case and is addressed to the Isle of Man Financial Services Authority. To the extent that it contains information that is restricted under the Insurance Act 2008, the Flint Report is confidential to the Authority and the Authority is statutorily prohibited from publishing the restricted information therein. The exception is Chapter 10 (Summary of Findings) which is published as Appendix B to this Report and which has been carefully assessed as containing no restricted information. The Authority is able to share the Flint Report and the restricted information therein in full with the Treasury pursuant to a

statutory gateway in paragraph 2 (1) (f) of Schedule 6. The Authority considers that such disclosure is proportionate to the achievement of the regulatory objectives of the Authority, noting in addition the commitments made by the Treasury Minister and the interest in the Authority's role as a regulator independent of political membership. A full copy of the Flint Report was provided to the Treasury Minister at the same time as this Treasury Report. As a primary recipient of restricted information under the Act similar prohibitions will continue to apply to the Treasury as apply to the Authority preventing the onward disclosure of the Flint Report or any restricted information by the Treasury, unless it can rely on a statutory gateway within the Insurance Act 2008 applicable to it. **RESTRICTED INFORMATION, SAVE FOR CHAPTER 10**

The Draft TMP Report – Entitled '*PowerPlan Company Limited (in liquidation), Report by the Liquidator to the Regulatory Authorities raising concerns in relation to the conduct of Scottish Power UK plc*', issued by TMP as liquidator of PPCL and dated 6 February 2012. The Draft TMP Report is a 152 page report addressed to the Regulatory Authorities, including the IPA, although this was not received at the IPA until 15 February 2013. As far as the Authority is aware this document is not in the public arena and as such has been treated as **RESTRICTED INFORMATION** as a complete document, although many of the matters set out are repeated in the Published TMP Report.

The Published TMP Report – Entitled '*PowerPlan Company Limited (in liquidation), Report by the Liquidator to the Regulatory Authorities raising concerns in relation to the conduct of Scottish Power UK plc and the Directors of its former subsidiary Powerhouse Insurance Limited (in liquidation)*' issued by TMP as liquidator of PPCL and dated 7 February 2014. The Published TMP Report is marked v9 and is a 46 page document addressed to the Regulatory Authorities. The Published TMP Report was published on a campaign website[16] and whilst that site has now been taken down the report remains available on the internet[17]. Following such publication, the information contained therein is no longer restricted information and has been used by the Authority inter alia for the purposes of this Report. **NOT RESTRICTED INFORMATION**

The KSA Report – Entitled '*Powerhouse Insurance Limited (in liquidation), Report by the Liquidators to the Regulatory Authorities*' issued by KSA as liquidators of PIL dated 3 March 2014. The KSA Report is an 11 page report addressed to the Regulatory Authorities. As far as the Authority is aware this document is not in the public arena. **RESTRICTED INFORMATION**

The APPG Report – Entitled '*ScottishPower's Cashback Mis-selling Corporate dishonesty and regulatory failure*'. How 625,000 UK consumers lost out on the PowerPlan Cashback Promise issued by an All-Party Parliamentary Group, un-dated but issued in April 2016. The APPG Report was published on a campaign website[18] and whilst that site has now been taken down the report remains available on the internet[19]. Following such publication, the information contained therein is no longer restricted information and has been used by the Authority inter alia for the purposes of this Report. **NOT RESTRICTED INFORMATION**

94. Two further reports from TMP, in addition to the Draft TMP Report and the Published TMP Report, were received by the IPA, both dated 7 February 2014. The first was marked v10a and is a 46 page document received by the IPA on 13 February 2014 and the second was marked v18 and is a 128 page document received by the IPA on 21 March 2014.

[16] www.scottishpowerbrokenpromises.co.uk
[17] PowerPlan Company Limited (in liquidation), Report by the Liquidator to the Regulatory Authorities raising concerns in relation to the conduct of Scottish Power UK plc and the Directors of its former subsidiary Powerhouse Insurance Limited (in liquidation), dated 7 February 2014
[18] www.scottishpowerbrokenpromises.co.uk
[19] ScottishPower's Cashback Mis-selling Corporate dishonesty and regulatory failure. How 625,000 UK consumers lost out on the PowerPlan Cashback Promise

95. Chapter 10 of the Flint Report was written by Mr Flint QC with a view to publication. The Authority is satisfied, having taken legal advice from the AGC, that Chapter 10 may be published in full on the basis that it does not contain any restricted information.

Appendix A - The appointment of Mr Flint QC and terms of reference of the independent review

96. Mr Murray of the AGC was instructed by the Authority in December 2015 to identify and instruct suitable counsel to undertake an independent review of the regulatory dealings of the IPA in relation to Powerhouse Insurance Limited.

97. Having undertaken some research, Mr Murray approached Blackstone Chambers, a leading set of London barristers, and the suggestion came back from Blackstone Chambers regarding the instruction of Mr Charles Flint QC. Mr Flint QC is a highly respected barrister and a leading specialist on the regulation of financial services under the UK Financial Services and Markets Act 2000. He has advised and acted for both institutions and regulators, within the UK and beyond, in regulatory proceedings and investigations and judicial review and has been involved in many of the major regulatory cases in the UK which have arisen in the last 20 years.

98. Following discussion of the draft terms of reference Mr Flint QC accepted the appointment on 11 March 2016 the basis of which was to carry out an independent review of the regulation of PIL, by the IPA, between 1997 and 2010 (being the date of surrender of authorisation of PIL), based on all relevant documents available to the Authority, including, for the avoidance of doubt, all information supplied to the Authority and IPA by TMP and the KSA Group subsequent to those dates.

99. The terms of reference of the review were set out in a letter from the Authority to Mr Flint QC dated 19 August 2016 and are set out in full in paragraph 102 below. In summary, the terms of reference required Mr Flint QC to report on the following matters:

- the causes of the insolvency of PIL, when it became insolvent and whether it had been in breach of any statutory and regulatory requirements over the relevant period of the review;
- whether there are grounds for criticism of the conduct of the directors, managers, auditors or legal advisers of PIL with regard to the treatment of liabilities on cashback policies, and whether the Authority should now take any action on any such criticism;
- whether the IPA properly exercised its statutory powers of supervision of PIL, until it ceased to be authorised on 1 April 2010;
- to make any recommendations as to the adequacy of the legislative framework as it applied to an insurer in the position of PIL during the relevant period of the review, and the IPA's discharge of its regulatory responsibilities, and any immediate further steps which the Authority might now take.

100. Mr Flint QC was assisted in his work by Mazars, a firm of accountants and the letter of engagement between the Authority and Mazars is detailed in paragraph 103 below.

101. On 24 February 2017 Mr Flint QC issued his findings in his report to the Authority entitled 'Independent review of the role of the Isle of Man Insurance and Pensions Authority in relation to the failure of Powerhouse Insurance Limited' ('The Flint Report').

102.

ISLE OF MAN
FINANCIAL SERVICES AUTHORITY
Lught-Reill Shirveishyn Argidoil Eirinn Vannin

Charles Flint QC
Blackstone Chambers
Blackstone House
Temple
London
EC4Y 9BW

19 August 2016

Dear Mr Flint QC

Independent review of regulatory dealings of Insurance and Pensions Authority of the Isle of Man in relation to Powerhouse Insurance Limited

You have been engaged by the Isle of Man Financial Services Authority ("**FSA**") to undertake a predominantly documentary review of a number of papers relating to the affairs of Powerhouse Insurance Limited ("**PIL**") during the period of its authorisation by the Insurance and Pensions Authority ("**IPA**").

As part of your Terms of Reference you will be speaking to a number of current and potentially also one or more former officers of the IPA as a small part of your review.

Two copies of the Terms of Reference are enclosed and I would be grateful if you could confirm your agreement to the Terms of Reference by signing and returning the second copy to me at the above address.

I am advised that there has previously been dialogue between your Clerks and Chambers with regard to the terms of your engagement and I should be obliged if you are able to continue to work to the agreed terms.

On behalf of the FSA we confirm are also content for you to draw on the assistance of

a) such appropriate junior Counsel within your Chambers who is available to assist you. We note that Mr Daniel Burgess has previously been proposed in this regard; and

b) accountants to assist with such financial analysis as you consider may be required, in line with terms of engagement to be finalised via Attorney General's Chambers under your lead instruction of such accountants.

Yours sincerely

Karen Badgerow
Chief Executive

Enc. Terms of Reference

INVESTORS IN PEOPLE

Isle of Man Financial Services Authority
PO Box 58 • Finch Hill House • Bucks Road
Douglas • Isle of Man • British Isles • IM99 1DT
Tel: +44 (0)1624 646000 • www.iomfsa.im

TERMS OF REFERENCE
19 August 2016

Terms of review of actions by the regulator

(1) Whether the IPA properly exercised its statutory powers between 1997 and 2010 (the date of PIL's surrender of authorisation with the IPA) in supervising the affairs of PIL, including

- what further steps could or should have been taken to protect the interests of policyholders of PIL
- whether on the basis of the materials before it, the IPA failed in that period to investigate the affairs of PIL or take other appropriate action within its powers

(2) During the relevant period whether PIL was in breach of any of the statutory or regulatory requirements, and what were the causes and timing of the insolvency of PIL in terms of:

- the Companies Acts 1931-2004 (Acts of Tynwald); and / or
- the Insurance Act 1986 (Act of Tynwald) (as amended)

(3) Whether there are grounds for criticism of the directors, managers, auditors and legal advisers of PIL in relation to their interaction with other counter-parties (including the IPA, other regulators, contracting entities and creditors) with regard to the treatment of liabilities on cashback policies and whether the FSA should now take any action in respect of any such grounds for criticism

(4) And to **make any recommendations** arising out of the matters so reviewed including, in particular as to:

(a) the conduct and processes of the IPA over the material time.

(b) any immediate further steps which might now appropriately be pursued by the FSA within their statutory powers regarding any ongoing regulatory concerns.

(c) as may be required consequent upon other findings with regard to the IPA's discharge of its statutory duties at the material times, to provide an overview with regard to the adequacy of the relevant legislative provisions.

<u>Further instructions to potentially follow:-</u>

In light of the findings in (1) to (3) above and the information received by the IPA since 2010 (and the FSA since 1 November 2015), in particular as supplied by the liquidators of PIL and PPCL, to assist the FSA in taking forward the recommendations identified in (4)(b) above.

Overview methodology

<u>Within the review</u>

In relation to the affairs of PIL by way of Counsel undertaking a review of:-

(a) documents delivered to the IPA by PIL between 1997 and 2010; and

(b) the 'memory stick' and other documents with subsequently delivered to the IPA by the liquidators of PIL / PPCL.

(c) retrospective accounting analyses to be undertaken by competent accountants in relation to issues identified by Counsel as being necessary to inform his own review.

in each case comparing the findings of the review as against the findings of the reports from the liquidators of each of PIL and PPCL.

The FSA has committed that staff remaining within its employment will be available to assist Counsel with regard to such review.

The current intention is that your written report will be for the internal review purposes of the FSA and that such report not be published. However, the FSA can envisage that there may well be demands for the Terms of Reference and a summary of the report's findings to be published.

Potentially within the methodology for the review

Interviews by Counsel and/or questions directed to the former Chief Executive of the IPA, David Vick. AG's Chambers considering issues re: indemnity to Mr Vick with colleagues in Government.

Excluded from the methodology at this stage

Any delegation of powers to inspect and investigate per Schedule 5 of the Insurance Act 2008.

Interviews with past or present directors, auditors, managers and legal advisors of PIL.

Interviews and communication with the liquidators of PIL and PPCL, whose reports will be taken to speak for themselves as to relevant issues.

103. Pages 1, 2 and 8 of the letter from Mazars - being the relevant pages setting out the scope of engagement

MAZARS

Isle of Man Financial Services Authority
PO Box 58
Finch Hill House
Bucks Road
Douglas
Isle of Man
British Isles
IM99 1DT

Direct line +44 (0)20 7063 4101

Email nigel.grummitt@mazars.co.uk

30 September 2016

Dear Mrs Signorio-Hooper

Independent review of the regulatory dealings of Insurance and Pensions Authority of the Isle of Man in relation to Powerhouse Insurance Limited

1. The purpose of this letter is to acknowledge the instructions you have provided to us to act in the above matter ("the Services" or "the Engagement"). This letter sets out our understanding of the work which you wish us to perform, our respective rights, obligations and responsibilities, as well as the information and support we need from you in order that we may deliver the Services.

2. Subject to paragraph 3 below, the attached General Terms and Conditions of Business form part of and should be read in conjunction with this letter. They form part of our contract with you (this letter and the General Terms and Conditions of Business are together referred to as the "Engagement Letter"). In particular we draw your attention to the section headed "Liability" at paragraph 34.

3. We acknowledge and agree to the amendment to the General Terms and Conditions of Business at paragraphs 5.3 and paragraph 11 thereof as follows:

3.1. Section 5.3 is deleted and replaced with:

"We acknowledge that the documents and information that we will be provided with by you are restricted information under paragraph 1(1) of Schedule 6 to the Insurance Act 2008, an Act of Tynwald, the Parliament of the Isle of Man and we recognise and agree to the provisions of that Act as they will apply to us as a recipient of that restricted information. We acknowledge that you have provided the restricted information to us for the purpose of enabling or assisting the Authority to discharge its functions under that Act utilising powers available to you under paragraph 2(1)(f) of Schedule 6."

3.2. At Section 11 the following paragraph is inserted:

"11.3 We acknowledge, agree and recognise the provisions of the Insurance Act 2008 (of Tynwald) in the providing of the Services to you under this Engagement Letter."

Mazars LLP - Tower Bridge House - St Katharine's Way - London - E1W 1DD
Tel: +44 (0)20 7063 4000 - Fax: +44 (0)20 7063 4001 - www.mazars.co.uk

MAZARS

Our instructions

4. We understand that you have instructed Mr Flint QC to undertake an independent review of the actions or inactions of the Insurance and Pensions Authority ("**IPA**") which regulated Powerhouse Insurance Limited ("**PIL**"), an Isle of Man incorporated insurer. You require us to provide Mr Flint QC with accountancy advice relevant to the adherence by PIL to its statutory and regulatory duties, in particular in maintaining and reporting adequate solvency and liquidity under:

   4.1. the Companies Acts 1931-2004 (of Tynwald) (if so required), in particular the provisions of Part IV of the Companies Act 1931 (of Tynwald);

   4.2. the Insurance Regulations made under the Insurance Act 1986 (of Tynwald) and Insurance Act 2008 (of Tynwald) (together the Insurance Acts) with regard to solvency and otherwise; and

   4.3. presenting true and fair accounts prepared in accordance with the Companies Acts 1931-2004 and or as required by the Insurance Acts,

   with such analysis being informed by the Insurance Core Principles issued by the International Association of Insurance Supervisors as well as the accounting requirements and other legislative provisions in force in comparable jurisdictions at the applicable times.

5. You have appointed Mazars LLP to provide expert accounting advice in relation to this matter. Mazars will act in the capacity of expert advisor.

6. You have instructed us that all communications regarding the scope of the work to be undertaken, any queries arising from our analysis and the findings of our work should only be between Mr Flint QC and Mazars LLP, that we should not include or involve the Isle of Man Financial Services Authority ("**FSA**") in these communications and that we should not directly provide you with our findings. You have therefore authorised us to take detailed instructions for the scope of our work solely from Mr Flint QC, all of which will fall within the terms of this Engagement Letter, and to discuss freely matters and exchange information with Mr Flint QC. You will however also be providing some information to us.

7. The work undertaken will not constitute an audit or a due diligence investigation. As chartered accountants, we do not claim to have any detailed legal knowledge and we will therefore not give legal advice. We will rely on you and Mr Flint QC to advise us on any points of law which are relevant to this assignment or its conduct.

Scope of our responsibilities

8. The duties and responsibilities of Mazars LLP shall be limited to forensic and investigatory, financial consultancy and insolvency work. Those areas for which we will not be responsible include (but are not limited to) the following:

Mazars LLP - Tower Bridge House - St Katharine's Way - London - E1W 1DD
Tel: +44 (0)20 7063 4000 - Fax: +44 (0)20 7063 4001 - www.mazars.co.uk

MAZARS

Agreement of terms

35. You agree that you have fully considered the provisions of the Engagement Letter and that they are reasonable in the light of all the factors relating to the Engagement.

36. If there is anything in this letter or in the General Terms and Conditions of Business attached which you do not agree or wish to discuss, please do not hesitate to contact us. Otherwise, we shall be grateful if you can confirm your agreement to these terms by countersigning and returning a copy of this letter. For the avoidance of doubt, you warrant that you have discussed the terms of this Engagement Letter with Mr Flint QC and he has agreed to the terms that are expressly referable to him.

37. Please note that if you or Mr Flint QC ask us to commence the provision of the Services, or allow us to continue to provide the Services after the delivery of the Engagement Letter without having objected to the terms set out in the Engagement Letter, then we shall be entitled to treat you as having accepted the terms of the Engagement Letter from the date upon which we began to provide the Services.

We look forward to working with you and Mr Flint QC.

Yours sincerely

Mazars LLP

Mazars LLP

Acceptance

I confirm my agreement to the terms of the Engagement Letter.

Signed:

Name: Karen Badgerow

Date: Sept 30/2016

Mazars LLP - Tower Bridge House - St Katharine's Way - London - E1W 1DD
Tel: +44 (0)20 7063 4000 - Fax: +44 (0)20 7063 4001 - www.mazars.co.uk

Appendix B - Summary of findings of The Flint Report

104. Chapter 10 of the Flint Report summarises the findings of the independent review of Mr Flint QC and that Chapter is reproduced in its entirety here.

105. As detailed in Section 6 of this report – The Flint Report *in toto* is restricted information; but, on the basis of advice received, the Authority considers that Chapter 10 of that report does not contain restricted information.

10. Summary of Findings

315. My conclusions on each aspect of the story of PIL have been set out earlier in this report. I now summarise those findings.

316. There is no evidence that the affairs of PIL were mismanaged by Scottish Power. Although the reserves to meet the cashback liabilities later proved to be inadequate they were established on a reasonable basis. Scottish Power recommended that reinsurance should be taken out to cover any excess liabilities and reinsurance of £4 million was put in place. When the company was sold to PRL in 2001 there were adequate assets to meet cashback liabilities, but Scottish Power did agree to provide an indemnity for any cashback liabilities in excess of the reserves provision and the reinsurance.

317. Between April 2002 and July 2003 the directors of PIL agreed that the company should provide unsecured financing to the Powerhouse Group to a total of £36.5 million, which exceeded PIL's net assets. The directors failed properly to consider the risks of that lending and permitted the company to lend the maximum that could be advanced without breaching the minimum solvency margin requirement. That financing was contrary to the company's investment guidelines, imprudent and not in the best interests of PIL.

318. When the cashback liabilities began to mature from April 2002 PIL found that it was facing liabilities considerably in excess of the provision which had been made, but reasonably relied on the indemnity from Scottish Power as ensuring that the excess liabilities would be met.

319. In March 2003 Scottish Power repudiated liability under the indemnity contained in the SPA on grounds which were legally arguable, but contrary to the clear understanding of the parties to the underlying insurance agreements. However the Cashback Funding Agreement was quickly put in place in June 2003 under which Scottish Power agreed to fund £25 million of excess cashback liabilities.

The directors of PIL reasonably relied on that funding agreement in assuming that excess liabilities would be met, but may not have been aware that the funding agreement could be terminated in the event that PRL became insolvent.

320. The White Summit transaction which took place in August 2003 was entered into at the instigation of the Powerhouse Group, and was not the responsibility of the directors of PIL. The effect of the transaction was that dividends of £29.57 million were declared which had the effect of discharging of PHL's indebtedness to PIL. The business was reorganised so as to leave PIL retaining the Scottish Power cashback liabilities with assets, including £1.6 million owed by PHL, which were asserted to be sufficient to enable PIL to meet the solvency margin requirement.

321. The Powerhouse Group entered into insolvency on 20 August 2003 due to the withdrawal of support from its trade finance insurers. That event entitled Scottish Power both to set off claims against the cashback liabilities which it had agreed to fund and to terminate the Cashback Funding Agreement. From that point on PIL was not able to meet the minimum solvency margin required under the Insurance Act 1986 and was effectively insolvent on a balance sheet basis in that it could not meet the cashback liabilities from its own resources.

322. The causes of the insolvency of PIL were a combination of the decisions of the directors to advance unsecured financing of £36.5 million to the Powerhouse Group, which it proved not to be in a position to repay, the White Summit transaction which had the effect of removing from PIL any prospect of meeting cashback liabilities from its own resources, namely the excess reserves on the repair warranty business, and the insolvency of PRL which lawfully entitled Scottish Power to terminate the Cashback Funding Agreement.

323. The very serious allegations of impropriety made by the liquidators of PPCL and PIL against the directors of PIL are baseless.

324. There are grounds for serious criticism of the decisions made by the board of PIL in relation to the financing advanced to the Powerhouse Group, but the evidence would not support any application to the court for a directors' disqualification order, or any other regulatory action against the former directors.

325. The evidence available to this review does not give any grounds to criticise the conduct of the managers, auditors and legal advisers to PIL with respect to the treatment of cashback liabilities. There are no further steps which are required to be taken by the FSA arising out of the conduct of those concerned in the affairs of PIL.

326. In general PIL complied with its regulatory duty to provide regular accounting information and solvency margin calculations to the IPA. However its statutory and management accounts from November 2002 onwards were not prepared on a proper basis in that the balance sheet did not disclose the gross amount of all estimated outstanding cashback liabilities, together with the amounts recoverable to meet such liabilities from reinsurers and Scottish Power. That error of approach did not affect the reported solvency of the company but it did have the effect that the scale of the cashback liabilities and the extent of reliance on the

Scottish Power indemnity was not disclosed to the IPA. The loans made to PHL were properly disclosed in the accounting information provided to the IPA.

327. The regulatory regime in force between 2001 and 2003 did not provide a supervisory system which adequately protected the interests of policyholders of PIL. In particular the minimum solvency margin required under regulation 13 was set at an inadequate level, did not properly take into account the incidence of claims, and did not take into account the quality of assets held by the insurer.

328. The IPA failed to consider the risks arising from the large exposure in respect of financing advanced to the Powerhouse Group, which on the information available to the IPA in May 2003 substantially exceeded the net assets of PIL. The IPA also failed to make any enquiry in July 2003 as to the purpose and effect of the White Summit transaction and approved the change of control without any knowledge or understanding of the risks posed by that transaction. These serious failures to consider the risks to the business of PIL, and thus the risks to its policyholders, arose from a highly restrictive regulatory approach, concentrated solely on compliance with the solvency margin, and which did not include any general consideration, beyond the letter of the regulations, of the risks to which the insurer was actually exposed.

329. The regulatory failings identified are unlikely to have made any difference to the demise of PIL. By May 2003 PIL had an exposure to the Powerhouse Group in excess of its net assets, which indebtedness probably could never have been repaid. If the IPA had refused to approve the change of control to White Summit and that transaction had not taken place, the likelihood is that the insolvency of the Powerhouse Group, and thus of PIL, would have followed.

330. I make no recommendations to the FSA as to its regulatory regime, which has substantially changed since 2003. The lessons to be learned from the history of PIL are clear. The board of the FSA is in the best position to decide, taking into account its regulatory objectives and priorities, whether any further adjustments to the prudential supervision of general liability insurers are required in the light of the findings in this report.