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# HM TREASURY CONSULTS ON NEW UK INSURER RESOLUTION REGIME

# HM TREASURY CONSULTS ON NEW UK INSURER RESOLUTION REGIME

HM Treasury has published its long-awaited consultation on a proposed insurer resolution regime (IRR). The proposals would give the UK authorities new tools and powers to manage the failure of insurers so as to minimise disruption to policyholders and the wider economy. The consultation is relevant to UK-authorised insurers (including reinsurers) and their holding companies, as well as their counterparties and investors. The consultation closes on 20 April 2023.

Insurers will need to consider the potential impact of the new regime on their business, in particular the possible impact on their debt issuance, financial and supply contracts and insurance and reinsurance terms or pricing and whether they are likely to be within the scope of the proposed additional pre-resolution planning obligations. Insurance groups that are issuers in public markets will also need to consider how to address the proposals in risk factors in their offering documents. Insurers may wish to respond to the consultation proposals to seek to ensure that the IRR is proportionate to the risks presented by the insurance sector.

The consultation paper is available **here**.

## Current position and objectives

Currently, the PRA's typical approach to dealing with an insurer in financial distress is to oversee the execution of the firm's recovery plan and, if necessary, to remove the insurer's permission to write new business and place it in run-off. While the PRA does not have a zero-failure regime, it is responsible for ensuring that failed insurers exit the market in an orderly manner. The existing UK insolvency regime also contains specific provisions to deal with insurer failure, including powers for the court to order a reduction ('write-down') of insurers' contracts under section 377 of the Financial Services and Markets Act 2000 (FSMA).

The government has recently proposed other changes to improve the existing mechanisms in the UK's insolvency regime to deal with insurer failure. The Financial Services and Markets Bill 2022, which is now being considered by Parliament, aims to enhance the court's write-down powers, including by allowing those powers to be exercised at an earlier stage and to clarify that the write-down may extend to all unsecured creditors, and to override certain supplier termination rights and policyholder surrender rights that otherwise might interfere with insolvency or write-down processes. For more information on these proposed changes, see our September 2021 blogpost **here**.

### Key points

- New regime giving the UK authorities additional options to manage the failure of insurers.
- Regime would apply to UK insurers (including reinsurers), their holding companies and members of their group and UK branches of foreign insurers.
- Some exceptions would apply including for Lloyd's of London and smaller (re)insurers.
- The Bank of England would be the resolution authority for insurers.
- Insurers can be resolved if they are failing or likely to fail, remedial action is unlikely, and resolution is in the public interest and is required to meet the resolution objectives.
- Resolution authority would be able to transfer the insurer or its business to a purchaser, a bridge institution or into temporary public ownership or to reduce (or convert into equity) the claims of unsecured creditors.
- Safeguards would apply to ensure that creditors are no worse off than in liquidation.
- A limited number of insurers would be subject to additional pre-resolution planning requirements.
- Regime would not require insurers to meet a minimum requirement for own funds and eligible liabilities or contribute to a new resolution fund.
- Consultation does not state specific requirements for non-UK law contracts to include bail-in or stay recognition clauses.
- The consultation deadline is 20 April 2023.

However, HM Treasury is concerned that the PRA's current powers and the insolvency regime may be inadequate to manage the failure of one of the UK largest firms (particularly a rapid failure), the failure of multiple insurers concurrently or the failure of insurers offering 'niche' business lines where replacement or substitute cover cannot easily be obtained.

The IRR aims to address these concerns and to provide the UK authorities with more options to manage the failure of an insurer in an orderly manner. The proposals aim to contribute to financial stability, to promote policyholder protection, to reduce value destruction in the event of insurer failure, to promote public confidence in the insurance sector, to promote competitiveness and to reduce risks to economic growth and public funds. The proposals would also bring the UK into line with the Key Attributes of Effective Resolution Regimes for Financial Institutions first published by the Financial Stability Board in 2011.

**The IRR would provide the UK authorities with additional options to manage insurer failure in orderly manner**

## Timing

The consultation paper does not discuss the government's proposals for implementing the proposals after the consultation closes on 20 April 2023 and it is not yet clear when the IRR, if implemented, would take effect. New primary legislation implementing the IRR might be included in the King's Speech for the 2023-24 parliamentary session (not now due to start until autumn 2023). However, the passage of new legislation may also be affected by a UK general election, which must be held by January 2025.

Insurance groups operating in both the UK and the EU may be affected by both the UK IRR and the concurrent proposals for a new EU recovery and resolution regime for insurers (see below). In September 2021, the European Commission submitted a legislative proposal for a new Insurance Recovery and Resolution Directive, which would bring the EU regime into line with the Financial Stability Board's Key Attributes. This proposal is currently being considered by the European Parliament and the Council of the EU and may be adopted later this year. The Commission's proposal envisaged that Member States would be given 18 months to adopt national implementing rules and thus the proposed Directive could be in force in early 2025 (although the Council of the EU has proposed a six-month delay to this timetable). For more information on the proposed Directive, see our October 2021 client briefing **here**.

## Proposed scope of the regime

The IRR would apply to all UK-authorised insurers (including reinsurers), mixed financial holding companies, insurance holding companies, mixed activity insurance holding companies, regulated and unregulated entities within the corporate group of an insurer and UK branches of foreign insurers. The regime would not apply to Lloyd's of London, smaller insurers, friendly societies, and insurers exempt from the recently announced Solvency II reforms.

Some entities could fall under both the IRR and the UK bank resolution regime, such as mixed financial holding companies, mixed activity insurance holding companies and regulated and unregulated group entities, where the insurer's group also includes a UK bank or investment firm that falls within the scope of the Banking Act 2009.

Despite the wide scope of the IRR, HM Treasury believes that only a few insurers would likely meet the proposed conditions for resolution action under the regime, with the majority instead being placed into a different process at the point of failure. HM Treasury also expects that only a limited number of systemically important firms would be within scope of the proposed pre-resolution planning requirements discussed below.

**HM Treasury believes that only a few insurers would likely meet the proposed conditions for resolution action**

## Resolution authority, objectives and conditions

### Resolution authority

HM Treasury proposes that the Bank of England would be the resolution authority under the IRR (RA). HM Treasury considers that a single RA for all insurers would ensure quicker, more flexible resolution when the IRR is triggered. The Bank of England already acts as the RA for UK banks, large investment firms, building societies, and central counterparties and so has extensive knowledge of managing resolution frameworks.

### Resolution objectives

The IRR would include resolution objectives that the RA would need to consider while adopting or considering resolution action. The proposed resolution objectives are:

- to protect and enhance the stability of the financial system of the UK, including by preventing contagion and protecting the ability of those who are or may become insurance policyholders to access critical functions, including the continuity of services on existing policies;
- to protect and enhance public confidence in the stability of the financial system of the UK;
- to protect public funds, including by minimising reliance on extraordinary public financial support;
- to protect policyholders of the firm in resolution, including those covered by an insurance guarantee scheme; and
- to avoid interfering with property rights in contravention of a Convention Right (within the meaning of the Human Rights Act 1998).

Critical functions would be defined as those activities, services, or operations of an insurer that, if discontinued, would likely cause disruption to vital services for the UK economy or the country's financial stability. The ease with which a service or product can be changed at a fair cost and within an acceptable period at the initiative of third parties would also affect how critical a function is. HM Treasury intends to use these elements to define critical functions and it would be given the authority to add to the definition by specifying the precise operations, services, or activities that would be categorised as critical functions. Insurers will need to consider whether any of their operations, services or activities could be categorised as critical for the purposes of the new regime.

## Resolution conditions

HM Treasury proposes that four cumulative resolution conditions would need to be met for an insurer to be placed in resolution, to set a high bar to justify the use of resolution powers (see box).

### Proposed resolution conditions

- The PRA assesses that an insurer is failing or likely to fail (defined as the insurer failing or likely to fail to meet the threshold conditions for authorisation such as to justify the variation or cancellation of permissions, the insurer being or about to become insolvent and/or the insurer requiring extraordinary public financial support);
- The RA assesses that having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the insurer that will result in the first condition ceasing to be met;
- The RA assesses that the exercise of the stabilisation powers is necessary having regard to the public interest in the advancement of one or more of the statutory resolution objectives; and
- The RA assesses that one or more of the statutory resolution objectives would not be met to the same extent if stabilisation powers were not deployed.

When deciding whether the first resolution condition is met, the PRA would not be tied to a specific point on the Solvency II 'ladder of intervention' or to breaches of a fixed level of the Solvency Capital Requirement or Minimum Capital Requirement. It is envisaged that, if the firm could be run-off safely without resolution action, the proposed resolution conditions would not be met, and that, where an insurer meets all the resolution conditions, the PRA would remove or limit the insurer's permission to write new business, except where it is necessary to maintain an economically critical product which is not substitutable or offered by others.

The PRA would be required to consult with the RA before deciding that an insurer meets the first resolution condition and the RA would be required to consult with the PRA, the FCA and HM Treasury before establishing whether the other conditions are satisfied.

The consultation paper does not set out the proposed conditions for resolution of holding companies or other group companies within the scope of the regime.

## Pre-resolution valuation

Before exercising any of the stabilisation options, the RA would need to ensure that the assets and liabilities of the failing insurer are valued. The purpose of this valuation is to ensure that any losses and costs which may arise during resolution are identified in advance of entry into resolution and to inform the RA's decisions about whether the resolution conditions are met, the stabilisation options that should be deployed and how the stabilisation powers should be exercised, including decisions on how to assign losses.

The RA would need to appoint an independent valuer to conduct this valuation unless the RA determined that there was a need for urgency. In this scenario, the RA would be able to conduct a provisional valuation, followed by the appointment of an independent valuer to conduct a full valuation.

## Stabilisation options and safeguards

### Stabilisation options

When the resolution conditions are met, the RA would be able to use any of the following stabilisation options in relation to a failing insurer. It is also expected that the RA would be able to exercise these options in relation to holding companies and other entities within the scope of the regime. However, any decision made by the RA that affects public funding would require HM Treasury's approval. When using these powers, the RA would act within a set of safeguards (see below), to promote outcomes that leave no creditor worse off (NCWO) than in insolvency.

### Proposed stabilisation options and tools

**Stabilisation options**

- Transfer of shares or business to a private sector purchaser;
- Transfer of shares or business to a bridge institution;
- Reducing or converting into equity unsecured creditor claims (bail-in);
- Temporary public ownership of insurer.

**Additional tools (to be used in combination with stabilisation options):**

- Transfer of assets, liabilities, property or rights to balance sheet management vehicle; and
- New insurer administration procedure.

**Transfer to a private sector purchaser**

The RA would be able to transfer the shares in or all or part of the business, assets and liabilities of a failing insurer to a willing private sector purchaser. The key difference between this and the existing arrangements that allow insurers to transfer their business under Part VII FSMA is control and speed: under the IRR, the RA would not require court approval and could arrange and implement a transfer under its own authority.

The transfer would override any right of veto by third parties (i.e., other than the willing acquirer) including other UK authorities, the shareholders of the failing insurer or of its parent, and policyholders and other creditors in the failing insurer.

**Transfer to a bridge institution**

The RA would also be able to transfer the shares in or all or part of the business, assets and liabilities of a failing insurer to a bridge institution owned by the RA. This is intended as a temporary measure to buy time to facilitate a subsequent transfer to a private sector purchaser, by giving more time for due diligence and valuation – which can be challenging for insurers. However, the duration of the bridge institution would be constrained to reflect its temporary nature.

Where a failing insurer's business is transferred to a bridge institution that is directly carrying out insurance policies, the bridge institution would require the relevant permissions under Part 4A FSMA and be subject to supervision by the PRA and the FCA.

**Bail-in**

The RA would be able to 'bail-in' a failing insurer by reducing or converting (into equity or other ownership instruments of the firm in resolution) all or parts of unsecured creditor claims, including policyholder claims, in a manner that respects the hierarchy of claims in liquidation. Insurance (but not reinsurance) claims rank above other non-preferential unsecured claims in the insolvency hierarchy. Accordingly, a bail-in would write down or convert creditors ranking below insurance creditors first, before those insurance creditors (and, if insurance claims are written down or converted, they would be treated equally, regardless of whether they are FSCS-protected claims). Where FSCS-protected policyholders are written down or converted the HM Treasury intends that the FSCS will also provide "top-up payments" up to the same limits that would apply in insolvency, subject to the usual eligibility criteria. In addition, bail-in would override 'pay-as-paid' clauses in reinsurance contracts to preserve the value of the reinsurance for the insurer where insurance claims have been written down or converted.

HM Treasury expects that the RA would use the bail-in option to restore a level of capital coverage sufficiently in excess of liabilities to enable the firm to continue a safe run-off (rather than to enable it to continue to write new business). Given this, and the different risk profiles and funding structure of insurers compared with other financial institutions, HM Treasury proposes that the IRR (unlike the resolution regime for banks) should not include a requirement for insurers to maintain an additional minimum level of own funds and (subordinated) eligible liabilities (MREL) over and above minimum capital requirements.

For similar reasons, HM Treasury also does not propose the creation of a separate resolution fund, pre-funded through regular contributions (or levies) collected from the insurance sector (additional to existing FSCS levies). The UK bank resolution regime also does not require contributions to a resolution fund, although UK banks are subject to a separate tax, the bank levy, which has been justified in part by the possible need for government funding support for bank resolution.

**Temporary public ownership**

The RA would be able to place a failing insurer into temporary public ownership, as a last-resort measure in the case that none of the other stabilisation alternatives are effective. It is intended that, where this stabilisation option has been exercised, the insurer's business will be returned to the private sector as soon as commercial and financial circumstances allow, in a manner that maintains financial stability and protects policyholders and the taxpayer while acting in a way that promotes competition.

## Other tools

The IRR would also include the following tools which could be deployed in combination with the stabilisation options.

**Balance sheet management vehicle**

The RA would be able to transfer relevant assets, liabilities, property or rights of the failed insurer to a balance sheet management vehicle as a warehouse to maximise value through an eventual sale or orderly wind down. The vehicle would be authorised and supervised by the PRA and FCA where it carries out insurance contracts.

**Insurer administration procedure**

The IRR would introduce a new insurer administration procedure in relation to insurers in resolution based on the provisions of Part 3 of the Banking Act 2009. This would provide the RA with the flexibility to exercise the proposed private sector purchaser and bridge insurer stabilisation options outlined above and to manage a failing insurer while ensuring that the firm's critical functions can continue to operate effectively.

The procedure would introduce a new objective for an appointed administrator to support a bridge insurer or private sector purchaser by making sure it has access to the services and facilities the RA determines it needs to function effectively, which would take precedence over the goal of "normal" administration.

### Safeguards

The Financial Stability Board's Key Attributes state that "creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime". To give effect to this NCWO safeguard, the IRR would require HM Treasury to make an order establishing a mechanism for calculating and paying any NCWO compensation after the exercise of one or more of the stabilisation options. HM Treasury would be allowed to appoint an independent valuer to determine the level of NCWO compensation required.

**Creditors should be no worse off than they would be in a liquidation of the failed insurer**

HM Treasury would also have the power to impose restrictions on bail-in and transfers of part only of the assets and liabilities of an insurer in resolution. HM Treasury may use these powers to ensure that a bail-in or partial property transfer does not adversely affect collateral arrangements, set-off or netting rights or associated legal opinions. The restriction on partial property transfers could also be used to introduce restrictions tailored to the insurance sector (e.g., in relation to unit-linked policies or reinsurance). In addition, the NCWO safeguard would apply to any (partial) transfer of insurance business, so that the RA would only contemplate splitting up a book of business where doing so would not leave creditors worse off.

## Pre-resolution planning

The RA would be required to carry out resolvability assessments and pre-resolution planning in relation to insurers. However, HM Treasury intends to ensure that the regime recognises the work that the PRA and insurers have already started to carry out under the Solvency II review and, as already noted, HM Treasury expects that only a small number of systemically important insurers would likely be subject to the proposed pre-resolution preparation procedures (in contrast to the banking regime which envisages resolution planning for all banks). It expects that a crucial factor in the RA's decision as to whether to subject an insurer to pre-resolution planning will be the degree to which an insurer would be likely to fulfil the proposed resolution conditions – in particular, the condition that resolution of the failed insurer must be in the public interest.

### Resolvability assessments

The RA would need to complete regular resolvability assessments of the identified insurers to evaluate the feasibility and effectiveness of the various resolution strategies. A key element of the resolvability assessment will be that the RA is empowered to direct a firm to act to remedy barriers to resolvability and take enforcement action if the firm does not comply.

HM Treasury expects only a small number of insurers would be subject to additional pre-resolution planning

### Resolution plans

The RA would also prepare a resolution plan for identified insurers setting out the proposed resolution strategy and an operational plan for its implementation. The RA would be obliged to update the plan annually, or more frequently when material changes take place to the firm's structure, strategy or business activity, or there is a substantive change in economic conditions. HM Treasury expects that firms may need to carry out some additional work to support the creation of resolution plans.

## Ancillary matters

### Ancillary provisions

HM Treasury plans to introduce provisions to ensure that the exercise of resolution powers does not trigger a default or early termination under contracts. This would be based on section 48Z of the Banking Act 2009 which applies to banks.

The regime would also impose a time-limited restriction on the exercise of policyholder surrender rights where a failing insurer enters into resolution. This will mainly affect unit-linked and with-profits policies.

The regime would also restrict the starting of insolvency proceedings against a firm, without the RA's permission, if a stabilisation option has been exercised in relation to the firm or if the firm satisfies the resolution conditions.

### RA ancillary powers

The RA would also have ancillary discretionary powers that could be used in conjunction with a stabilisation option (see box). The PRA already has some of these powers, and the RA will only possess these ancillary powers when a firm has been placed in resolution.

### Proposed ancillary powers

The RA would have powers to:

- take action in relation to directors and senior managers, including removing and/or replacing a director or senior manager of a specified insurer in resolution;
- appoint resolution administrators;
- appoint skilled persons or investigators;
- prohibit or restrict the payment of dividends or other distributions to shareholders;
- prohibit the payment of variable remuneration to, and allow the recovery of monies from, members of the board, senior management, key persons in control functions, and major risk-taking staff, including claw-back of variable remuneration and discretionary pension benefits;
- prohibit the transfer or pledging of the insurer's assets without RA approval;
- subject to safeguards, introduce a temporary (up to two-day) suspension of:
  - payments to unsecured creditors in any contract where one of the parties is the insurer in resolution;
  - creditors' action to attach assets or otherwise collect money or property; and
  - termination of contracts;
- apply to the court for a stay of legal proceedings once the RA has exercised one or more stabilisation option(s);
- terminate, continue, modify, restructure, transfer, assign and/or create contracts, including derivatives, securities, financing transactions and insurance contracts, subject to appropriate safeguards; and
- initiate the liquidation of the whole or part of the insurer.

### HM Treasury ancillary powers

HM Treasury would have the authority to introduce provisions dealing with the fiscal repercussions of the RA exercising one or more stabilisation options and to amend UK law to permit the effective use of stabilisation options and broader resolution powers in a given resolution. Additionally, HM Treasury would have the authority to amend the application of company law to insurers in resolution.

### Cross-border considerations

The consultation document does not envisage requiring insurers or their group companies to include clauses in their contracts governed by non-UK law to recognise and give effect to the exercise of bail-in powers or the overrides and stays of termination and enforcement rights in resolution (as is required under the resolution regime for banks). However, PRA rules or the RA's pre-resolution planning might require the inclusion of such terms in contracts to ensure that contracts governed by non-UK law do not operate as an impediment to effective resolution.

The IRR would provide a framework for the RA to recognise resolution actions taken by other jurisdictions' resolution authorities and would allow the use of the stabilisation options to resolve UK branches of non-UK insurers. The interaction of different resolution (and insolvency) regimes will be an important issue for the RA when formulating resolution plans for cross-border groups.

HM Treasury would have the power to restrict the RA's exercise of stabilisation powers where this would contravene the UK's international obligations.

### Further ancillary matters

HM Treasury would publish a code of practice setting out guidance as to how and in what circumstances the authorities would use the proposed resolution tools. HM Treasury, the RA, the FCA and the PRA would be required to consider the specifics of the code when performing their separate duties.

The Bank of England would also publish a document setting out the approach of the PRA and RA to insurance resolution following the introduction of the proposed regime.

The IRR would also require HM Treasury to set up an advisory group to offer advice on how the resolution regime will affect insurers, people with whom insurers do business, and financial markets, among other things.

## Comparison with other regimes

The IRR closely follows the UK bank resolution regime, but with some differences to cater for the specificities of the insurance sector. For example, as already noted, the IRR would not subject all insurers to resolution pre-planning requirements, would not require insurers to meet a minimum requirement for own funds and eligible liabilities and may not require the inclusion of recognition clauses in non-UK law contracts. Other differences will flow from the different creditor hierarchy that applies to insurers in liquidation, which will affect the way in which stabilisation powers are exercised, in particular having regard to the NCWO safeguard (e.g., in relation to the treatment of reinsurance claims and unit-linked and ring-fenced portfolios in bail-in).

The IRR also has many similarities to the proposed EU Directive on insurance recovery and resolution, but with some differences. For example, the proposed Directive would require a broader range of insurers and insurance groups to participate in pre-resolution planning (IRR envisages that only a limited number of insurers would have to do this) and would treat 'solvent run-off' as a specific resolution tool (under IRR, solvent run-off is not a specific stabilisation option - it is envisaged that the resolution conditions would not be met if a safe and solvent run-off is possible). The proposed Directive would also specifically require insurers to include bail-in and stay recognition clauses in certain contracts governed by the law of third countries (as already noted, this is not specifically envisaged by the consultation). In addition, the Council of the EU is now proposing amendments to the legislative proposal that would require the creation of national financing arrangements for insurance resolution.

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