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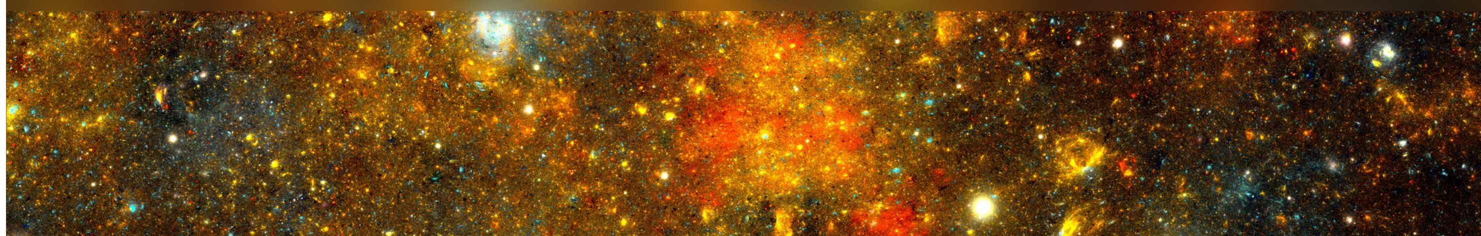

UK GOVERNMENT'S RESPONSE TO INSURER RESOLUTION REGIME CONSULTATION

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Background

In January 2023, HM Treasury (HMT) initiated a consultation on the proposed Insurance Resolution Regime (IRR), intended to equip the Bank of England with increased authority to manage systemic insurer failures in a flexible manner.

For more detail about the proposed IRR, please refer to our briefing: "HM Treasury Consults on New UK Insurer Resolution Regime – February 2023."

The consultation received 13 written responses, supplemented by engagement sessions with stakeholders and this briefing summarising the outcome of that process. References in this briefing to "insurance" also include "reinsurance".

Objectives of the IRR

The IRR will align the UK insurance sector with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions (the "Key Attributes"). These global standards aim to manage financial institution failures without severe disruptions or reliance on public funds. HMT also wishes to align the insurance sector with the resolution framework currently in place for banks and which was successfully utilised recently in the resolution of Silicon Valley Bank UK. There was near unanimous support in the consultation for this proposed alignment.

Under the IRR, the PRA will continue its role in assisting distressed firms with orderly recovery or exit, including the use of run-off if necessary, and the Government intends to leverage the PRA's existing activities and exposure in pre-resolution planning. The IRR is intended to enhance these efforts by providing essential tools for situations where recovery or run-off alone cannot adequately ensure financial stability, protect policyholders, and support economic growth but incorporates safeguards such as Resolution Conditions (RCs) and "no creditor worse off" (NCWO) compensation, suitably adapted for the insurance sector.

Timing for Implementation

The specific implementation date for the IRR remains uncertain. The Government intends to enact legislation when parliamentary time allows, which is unlikely to be before the next general election. Once the legislation is enacted, the Bank will have the necessary tools, stabilisation options, and supplementary powers prescribed by the IRR. A minimum lead-in period of 12 months will be provided to firms for the effective implementation of any new requirements (as suggested by a majority of respondents to the consultation).

A Code of Practice will be published after the legislation has been enacted, which will provide essential implementation details.

Key points

- Implementation date: Legislation to be enacted following the next general election, with implementation likely to be in 2025.
- Lead-in time: Firms will have at least 12 months to implement the IRR requirements.
- IRR tools: The IRR will enhance the tools available to regulators to resolve insurers but will not replace existing measures such as recovery and run-off.
- Resolution authority: The Bank of England will be the resolution authority for insurers, in collaboration with the PRA and FCA.
- Scope: The IRR will apply to UK branches of foreign insurers, holding companies, niche insurers, and mutuals, but will not apply to Lloyd's.
- Gibraltar insurers: The IRR will also apply to Gibraltar insurers, which are to be aligned with UK insurers through a Gibraltar specific regime.
- Entry into resolution process: The IRR will allow the PRA to determine and respond to potentially systemic failure in a more flexible way than the Solvency II ladder of intervention.
- IRR and enhanced FSMA write-down measures: The IRR and the proposed enhanced FSMA write-down measures in principle have different purposes and will only overlap in limited circumstances.
- MREL: The IRR will not introduce MREL for insurers but will instead rely on other tools to resolve insurers.
- FSCS-protected policyholders: FSCS-protected policyholders will be protected after bail-in, through top-up payments from the Government (up to the existing limits).

Bank's Role as Resolution Authority

There was support expressed for the appointment of the Bank as RA, given its experience of the banking resolution regime (though some respondents flagged its lack of insurance sector expertise). The Bank's role will not supersede the prudential supervisory responsibilities of the PRA; instead, it will focus on addressing systemic insurer risks. To address concerns about potential conflicts of interest, the Government proposes ensuring operational independence for the Bank's resolution functions. Close collaboration with the PRA and FCA, while respecting the unique business models of insurers, is also envisaged.

Scope of the Regime

UK Branches of Foreign Insurers

Further consideration has been given to whether UK branches of foreign insurers should fall within the scope of the IRR. While some consultation responses referenced Key Attributes (KAs) that exempt branches if the host jurisdiction respects resolution actions of the home jurisdiction, the Government points out that the UK no longer has such obligations post-EU exit, rendering this exemption inapplicable.

The IRR aims to enable home resolution authorities to undertake necessary actions. Consequently, the Government does not think it necessary to impose a statutory requirement for Bank-led pre-resolution planning on UK branches of foreign insurers.

Nonetheless, these branches will remain within the scope of the IRR so as to ensure the cross-border resolution of these insurers in the event of failure:

1. The home resolution authority of the insurer's headquarters will manage the failure of UK branches, and the Bank will recognise and support the actions of the home resolution authority.

2. The Bank will possess backstop powers to autonomously resolve UK branches if cooperation with the home authority proves ineffective.

Any additional planning required will be carried out by the Bank of England as the host resolution authority (RA). However, the Bank will require some assistance from the branches, such as the provision of reporting or information, to achieve this aim.

Holding Companies

In the context of insurance groups and financial conglomerates, the Government has concluded that both holding companies and individual insurance firms should be within the scope of the IRR. This approach allows the Bank to apply stabilisation powers to either the holding company or the solo individual firm, depending on the circumstances. This is consistent with the exercise of the bail-in option, which could be applied to either the insurance firm or its holding company. The inclusion of group entities within resolution regimes is consistent with international standards, as it permits a more holistic approach to resolution that considers the impact of resolution actions on the group as a whole. Accordingly, the RA would be unlikely to use the IRR measures in respect of a holding company where insurance is a small part of a non insurance business.

Key points (continue)

- Bail-in, Shareholders and Secured Creditors: During bail-in, shareholders will bear losses before creditors, in order to maintain the creditor hierarchy. Secured Creditors will be excluded from bail in if they have a fixed change of financial collateral arrangement. Floating charge holders would not be exempt. Pay as paid clauses will be overridden.
- Pre-resolution valuations: Pre-resolution valuations will guide the resolution authority's decisions, and subsequent independent valuations will assess NCWO compensation. Detailed guidance on valuation will follow.
- Resolution and Recovery Plans: Effective pre-resolution planning will be supported by Resolution and Recovery Plans an Resolvability Assessments.
- Ancillary powers: The resolution authority will have a range of ancillary powers, including the ability to restrict policyholders' surrender and switching rights.

Niche Insurers

Niche insurers offering specialised and non-substitutable insurance products to specific segments of the UK market may fall within the scope of the IRR due to the public interest in their products remaining available. The Bank will engage with relevant firms based, ensuring that pre-resolution planning for niche insurers is proportionate and tailored to their products and business models.

Mutuals

The UK IRR will encompass non-friendly society mutual insurers. This may require the Bank to tailor stabilisation tools to mutual structures.

However, it is anticipated as a result of the use and the nature of the businesses that most mutual insurers will not meet the statutory criteria for resolution actions and as a result, mutuals are unlikely to be subjected to the most interventionist tools of the IRR, such as bail-in.

Lloyd's

After careful consideration, the Government has opted to exclude Lloyd's from the scope of the IRR. In its view, Lloyd's already possesses mechanisms to achieve resolution objectives and extending the IRR's scope to cover Lloyd's would be intricate and unworkable.

Lloyd's operates as a unique marketplace characterised by a complex legal structure. It is also subject to a range of existing regulations and a central fund that address systemic risks. These regulations and funding arrangements are aligned with the objectives of the IRR and provide Lloyd's with mechanisms for resolution actions, such as loss absorption and liability restructuring.

Gibraltar Access

Gibraltar-based insurers currently have the ability to access the UK market post-Brexit. A permanent replacement regime known as the Gibraltar Authorisation Regime (GAR) is in the process of being established. Gibraltar insurers who are granted access to the GAR will hold Schedule 2A permissions, akin to Part 4A permissions.

The Government is considering broadening the scope of the IRR to encompass insurers with Schedule 2A permissions and UK branches. The rationale is to ensure a level playing field in the UK insurance market. However, given that this was not discussed in the original consultation, the Government indicated that it is open for further engagement from stakeholders on this point.

Entry into Resolution Process

Industry stakeholders agreed with the Government proposals that entry into the Regulation Process should not be based on pre set requirements, such as the Solvency II ladder of intervention, but should instead use a more flexible system that grants the PRA greater latitude in determining when to intervene.

The new framework will therefore be structured around four resolution conditions (RCs), with RC1 ("failing or likely to fail") being the pivotal condition for determining whether an insurer necessitates resolution. The PRA will have the flexibility to assess whether an insurer meets RC1, taking into consideration factors such as the insurer's financial robustness, its ability to continue operating, and the repercussions of its failure on the financial system.

More guidance on the application of RCs by the PRA, the Bank, and other relevant authorities will be outlined in a forthcoming Code of Practice, set to be published after the implementation of the IRR.

The IRR and Section 377A

Consultation responses raised questions about the interplay between the IRR and the enhanced section 377A write-down measures introduced by the Financial Services and Markets Act 2023. The Government expects that each set of requirements will apply to different types of entity. While the IRR addresses systemic insurer failures, section 377A is designed to aid mid-sized insurers on a temporary basis to assist in providing continued cover.

In light of questions raised, though, the Government has further considered this area, and agrees that while occurrences of overlap between the IRR and section 377A are likely to be rare, they are not inconceivable. Accordingly, an amendment to section 377H(2) of FSMA 2000 is being contemplated to prevent overlap, specifically by adding a resolution action taken by the RA to the list of revocation events after which a write-down order ceases to be effective.

MREL

Inclusion of Minimum Required Eligible Liabilities (MREL) (resources available to be written down or converted on resolution) within the IRR is agreed to be disproportionate, and will not be pursued.

Role of FSCS under Bail-In Stabilisation Option

Supported by consultation responses, the Government reiterates its commitment to safeguarding FSCS-protected policyholders in the event of a bail-in. Additional top-up payments (up to the existing limits) will therefore need to be made to such policyholders to ensure continued coverage, even where benefits have been reduced.

Exceptions to this provision apply to secured creditors, particularly those with fixed charges or financial collateral arrangements. However, reinsurance cedants with floating (rather than fixed) charges will fall within the write-down scope (see further below).

The Government will address the tax implications for policyholders who receive FSCS top-up payments, ensuring consistency across the UK's resolution regimes.

Proposed Treatment of Shareholders and Policyholders in the Bail-In Stabilisation Option

The Government proposes to treat shareholders as the first to bear losses in a bail-in resolution, followed by creditors, including subordinated debt holders. This is consistent with established practice in the banking regime's bail-in stabilisation approach. A statutory order will be created to delineate the sequence in which shareholders and creditors bear losses during a bail-in resolution, preserving the existing creditor hierarchy.

The Government also proposes to treat all liability classes consistently during the bail-in option. This means that if one liability class is converted or written down, all other subordinate liability classes must also be converted or written down. This is to prevent inadvertent preferential treatment for any one class of creditors.

Creditors subject to write-down following a bail-in will include unsecured creditors, and secured creditors with floating charges. This is to prevent inadvertent preferential treatment for inward reinsurance creditors holding subordinated floating charges (a structure often used to put them on a par with direct policyholders. Secured creditors holding fixed charges or financial collateral arrangements will be excluded from a bail-in.

Pay as paid clauses are to be overridden. Some respondents had raised concerns about this, but the Government concluded that failure to override such clauses would result in an undue financial benefit to a reinsurer, following bail-in of its cedants.

To facilitate effective bail-in implementation, bail-in recognition clauses will be integrated into some (but not all) non-UK law governed contracts. These clauses will compel relevant entities to acknowledge the potential impact of the RA's stabilisation power and commit to complying with conversion or cancellation mandates during bail-in resolution. The specific requirements for these clauses will be established by the government, in consultation with the Bank and the PRA, taking into account firm attributes and contract types. The scope of these clauses will be tailored for practicality and proportionality, with existing contracts grand fathered until they are materially amended at which point the bail-in recognition clauses will be required to be included.

The Government advocates a flexible approach to the timing of bail-in execution, recognizing the need to respond to real-time circumstances to effectively achieve resolution objectives.

Pre-Resolution Valuation and NCWO Compensation

The IRR's framework envisages two types of valuation:

- Pre-resolution valuations, required before the RA can activate stabilisation options. These valuations will inform the RA's decisions on whether or not RCs have been met and on deploying stabilisation options.
- Post-resolution, an independent valuer appointed by HMT will assess NCWO compensation, if applicable, for the firm's creditors and/or shareholders.

Pre-resolution valuations

The Government proposes integrating high-level principles into legislation to ensure prudent and focused actuarial estimations. These principles will be followed up with detailed pre-resolution valuation standards and rules, which will evaluate the potential consequences of the RA's potential actions under stabilisation options. The proposed methodology will likely be based on the failing firm's latest audited position, adjusted for prevailing market conditions.

NCWO compensation

While it is challenging to predict future claims, an independent valuation at a specific point in time will determine NCWO compensation post-resolution (i.e. a partial transfer to a private sector purchaser or bridge entity, or bail in stabilisation). This approach aligns with existing valuation frameworks in banking and Central Counterparties (CCP) resolution. The government retains the authority to specify principles for the independent valuer.

The Government's overarching principle is that NCWO compensation should adhere to international standards to ensure equitable treatment for policyholders and creditors, no less favourable than in insolvency. The position of with-profit policyholders within the NCWO compensation framework has been considered, with conversions from with-profits to unit-linked policies explored as a mechanism for ensuring fairness.

Ancillary Powers

There was broad support in the consultations for the RA to have the power to impose restrictions on policyholder surrender and switching rights under IRR, to mitigate the risk of policyholders surrendering en masse if the insurer enters resolution.

These powers will differ from similar measures introduced by FSMA – they will be at the discretion of the RA, and not automatic. The length of such restriction would be for determination on a case by case basis, at the point of resolution.

Pre-Resolution Planning

Effective pre-resolution planning involves crafting Resolution and Recovery Plans at the firm level, coupled with Resolvability Assessments carried out by national resolution authorities in line with international standards.

In response to feedback, the Government acknowledges the importance of engagement between systemically significant UK-headed insurers and the RA for effective pre-resolution planning under the IRR. This approach aligns with international standards and recognizes the importance of minimising duplicative activities carried out separately by the PRA and the Bank.

The RA will leverage information already provided to the PRA through exit planning and supervisory arrangements, streamlining the process for firms under both regimes. The RA's pre-resolution requirements will align with the PRA's exit planning regime, ensuring that additional information is sought only when it uniquely benefits firms in their resolution planning under the IRR.

Specifics regarding the information and data firms need to provide for pre-resolution plans, along with interactions with the RA, will be elaborated further in the forthcoming Code of Practice.

Preparatory Work for Implementation

The Bank is preparing to dedicate substantial resources and establish internal frameworks to accommodate its role as the single RA for insurers. This transition is backed by appropriate funding and resources required for effective execution. The RA's scope extends beyond the IRR, necessitating close coordination with the PRA and the FCA to ensure consistency, synergy, and operational effectiveness.

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