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Insurers in Financial Difficulty: The UK Government and Prudential Regulation Authority Issue Consultation Papers Concerning Distressed (Re)insurers

In late January 2023, the UK government issued a detailed consultation paper to introduce a long-awaited resolution regime for UK (re)insurers. The new regime addresses long-standing concerns about how the UK would manage one or a series of failures in the (re)insurance sector considering the difficulty and time required to resolve insurance company failures. Although the banking crisis of 2008 accelerated these concerns, there remain relatively few actual examples of failure. Nonetheless, the UK government is also concerned about the unpredictable conditions the sector currently faces and therefore anticipating the pending partial relaxation of capital standards through the reduction of risk margin, among other steps.

Though not necessarily obvious to the outside observer, it is hard to overstate the degree to which the specter of the Equitable Life failure in 2000 continues to hover over the UK's approach to the prudential regulation of insurers. Current regulatory proposals continue to reflect the themes from the Equitable case.

Borrowing heavily from the frameworks of the International Association of Insurance Supervisors (IAIS) and the Financial Stability Board (FSB), both to which the UK has contributed frequently over time, and the existing UK framework for banks put in place following the 2008 financial crisis, the consultation paper lays out a series of sweeping powers enabling the Bank of England to act as 'resolution authority' (RA) in the event of a determination by the Prudential Regulation Authority (PRA) that one of a number of specified conditions has been triggered. The proposals would then give the RA powers to initiate one (or a combination) of the following processes:

- Portfolio transfer to a private sector transferee.
- Establishment of a temporary 'bridge' institution to take control and continue certain critical functions.
- 'Bail-in' of a (re)insurer's creditors, including policyholders (see further on 'write-downs' below).
- As a last resort, placing the firm into temporary public ownership.

The regime would be subject to a 'no creditor worse off' (NCWO) safeguard, whereby creditors have a right to compensation where they do not receive at a minimum what they would have received under the liquidation of the firm under the applicable insolvency regime. The regime would not apply to Lloyd's, smaller (non-Solvency II) (re)insurers and friendly societies.

Alongside this protocol, the paper envisages that the RA may establish a vehicle to manage or run down nonperforming or difficult-to-manage assets. The RA may also initiate a new 'insurer administration procedure' (equivalent to the procedure currently in place for banks) to assist with the portfolio transfer and creation of a bridge institution listed above.

This UK proposal mirrors continuing initiatives at EU level, where in September 2021, the European Commission adopted a legislative proposal for an insurance recovery and resolution directive (IRRD), with possible adoption in 2023.

These developments will require significant planning by (re)insurers. The largest and systemically most important global (re)insurers have been required for some time now to develop and maintain 'living wills.' Now the PRA is turning its attention to smaller firms. Although all firms are already required under the PRA's Fundamental Rule 8 to prepare to 'exit' in orderly fashion for resolution, the PRA will consult in 2023 on whether to add a specific rule requiring all insurers to produce exit plans.

The current consultation is open until 20 April 2023.

Bail-in/Write-Down

In connection with the regime proposal, earlier in February 2023 the PRA published a consultation paper to address numerous details related to the 'bail-in' (or 'write-down') tool referenced above.

Currently, a (re)insurer may apply under Section 377 of the Financial Services and Markets Act 2000 (FSMA) for a court order to reduce the value of its contracts (known as a write-down order) if the firm is, or is likely to become, unable to pay its debts. However, this mechanism is not understood well, and, to our knowledge, has never been used. The UK government is using the proposed Financial Service and Markets Bill (FSMB), which is currently proceeding through the UK Parliament, as an opportunity to expand and clarify the scope of this regime with the aim of making such powers a practical statutory solution for distressed (re)insurers.

The enhanced write-down regime comprises the following:

- A two-part test (i) that the (re)insurer is (or is likely to become) unable to pay its debts and (ii) that the write-down would be reasonably likely to lead to a better outcome for the (re)insurer's policyholders and other creditors as a whole (*i.e.*, compared with the next most likely scenario).
- A court-based process, with heavy PRA involvement throughout.
- The appointment by the court of a (PRA-approved) 'write-down manager.'
- A moratorium on legal process and the enforcement of security while the write-down is in progress, subject to an automatic termination six months after the write-down comes into force.
- The potential for liabilities to be 'written-up' if (i) the (re)insurer's financial position improves or (ii) the (re)insurer enters into formal insolvency proceedings.
- Opportunity for written-down liabilities to be deferred — but not extinguished — on a (re)insurer's balance sheet.
- A stay on policyholders preventing surrendering of their with-profits and unit-linked policies.
- The option for associated reinsurance coverage not to be written-down (or otherwise impacted).
- Exclusion from the scope of liabilities for a range of creditors, including secured creditors (except floating charge holders), suppliers, reinsurers (and other providers/suppliers of financial services) and employees.

The PRA offers several detailed proposals to address the interaction of the write-down regime with the Financial Services Compensation Scheme (FSCS), the industry levy-funded body designed to compensate in-scope policyholders following failure of an insurer. The PRA also proposes which persons must be notified when the write-down order is made, including policyholders, reinsurers, trade creditors, financial counterparties and intermediaries. Finally, the February paper explores the process of write-down applications and the appointment of write-down managers.

Nonetheless, all of these ongoing consultation and parliamentary processes still leave details related to the practical implementation of such a scheme to be resolved and clarified. In practice, the regime will likely require the vesting of wide powers and discretions with the 'write-down manager' and (behind the scenes) with the PRA. Particular case aspects to determine include:

- Whether a 'write-down' is preferable to insolvency.
- What percentage of write-down to apply.
- The parameters of creditor categories that are in/out of scope.

- When to issue equity in the insurer (or cash as an alternative) to written-down policyholders as compensation.
- When 'written-down' insurers may make claims against their reinsurers.
- The complicated counterfactual of an NCWO analysis (see above) and the circumstances under which liabilities may be 'written-up' following a (re)insurer's recovery.

Whether the prospect of a (re)insurer exiting from write-down is realistic and whether in practice any policyholder would wish to pay new a premium into such a business are open questions. And myriad related questions of detail arise, *e.g.*, whether insurance premium tax (IPT) paid by policyholders on written-down policies is refundable.

The consultation is open until 31 March 2023. The PRA is proposing an implementation date for new regime around July 2023.