HERBERT SMITH FREEHILLS

INTRODUCING A UK INSURER RESOLUTION REGIME

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Legal Briefings

The Treasury unveils plans for a new Insurer Resolution Regime in bid to remain at the forefront of international standards

HM Treasury unveiled yesterday its long awaited consultation paper for a new Insurer Resolution Regime (IRR) with the consultation set to run until 20 April 2023.

The management of UK (re)insurers in financial difficulty is currently handled through a mixture of standard corporate and (re)insurer-specific insolvency arrangements. Proposals to amend the existing insolvency arrangements for (re)insurers are under review as part of the Financial Services and Markets Bill. The IRR will sit on top of these arrangements and provide a pre-insolvency set of powers. It will give regulators additional tools to manage the failure of (re)insurers in an orderly manner where such a failure would have a wider impact on the financial system and policyholders.

KEY POINTS TO NOTE

- The proposed regime aims to ensure the UK remains at the forefront of international standards and can manage the failure of major insurer. It borrows heavily from the existing and proposed bank and Central Counterparties recovery and resolution regimes, but there are differences to reflect the insurance market.

- The proposed IRR introduces powers and tools to be exercised to keep a (re)insurer operating as a going concern and avoid insolvency.

- The proposed resolution powers under the IRR would be exercised by the Bank of England and include a range of powerful tools including bail-in – the power to reduce or convert all or part of unsecured creditors' claims.

- The industry should carefully consider the proposals and assess whether they are compatible with the (re)insurance market.

In recent years there have been few UK insurer failures. This means the current (re)insurer insolvency regime, which is spread over various pieces of legislation, remains largely untested and subject to considerable uncertainty. Developing an understanding of how the IRR aligns with, and complements, this particularly complex area of law and regulation will be particularly important.

(Re)insurers will need to understand how the new regime affects them, ensure they continue to feed into any pre-resolution planning and are able to assist the resolution authority with the development of resolution plans. It is likely, similar to the bank space, that (re)insurers will be required to obtain contractual recognition of bail-in powers and express powers to stay certain contractual rights where contracts are governed by non-UK law, and so are beyond the reach of UK legislation.

SCOPE OF IRR

The scope of the IRR will be broad, covering all UK-authorised (re)insurers that have a Part 4A FSMA permission to effect and/or carry out contracts of insurance (including branches of overseas insurers). Only smaller non-Solvency II insurers, friendly societies and the Lloyd's market will be excluded. The IRR would also capture mixed financial holding companies, insurance holding companies, mixed activity insurance holding companies and the group entities of a (re)insurer.

Despite this wide scope, in practice it is expected only a small number of larger (re)insurers or those with unique products would be directly affected by the new regime. This is because certain resolution conditions (most importantly, a public interest test) need to be met before the regulators are able to use their new powers. A commitment to proportionality has been embedded in the regime.

The table below illustrates the main features of the IRR.

Proposed features of the IRR	
Resolution Authority	Bank of England (as with bank and FMI resolution rules)
Resolution Objectives which guide the actions of the authorities and regulators	• Protecting and enhancing financial stability by preserving access to critical functions and preventing contagion • Protecting and enhancing public confidence in the stability of the financial system of the UK • Minimising the use of public funds • Protecting policyholders • Minimising limitation of property rights
Resolution Conditions which must be met before the Resolution Tools can be used	• Failing or likely to fail (FOLTF): the PRA to make the assessment • No private alternative solution available: the BoE to make the assessment • Public interest assessment: the BoE to make the assessment • Assessment that resolution objectives would not be met to the same extent if resolution action was not taken: the BoE to make the assessment
Valuation	The valuation of the failing (re)insurer is a key step to enable the BoE to assess which are the appropriate Resolution Tools.
Resolution Tools	• Transfer all or part of the business to a willing private sector purchaser • Bridge institution – a temporary home for the failing business to ensure critical operations can continue whilst a permanent outcome is found • Bail-in – the writing down of unsecured creditors' claims and a corresponding award of ownership in the failing (re)insurer as a form of compensation • Temporary public ownership – a tool of last resort which was used for failing banks in the financial crisis • Balance sheet management vehicle – this allows the setup of an asset management vehicle to manage the assets and liabilities that have not been transferred to the resolved entity • Insurer administration procedure – providing the BoE with the flexibility to exercise the proposed private sector purchaser and bridge insurer tools, while ensuring that the (re)insurer's critical functions are preserved
Additional Powers	• A moratorium to prevent Resolution Tools triggering contractual termination rights and policyholder surrender rights • Additional powers to take control of (re)insurers and initiate administration and insolvency type procedures
Safeguards	No Creditor Worse Off (NCWO). The IRR provides for a mechanism to compensate any creditors that end up worse off as a result of the use of the IRR tools than if the normal insolvency process had been followed.
Resolution Planning and Resolvability Assessments	• Required only for (re)insurers that might meet the Resolution Conditions. • The BoE will need to complete regular Resolvability Assessments of the identified (re)insurers to evaluate the feasibility and effectiveness of the various resolution strategies. • Resolution Plans will set out the proposed resolution strategy for a (re)insurer and an operational plan for its implementation. These will be updated regularly. • (Re)insurers will need to support the BoE in completing assessments and plans and may be directed to take actions as a result of them to remove barriers to resolvability.

IRR shares many similarities with the EU proposal for an Insurance Recovery and Resolution Directive (IRRD) but the UK's IRR has been developed separately. It has also been made with particular reliance on, and repeated reference in the Consultation Paper to, the Financial Stability Board's Key attributes of effective resolution regimes for financial institutions and the UK will no longer automatically form part of pan European co-operation.

The IRR also closely follows the UK bank resolution regime, with some differences to cater for the specificities of the insurance sector. In particular, the IRR:

- Does not set any minimum requirement for own funds and eligible liabilities as in bank resolution, which would impose additional capital buffers on top of the existing prudential requirements and would inflate the balance sheet of (re)insurers and entail high costs for the insurance industry.

- Includes resolution tools for crisis management purposes similar to the ones available for failing banks (bail-in and transfer tools) and also has a tool of last resort placing the failing (re)insurer into temporary public ownership.

- Treats policyholders in a similar manner as depositors under bank resolution rules with the Financial Services Compensation Scheme covering eligible policy amounts (by providing top-up payments) up to the same limits that would apply in an insolvency scenario.

- Provides for the No Creditor Worse Off (NCWO) safeguard, as in bank resolution, which aims to leave creditors no worse-off in resolution than they would have been under the insolvency alternative. However, as with bank resolution, the effectiveness of the NCWO safeguard depends on the ability to quickly map the liabilities of a (re)insurer by creditor class in accordance with the applicable hierarchy (which is far from clear for life insurers in particular, given the range of policy types typically issued by such firms). This mapping exercise will be more difficult for cross-border entities where multiple creditor hierarchies would need to be considered.

- Does not impose resolution planning and resolvability assessment obligations for all (re)insurers but only for those that would most likely qualify for resolution action. This approach reflects the existing UK regulatory framework which already requires (re)insurers to develop recovery and resolution plans as well as to conduct resolvability assessments. Therefore, the Treasury considers imposing additional pre-resolution planning requirements for entities only where proportionate.

NEXT STEPS

A careful analysis of the proposed regime is needed to fully understand how it is intended to work and its implications for (re)insurers and those connected to the sector.

(Re)insurers should start their thinking early and collaborate within the industry to ensure that the Treasury delivers on its promise for world leading regulation of (re)insurers which is fit for purpose and tailored to the unique features of the UK sector.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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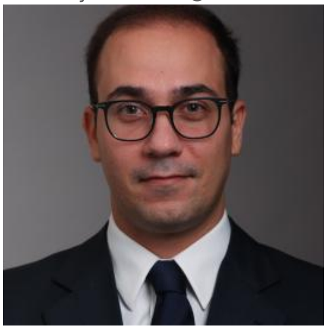

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