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UK Introduces Write-Down Procedure for Insurers' Policyholder Liabilities

FSMA 2023 includes a court procedure for failing insurers to temporarily write-down liabilities, with implications for counterparties.

The recently passed Financial Services and Markets Act 2023 (FSMA 2023) provides for a new write-down procedure under which failing insurers can apply to court to have their insurance liabilities written down. Write-downs are intended to be temporary (though no period is specified), followed by a subsequent write-up, which is a transfer of the business or application of insolvency procedures. While reinsurers and certain other creditors are prevented from terminating contracts during a moratorium period of at least six months, derivative counterparties remain able to terminate (and apply close-out netting) regardless. The protection afforded to financial collateral arrangements and certain other security arrangements underscores the importance of appropriate security to support inwards and outwards reinsurance for UK firms.

Procedure

Insolvent insurers have for a long time been granted a power to apply to court for a reduction of their insurance liabilities, as an alternative to winding-up. The most recent incarnation was Section 377 of the Financial Services and Markets Act 2000 (FSMA 2000). However, this power has not been applied in modern times and was last judicially considered in the 1970s. FSMA 2023 dramatically overhauls the current Section 377, replacing it with a new set of provisions and associated schedules, supplemented by new Prudential Regulation Authority (PRA) rules and policy.[1]

The new write-down power contained in Section 377A of FSMA 2023 comes into force on 19 September 2023, when the associated PRA rules commence. It will be available to any UK-authorised insurer (except Lloyd's of London and friendly societies). Whilst the write-down could be ordered in relation to a foreign insurer with a UK-authorised branch, this is unlikely in practice as the main target is UK-headed insurers and generally those at the smaller and less complex end of the spectrum. Branches make unlikely targets since a write-down is intended to apply to *all* in-scope liabilities, and the efficacy of this scope in relation to foreign insurance liabilities may be uncertain. Given that the procedure applies in proximity to insolvency, there is a risk it may not be effective in avoiding insolvency in the home jurisdiction, resulting in conflicting procedures. Also, firms with material derivatives exposures (which tend to be larger, more complex firms) will generally not be suitable candidates, as close-out netting can be applied in response to a firm entering write-down.

A write-down under section 377A would operate as follows:

- The insurer (or any of its shareholders or creditors, including a policyholder) may apply to court for a write-down order. So too may the PRA or HM Treasury (HMT).
- The PRA needs to consent (unless it, or HMT, is the applicant). Therefore, applicants need to engage with the PRA at an early stage, including in relation to the choice of a nominee write-down manager and the development of a write-down plan.[2]
- The court will make a write-down order if:
  - the insurer is, or is likely to become, unable to pay its debts (aligning with the test for entering administration); and
  - making the order is reasonably likely to lead to a better outcome for the insurer's policyholders and other creditors (taken as a whole) than not making the order. Though deliberately short of a "no creditor worse off" test, the PRA expects this to require the write-down to "broadly respect the creditor hierarchy".[3]
- The court order would sanction the write-down plan, which would likely take the form of a percentage discount to in-scope liabilities falling due from the effective date of the order.
- Generally, the court would also appoint the write-down manager at the same hearing (though another provision allows to do this separately). The PRA also needs to approve this appointment. The write-down manager will be an officer of the court, appointed to monitor implementation of the write-down plan (including whether it remains in creditor interests), and would be able to seek further court orders, including to terminate the write-down. The write-down manager will have leverage over the firm without actually controlling it, and may be thought of as an "administrator lite". The firm's management would remain in place.

In-scope Liabilities

Although the main target for write-down would be policyholder liabilities, the scope is defined as any liability not specifically excluded. The exclusions ensure the continued operation of the firm — covering ongoing trade suppliers, employee costs, and the costs of the write-down manager. Liabilities under "financial contracts" are also excluded, since these are needed to ensure operational continuity. The definition of a "financial contract" is broad, including just one notable exception for capital market investments (such as bonds). Bonds are in scope of write-down, but since insurers tend not to issue bonds at solo level, they will likely be an empty set. Accordingly, financial counterparties will generally not be written down.

The position is different for inwards and outwards reinsurance. Unsecured cedants and outwards reinsurers to whom unsecured sums are owed will be able to be written down, and may face complete write-off, given they rank after direct policyholders in the creditor hierarchy. Though not stated explicitly, set-off would likely continue to apply (as a function of the "better outcome" test), meaning that funds withheld by a cedant under write-down would be eroded through set-off as claims crystalise, on a 1:1 basis. The reversal of credit risk inherent in a funds withheld arrangement should therefore not result in the funds withheld being treated as a standalone liability of a firm under write-down — such funds should be able to be eroded through set-off, just as they would be in winding-up. Those cedants holding a subordinated floating charge[4] would be written down *pari passu* with direct policyholders, but would not be topped-up by the Financial Services Compensation Scheme (FSCS) (which does not cover losses incurred by reinsurance creditors). Ordinary floating charge holders would generally rank ahead of direct policyholders and thus avoid write-down by virtue of their place in the creditor waterfall (although technically they are in scope). Holders of fixed charges and financial collateral arrangements would be entirely excluded from write-down.

Effect

The effect of a write-down will be to legally extinguish the written-down part of the liabilities, unless and until a subsequent write-up occurs. For Solvency II and insolvency law purposes, the contingent value of any future write-up will be disregarded.

Despite written-down liabilities being extinguished from the insurer's perspective, they continue from an FSCS perspective and are topped-up (subject to usual eligibility and haircuts). Top-ups are to be administered by the firm, using an off-balance sheet trust account funded by the FSCS.

A write-down would create new net assets (by extinguishing liabilities), and would therefore create shareholder value. To prevent shareholders extracting this value, prohibitions apply on the payment of bonuses, dividends, and on other asset dealings outside business as usual. A Part VII transfer of the business would also terminate the write-down, so the value of the write-down cannot be realised through the sale of the business. However, the ability to seek a reduction of insurance liabilities as part an insurance business transfer scheme, subject to the approval of the court, remains in Part VII.

Impact on Counterparties

Outwards reinsurers facing a cedant under write-down will not be able to point to the write-down of the reinsured liabilities to reduce their own liability under the reinsurance contract. This follows the position in insolvency, where reinsurers are generally not able to rely on cedant insolvency to avoid or reduce liability. As noted above, the direct impact of write-down on inwards and outwards reinsurance largely depends on the presence and form of any collateral or other security arrangements.

Additionally, there is an *ipso facto* moratorium, which prevents reinsurers and various financial counterparties terminating their contracts by reason only of the write-down process.[5] A moratorium against creditor action also applies. These limitations are in place for six months (extendible) following the write-down order, though termination for non-payment remains available and financial collateral arrangements are unaffected. For the same period, with-profits and unit-linked policyholders are prevented from surrendering or switching policies (subject to carve-outs and a hardship exemption process).

The list of "financial contracts" falling into scope of the *ipso facto* moratorium is based on Schedule ZA2 to the Insolvency Act 1986, but deliberately does not include derivatives or any master agreement for any of the other contracts mentioned. Additionally, the moratorium expressly does not affect "protected arrangements" (security interests, title transfer, set-off, and netting). The effect is to ensure that close-out netting can be triggered and operate normally, including through a write-down process. HMT has explicitly sought to preserve clean netting opinions in relation to UK insurers through this drafting.

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Endnotes

1 PS12/23: https://www.bankofengland.co.uk/prudential-regulation/publication/2023/september/dealing-with-insurers-in-financial-difficulties.

2 The PRA has issued a Statement of Policy setting out its approach to giving consent to a write-down and to the appointment of a write-down manager: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2023/dealing-with-insurers-in-financial-difficulties-sop.pdf (PRA SoP).

3 Paragraph 12 of the PRA SoP.

4 These are floating charges issued by the firm which, on its terms, ranks the cedant *pari passu* with direct policyholders. This is designed to overcome the perceived unfairness of direct policyholders having statutory priority over cedants, including in relation to cedant assets paid across to back the technical provisions.

5 Part 3, Schedule 19C to FSMA. Note that reinsurers generally cannot terminate for cedant credit events (other than non-payment) anyway, as this would undermine effective transfer of risk for Solvency II purposes: Article 210 (for standard formula firms) and Article 235 (for internal model firms) of onshored Commission Delegated Regulation (EU) 2015/35.