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Client Alert
Commentary

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# UK Proposes Insurer Resolution Regime

***The proposals would give the Bank of England wide-ranging powers to deal with acute failure scenarios, treating policyholder liabilities as loss-absorbing.***

HM Treasury (HMT) is proposing[1] a new UK resolution regime for insurers that would appoint the Bank of England (BoE) as resolution authority (RA) with sweeping powers to resolve insurers through transfer or bail-in, and to make resolution plans and assess resolvability in advance.

The regime would share many similarities with the Banking Act 2009 (BA09). Crucially, however, there will be no minimum requirement for own funds and eligible liabilities (MREL), a BA09 concept, which sets a minimum loss-absorbing capacity for banking firms, including liabilities that can absorb losses through write-down or conversion to equity. MREL gives rise to “bail-in bonds” for banks, which will not be required under the insurer resolution regime. The absence of MREL significantly impacts business-as-usual operations and the execution of an insurer resolution, and marks a major point of departure from the bank regime.

All UK Solvency II insurers would be in scope of the new powers (other than friendly societies and Lloyd’s of London). However, in practice only the largest firms (and some niche players) would be candidates for resolution and thus subject to resolution planning, resolvability assessments and, potentially, contractual recognition requirements. Other firms will be affected indirectly, through exposure as cedants and by virtue of the mutualisation of losses borne by the Financial Services Compensation Scheme (FSCS) following a policyholder bail-in. UK branches of foreign firms would also be in scope, but mainly to facilitate UK implementation of the home authority’s resolution action.

This Client Alert discusses the key aspects of the proposed regime, how it would impact insurers and counterparties, and next steps as the proposal is expected to proceed through the legislative and implementation processes.

## Entry Into Resolution

Following the BA09 precedent, the insurer resolution regime would set a high bar to action by requiring that four resolution conditions (the RCs) are met before stabilisation tools are used:

- (RC1) The firm is failing or likely to fail (FOLTF).
- (RC2) Nothing else can be done.

- (RC3) Intervention is necessary in the public interest.
- (RC4) The "resolution objectives" would not otherwise be met to the same extent.

The resolution objectives are to: protect and enhance UK financial stability and public confidence, protect public funds, protect policyholders, and avoid interfering with A1P1[2] property rights. A pre-resolution valuation, undertaken in accordance with valuation standards to be determined by HMT, would inform decisions on whether the RCs are met, and if so, which tools to deploy.

The Prudential Regulation Authority (PRA) would assess RC1 while the RA would assess and the remaining RCs. Considerable judgment is involved in this exercise and contextual factors can have a decisive impact, as seen during the Silicon Valley Bank resolution weekend. In that case, the BoE initially released a statement implying that RC3 may not have been met, but subsequently determined that all conditions had been met once a credible buyer had been found.

Predictability is further challenged in the insurance context by the difficulties likely to be involved in assessing a large and complex insurer to be FOLTF. There are several limbs under which FOLTF might be established, but the most relevant is the one in which a firm is failing or likely to fail to meet the Threshold Conditions (TCs) — which includes "appropriate financial resources" — in circumstances that would justify removal of permission to effect contracts of insurance. HMT has intentionally avoided setting the test by reference to the Solvency II ladder of intervention or a specific Solvency Capital Requirement (SCR) coverage ratio. This is meant to allow flexibility to deal with different failure scenarios, and to avoid resolution tools being unavailable in a crisis because usual recovery periods have not been allowed to run.

A serious SCR breach, or one with a clear downward trajectory, would be needed to satisfy RC1. The Solvency II capital rules contain a trigger point for the write-down or conversion to equity of restricted Tier 1 instruments (rT1) based around: <75% SCR coverage, breach of the Minimum Capital Requirement (MCR), or three-month SCR breach.[3] This threshold would mark the earliest point at which a permanent loss is imposed on external debt investors through the conversion of the instrument and may therefore be an appropriate checkpoint for a FOLTF assessment. Firms tend to operate to capital management buffers materially in excess of SCR (typically in the range of 130% to 150% of SCR). Therefore, extensive management/recovery actions would already have been triggered by the point a FOLTF test is applied, and RC2 would prevent stabilisation tools from being deployed if other options (including solvent run-off) remain possible.

## Stabilisation Tools

### Transfer Options

Once resolution is triggered, the RA would have extensive powers to order the transfer of the failed insurer's business (or shares in the firm itself, or its holding company) to a private sector purchaser, a bridge vehicle (a Bridge), or a balance-sheet management vehicle (BSMV) (or some combination). A Bridge is time-limited (to five years, extendible in two-and-a-half-year increments) on the basis it is being used to warehouse a business pending onward sale to a private sector purchaser. A BSMV is similar to a Bridge, but is not time-limited — accordingly, it would more likely be used to hold a business which is being run-off or may eventually be sold in slower time. These two vehicles allow a good book (Bridge) / bad book (BSMV) split to be effected. Transfer into temporary public ownership would also be an option, as a last resort. In many ways, transfer to a private sector purchaser is the ideal solution, and recent experience in the banking sector suggests it is generally the preferred route. As with all stabilisation tools, the RA would be able to directly order a transfer of insurance business. This direct power would be an important exception to the mandatory court process under Part VII of the Financial Services and Markets Act 2000 (FSMA) and a significant change to the current tools available upon failure of an insurance firm.

## Bail-in Option

The RA would also have bail-in at its disposal. As HMT has ruled out insurer MREL, bail-in would operate as a write-down of in-scope liabilities in accordance with the creditor hierarchy, followed by the issuance of new shares in respect of the net asset value created by the write-down, thus diluting the original shareholders and allocating losses to them. If policyholders are written down, the new shares would be issued into a “mechanism” (as yet unspecified), allowing for cash flows from the holding or disposal of those shares to fund cash compensation to written-down creditors over time.

The write-down regime would impact creditors in a waterfall effect:

- The first major class of liabilities in scope of write-down would be the holders of subordinated debt, which most major insurance groups tend to have, typically rT1 or Tier 2 (T2), to the extent write-down or conversion has not already been contractually triggered. Whilst a write-down of rT1 and T2 would increase net assets, it would not necessarily improve own funds overall as the effect would be to replace the rT1 or T2 with Tier 1 equity.

- Senior unsecured creditors would be the next class in the creditor hierarchy. However this class would not likely represent a significant slice and would be reduced further by the exclusion of most operating expenses from the scope of bail-in. This category would include unsecured reinsurance cedants with respect to contracts of reinsurance, although the prevalence of security to support reinsurance is likely to limit the impact of write-down on this class of creditors.[4]

- The next major class of creditors to be written down would be direct policyholders. All direct policyholders rank equally (ahead of other unsecured creditors,[5] and regardless of whether they are FSCS-protected) and so would be written down *pari passu*. Those that are eligible for FSCS protection would be topped-up by the firm to 90% or 100% (administering an off-balance sheet account funded by the FSCS), and the FSCS would step into their shoes as creditor. Given the mix of business in the largest UK firms, the FSCS would likely become the largest bailed-in creditor with an interest in the compensation mechanism referred to above.

The write-down regime would respect the creditor hierarchy and “no creditor worse off” compensation would be payable (following a further independent valuation exercise) if any creditor is actually worse off — after taking account of FSCS protection and cash compensation — compared with the insolvency counterfactual.

Extensive ancillary powers would also be available, including powers to replace directors and senior managers, restrict bonuses and dividends, appoint a resolution administrator, impose a two-day suspension on payments and creditor rights, stay policyholder surrender and switching rights, and restructure liabilities. These powers may be useful in, for example, converting with-profits business to unit-linked, to facilitate a transfer of business, or to terminate options or guarantees. *Ipso facto* termination rights based on the exercise of stabilisation powers would also be permanently switched off, meaning that counterparties of insurers (including under reinsurance, derivative, and other financial contracts) would not be able to terminate by reason only of resolution, which may drive increased creditor demand for earlier termination rights in such contracts. Other termination triggers (e.g., for non-payment) would remain available and netting sets would be kept together.

## Timing and Next Steps

HMT will need a primary legislative vehicle to deliver the proposed regime. The timing is not yet clear, with HMT promising a regime "when parliamentary time allows" — potentially after the next general election. A host of subordinate material will also be required, including secondary legislation, an HMT code of practice, PRA rules (including in relation to the contractual recognition of stays and bail-in, and FSCS top-ups), and policy materials issued by the RA. The regime is therefore unlikely to become operational for some time as all these materials will take time to develop and consult on.

In the meantime, as signalled in the PRA's "Dear CEO" letter of 10 January 2023, insurers of all sizes can expect to see the PRA increasingly focussed on exit planning. The PRA has also committed to a consultation later this year on requirements for insurers to prepare exit plans, which for many firms will mean preparing for solvent run-off (after the exhaustion of other management actions). This development may lead to some corporate restructuring and greater focus on the documentation of intra-group funding, reinsurance, and service arrangements. Larger firms, particularly in the "Internationally Active Insurance Group" population, will continue to be subject to detailed planning and resolvability requirements.

Counterparties of insurers (including offshore reinsurers) may also wish to follow developments, particularly as they will affect contractual termination rights, the effectiveness of security, and bail-in.

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**Endnotes**

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[1] HMT, “Introducing an Insurer Resolution Regime: Consultation” (January 2023): https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1131030/_Final__IRR_Consultation_-_Templated__Clean___1_.pdf (the HMT CP). See also HMT, “Introducing an Insurer Resolution Regime: Government Response to Consultation” (August 2023): https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1175491/Government_s_response_to_the_consultation_on_introducing_an_Insurer_Resolution_Regime.pdf (the CP Response).

[2] Article 1 of the first Protocol to the European Convention on Human Rights, applicable in the UK under the *Human Rights Act* 1998.

[3] Article 71(8) of onshored Commission Delegated Regulation (EU) 2015/35.

[4] Unsecured cedants rank after direct policyholders and so would be written down first. Those cedants holding a subordinated floating charge (designed to rank equally with direct policyholders) would be written down *pari passu* with direct policyholders. Other secured cedants would be excluded from write-down altogether. This underscores the growing importance of security arrangements for reinsurance.

[5] Regulation 21 of *The Insurers (Reorganisation and Winding Up) Regulations 2004* (SI 2004 / 353).