By email: insurer.insolvency.consultation@hmtreasury.gov.uk

13 August 2021

The City Of London Law Society: Response to HM Treasury's consultation "Amendments to the Insolvency Arrangements for Insurers"

1. INTRODUCTION

1.1 This document is a response to HM Treasury's consultation paper, "Amendments to the Insolvency Arrangements for Insurers", which was published on 20 May 2021 (the "**Consultation**"). Paragraph references in this response are to paragraph numbers used in the Consultation.

1.2 The City of London Law Society (the "**CLLS**") represents approximately 17,000 City lawyers, through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. The CLLS Insolvency Law Committee, made up of solicitors who are expert in the field, has prepared the comments below in response to the Consultation. A link to a list of the individuals and firms represented on this Committee is set out at the end of this response.

1.3 We set out below our response to the questions listed in Chapter 3 of the Consultation. We have kept our comments at a high level but would be happy to discuss or expand on any of the comments made in this response, if requested. We have included the contact details of our chairperson, Jennifer Marshall (Allen & Overy LLP), at the end of this response.

2. CONSULTATION QUESTIONS

Introductory remarks

2.1 Before we turn to the questions listed in Chapter 3 of the Consultation, we make below some preliminary observations given that it is not entirely clear to us what is driving these proposals or why it is felt necessary to introduce these changes. In particular:

(a) We are not aware of any recent examples where an insurer or reinsurer has ended up in a terminal insolvency process due to the lack of adequate tools for dealing with the financial difficulties faced by that insurance company. We are also unaware of any of the industry trade bodies (such as the ABI or IRLA) calling for the introduction of new tools. The Consultation does not specify whether the regulators (including the PRA) have views on the proposals, given their potential impact on policyholders.

(b) Furthermore, many of the existing tools used to restructure distressed companies (including the restructuring plan that was recently introduced by the Corporate Insolvency and Governance Act 2020) could be used effectively to restructure the liabilities of an insurance company; the advantage of using the existing tools is that they are tried and tested and so should lead to greater certainty of outcome.

(c) Finally, we note the comments made in paragraphs 1.13 to 1.15 of the Consultation regarding the proposals that a specific resolution regime might be introduced for insurance companies. It is not apparent to us why a specific resolution regime is required for an insurance company which, unlike a bank, is unlikely to be subject to a "run" or events which could (absent fraud, as was the case with Independent Insurance in 2001) cause a precipitous collapse. However, given that this resolution regime is likely to be consistent with international standards (including the FSB's Key Attributes Assessment Methodology for the Insurance Sector) and, we would assume, would include similar safe-harbours and protections as are included in the bank resolution regime under the Banking Act 2009, we consider that this would be a preferable way of dealing with distressed insurance companies, particularly given that these safe-harbours and protections have been tested in the market rather than those otherwise proposed in the Consultation.

2.2 Given the inherent uncertainty involved in introducing new measures, and the potential impact that these would have on legal opinions and on those involved in structuring transactions involving insurance companies, we consider that the case for introducing these proposed new measures would need to be very high. For the reasons given below, it is not clear to us that such a case has been made.

General Questions

I) In what circumstances do you envisage these proposals would be used?

2.3 It is not clear to us that insurers would use these proposals. The lack of precedent for the existing write-down powers under section 377 of the Financial Services and Markets Act 2000 ("**FSMA**") and its predecessor provisions, the impact of the proposed moratorium on financial contracts, and the general uncertainty of the scope of the Consultation may result in the proposals going unused. We suspect that insurance restructuring practitioners may prefer to use existing tools such as the scheme of arrangement and the new restructuring plan given that these would deliver greater certainty of outcome. Even if the new write-down power is not used, the fact that it exists would need to be dealt with in legal opinions and this could destabilise the UK insurance market from day one. We expand on our concerns in our responses to the questions below.

2.4 We note that HM Treasury and the Bank of England are actively engaged in the development of a specific resolution regime for insurance companies that will be "aligned with internationally agreed standards and best practice" (paragraph 1.15). We would urge HM Treasury to postpone the proposals in this Consultation and revisit them as part of the draft special resolution regime. While it is not apparent to us why such a special resolution regime is required for insurance companies, pending the possible introduction of that regime, distressed insurers should look to existing and established tools under insolvency law (in particular, administration) and company law (for example, schemes of arrangement and restructuring plans) to manage through their distress.

II) Do you envisage any impediments to the use of the proposed measures in practice?

2.5 We envisage a number of impediments to the use of the proposed measures in practice. In particular:

(a) **The proposed measures in Proposals One and Three are untested and uncertain.** The stated objective of the proposals is to enhance and provide clarity on existing powers for managing insurer distress (paragraph 1.11). However, the proposed extension of section 377 FSMA (Proposal One) and the introduction of a new moratorium on certain contractual termination rights (Proposal Three) could have the opposite effect. The use of the existing section 377 FSMA write-down power is without precedent, while the new proposals are untested and uncertain. Consequently, distressed insurers will be likely to instead look to existing "tried and tested" restructuring tools (such as the scheme of arrangement, the restructuring plan, or an administration) to provide certainty through periods of distress.

(b) **Impediments to the appointment of a "write-down manager"**: we are concerned that there are a number of impediments to candidates accepting an appointment as a write-down manager. In particular:

(i) The remit of the write-down manager is not entirely clear from the Consultation. For example, we are unsure what a write-down manager's status will be in relation to a distressed insurer and its creditors, how the write-down manager might fulfil his or her role, and how he or she might interact with the insurer and its creditors while the directors retain responsibility for the on-going management of the insurer. Restructuring and insolvency professionals have raised similar concerns in relation to the existing role of the independent "monitor" in a moratorium under Part A1 of the Insolvency Act 1986 (introduced in June 2020 by the Corporate Insolvency and Governance Act 2020). By analogy, we would anticipate that many of these concerns will apply equally to the role of the write-down manager.

(ii) The Consultation makes clear that the write-down manager's actions and appointment could be open to challenge (paragraphs B.100 to B.103). However, there is a lack of clarity on the scope of the duties of a write-down manager, and the extent of a write-down manager's personal liability in the event there is a successful challenge to their actions. If any such personal liability exists, we would anticipate that a candidate for an appointment would require D&O insurance and/or indemnification prior to taking any appointment. The question of who provides that insurance and/or indemnification, and the negotiation of the scope of that insurance and/or indemnity, might act as a roadblock to any appointment. Indeed, our experience is that it is currently very difficult for turnaround specialists or "chief restructuring officers" to obtain suitable D&O insurance so we suspect this may be even more difficult for the write-down manager where scope, remit and potential exposure are uncertain.

(iii) The Consultation confirms that the costs of the write-down manager would be recovered from the insurer (paragraph B.93). However, the Consultation does not make clear how these costs might rank on any subsequent insolvency of the insurer (should the write-down fail to preserve the solvency of the insurer). For example, if the costs of the write-down manager rank as a general unsecured claim of the insolvent estate, then we could foresee candidate write-down managers seeking pre-funding arrangements or advance payment of their costs in anticipation of an appointment, which would be another hurdle to any appointment and write-down procedure.

(iv) The Consultation confirms that the write-down manager need not be a licensed insolvency practitioner, and would not be acting as an insolvency practitioner during their appointment as a write-down manager (paragraphs 2.12 and B.90). We can see why suitably qualified persons, other than insolvency practitioners, might be appropriate for an appointment where a wind-down takes place before the formal insolvency of an insurer. However:

(A) it may be appropriate in many circumstances for the write-down manager to be a licensed insolvency practitioner. For example, there are several concepts in the Consultation (such as the tests as to whether or not an insurer is eligible for the write-down procedure) that may be more familiar to experienced insolvency and restructuring professionals; and

(B) it is unclear from the Consultation how the write-down manager and any subsequent administrator or liquidator are intended to interact, in the event the insurer falls into insolvency following a write-down. For example, would the write-down manager be eligible to take the administrator or liquidator appointment (provided the write-down manager were a licensed insolvency practitioner)? If not, this may deter any candidate from wanting to take on the appointment as write-down manager.

(v) We wonder whether HM Treasury has discussed the Consultation with any persons that would be eligible to take a write-down manager appointment, should the proposals come into law. It would be helpful to understand the perspectives of such individuals on whether or not they might take a write-down manager appointment, in light of the perceived impediments to any appointment set out above.

(c) **The potential "write-up":** the Consultation states that an insurer's liabilities "can be written up if the insurer's financial position is later found to be better than assumed in the initial write-down" (paragraph B.39). We can see this causing a number of issues in practice. For example, how will accountants record written-down liabilities on an insurer's balance sheet for IFRS purposes (if there is the potential for that liability to be written-up at an unspecified future point in time)? What will the tax treatment be for the written-down liability? And, how will directors of an insurer assess the ongoing solvency of an insurer (either on a balance sheet or cashflow basis) if there are liabilities that might be written-up in the future?

(d) As the directors remain responsible for the management of the insurer through and following the write-down procedure, how is it intended that directors assess whether they are complying with their duties (to act in the best interests of the company or of its creditors) if they do not have a clear view as to the extent of the insurer's liabilities? We consider that this last point is sufficiently important that it should be dealt with expressly in any legislation.

(e) **The regulator's view on the use of the write-down power**: any write-down may have a significant impact upon the claims of consumers against an insurance company. Has HM Treasury consulted with the PRA and the FCA to seek their views on the proposals and to ascertain the circumstances in which the PRA might grant its consent to a write-down application? We have recently seen financial regulators actively involved in restructurings that impact consumers (for example, the FCA's opposition to the recent schemes of arrangement proposed by Amigo Loans and Provident). We would anticipate that insurers and potential write-down managers will need clear guidance from the PRA as to how it will react to requests for its consent before making a write-down application.

III) Do you agree that these proposals would usefully add to the flexibility with which the distress of an insurer could be managed?

2.6 We do not agree. We are concerned that the difficulties and impediments described in our previous responses will outweigh any flexibility introduced by the proposals.

IV) Do you have any other comments on these proposals or the current insolvency arrangements for insurers?

2.7 No.

Proposal One

V) *How will the proposed amendments to section 377 FSMA enhance the UK authorities' ability to manage the distress of an insurer, resulting in a better outcome for policyholders and creditors?*

2.8 We are concerned that the proposed amendments to section 377 FSMA will not enhance the UK authorities' ability to manage the distress of an insurer. Please see our responses to questions I to III above.

VI) *To what extent do you believe that the proposed amendments to section 377 FSMA will improve the usability of the write-down procedure?*

2.9 Please see our response to questions I to III above.

VII) *Do you believe the tests which the court would need to be satisfied are met in order to sanction a write-down under section 377 FSMA (as amended by this proposal) are sufficient to safeguard against undue impact of a write-down on an insurer's creditors (including its policyholders)?*

2.10 We are concerned that the tests and safeguards are underdeveloped. For example:

(a) To sanction a write-down, "the court would need to be satisfied that the write-down would be reasonably likely to lead to a better outcome for the insurer's creditors as a whole, including its policyholders" (paragraph B.9). This test appears to be similar to the "comparator" test that a court will consider when asked to sanction a scheme of arrangement (or the more recent "no worse off" test for restructuring plans when compared with the "relevant alternative"). However, it is not clear from the Consultation how a court might assess what is "reasonably likely to lead to a better outcome …", and whether or not this test is deliberately different from similar tests that exist in other UK restructuring tools. The courts are well practised in assessing the "comparator" for the purposes of a scheme of arrangement, and precedent for the "relevant alternative" test in a restructuring plan has developed in recent months. Given the uncertainty of the new test in respect of a write-down regime, insurers (and restructuring practitioners) may prefer to utilise other existing and more certain insolvency and restructuring regimes. Furthermore, the concept of a better outcome for the creditors "as a whole" is a difficult one (as different creditor groups may have different views or may achieve different outcomes). For example, would a write-down proposal meet this test if it were better for the policyholders than a liquidation might be but not so good for reinsurance creditors?

(b) The safeguards listed from paragraph B.32 of the Consultation appear to be underdeveloped. For example, it is not clear what financial liabilities will fall within the scope of a write-down. Paragraph B.32 refers to the write-down applying to "(almost) all unsecured creditors of the insurer (e.g. unsecured bondholders)", while paragraph B.33 describes an exemption for "liabilities arising from financial contracts". By contrast, existing insolvency and restructuring procedures provide extensive and specific safeguards for financial contracts. The safeguards under the Banking Act 2009 and the moratorium procedure under Part A1 of the Insolvency Act 1986 are examples of this. Consequently, we are concerned that Proposal One could have significant unintended consequences for UK insurers and their financial counterparties.

(c) One example of an area that needs to be further developed is the reference in paragraph B.32 to secured creditors being out of scope of a write-down. It is not clear whether this reference includes both fixed security and floating security (and, if it is intended only to include the former, would this include a floating charge that had crystallised by the time of the write-down). Furthermore, would any unsecured deficiency claim (if the value of the secured assets was insufficient to cover the secured claim) be capable of being written down and, if so, how would the secured assets be valued for these purposes?

(d) We note the reference in B.11 to the court needing to take account of the order of priority that would apply in a winding up when considering the interests of the different groups of creditors. It was not clear to us whether this would be a requirement that would be built into the legislation or whether it would simply be part of the test that the court would apply when satisfying itself that the write-down would be reasonably likely to lead to a better outcome for the insurer's creditors as a whole. Similar discussions were had in relation to the new restructuring plan (i.e. whether it was necessary to build in an absolute or relative priority rule or whether this could be left to the general discretion of the court when approving the plan).

(e) Finally, we consider that further thought should be given to the level of disclosure required to be given to creditors (including policyholders) in respect of the proposed write-down. An "explanatory statement" is required to be sent to creditors in relation to schemes of arrangement and restructuring plans containing sufficient information to allow creditors to form an informed decision regarding such proposals. These documents can run to hundreds of pages in a complex case. We are conscious that, in the case of a proposed write-down, some of the creditors may not be as sophisticated as the financial creditors who tend to be involved in schemes and plans, and we wonder if the level and nature of disclosure should be tailored accordingly.

VIII) Do you support the nominee write-down manager being able to provide independent views to the court (including on the impact of the write-down on an insurer's creditors (including its policyholders) at a write-down court hearing?

2.11 The concept of an independent write-down manager seems sensible. However, our response to question II sets out a number of impediments that we foresee to the appointment of a write-down manager.

IX) Would the proposed amendments to section 377 FSMA be likely to impact an insurer's costs (including in relation to debt issuance)?

2.12 Please see our response to question XVII below.

X) To what extent would be proposed moratorium on legal process during a write-down under section 377 FSMA assist in the write-down process?

2.13 Given the uncertainties surrounding the proposed amended write-down procedure, an insurer may instead look to appoint an administrator and benefit from a moratorium in that way.

XI) Do you have any other comments on Proposal One?

2.14 The Consultation states that as a "statutory variation", the write-down would not apply to those contracts governed by the laws of other jurisdictions, and that the government considers that "re-papering these existing contracts may be sensible". As a practical matter, is it realistic to expect insurers to review their entire portfolio and then repaper relevant contracts, and how frequently would insurers need to conduct this repapering exercise? We would anticipate that changing the governing law of contracts will, in many cases, require the consent of the insurance company's contractual counterparties. What commercial incentive would those counterparties have to change the governing law of their contracts to English law, simply for the purposes of falling within the write-down regime? Also, what would happen in relation to insurance contracts written on an underwriting stamp basis where a number of insurers are severally liable?

2.15 It is not clear from the Consultation whether HM Treasury has undertaken any recognition analysis of the write-down procedure and the write-down manager. Many insurers will have counterparties in, and exposure to, other jurisdictions, such as the US. For the amended write-down power to be of use, we would expect a distressed insurer to be keen to understand whether the procedure is capable of recognition under, for example, the UNCITRAL Model Law.

2.16 Has any analysis been done regarding the cost of reinsurance if liabilities under these contracts are not included in the write-down? There will clearly end up being a mis-match between the liabilities of the insurer and the re-insurer in such circumstances. We also wonder how any write-down would impact upon liabilities under guarantees given by group companies if such companies are not included in the write-down.

Proposal Two

XII) Do you support the introduction of a write-down manager to support a write-down under section 377 FSMA (as amended by Proposal One)?

2.17 Please see our response to question VIII above.

XIII) To what extent do you agree with the proposed eligibility criteria for a write-down manager under Proposal Two?

2.18 Please see subparagraph (b) of our response to question II above.

XIV) Do you think the proposed role and powers of the write-down manager would be adequate to ensure the development/ implementation of a write-down is in the interests of the insurer and its creditors (in particular policyholders)?

2.19 Please see subparagraph (b) of our response to question II above.

XV) Do you have any other comments on Proposal Two?

2.20 We would urge HM Treasury to postpone the introduction of the extended write-down procedure until the introduction of the special resolution regime for insurance companies.

Proposal Three

XVI) Do you agree that the proposed moratorium under Proposal Three would help provide stability, leading to better outcomes for policyholders and creditors overall, in the circumstances outlined above?

2.21 We do not agree. Unless there are sufficient safeguards for financial contracts (for example), we believe the proposed moratorium will destabilise the UK insurance market for the reasons described in our response to question XVII below. We note that the Consultation does not refer to any such safeguards (and indeed we note that paragraphs B.109 and B.110 suggest that the proposed moratorium might be targeted, in particular, at financial contracts).

2.22 Furthermore, we are not convinced of the need for such wide-ranging provisions, given that sections 233A and 233B of the Insolvency Act 1986 will apply in the event of certain types of insolvency proceedings in any event (and these provisions could, subject to suitable safeguards, be extended to cover a write-down). We note the reference to service contracts in paragraph B.110 but, in our experience, these contracts would not have insolvency termination events in any event.

2.23 Finally it was not clear to us whether reinsurance contracts (including ones structured as longevity swaps) would be caught by the proposed moratorium. Such contracts will have been entered into on the basis of the law as it currently stands and so it may be necessary to introduce grandfathering provisions to protect rights under existing contracts. The proposals could also have a significant impact on reinsurance going forwards if it is not possible to terminate these arrangements in the event of an insolvency of the insurer.

XVII) How would the proposed moratorium under Proposal Three affect the terms on which insurers are able to enter into financial contracts and service contracts?

2.24 The existence of the proposed moratorium would be likely to destabilise a number of finance transactions that insurers rely on in their ordinary course business (outside of distress and insolvency). By way of example:

(a) **Derivatives transactions**: Unless safeguards are introduced for set-off and netting under derivative contracts, the proposals could have a significant impact on the costs of derivative transactions for UK insurers. The proposals may even restrict the number of counterparties that are willing to enter into derivative transactions with UK insurers. That could put the UK insurance market at a competitive disadvantage internationally.

In particular, if an insurer (or its counterparty) wishes to carry capital in relation to potential derivative exposures on a net, rather than a gross, basis[1], it will need to satisfy the regulators that it will be able to terminate or "close out" such derivative positions in the event of a liquidation or administration of the insurance company. In other words, the insurance company (and its counterparty) will need a "clean" netting opinion in this regard. The ISDA industry netting opinion is currently "clean" for insurance companies but, if the proposals are brought into law without any safeguards in this respect, that opinion will need to be updated to reflect the fact that it will no longer be possible to terminate or "close-out" during the proposed moratorium.

The proposed moratorium raises two immediate concerns in relation to the close-out and netting of derivative transactions:

(i) the proposed moratorium could prevent a counterparty from terminating its derivative contracts with an insurer, with termination being an essential first step of close-out netting; and

(ii) the Consultation states that the moratorium will remain "switched on" until the date of the winding-up order (in a compulsory winding-up of an insurer) or for the duration of the administration (in an administration of an insurer). We do not understand how the proposed moratorium is supposed to work alongside existing insolvency set-off rules. For example, the proposal could create a scenario where a counterparty to a derivatives transaction with an insurer would not be able to close-out their derivatives transactions until after the exercise of insolvency set-off under:

(A) Rule 14.25 of the Insolvency (England and Wales) Rules 2016/1024 (the "**IRs**"), where the insurer is subject to a compulsory winding-up petition; or

(B) IR 14.24, where the insurer is subject to an administration.

This is unworkable. Counterparties to derivative transactions need to be able to terminate their transactions with insurers, and exercise rights of set-off, promptly and certainly before the insolvency set-off rules come into effect.

[1] If an insurer (or its counterparty) were required to carry capital on the basis of its gross positions, this would be extremely expensive for both parties.

We believe that the uncertainty the proposed moratorium will bring to the ability of derivative transaction counterparties to close-out and net their transactions with insurers will result in an increase in the cost of, and/or a reduction in the availability of, derivative contracts for UK insurers.

(b) **Lack of safeguards**: existing moratorium regimes have extensive safeguards for financial contracts (for example, see the special resolution regime under the Banking Act 2009[2] and the moratorium under Part A1 Insolvency Act 1986). By contrast, the proposed write-down procedure and moratorium do not appear to replicate many of these financial contract safeguards. The lack of adequate safeguards will introduce uncertainty for insurers and their financial counterparties, which may have adverse consequences for UK insurers (for example, by increasing the costs of their finance contracts) due to the perceived increased risk for any counterparty that enters into financial transactions with an insurer.

XVIII) Factoring in the safeguards outlined above, do you have any concerns about the impact of the proposed moratorium under Proposal Three on the rights of an insurer's counterparties?

2.25 We do have concerns. See our response to question XVII above.

XIX) Do you have any other comments on Proposal Three?

2.26 We would urge HM Treasury to postpone the introduction of a specific moratorium for insurance companies until the introduction of the special resolution regime for insurance companies.

Proposal Four

XX) Do you agree that the proposed stay under Proposal Four would help provide stability, leading to better outcomes for policyholders and creditors overall, in the circumstances outlined above?

2.27 We wonder whether any thought has been given to whether there have been any securitisations of surrender rights and, if so, how such existing arrangements might be impacted by the proposals. In general, however, we have less experience of this area and so are not able to comment.

XXI) Factoring in the safeguards outlined above, do you have any concerns about the impact of the proposed stay under Proposal Four on the rights of an insurer's policyholders?

XXII) Do you have any other comments on Proposal Four?

Proposal Five

XXIII) To what extent do you agree with government's proposal to ensure protected policyholders are not financially worse off as a result of a write down under section 377 FSMA (as amended by Proposal One), as compared to insolvency?

2.28 We see Proposal Five as the least concerning of the proposals outlined in the Consultation.

XXIV) Do you have any other comments on Proposal Five?

2.29 No.

Point of contact

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[2] We do not think it would be sufficient simply to introduce the safeguards in the Banking Act for set-off and netting agreements without considering the more extensive safeguards in Part A1 of the Insolvency Act 1986 re financial contracts. The protections in the Banking Act are intended to deal with the SRR where any stay is likely to be limited to 48 hours or so whereas the proposed moratorium could be for some months.

Should you have any queries or require any clarifications in respect of our response, please feel free to contact our chairperson.

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Other members of the Insolvency Law Committee are listed here:

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