The Financial Services and Markets Bill 2022 – Insurer Insolvency

1. Overview

In May 2021, HM Treasury published a consultation on Amendments to the Insolvency Arrangements for Insurers. The consultation proposed changes to the existing (and limited) write down power of the court under section 377 of the Financial Services and Markets Act 2000 (**FSMA**). A response document to the consultation was published in April 2022 and changes to relevant legislation were set out in the Financial Services and Markets Bill (**FSMB**) which was introduced into Parliament in July 2022.

Paragraph 1 of Schedule 12 to the FSMB will delete the existing section 377 of FSMA (Reducing the value of contracts instead of winding up) and insert new sections 377A to 377J. Section 377 of FSMA currently provides that where an insurer has been "proved to be unable to pay its debts" the court can reduce the value of one or more of its contracts instead of making a winding up order, on such terms and conditions as the court thinks fit.

The amendments widen the circumstances in which the court's write-down power can be used but also add extensive additional provisions governing the way in which it used. Some of the provisions (for example, in respect of policyholder surrender rights) will also apply where an insurer is subject to other insolvency proceedings such as administration or a petition for winding-up.

2. Write-down of liabilities

2.1 The new write down power

Under new section 377A, the court will be able to make a write-down order if it is satisfied that:

(i) the insurer "*is, or is likely to become, unable to pay its debts*" (within the meaning given to that expression by section 123 of the Insolvency Act 1986 or Article 103 of the Insolvency (Norther Ireland) Order 1989); and

(ii) making the order is reasonably likely to lead to a better outcome for the insurer's policyholders and other creditors than not making the order (section 377A(2)).

This reflects the key intent of the consultation, which was to make it easier for the write-down power to be used where appropriate.

Write-down orders cannot be made in respect of an insurer (i) in administration or (ii) in liquidation as a result of either a resolution for voluntary winding up or a winding-up order (section 377A(4)). In addition, no write-down order can be made to reduce the value of any "excluded liability", discussed below (section 377A(5)).

2.2 Excluded liabilities

The following liabilities are excluded from the application of a write-down order:

- liabilities with an original maturity of less than 7 days

- amounts payable in respect of goods delivered or services provided on or after the date on which the write-down order is made

- remuneration or expenses of a write-down manager

- amounts secured on property of any kind other than amounts secured by floating charge

- amounts payable in respect of employee wages or salary or redundancy payments

- contributions to occupational pension schemes

- amounts payable under "a contract or other instrument involving financial services", as defined in Schedule ZA2 to the Insolvency Act 1986, other than agreements in respect of arrangements involving the issue of a capital market investment.

Contracts listed in Schedule ZA2 include contracts for the provision of financial services; securities contracts; commodities contracts; futures or forwards contracts; swap agreements and master agreements in respect of any of these. Inwards reinsurance contracts do not fall within this category and will not be excluded by virtue of benefitting from a floating charge – this position was confirmed by HM Treasury in the response document, with the explanation that it wanted to avoid giving preferential treatment to those inward reinsurance creditors who have been granted a floating charge but are contractually subordinated to rank alongside direct policyholders.

3. Restrictions on enforcement and dealing with assets

3.1 Restrictions on enforcement

New Schedule 19B, Part 1 specifies that during the period starting from when an application for a write-down order is made and ending six months after the write-down order takes effect, or later if ordered by the court:

- no step may be taken to enforce security over the insurer's property;

- no step may be taken to repossess goods in the insurer's possession under a hire-purchase agreement;

- restrictions will apply to landlords' rights of forfeiture or (in Scotland) "irritancy" in relation to premises let to an insurer

- no legal process may be instituted, carried out or continued against the insurer or its property,

except with the permission of the court and subject to the exceptions referred to below.

The exceptions to the moratorium on proceedings are in respect of: (i) arrangements entered into after the date the application for the write-down is made; (ii) employment tribunal proceedings and other employment proceedings; (iii) the exercise of functions by the FCA or PRA; and (iv) the enforcement by a consumer of a money award or direction under section 229 or 404B of FSMA (Financial Ombudsman Scheme).

3.2 Restrictions on insurer dealing with assets

Schedule 19B, Part 2 provides that an insurer which is subject to a write-down order may not:

- dispose of any of its assets other than in the ordinary course of business or with the consent of the PRA
- pay variable remuneration except with the consent of the PRA
- make a distribution except with the consent of the PRA.

3.3 Treatment of written down liabilities

For the purposes of certain insolvency provisions, Schedule 19B, Part 3 specifies that in determining the value of a written down liability no account is to be taken of the contingent or prospective value of the liability arising from any expectation that the write-down order will be varied, further varied or cease to have effect.

In contrast, in determining the value of any liability under an outwards reinsurance contract, no account is to be taken of the reduction in value of any underlying liabilities under the primary contracts of insurance. It is worth noting that the provision will only have effect in respect of contracts to which FSMA applies and contracts governed by the law of another jurisdiction may therefore not benefit from this provision.

4. Surrender and termination of contracts

New Schedule 19C of FSMA sets out rules in respect of (i) policyholder surrender rights and (ii) termination of certain categories of contract, which in each case will apply:

- during the period starting from when an application for a write-down order is made and ending six months after the write-down order takes effect, or later if ordered by the court; or
- if the insurer is in administration or awaiting administration; or
- if a petition for the winding-up of the insurer has been presented and has not been withdrawn or determined.

4.1 Policyholder surrender rights

Part 2 of Schedule 19C sets out rules relating to policyholder surrender rights.

Relevant contracts of insurance

Restrictions on policyholder surrender rights apply to contracts of long-term insurance <u>other than</u> ones to which all of the following conditions apply:

- the benefits under the contract are payable only on death or in respect of incapacity due to injury, sickness or infirmity;

- the contract has no surrender value, or the consideration consists of a single premium and the surrender value does not exceed that premium; and
- the contract makes no provision for its conversion or extension in a manner which would result in it not complying with either of the above conditions.

"Surrender rights" are not defined but are unlikely to include termination in respect of default or other termination triggers set out in an agreement.

Restrictions on surrender rights

Where the schedule applies, the total value of a policyholder's rights under a relevant contract of insurance which the policyholder may surrender in a relevant period must not exceed the surrender limit for that period.

The relevant period is 12 months beginning from when the insurer entered into financial difficulties and each subsequent period of 12 months. The surrender limit is 5% of the total value of the contract at the beginning of the relevant period.

For these purposes, the exercise by a policyholder of switching rights, where the policyholder can change the property by reference to which a value of a right is determined, counts as a surrender.

Exceptions

The restrictions do not apply if or to the extent that consent for the surrender of an amount in excess of the surrender amount has been given by: (i) the court; (ii) a relevant office-holder (which includes a provisional liquidator, administrator and write-down manager); or (iii) where there is no relevant office-holder, the insurer. This may be appropriate if not giving consent would cause the policyholder hardship. See also paragraph 4.3 below.

4.2 Termination of relevant contracts

Part 3 of Schedule 19C sets out restrictions on termination rights in respect of certain categories of contract.

Relevant contracts

The restrictions apply to contracts to which the insurer is a party which fall into one of the following categories:

(i) a contract for the supply of goods or services to the insurer;

(ii) a "financial contract"; and

(iii) a reinsurance contract under which contracts of insurance the insurer carries out as principal are reinsured.

Financial contracts include a variety of different types of contract, as specified in the schedule, including types of: contracts for the provision of financial services; securities contracts; commodities contracts; futures or forwards contracts; and swap agreements. The list is essentially the same as that set out in Schedule ZA2 to the Insolvency Act 1986 except that it does not include (i) inter-bank borrowing agreements; or (ii) master agreements for any of the types of agreement listed.

Restrictions

There are three restrictions which apply to relevant contracts where the schedule applies.

(i) Where a relevant contract was entered into before the insurer first entered into financial difficulties, any provision of the contract ceases to have effect if and to the extent that under the provision the contract would terminate, a supply would cease or “any other thing would occur” because the insurer is in financial difficulties, or another party would be entitled to terminate the contract, cease a supply or do any other thing because the insurer is in financial difficulties.

(ii) Where a provision in a relevant contract entitles another party to terminate the contract, cease a supply or do any other thing because of an event occurring before the insurer was in financial difficulties, and the entitlement arises before the insurer was in financial difficulties, the entitlement cannot be exercised while the insurer is in financial difficulties.

(iii) A supplier of goods or services to an insurer must not make it a condition of a supply of goods or services while the insurer is in financial difficulties that any outstanding charges in respect of a supply made to the insurer before it was in financial difficulties must be paid, or do anything which has that effect.

Consent

The court, a relevant office holder or (if there is no relevant office holder) the insurer can consent to termination of relevant contracts or other actions restricted by the schedule.

4.3 Exclusions and disapplications

There are some exclusions from the operation of the provisions of Schedule 19C. In particular, nothing in the schedule affects any “protected arrangements” within the meaning of section 48P of the Banking Act 2009. These include close-out netting arrangements under ISDA, and the Treasury response document to the consultation explicitly refers to these as being outside of scope of the moratorium provisions in the schedule. This is important to allow standard industry opinions on derivative contracts to continue to operate as currently

In addition, Part 7 of the Companies Act 1989, the Financial Markets and Insolvency Regulations 1996, the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 and the Financial Collateral Arrangements (No. 2) Regulations 2003 take primacy over and are unaffected by Schedule 19C.

The court may disapply or modify the operation of the schedule with respect to one or more contracts to which the insurer is a party if one of the following grounds is made out:

- not making the order would be likely to cause hardship to any person
- where the insurer is subject to a write-down order, making the order is reasonably likely to lead to a better outcome for policyholders and creditors than not making the order
- where the insurer is in administration, making the order is reasonably likely to promote the purpose of administration.

5. Process

Many of the new provisions deal with how an application for a write down should be made and processed. Key points include:

- an application for a write-down order can be made by Treasury, the PRA, the insurer itself, any shareholder of the insurer, and any policyholder or other creditor of the insurer (including a contingent or prospective creditor) (section 377C(1)). If the application is made by anyone other than the Treasury or the PRA the consent of the PRA is needed before the application is made (section 377C(3))
- the PRA and FCA are entitled to be heard at any relevant hearings (section 377D)
- the court may appoint a write-down manager, who the PRA must confirm to be suitably qualified (section 377G). The rights and responsibilities of the write-down manager are set out in a new Schedule 19A to FSMA. These include making recommendations to the directors of the insurer and applying to the court for revocation or variation of a write-down order if thought appropriate
- the court can subsequently revoke or vary a write-down order, including by removing one or more of the insurer’s liabilities from the scope of the order (section 377I(1)). An application for revocation or variation can be made by the same persons as those who can apply for the original order, plus the FCA, the FSCS and the write-down manager (section 377I(4)).

6. Termination of write-down

A reduction in the value of a liability of an insurer under a write-down order ceases to have effect on the occurrence of a “termination event” (section 377H(1)). Termination events are where:

- the write–down order is revoked
- the write-down order is varied to remove the liability in question from its scope
- the insurer ceases to have permission under Part 4A to carry out contracts of insurance
- the liability is transferred pursuant to a Part VII insurance business transfer scheme
- a winding up order is made against the insurer
- a liquidator is appointed for the voluntary winding up of the insurer

- a voluntary arrangement under Part 1 of the Insolvency Act 1986 or Part 2 of the Insolvency (Norther Ireland) Order 1989 comes into force

- the insurer enters into administration.

At the point of insolvency, therefore, the write-down of liabilities will cease to have effect and creditors can claim for the full amount owed in the relevant insolvency proceedings.

7. The Financial Services Compensation Scheme

The current position

Under the current FSCS rules, the scheme will only be engaged when the relevant insurer is deemed by the FSCS or PRA to be 'in default', i.e. it is deemed unable or likely to be unable to satisfy claims or one of various formal insolvency processes is instigated or concluded. If a write-down has taken place prior to this, the value of the claim under the FSCS would be for the written-down amount.

The Bill

A new section 217ZA and 217ZB will require the compensation scheme to include provision to safeguard policyholders affected by a write-down order, in particular to require financial assistance to be given to insurers to enable payments to be made to those policyholders in respect of the reduced value of their entitlements. The scheme may also make provision for the scheme manager to have a right of recovery in respect of this financial assistance from the insurer.

PRA amendments to the FSCS

In the Treasury consultation it comments that the detail of the FSCS are a matter for the PRA Rulebook but proposes that the PRA considers whether to introduce rules:

- so that compensation amounts payable following any subsequent insolvency are calculated using the original pre-write-down value of the claim; and

- to ensure that any policyholders whose claims fall due following a write-down but while the insurer is still solvent receives "top up payments" from the FSCS.

It is expected that the PRA will consult on making these changes to the scheme.

January 2023

Published to provide general information and not as legal advice. © Slaughter and May 2023