BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

EIOPA - Recovery & Resolution in Insurance Seminar

Resolution power: Run-off – by Anirvan Choudhury (PRA,UK)

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Agenda

Resolution Options for Insurers

Portfolio Transfer

Bridge Insurer

Restructuring Liabilities

Insolvency & Liquidation

Run-off

Run-off: ***Firm is closed to new business and the liabilities 'run off' over time; the firm continues to honour (in full or in part) existing contracts***

Run-off - Preferred Strategy for Insurance Resolution

- Insurers are less susceptible to ‘fast-burn’ failure than banks
- Consequently, insurers are likely to have more time in which to attempt to restore their solvency and viability i.e. ‘Recovery’
- Liabilities are often ‘long-tail’ with claims emerging many years/decades later
- Insurers can typically exit the market over a longer time period than banks

- ✓ **At present, the UK does not have a special resolution regime for insurers;**
- ✓ **Solvent run-off is the preferred resolution strategy for insurers.**

Benefits of Insurance Run-off

- Entering run-off can benefit firms and the PRA's objectives in various ways:

  1) **Removes capital strain from writing new business**
  2) **Enables cost reduction by cutting costs associated with distribution and taking on new business**
  3) **Enables an orderly exit from the market**
  4) **Can be pre-emptive e.g. taken ahead of the firm getting into financial difficulties**
  5) **Avoids new policyholders being exposed to the firm**

- A firm does not have to be in (or anticipating) financial difficulties to enter run-off; equally being in run-off does not by itself mean the firm poses serious risk to the PRA's objectives *{safety & soundness and policyholder protection}.* *[See slide 8]*

Key Objectives for Run-off: Focus on Policyholder Protection

PRA's engagement with run-off firms is aimed at ensuring :

Policyholders maintain their insurance cover & claims continue to be submitted in usual course

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Payments to policyholders continue without disruption; maximise payment to policyholders

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Insolvency: The method for distributing assets amongst creditors is fair to current and future claimants

Insolvent Run-off:

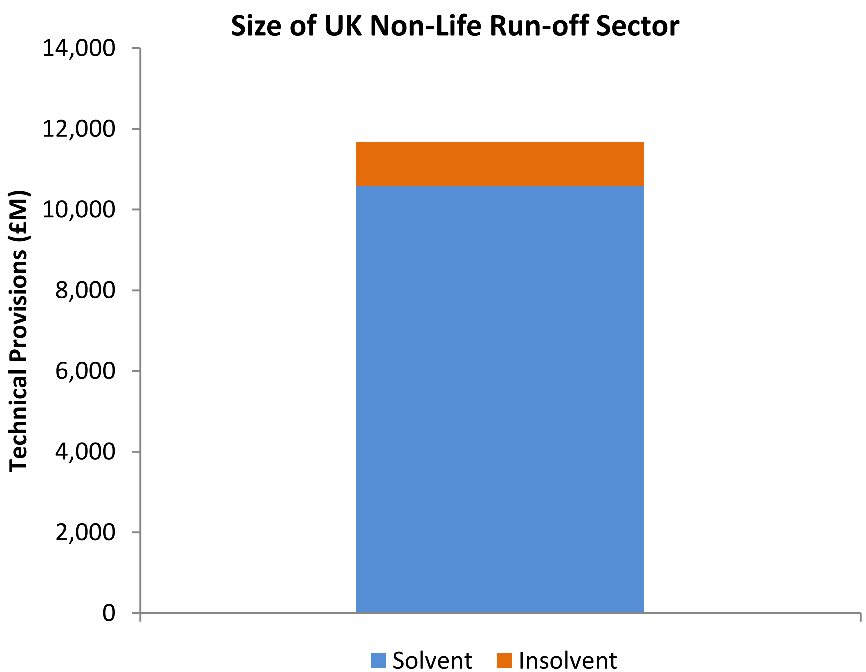
UK's Financial Services Compensation Scheme (FSCS) protects eligible policyholders:

- **Life insurance [100%]**
- **General insurance (compulsory: motor & EL, etc.) [100%]**
- **Claims relating to death and incapacity [100%]**
- **Other retail & SME general insurance [90%]**

Size and Nature of the Non-Life Run-off Sector in the UK

Solvent Run-off		Insolvents
Acquirers	Inactives	
6	50	36

- The PRA supervises 92 GI Run-off firms with over c.£12b in Gross TPs; c.£3b+ of additional TPs expected to enter run-off during 2018-19



- **Acquirers:** Firms that actively acquire legacy portfolios and therefore do not follow the typical downward trajectory in terms of technical provisions and capital resources of a firm in run-off

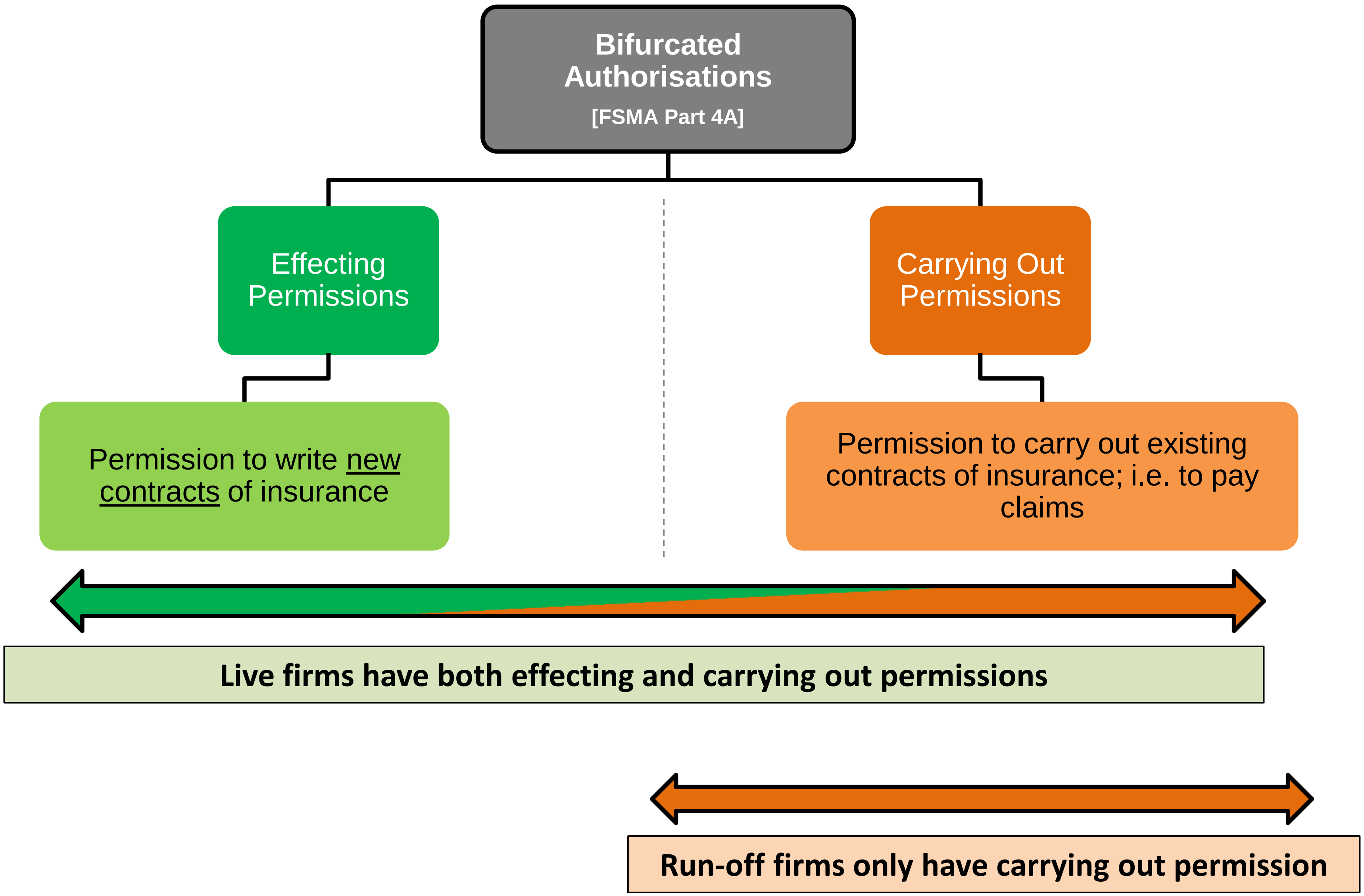
- **Inactives:** Firms with passive legacy portfolios look to run-off existing book of business

- **Insolvent Firms** – Managed by an Insolvency Practitioner, charged with realising the firm's assets for the benefit of creditors. ***High Court supervised process***; viewed as disorderly run-off, ***paying claims at a set % of full value.***

Why Firms Enter Run-off [this is not an exhaustive list]

Strategic	• Stop writing business in a particular geography/territory • Exit unprofitable line of business or distribution channel • Change in Group strategy
Financial	• Persistent losses that raises concerns regarding viability *(depletion of capital resources)* • Inability to raise new capital • Shareholders refuse to inject capital
Capital Management	• Reallocate capital to core businesses • Release capital & capital optimisation • Early finality

UK Authorisations Regime: Effecting vs Carrying-out Permissions



Mechanisms for Entry into Run-off

Voluntary Variation of Permissions (VREQ):

[Initiated by the insurer]

- Board decides to cease writing any new business
- Within 28 days of that decision the firm must submit a run-off plan to the PRA – known as a Scheme of Operations *(See next slide for details)*

Own Initiative Variation of Permissions (OIREQ)

[Imposition of requirements by PRA]

- The firm is failing, or is likely to fail, to satisfy Threshold Conditions
- It is desirable to exercise the power in order to advance any of the PRA’s objectives
- The firm has failed during a period of at least 12 months to carry on a regulated activity to which the Part 4A permission relates
- OIREQ will need to stand up to scrutiny
- Submit Scheme of Operations to the PRA *(See next slide for details)*

Supervision of Run-off Firms: Scheme of Operations

Description of the **firm's run-off strategy** for the period until all liabilities will be met

Description of the **business underwritten** by the firm

Financial projections (including appropriate scenarios and stress-tests)

Forecast summary **P&L, balance sheet, MCR and SCR** at the end of each financial year

Description of the assumptions underlying those forecasts and the reasons for adopting those assumptions

Identify any material **related party transactions**

Notify the PRA at least 28 days before entering into or carrying out any **material transaction** ***(e.g. dividend)***

Notify the PRA promptly of any matter which represents a **significant departure** from the scheme of operations

Run-off firms are required ensure that the SoO remains up to date at all times

Features of Insurance Run-off

Duration of Liabilities	▪ Liabilities could be either ***short tail or long-tail*** depending on the product type; ▪ ***Long-tail*** liabilities difficult to predict how the external context will develop therefore exposed to ***unknown costs and greater risk*** *(latent liabilities, unknown policyholders etc.)*
Expense Strain	▪ Managing expenses is a key focus for run-off firms, specifically ***reducing fixed costs*** as far as possible; ▪ Certain types of contacts have on-going revenue stream but revenues fall with policy numbers and therefore ***managing expenses*** becomes a key focus
Staff Retention	▪ Retaining and ***attracting talent*** for passive run-off firms can be challenging
Outsourcing Arrangements	▪ Run-off firms make extensive use of outsourcing arrangements & this increases the variable component of their cost base. Firms need to demonstrate that they are able to ***manage their outsource providers*** adequately
Active Acquirer Market	▪ <u>Life Insurance</u>: Active closed book ***consolidator market***: these business models seek capital and expense efficiencies by combining smaller books. ▪ <u>General Insurance:</u> ***Active run off market*** in existence with portfolios being bought and sold; recent in-flow of additional capital

Supervision of Run-off Firms (Continued) – Specific Areas of Focus

Expense Review	❖ Analysis of the ***nature and scale of expenses*** incurred by run-off firms (peer analysis & firm specific)
Investment Risk	❖ Monitor changes in asset portfolios ***('Search of Yield')*** – [peer analysis & firm specific]
Capital Extractions	❖ Run-off firms require ***PRA approval*** prior to declaring dividends to shareholders
Counter Party Credit Risk	❖ Assess level of ***reinsurance cessions*** to 'Parent Company' or 3rd Party reinsurance providers ❖ On-going monitoring of mitigations (e.g. collateral etc.) in place on reinsurance arrangements
Reserve Reviews	❖ Monitor ***reserve development*** and risk based review of different classes of Technical Provisions (e.g. Pollution, Asbestos etc.) ❖ Commission S.166 (***skilled persons report***) - this is not limited to review of reserves
New Acquisitions	❖ Acquiring/accepting run-off portfolios require of Variation of Permission (VoP); ***limited effecting permissions*** provided by the PRA to allow the run-off firm to accept new liabilities ❖ PRA reviews ***Independent Experts report*** for every portfolio transfer transaction (FSMA Part VII); ❖ PRA provides reports to the ***High Court on Part VIIs (Portfolio Transfers)***

PRA's supervisory approach is forward looking & judgement based; The items listed above highlight some (not all) of the features specific to supervising of insurers in run-off. These are in addition to other regular supervisory activities

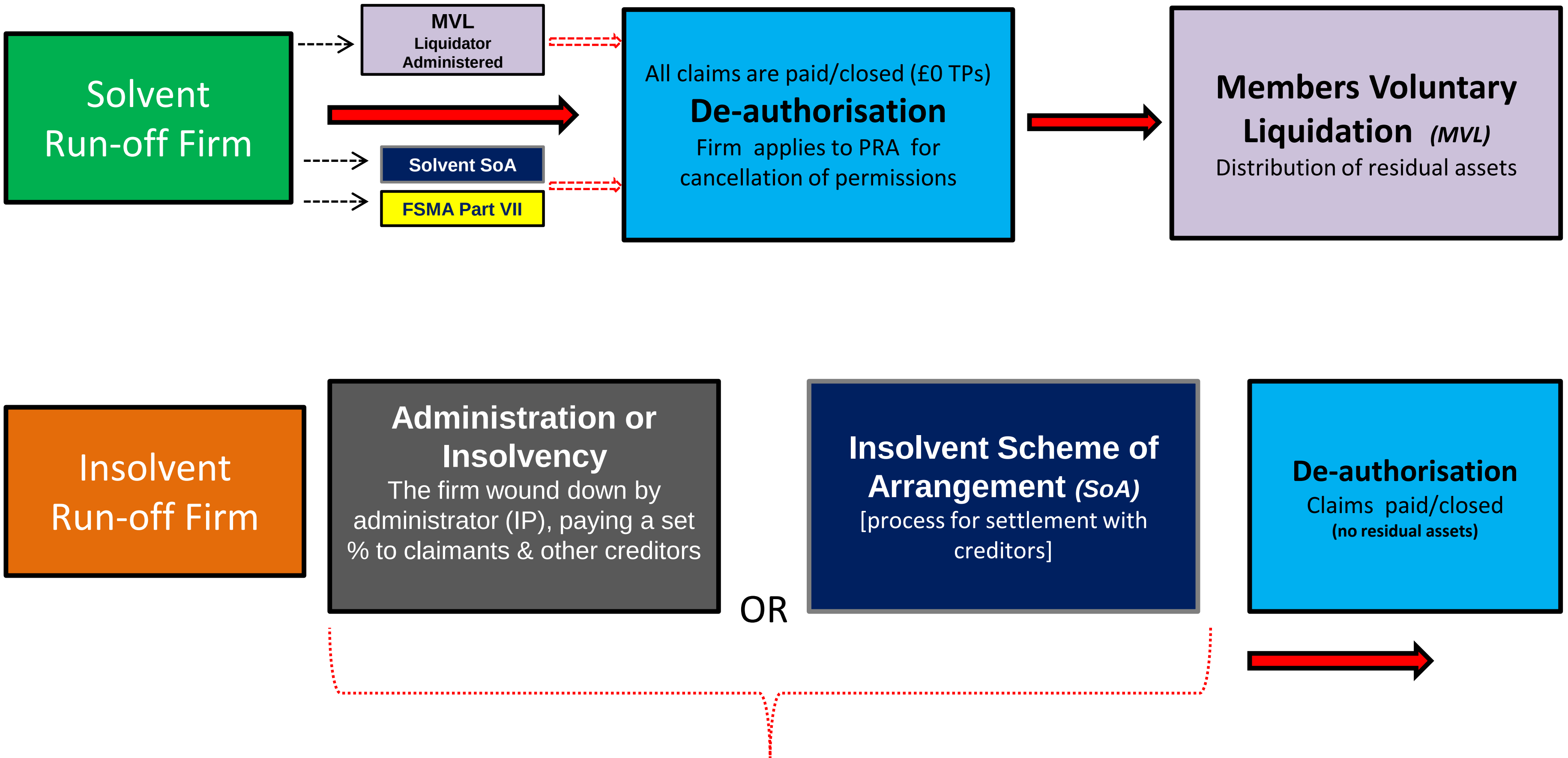
Potential Risks to Achieving Orderly Run-off – *Focus Remains on Policyholder Protection*

High Market Share	❖ Potential adverse impacts from reduction of capacity in concentrated markets ❖ More likely to be an issue for general insurers than life insurers
Product Type	❖ Protect continuation of critical economic functions ❖ Certain product types more likely to cause concern to PRA objectives (e.g. annuities higher risks)
Size	❖ Potential reputational and market impacts from large firms exiting the market, regardless of whether they operate in concentrated markets ❖ Interconnectedness to the wider financial sector
Revenue Stream & Cost Profile	❖ Risk of capital erosion if firm cannot cover its fixed expenses from diminishing book of business ❖ Minimum fixed cost (governance etc.) to running any firm; the smaller the firm the fewer policies there are to spread fixed costs over
Asset Profile	❖ High proportion of illiquid assets ❖ Complex derivative and reinsurance contracts
Management Capability & Complexity	❖ Ability of existing management team to execute smooth run-off ❖ Corporate structure, intra group relationships, etc.

Options to Accelerate Run-off

Change in Control	Portfolio Transfer [FSMA Part VII]	Commutations	Novation	Scheme of Arrangement [SoA]
• Selling the share capital to another insurance firm *[exit route for owners/investors - may not result in quicker run-off]*	• Transferring the business to another insurance firm via FSMA Part VII Transfer *[court approval]*	• Agreeing to settle future liabilities before the end of the contract period	• Transfer of the rights of a particular insurance contract to another provider	• Court approved agreement between a company, shareholder & claimants *[See next slide]*

Mechanisms to Exit Run-off



Insolvency Process:

- **Process follows Company law under Companies Act**
- **In either case, the process is supervised by the courts not the PRA; although firms have to seek PRA's view before approaching the court**

Case Study – Run-off in Practice

General Insurance Company X set up in London in the 1970s by large overseas P&C insurer

- Wrote long-tail and short-tail business including PI, APH, Catastrophe Reinsurance across the world with offices in multiple countries

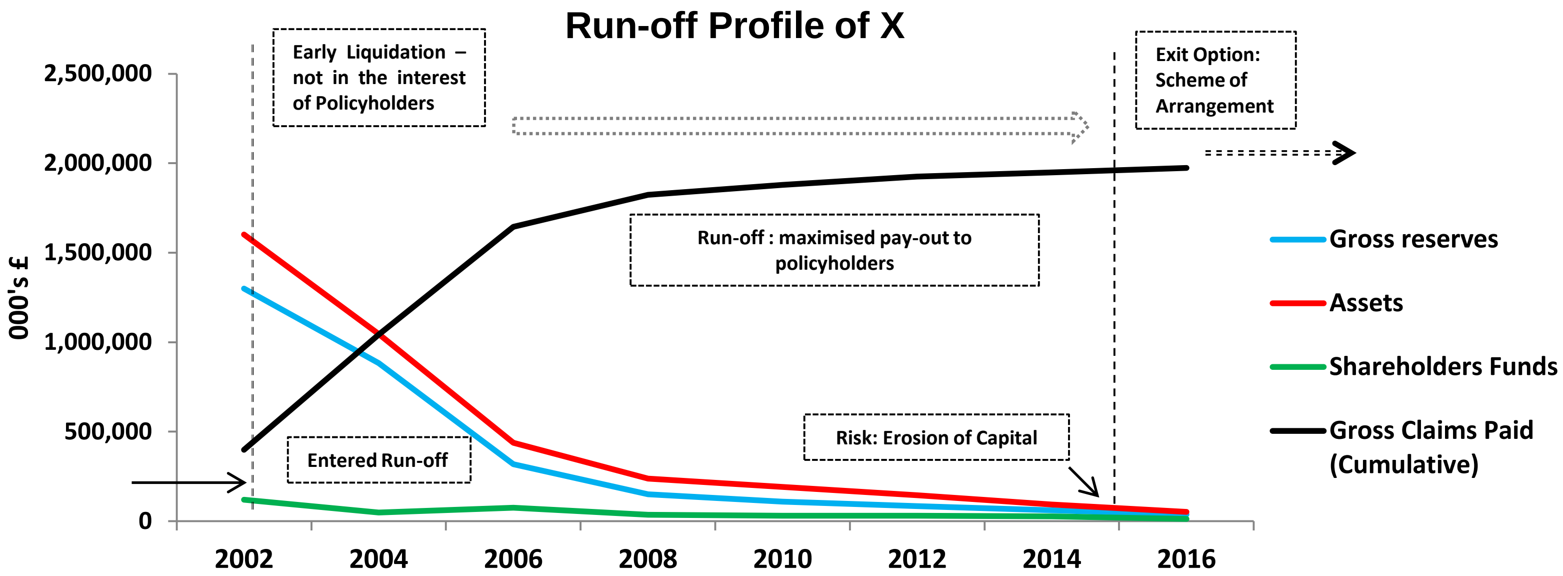
- Small profits in 1990s followed by losses in 1999 and 2000; weak reserving function
- Incurred heavy losses due to WTC in 2001, leading to drop in capital coverage and the firm was put into run-off

- Change in business strategy of parent company (exit international insurance sector) & therefore parent did not wish to inject further capital into X
- Sold to a Run-off Specialist Acquirer in 20xx

- Currently discussing resolution options as expenses are now in excess of investment income, thus eroding capital

Focus of Supervisory Activities

- ✓ Monitor adherence to Scheme of Operations
- ✓ Analyse scale and nature of expenses
- ✓ Monitor asset mix and investment income
- ✓ Reserve reviews of different classes of business
- ✓ Scrutinise dividend extraction requests
- ✓ Treating customers fairly (conduct issues - FCA)



- Total claims paid to policyholders far in excess of Gross TPs at the beginning of the run-off
- Actively managed run-off to generate cash flow/profits via investment income, claims settlement through commutations and reduction of expenses
- Policyholders continue to receive full payment of claims
- ***Return on Investments*** **<** ***Expenses*** ⇒ ***Erosion of Capital***
- *Exit Option: Scheme of Arrangement to settle with remaining policyholders?*