Reforming China's Crisis Management and Market Exit Mechanism for Insurers – A Comparative Legal Study Between China, the UK and the US

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Abstract

Insurers are specifically regulated financial institutions. From time to time, there are cases where insurers fall below statutory or regulatory requirements and run into trouble. Only with a well-designed crisis management and market exit mechanism for insurers (the CMME mechanism), can crises of insurers be addressed in an effective and efficient way.

Unfortunately, the CMME mechanism has not been well formed in China. The current CMME mechanism is based on the bankruptcy system for ordinary companies, but there is a lack of special consideration for insurers. As a consequence, it is unfeasible to apply many of the measures/procedures therein to troubled insurers. In practice, no case involving a bankruptcy procedure of an insurer has ever occurred. This situation should not continue as the norm in the future, and it is necessary to reform the CMME mechanism to make it more compatible with the special features of insurers.

There are two possible routes the reform of the CMME mechanism in China can take: one is to enhance the current mechanism by making more modifications or supplements for insurers to the general bankruptcy system, like the CMME mechanism in the UK; and the other is to rebuild the mechanism to make it independent of the general bankruptcy system, like the CMME mechanism in the US. Recognising that the CMME mechanisms in the UK and the US represent two typical alternative models,

this thesis conducts a comparative legal study of the CMME mechanisms in China, the UK and the US, with the aim of finding out how the mechanism in China can be reformed.

Based on the comparative study, this thesis (broadly following the US model) proposes a brand-new CMME mechanism for China, which is independent of the general bankruptcy system, and puts forward a set of recommendations on how the overall framework of the mechanism can be designed.

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Abbreviations

AIG	American International Group
AIGC	Anbang Insurance Group Company
AIGFP	AIG Financial Products Corp.
CBIRC	China Banking and Insurance Regulatory Commission
CDS	credit default swaps
CISFC	China Insurance Security Fund Company
CMME mechanism	crisis management and market exit mechanism for Insurers
CVA	company voluntary arrangement
EIOPA	European Insurance and Occupational Pensions Authority
ESRB	European Systemic Risk Board
FCA	Financial Conduct Authority
FDIC	Federal Deposit Insurance Corporation
FSB	Financial Stability Board
FSCS	Financial Services Compensation Scheme
FSOC	Financial Stability Oversight Council
G-SIIs	Global Systemically Important Insurers
IAIS	International Association of Insurance Supervisors
ICPs	Insurance Core Principles
IRMA	Insurer Receivership Model Act

ISF	Insurance Security Fund
NAIC	National Association of Insurance Commissioners
PRA	Prudential Regulation Authority
TARP	Troubled Asset Relief Program

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China

- Enterprise Bankruptcy Act
- Insurance Act

- Insurance Security Fund Regulations
- No.10 Regulatory Rules on Insurers' Solvency: Comprehensive Rating of Risks (Supervising by Category)

UK

- Companies Act 2006
- Financial Services and Markets Act 2000
- Insolvency Act 1986

- Council Directive 2009/138/EC of 25 November 2009 on the Taking-up and Pursuit of the Business of Insurance and Reinsurance (Solvency II) [2009] OJ L 335/1
- FCA Handbook
- Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, SI 2010/3023
- Insolvency (England and Wales) Rules 2016, SI 2016/1024
- Insurers (Reorganisation and Winding Up) Regulations 2004, SI 2004/353
- Insurers (Winding Up) Rules 2001, SI 2001/3635
- PRA Rulebook

US

- Administrative Supervision Model Act

- Dodd–Frank Wall Street Reform and Consumer Protection Act
- Insurer Receivership Model Act
- Life and Health Insurance Guaranty Association Model Act
- McCarran–Ferguson Act
- New York Insurance Law
- Property and Casualty Insurance Guaranty Association Model Act

Chapter 1 Introduction

Given the fact that the crisis management and market exit mechanism for Insurers (the CMME mechanism) has not been well formed in China, this thesis seeks to find out how the mechanism can be reformed to be more compatible with the special features of insurers. There are two possible routes the reform of the CMME mechanism in China can take: one is to enhance the current mechanism by making more modifications or supplements for insurers to the general bankruptcy system, like the CMME mechanism in the UK; and the other is to rebuild the mechanism to make it independent of the general bankruptcy system, like the CMME mechanism in the US. Recognising that the CMME mechanisms in the UK and the US represent two typical alternative models, this thesis would like to conduct a comparative study of the CMME mechanisms in China, the UK and the US, with the aim of coming up with recommendations for the future reform of the CMME mechanism in China.

Based on the comparative analysis, this thesis will argue that the US model is preferable to the UK model in general, and it is better for China to follow the US model when reforming the CMME mechanism. In other words, China should have a CMME mechanism which is independent of, rather than based on, the general bankruptcy system, so that some arrangements (eg creditors' meetings) which are inherent in the general bankruptcy system but are arguably not suitable for insurers can be avoided after the reform. It will be recommended in the thesis that measures/procedures in

the reformed CMME mechanism mainly include pre-takeover measures, takeover,[1] reorganisation and liquidation. When an insurer falls below statutory or regulatory requirements, the insurance regulatory authority should initiate appropriate measures/procedures to tackle the crisis. While the regulatory authority will have full authority in carrying out pre-takeover measures or a takeover, it should petition the court to commence a reorganisation or liquidation procedure and then carry out the procedure under the supervision of the court. In reorganisation or liquidation, the regulatory authority can decide all relevant issues, subject to the court's approval or review, without seeking decisions from creditors of the insurer. During the process, the insurance guarantee scheme can perform the function of protecting policyholders or the function of rescuing the troubled insurer, and if the crisis of the insurer poses a threat to financial stability, it is still possible that emergency lending may be provided by the central bank for rescue purposes.

As the introduction to the thesis, this chapter will, in turn, show the background to the research, set out the research questions, define the scope of the research, review the current developments in the research area, explain the research methodology, and display the structure of the thesis.

1.1. Background to the Research

[1] When "takeover" is used in the context of the CMME mechanism in China, it refers to a regulatory measure by virtue of which the regulatory authority can take over a troubled insurer (ie take control of the insurer's management and property) to address a crisis of the insurer.

Insurers[2] are important intermediaries between the real economy and the financial market. By effecting and carrying out insurance contracts, insurers provide insurance services to individuals and institutions who pay premiums, and then invest the collected funds into the financial market as well as real economy sectors. Despite their expertise in diversifying risks, insurers may sometimes run into trouble as excessive risks accumulate, which makes them fall below statutory or regulatory requirements and threatens their on-going sound operation. Due to the role insurers play in society, crises of insurers may not only harm the rights of policyholders, but also pose a threat to financial stability. Therefore, having a proper legal mechanism in place to deal with troubled insurers becomes a matter of concern. In this thesis, this mechanism will be referred to as the crisis management and market exit mechanism for insurers (the CMME mechanism).

As the term indicates, the CMME mechanism serves two main functions: one is the crisis management function, and the other is the market exit function. Measures or procedures which serve one of these functions, whatever they are termed in a certain jurisdiction, can be regarded as components of this mechanism. When an insurer fails to meet statutory or regulatory requirements and thus becomes a troubled insurer,[3] relevant measures/procedures in this mechanism will be initiated for the purposes of

[2] In this thesis, “insurer” refers to an insurance company, as a legal entity, which has obligations under policies to policyholders. The terms “insurer” and “insurance company” will be used interchangeably during the discussion.

[3] Generally speaking, “troubled insurers” used in this thesis is a synonym for “distressed insurers”, “failing insurers”, “ailing insurers”, “financially impaired insurers”, etc., used in other materials.

restoring or dissolving the insurer. Generally speaking, the CMME mechanism covers a wide range of areas in the current legislation or literature, which, in each jurisdiction, mainly include the regulatory intervention framework, the insolvency/bankruptcy system,[4] and/or the resolution regime.[5]

Despite its significance, unfortunately, the CMME mechanism has not been well formed in China. In line with the fact that the history of the insurance industry as well as the insurance regulation in China is still short,[6] the CMME mechanism is at an early stage of development, with not enough attention being paid to it. Basically, the current CMME mechanism is based on the bankruptcy system for ordinary companies, but lacks consideration of the special features of insurers. Thus, there are serious flaws in the mechanism. For example, it is even not clear how policyholders, who normally constitute the majority of an insurer's (potential) creditors, will be treated if the insurer enters a bankruptcy procedure. As a consequence, it is unrealistic to expect that crises of insurers can be addressed in an effective and efficient way. In practice, there has not been any case involving a bankruptcy procedure of an insurer. This situation should not continue as the norm in the future. In a market-based economy, insurers' entry into and exit from the insurance market should be common. It is natural

[4] The "insolvency system" in the UK is equivalent to the "bankruptcy system" in the US and China. In this thesis, the term "bankruptcy system" will be used when discussing issues in the US and China, and the term "insolvency system" will be used anywhere else.

[5] For a more detailed discussion of "resolution regime", see Section 2.3.2 in this thesis.

[6] For more information about the history of the insurance industry as well as the insurance regulation, see Zhuyong Li and Shi Qiao, 'The Development of Insurance Law in China: Review and Prospect' (2019) 100 Financial Law Forum 98, 99.

that intense competition in the insurance market or accumulated excessive risks during the operation of insurers will sometimes force some underperforming insurers to exit the market.[7] Only with a well-designed CMME mechanism in place can relevant parties respond in a lawful and proper way in the event of crises of insurers. Therefore, to reform the CMME mechanism in China is a necessity.

In fact, in China, back in 2012, an appeal to establish a special bankruptcy system for financial institutions was made by the regulatory authorities in the "The 12th Five-Year Plan for Development and Reform of the Financial Industry". Targeted at insurers, it was also recommended in this plan that the "Rules on Crisis Management of Insurers" should be enacted.[8] However, until now, neither has a special bankruptcy system for financial institutions been established, nor have specific "Rules on Crisis Management of Insurers" been made. It has to be admitted that a bulk of laws (including regulations) in the financial area are crisis-driven. As is often the case, the legislature or regulatory authorities are not incentivised enough to introduce or revise certain laws until a major crisis takes place. The relatively low incidence of major crises of insurers can to a certain extent explain why the law-making process of the CMME mechanism is so slow. But since the authorities have already recognised that the current mechanism is inadequate, to accelerate the reform process will always be a wise choice. In line with this notion, the regulatory authorities issued "The Plan to Accelerate the Reform of

[7] For relevant discussion, see Section 2.2.4 in this thesis.

[8] The People's Bank of China and others, 'The 12th Five-Year Plan for Development and Reform of the Financial Industry' (September 2012) <www.gov.cn/gzdt/2012-09/17/content_2226795.htm> accessed 25 November 2016.

the Market Exit Mechanism" in 2019, which reiterated the necessity of reforming the market exit mechanism for financial institutions.[9]

Considering the fact that China is now the second largest economy[10] in the world and its insurance market becomes more and more open to overseas investors, the need for a well-designed CMME mechanism is strong and urgent. Inadequate suitable arrangements in the mechanism may not only impede troubled insurers' exit from the market, but in turn deter prospective newcomers' entry into the market as well.[11] The existence of troubled insurers may cause market disorder, and the interests of healthy insurers might be jeopardised if troubled insurers use unfair competition strategies to grab market share. A sound and well-functioning insurance market should always welcome competitive insurers and at the same time eliminate troubled ones. Troubled insurers' involuntary exit from the market can alert other insurers in the market and prompt them to improve their own performance. Thus, having a well-designed CMME mechanism in place can promote the sound development of the insurance market.

In recognition of inadequacies in the current CMME mechanism in China, this thesis, from the legal perspective, seeks to examine how the mechanism can be reformed to

[9] The National Development and Reform Commission and others, 'The Plan to Accelerate the Reform of the Market Exit Mechanism' (July 2019) <www.gov.cn/xinwen/2019-07/16/content_5410058.htm> accessed 16 July 2019.

[10] For relevant statistics, see International Monetary Fund, 'World Economic Outlook Database' <www.imf.org/external/pubs/ft/weo/2019/02/weodata/index.aspx> accessed 5 June 2020.

[11] W. Jean Kwon, Hunsoo Kim and Soon-Jae Lee, 'Can Insurance Firms Easily Exit from the Market? A Global Comparative Analysis of Regulatory Structures' (2005) 30 The Geneva Papers on Risk and Insurance - Issues and Practice 268, 269.

be more compatible with the special features of insurers. Since the CMME mechanisms in the UK and the US represent two typical alternative models, with the UK one based on the general insolvency system and the US one completely independent of the general insolvency system, a comparative study will be conducted so as to see what experience or lessons can be learnt from the mechanisms in the UK and the US.[12]

1.2. Research Questions

Revolving around the overarching question as to how the CMME mechanism in China can be reformed to be more compatible with the special features of insurers, this thesis will carry out comprehensive research on the CMME mechanisms in China, the UK and the US. To achieve the overarching goal of coming up with recommendations for the reform of the CMME mechanism in China, the following sub-questions will be answered as the thesis proceeds:

A. What makes the CMME mechanism unique?

B. How are measures/procedures designed or arranged in the current CMME mechanism in China? What are the problems in the current mechanism?

C. How are measures/procedures designed or arranged in the CMME mechanisms, respectively, in the UK and the US? What experience or lessons can be learnt from

[12] Note: In the UK, laws governing the insolvency system are different between England and Wales, Scotland, and Northern Ireland. In this thesis, when the CMME mechanism in the UK is discussed, only laws in England and Wales are considered.

these two jurisdictions?

D. Based on the comparison of the CMME mechanisms, to what extent can China learn from the UK and the US?

E. In the future in China, whether the CMME mechanism should remain based on the general bankruptcy system or should be reformed to be independent of the general bankruptcy system? How can measures/procedures be designed or arranged to form an effective and efficient CMME mechanism?

1.3. Scope of the Research

The crisis management and market exit mechanism for insurers (the CMME mechanism) is not a specifically defined mechanism in the current legislation. In this thesis, the CMME mechanism refers to a set of measures/procedures that can serve the crisis management function or the market exit function in the event of crises of insurers, which are legal entities having obligations under policies to policyholders. Due to the fact that the CMME mechanism in China has not been well formed, the thesis will focus on examining how the overall framework of the CMME mechanism in China can be reformed, but without considering arrangements for cross-frontier issues.

Measures or procedures which can serve the crisis management function or the market exit function in dealing with troubled insurers will be regarded as components of the CMME mechanism, and thus fall within the research scope of this thesis. In fact, there is no clear border between the crisis management function and the market exit function. Since a market exit strategy can be a useful means of addressing a crisis of

an insurer, a need for crisis management often leads to an insurer's exit from the market. From the legal perspective, it can be said that when an insurer fails to meet statutory or regulatory requirements and regulatory authorities thus intervene to deal with the crisis, the crisis management process begins. In cases where a troubled insurer cannot return to normal conditions and should cease to exist as a legal entity, the market exit process begins and the insurer will be eventually liquidated. Therefore, the crisis management process and the market exit process are closely interlinked, together forming a complete process through which all crises of insurers will be addressed under the CMME mechanism.

When "insurer" is mentioned in this thesis, it is synonymous with "insurance company", which refers to a company having obligations under policies to policyholders.[13] The involvement of policyholders constitutes an important factor that should be taken into account in dealing with crises of insurers, and thus largely accounts for the uniqueness of the CMME mechanism. This also makes the CMME mechanism different from the mechanism dealing with troubled insurance-focused financial holding companies or troubled insurance-focused financial groups,[14] despite

[13] Note: In some laws/policy documents/writings, the term "insurer" has a broader meaning, not just referring to insurance companies. For example, in the policy documents issued by the IAIS, the term "insurer" means insurance legal entities and insurance groups, including insurance-focused financial conglomerates. See IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) 8 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

[14] With regard to "insurance-focused financial holding company" and "insurance-focused financial group", the IAIS's definitions of similar terms can be used for reference purposes. Generally speaking, an insurance-focused financial group consists of two or more legal entities, at least one of which is an insurance company, where one

the fact that there can be many common measures/procedures in these two mechanisms. This thesis will focus only on the mechanism for troubled insurers, without much mentioning the mechanism for troubled insurance-focused financial holding companies or troubled insurance-focused financial groups. Nevertheless, it should be noted that, due to the interconnectedness, dealing with a troubled financial holding company or financial group will inevitably have impacts on its subsidiary insurers to a greater or lesser extent, even if the subsidiary insurers themselves are in compliance with all statutory or regulatory requirements. Likewise, dealing with a troubled insurer will also inevitably have impacts on its holding company or financial group.

In the same vein, the discussion in this thesis will be confined to the crisis management and market exit mechanism for primary insurers, without considering pure reinsurers, since the business of pure reinsurers will not directly involve policyholders.[15] In fact, it is common practice to treat pure reinsurers like any other ordinary companies when they become insolvent. This means that pure reinsurers are normally subject to general insolvency law. Therefore, the thesis will not discuss issues

has control over one or more insurance companies and possibly other non-regulated legal entities, and whose primary business is insurance. Within the group, the head company, ie the entity which has control over one or more insurance companies and possibly other non-regulated legal entities, is the insurance-focused financial holding company. See IAIS, 'Glossary – "insurance group"' <www.iaisweb.org/page/supervisory-material/glossary> accessed 1 May 2020.

[15] With regard to "pure reinsurer", the UK FCA's definition can be used for reference purposes. According to the FCA, a pure reinsurer is an insurer whose insurance business is restricted to reinsurance. See FCA, 'Handbook – Glossary – "pure reinsurer"' <www.handbook.fca.org.uk/handbook/glossary/G936.html> accessed 1 May 2020.

relating to pure reinsurers.

Although the thesis will discuss the overall CMME mechanism, it is unrealistic and impossible to cover all aspects of this mechanism. Due to the fact that the CMME mechanism has not been well formed in China and there is still a paucity of relevant research, the focus in this thesis will be on the design of the overall framework of the mechanism. In other words, the thesis will mainly examine what major measures/procedures should be contained in the CMME mechanism, and how these measures/procedures can be designed or arranged to make the CMME mechanism more effective and efficient. Eventually, the thesis will put forward a reform proposal of the framework of the CMME mechanism in China.

When examining the CMME mechanism, the thesis will focus mainly on the phase when a troubled insurer has been taken over by a special group designated by regulatory authorities or courts. Although legal actions that can be taken against a troubled insurer before the insurer is taken over are also significant and indispensable, they are usually dealt with explicitly in the legislation and are similar in different jurisdictions. These legal actions normally include, among others, requiring the insurer to make certain corrections, restricting activities the insurer can carry out, and imposing sanctions on the insurer. By comparison, when it comes to the post-takeover phase, since actions taken in this phase will affect not only the troubled insurer but also policyholders, other creditors, shareholders or other interested parties of the insurer, legal issues become complicated. Legislation governing actions in this phase in different jurisdictions varies significantly. In fact, it is the lack of special consideration

for insurers in post-takeover measures/procedures in the current CMME mechanism in China that largely accounts for deficiencies of the mechanism. Considering these factors, this thesis will focus mainly on post-takeover measures/procedures and seek to find out how these measures/procedures can be designed to be more compatible with features of insurers.

Despite the importance of dealing with cross-frontier issues during crises of insurers, especially in a time when insurance giants tend to carry on business all over the world, this thesis will not touch on cross-frontier issues. In a certain jurisdiction, how to deal with cross-frontier issues will always be based on approaches to dealing with domestic issues. Considering the fact that the CMME mechanism in China has not been well formed, the most fundamental challenge at this stage is to examine how the framework of the CMME mechanism can be reformed at the domestic level. This will provide a foundation for future research on cross-frontier issues.

1.4. State of the Art

In the following sections, a brief review will be conducted on current developments of the CMME mechanisms at the international level as well as at the national level, respectively, in China, the UK and the US. Generally speaking, research on the CMME mechanism is still at an early stage around the world, and not much attention has been paid to this area by legal academics. Since the aim of the thesis is to provide recommendations for the reform of the CMME mechanism specifically in China, the review of developments in China will be more critical. Therefore, while the review will

point out the gaps existing in the current research in China, the review will just give a general description of what current developments are at the international level as well as in the UK and the US.

1.4.1. Proposals at the International Level

To enhance cooperation between nations in the financial area or just in the insurance area, there exist international standard-setting bodies such as the Financial Stability Board (FSB)[16] and the International Association of Insurance Supervisors (IAIS).[17] Guidance documents issued by these international institutions, albeit with no strictly binding effects, often represent the latest regulatory developments in the world, and will set the trend for their member states to follow. Issues relating to the CMME mechanism are always major concerns of these international institutions. Researching into the relevant guidance documents will show how research on the CMME mechanism develops at the international level.

In the "Insurance Core Principles" (ICPs) set by the IAIS, which are applicable to all jurisdictions and serve as the criteria for assessing the insurance regulatory system of a jurisdiction,[18] the ICP 10 (Preventive Measures, Corrective Measures and Sanctions)

[16] The FSB is an international body that monitors and makes recommendations about the global financial system, and there are currently 25 member jurisdictions (including China, the UK and the US). See 'About the FSB' <www.fsb.org/about/> accessed 2 May 2020.

[17] The IAIS is an international standard-setting body responsible for developing and assisting in the implementation of principles, standards and other supporting material for the supervision of the insurance sector. The members of the IAIS consist of insurance regulators from more than 200 jurisdictions. See 'About the IAIS' <www.iaisweb.org/page/about-the-iais/> accessed 2 May 2020.

[18] See IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) Introduction <www.iaisweb.org/page/supervisory-material/insurance-core-

and the ICP 12 (Exit from the Market and Resolution), revised and updated in November 2019, are directly related to the CMME mechanism. It is provided in the ICP 10 that there should be a wide range of measures in place for the supervisor to prevent a breach of regulatory requirements by an insurer, or to respond to a breach of regulatory requirements by an insurer.[19] These measures include, but are not limited to, restricting certain business activities of the troubled insurer, requiring the troubled insurer to reinforce the financial position, facilitating the transfer of policies to other healthy insurers, suspending the licence of the troubled insurer, making use of a system-wide lending facility for market-wide liquidity issues.[20] To deal with the situation where measures in the ICP 10 are not sufficient to restore a troubled insurer to normal conditions, the ICP 12 points out the ways through which the troubled insurer could exit from the market. According to the ICP 12, when a troubled insurer becomes or is likely to become no longer viable, and has no reasonable prospect of returning to viability, the insurer may be resolved and thus exit the market by means of portfolio transfer, run-off, restructuring, or liquidation.[21] Therefore, the ICP 10 and

principles-and-comframe> accessed 15 November 2019.

[19] See IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 10 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

[20] See IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 10 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

[21] See IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

the ICP 12 together delineate a general picture of the CMME mechanism, not only setting out basic principles which should be followed by each jurisdiction, but also providing guidance on how arrangements in the CMME mechanism in a jurisdiction can be designed.

Targeted at systemically important insurers, especially the designated Global Systemically Important Insurers (G-SIIs),[22] the FSB appealed to its member states to have in place a special resolution regime for insurers so as to deal with possible systemic crises.[23] To this aim, in October 2011, the FSB issued "The Key Attributes of Effective Resolution Regimes for Financial Institutions" (the "Key Attributes"), setting out essential features that should be contained in the resolution regime in a certain jurisdiction; in October 2014, the FSB added a guidance document titled "Resolution of Insurers" as an annex to the Key Attributes, providing specific guidance to help implement the Key Attributes in the insurance sector; in June 2016, the FSB published

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[22] The G-SIIs are insurance-focused financial groups whose distress or disorderly failure, because of their size, complexity and interconnectedness, could cause significant disruption to the global financial system and economic activity. The designation of G-SIIs was firstly published by the FSB in 2013, and then updated each year until 2018, when the designation was suspended after the IAIS published 'Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document'. See IAIS, 'Global Systemically Important Insurers: Policy Measures' (July 2013) <www.iaisweb.org/page/supervisory-material/financial-stability/archive> accessed 15 October 2017; FSB, 'FSB Welcomes IAIS Proposed Insurance Systemic Risk Framework and Decides not to Engage in an Identification of G-SIIs in 2018' (November 2018) <www.fsb.org/2018/11/fsb-welcomes-iais-proposed-insurance-systemic-risk-framework-and-decides-not-to-engage-in-an-identification-of-g-siis-in-2018/> accessed 2 May 2020.

[23] Note: When the term "insurers" is used by the FSB or the IAIS, normally it is a collective term referring to insurance companies, reinsurance companies, and insurance groups (including insurance-focused financial conglomerates). By comparison, when the term "insurers" is used in this thesis, generally it refers only to insurance companies as legal entities.

"Developing Effective Resolution Strategies and Plans for Systemically Important Insurers", further discussing issues to be considered in the resolution regime for insurers. It is always recognised by the FSB that resolution regimes for insurers are generally underdeveloped around the world. Only about one fourth of FSB jurisdictions have in place or have plans to introduce a resolution regime for insurers that is broadly aligned with the Key Attributes.[24]

However, the IAIS's attitude towards the FSB-proposed resolution regime has changed in recent years. Different from the initial attitude that the FSB-proposed resolution regime applies only to systemically important insurers, the IAIS now holds that measures contained in this regime should be applied to all insurers in a proportionate manner.[25] This is because a systemic crisis may be caused or amplified not only by the crisis of a systemically important insurer, but also by simultaneous crises of a group of insurers, none of which individually is recognised as systemically important.[26] Thus, the IAIS began to adopt a holistic approach to assessing and mitigating systemic risks in the insurance sector, taking account of the possible systemic risks stemming from certain individual insurers, because of their size, complexity, lack of substitutability, etc, as well as from a group of insurers, because of

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[24] FSB, 'FSB 2018 Resolution Report: "Keeping the Pressure up"' (November 2018) <www.fsb.org/wp-content/uploads/P151118-1.pdf> accessed 15 November 2018.

[25] IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector' (November 2019) 14 <www.iaisweb.org/page/supervisory-material/financial-stability> accessed 15 November 2019.

[26] IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector' (November 2019) 9 <www.iaisweb.org/page/supervisory-material/financial-stability> accessed 15 November 2019.

their collective exposures or activities.[27] As a consequence, the IAIS has integrated the elements of the FSB-proposed resolution regime into the updated ICPs, eg the ICP 10 and the ICP 12, making the measures that were originally designed to be applicable only to systemically important insurers now applicable to all insurers.[28] In line with this, the designation of G-SIIs has also been suspended since 2018.[29]

In addition, at the EU level, relevant policy-making authorities, such as the European Insurance and Occupational Pensions Authority (EIOPA) and the European Systemic Risk Board (ESRB), are researching on issues relating to the CMME mechanism. To appeal to build a minimum harmonised recovery and resolution framework for insurers at the EU level, these authorities have issued some working papers or proposals in recent years. For example, in July 2017, the EIOPA published "Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re)insurers Across the Member States"; in August 2017, the ESRB published "Recovery and Resolution for the EU Insurance Sector: A Macroprudential Perspective"; in 2017, the EIOPA published "Systemic Risk and Macroprudential Policy in Insurance"; in 2018, the EIOPA published "Failures and Near Misses in Insurance –

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[27] IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document' (November 2018) 12 <www.iaisweb.org/page/consultations/closed-consultations/2019/holistic-framework-for-systemic-risk-in-the-insurance-sector> accessed 15 November 2018.

[28] IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector' (November 2019) 17 <www.iaisweb.org/page/supervisory-material/financial-stability> accessed 15 November 2019.

[29] FSB, 'FSB Welcomes IAIS Proposed Insurance Systemic Risk Framework and Decides not to Engage in an Identification of G-SIIs in 2018' (November 2018) <www.fsb.org/2018/11/fsb-welcomes-iais-proposed-insurance-systemic-risk-framework-and-decides-not-to-engage-in-an-identification-of-g-siis-in-2018/> accessed 2 May 2020.

Overview of the Causes and Early Identification". These working papers or proposals represent the recent developments of research on the CMME mechanism and are always an important source of references for international standard-setting bodies such as the IAIS. Thus, although legislation at the EU level falls outside the scope of this thesis, research done by the EU authorities could still contribute to a better understanding of issues relating to the CMME mechanism.

1.4.2. Current Developments in China

It can be said that the CMME mechanism has not been well formed in China. The current CMME mechanism is based on the general bankruptcy system, but there is a lack of arrangements in the mechanism to accommodate the special features of insurers. Despite serious deficiencies in the legislation, this mechanism has not attracted much attention from legal academics. Legal research on issues relating to the CMME mechanism is insufficient, and there is especially a paucity of comprehensive studies on the entire mechanism.

1.4.2.1. Legal Framework

The major components of the current CMME mechanism include the regulatory intervention system (consisting of regulatory measures), the bankruptcy system (consisting of composition, reorganisation, and bankruptcy liquidation), and the Insurance Security Fund. These components are mainly provided for in the Insurance

Act, Enterprise Bankruptcy Act and relevant departmental regulations.[30]

Insurers are supervised by the China Banking and Insurance Regulatory Commission (CBIRC). When an insurer falls below statutory or regulatory requirements, there is a wide range of regulatory measures the CBIRC can take to deal with the troubled insurer. These regulatory measures include, for example, limiting the business scope, restricting investment activities, directing the insurer to transfer insurance policies, directing the insurer to increase the capital, restricting the payment of dividends to shareholders, limiting the remuneration of directors and senior managers, forbidding the insurer to write new policies, initiating a rectification, initiating a takeover, and revoking the licence of the insurer.[31] However, as to "takeover" – one of the most stringent regulatory measures, there are only 6 provisions governing this measure in the Insurance Act, and these provisions are short and rough. This not only causes difficulty in understanding "takeover", but also makes it impossible for "takeover" to be implemented in a manner in accordance with pre-determined clear rules.

In circumstances where insurers become insolvent, it is still likely that bankruptcy procedures (ie composition, reorganisation, and bankruptcy liquidation) will be initiated against troubled insurers according to the Enterprise Bankruptcy Act. However, the bankruptcy system for insurers is almost the same as that for ordinary

[30] In China, departmental regulations are enacted by departments under the State Council and constitute one type of legislation. The departmental regulations relating to the CMME mechanism are mainly enacted by the CBIRC.

[31] See Insurance Act, ch 6. (China)

companies, and there is a lack of arrangements in the legislation to adapt the bankruptcy procedures for insurers. For example, it is not known how a vast number of policyholders, as creditors or potential creditors of an insurer, can participate in creditors' meetings if the insurer is in a bankruptcy procedure. As a consequence, it is almost unfeasible for bankruptcy procedures to be implemented against troubled insurers. In fact, in practice, there has never been a case involving a bankruptcy procedure of an insurer.

1.4.2.2. Research

There is a paucity of legal studies on the entire CMME mechanism in China. The book *Research on the Risk Disposal and Market Exit System for Insurance Companies*, which was edited by Yanna Bo and published in 2013, is the only book carrying out legal research on the entire CMME mechanism.[32] It should be acknowledged that this book gives a good description of the CMME mechanisms in China, Japan and the US, serving as a useful source of research materials. However, despite recognising so many deficiencies in the current mechanism in China, the book fails to put forward a comprehensive set of recommendations on how the mechanism can be improved to be more compatible with the special features of insurers. For example, the book fails to clarify how regulatory authorities should function in different measures/procedures in the mechanism and makes no mention of how creditors' meetings can be held in a

[32] Yanna Bo, *Research on the Risk Disposal and Market Exit System for Insurance Companies* (Peking University Press 2013).

bankruptcy procedure of an insurer. Apart from this book, an article written by Ting Zhang analyses the entire CMME mechanism in China.[33] Obviously, the mechanism is too big to be discussed in detail in an article, although it is a comparatively long article. This article gives a general description of the current mechanism, points out major problems in the legislation, but again fails to provide specific recommendations for the reform of the mechanism.

Other works on the entire CMME mechanism are mainly produced by academics from the areas of, for example, actuarial science, insurance, or finance. After examining the CMME mechanism in China, these works also point out deficiencies in the current legislation, and appeal for legal reforms.[34] However, since research in these works is done from perspectives other than the legal perspective, there is, of necessity, no comprehensive set of recommendations for the reform of the CMME mechanism from the legal perspective. Recommendations for legal reforms in these works, if any, are normally general, in lack of details.

There are still some works focusing on certain aspects of the CMME mechanism. For example, some works focus on the takeover measure for insurers,[35] some works focus

[33] Ting Zhang, 'A Study on China's Risk Disposal and Market Exit System for Troubled Insurance Companies' in Jingshan Chen and Ting Zhang (eds), *Legal Comments on Crisis Management System for Financial Institutions in East Asia*, vol 1 (Law Press · China 2015).

[34] See, for example, Chen Guo, 'Reforming the Insurance Market Exit Mechanism in China' (Master Dissertation, Jilin University 2008); Lijuan Sun, 'Insolvency of Insurers – International Experience and Lessons' (2009) 6 Insurance Studies 67; Guanghui Yu, 'Research on the Evolution of Insurance Market Exit System in China 1949-2012' (Master Dissertation, Liaoning University 2013); Lijuan Sun, 'Research on Economic Influences and Regulation of Insolvency of Insurers – Experience and Lessons from the US' (2015) 6 Insurance Studies 97.

[35] See, for example, Qiongwei Yao, 'Reflecting on the Takeover of Yongan Insurance Company' (1998) 2

on the functions the insurance guarantee scheme can perform when dealing with troubled insurers,[36] and some works focus on policyholder protection during crises of insurers.[37] Although these works can contribute to better reflections on certain components of the CMME mechanism, there is a lack of consideration in each work about how the target component can fit in with other components in the CMME mechanism. As a consequence, these works fail to present a holistic picture of the CMME mechanism, let alone put forward a comprehensive set of recommendations for the reform.

It is not difficult to find that current legal research on the CMME mechanism is insufficient. The necessity of reforming the current mechanism in China requires more attention from legal academics. In light of this, a comprehensive legal study on the CMME mechanism is carried out in this thesis. Based on a comparative study between

Shanghai Insurance 23; Teng Wang, 'Reflecting on the Takeover of Yongan Insurance Company' (2001) 5 Shanghai Insurance 15; Bin Guan and Shiying Peng, 'Reforming the Takeover Measure of Insurers' (2019) 33 Journal of Huazhong University of Science & Technology 92; Xiang Long, 'Reforming the Takeover Measure in the Insurance Act' (2013) 12 China Finance 61.

[36] See, for example, Shengzhong Jiang, Weizhi Zhu and Jia Chen, 'Insurance Guaranty Fund: An International Comparison Perspective' (2008) 11 Insurance Studies 39; Haifeng Ma and Zhigang Xie, 'Regulatory Powers of the Insurance Security Fund in China' (2010) 3 Collected Essays on Finance and Economics 58; Haifeng Ma and Zhigang Xie, 'Research on the Insurance Security Fund's Function of Rescuing Troubled Insurers' (2011) 6 Commercial Research 117; Xiang Long, 'Improving the Insurance Security Fund's Function of Protecting Policyholders' (2011) 3 Insurance Studies 96; Yanna Bo, 'Improving the Insurance Security Fund's Functions in Addressing Crises of Insurers: An International Comparison Perspective' (2016) 5 Commercial Law Studies 85.

[37] See, for example, Jing Jia, 'Policyholder Protection in Liquidation of Life Insurers' (2015) 12 Shanghai Finance 95; Jing Jia, 'A Comparative Study on Policyholder Protection in Insolvency of Insurers' (PhD Thesis, University of International Business and Economics 2016); Peng Hu, 'Protecting Policyholders' Interests in Insolvency of Insurers' (2018) 2 Taxation and Economy 26.

China, the UK and the US, this thesis will finally come up with a proposal of an overall framework of the reformed CMME mechanism.

1.4.3. Current Developments in the UK

The CMME mechanism in the UK is largely based on the general insolvency system, and a number of modifications have been made to facilitate the application of the insolvency procedures to insurers. However, it is still arguable that the design model adopted in the current mechanism is not satisfactory. Unfortunately, little attention has been paid to this area by legal academics, and relevant research in the UK is scarce.

1.4.3.1. Legal Framework

The major components of the current CMME mechanism include the proactive intervention framework, the insolvency system (consisting of company voluntary arrangement, administration, and winding-up), schemes of arrangement, and the Financial Services Compensation Scheme.

Insurers are under the prudential supervision of the Prudential Regulation Authority (PRA). Confronted with a troubled insurer, the PRA could take appropriate regulatory measures according to the Proactive Intervention Framework.[38] In the situation where an insurer becomes or is likely to become insolvent, procedures in the insolvency system could also be initiated. Insolvency procedures for insurers are basically the same as those for ordinary companies, including company voluntary

[38] PRA, 'The Prudential Regulation Authority's Approach to Insurance Supervision' (October 2018) 30.

arrangement, administration, and winding-up, with modifications made to adapt these procedures for insurers. However, in practice, these insolvency procedures are seldom used, and most existing crises of insurers have been dealt with through schemes of arrangement. As a consequence, efforts to modify the insolvency system for insurers, in effect, have to a large extent been wasted.

The current CMME mechanism is far from satisfactory. Due to the fact that the mechanism is based on the general insolvency system, there exist some arrangements which are inherent in the insolvency system but are arguably not compatible with the special features of insurers. For example, it is required that major issues should be subject to creditors' decisions in insolvency procedures, but in the case of insurers, to seek decisions from all creditors (including policyholders) of insurers is almost an unachievable task.[39] Also, since there is a lack of arrangements designed for the purposes of maintaining financial stability, it is doubtful whether the current mechanism is sufficient to successfully address crises of insurers in cases where the insurers pose systemic risk.[40] In recognition of the inadequacy of the current CMME, regulatory authorities in the UK have been considering for years whether a special regime different from the insolvency system should be built to deal with troubled insurers.[41]

[39] For more detailed discussions, see, for example, Section 4.2.1.2 and Section 4.2.2.3 in this thesis.

[40] HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012) 29.

[41] See, for example, HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012) 32; Bank of England, 'The Bank of England's Approach to Resolution' (October 2017) 19.

1.4.3.2. Research

Although there existed special statutory provisions on how to deal with troubled insurers since the Life Assurance Companies Act 1870 was enacted, few legal academics have ever paid attention to issues relating to the CMME mechanism.

Discussions of the entire CMME mechanism can only be found in insurance law textbooks, often in a comparatively short chapter, if any, or just a few passages therein.[42] Determined by the "textbook" nature, these books only provide a general description of the current CMME mechanism, without analysing the mechanism in a critical way.

There are two books discussing the CMME mechanism from a certain perspective. The book *EU Banking and Insurance Insolvency* discusses the insolvency system for insurers under the EU legal framework.[43] The other book *Cross-Frontier Insolvency of Insurance Companies* discusses the insolvency systems for insurers in 16 jurisdictions, including the UK.[44] But the discussion in this book focuses mainly on how cross-frontier issues will be handled when an insurer with international business is placed into an insolvency procedure.

Only a handful of journal articles which concern issues relating to the CMME mechanism can be found. Among them, several articles discuss the use of schemes of

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[42] See, for example, Robert Merkin, *Colinvaux's Law of Insurance* (11th edn, Sweet & Maxwell 2016); John Birds, Ben Lynch and Simon Paul, *MacGillivray on Insurance Law* (14th edn, Sweet & Maxwell 2019).

[43] Gabriel Moss, Bob Wessels and Matthias Haentjens, *EU Banking and Insurance Insolvency* (2nd edn, Oxford University Press 2017).

[44] Gabriel Moss and others, *Cross-Frontier Insolvency of Insurance Companies* (Sweet & Maxwell 2001).

arrangement in dealing with troubled insurers;[45] one article discusses the court' power of writing down insurance benefits instead of making a winding-up order;[46] and one article talks about how changes in the insolvency system for insurers in the UK in early 2000s have implications for interested parties in the US.[47]

Therefore, it is fair to say that legal research on the CMME mechanism is scarce in the UK.

1.4.4. Current Developments in the US

The CMME mechanism in the US is a mechanism specific to insurers, which is completely independent of the bankruptcy system for ordinary companies. Basically, the current mechanism suffices to address crises of insurers of varying sizes, and regulatory authorities, in general, have rich experience in dealing with troubled insurers. It seems that regulatory authorities show more interest than legal academics in researching on issues relating to the CMME mechanism.

[45] Peter Fidler, 'Schemes of Arrangement for Insolvent Insurance Companies in the United Kingdom: Current Developments' (1995) 3(1) International Insurance Law Review 18; Alistair Hill, 'Schemes of Arrangement: Binding Unknown Creditors in Respect of Unknown Liabilities for Unknown Amounts' (2006) 8 Journal of International Banking and Financial Law 341; Look Chan Ho, 'Solvent Schemes for Insurers – A Touch of Class and Jurisdiction' (2006) 3(1) International Corporate Rescue 1; David Hindley and others, 'Schemes of Arrangement and Business Transfers' (10 August 2009) <www.actuaries.org.uk/system/files/documents/pdf/b08hindleypaper2.pdf> accessed 13 August 2019.

[46] Jennifer Donohue, 'Section 377 of the Financial Services and Markets Act 2000 and Bank "Bail-in": Insurance Wine in Bank Bottles!' (2013) 28(5) Butterworths Journal of International Banking & Financial Law 263.

[47] William Goddard, 'The Revolution of the Times: Recent Changes in UK Insurance Insolvency Laws and the Implications of Those Changes Viewed from a US Perspective' (2003) 10(1) Connecticut Insurance Law Journal 139.

1.4.4.1. Legal Framework

The major components of the CMME mechanism include the state receivership system (consisting of pre-receivership tools, conservation, rehabilitation and liquidation), the insurance guaranty associations, and the relevant regulation at the federal level.

Insurers are regulated at the state level, and the main responsibility for dealing with troubled insurers rests with state insurance regulators.[48] To coordinate the state insurance regulation, there exists the National Association of Insurance Commissioners (NAIC), which is formed by the chief insurance regulator of each state.[49] The NAIC has published a series of model acts, and state insurance laws will normally follow the model acts, although they may deviate from the models to a certain extent. In terms of the CMME mechanism, the most relevant model acts are, for example, the Administrative Supervision Model Act, the Insurer Receivership Model Act, the Life and Health Insurance Guaranty Association Model Act, and the Property and the Casualty Insurance Guaranty Association Model Act. By virtue of these model acts and relevant state laws, the US has established a CMME mechanism which is centred on the state insurer receivership system.

Due to the fragmented patterns of state insurance regulation, the state insurer receivership system alone is not sufficient to deal with a systemic crisis. To complement state laws, arrangements have been devised at the federal level to ensure

[48] McCarran–Ferguson Act § 1, 15 U.S.C. § 1011. (US)

[49] 'About the NAIC' <www.naic.org/index_about.htm> accessed 10 August 2019.

that crises of insurers will be addressed in an orderly manner when troubled insurers pose systemic risk. These arrangements mainly include designation of systemically important financial companies, orderly liquidation authority, and emergency lending from the Federal Reserve System.

Independent of the general bankruptcy system, the CMME mechanism is particularly designed for insurers. Most arrangements in the mechanism can be regarded as compatible with the special features of insurers, and the mechanism basically suffices to deal with troubled insurers. However, due to the separation of the state regulation and the federal regulation, the process of addressing crises will be inevitably hindered to a greater or lesser extent if troubled insurers pose systemic risk.[50]

1.4.4.2. Research

Issues relating to the state insurer receivership system are always a focus of insurance regulatory authorities and relevant practitioners. For example, apart from the relevant model acts, the NAIC has issued, and keeps updating, 'Receiver's Handbook for Insurance Company Insolvencies', which provides a comprehensive and detailed guidance for state insurance regulators to carry out receivership procedures. In addition, in the industry, there exists the International Association of Insurance

[50] International Monetary Fund, 'United State – Financial Sector Assessment Program – Review of the Key Attributes of Effective Resolution Regimes for the Banking and Insurance Sectors – Technical Note' (July 2015) 18 <www.imf.org/en/Publications/CR/Issues/2016/12/31/United-States-Financial-Sector-Assessment-Program-Review-of-the-Key-Attributes-of-Effective-43056> accessed 15 June 2018.

Receivers, which is formed by practitioners engaged in addressing crises of insurers and serves as a forum for professionals to exchange ideas.[51] Publications under the theme of dealing with troubled insurers are released by this association on a regular basis, providing practitioners with a good platform to share their experience or thoughts.

By comparison, not much attention has been paid to the state insurer receivership system by legal academics. There is a lack of comprehensive studies on the entire insurer receivership system carried out by academics, and only a few journal articles touch on the entire system.[52] Other works just focus on certain aspects of the insurer receivership system. For example, quite a few works discuss insurance guaranty associations;[53] some works discuss the insurer receiver;[54] some works discuss the

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[51] 'Welcome to IAIR' <www.iair.org/> accessed 10 August 2019.

[52] See, for example, Adam Hodkin, 'Insurer Insolvency: Problems & Solutions' (1992) 20 Hofstra Law Review 727; Debra J. Hall and Robert M. Hall, 'Insurance Company Insolvencies: Order out of Chaos' (1993) 12(2) Journal of Insurance Regulation 145; Peter H. Bickford, 'A Quiet Tyrant: The Insurers Rehabilitation and Liquidation Model Act' (1995) 7(11) Mealey's Litigation Reports 1; Francine L. Semaya and William K. Broudy, 'A Primer on Insurance Receiverships' (2010) 40 The Brief 22.

[53] See, for example, Bernard E. Epton and Roger A. Bixby, 'Insurance Guaranty Funds: A Reassessment' (1976) 25(2) Depaul Law Review 227; Paul G. Roberts, 'Insurance Company Insolvencies and Insurance Guaranty Funds: A Look at the Nonduplication of Recovery Clause' (1989) 74 Iowa Law Review 927; Kent M. Forney, 'Insurer Insolvencies and Guaranty Associations' (1995) 43 Drake Law Review 813; Spencer L. Kimball and Noreen J. Parrett, 'Creation of the Guaranty Association System' (2000) 19(2) Journal of Insurance Regulation 259; Cynthia J. Borrelli and Richard R. Spencer, 'A Primer on State Insurance Guaranty Associations' (2009) 21(2) Environmental Claims Journal 90.

[54] See, for example, Karl L. Rubinstein, 'The Legal Standing of an Insurance Insolvency Receiver: When the Shoe Doesn't Fit' (2003) 10 Connecticut Insurance Law Journal 309; Peter H. Bickford, 'Who Protect Us from the Receiver?' (15 November 2004) <https://pbnylaw.com/articles/whoprotectsusfromthereciever-11-04.pdf> accessed 10 July 2018.

exclusive jurisdiction of the receivership court;[55] and some works discuss issues relating to reinsurance during a receivership procedure.[56]

In contrast to the paucity of academic research on the state insurer receivership system, there is no lack of research on the relevant federal regulation which is part of the CMME mechanism. This is because the relevant federal regulation is not just targeted at insurers, but applicable to all financial institutions which may pose systemic risk. Topics relating to systemic crises will never fail to appeal to academics. As a consequence, within the domain of the CMME mechanism, there is abundant literature concerning designation of systemically important financial companies,[57]

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[55] See, for example, John N. Gavin, 'Competing Forums for the Resolution of Claims Against an Insolvent Insurer' (1988) 23(3) Tort & Insurance Law Journal 604; Christopher Mickus and Patrick Frye, 'Stopping Out-of-State Litigation Against an Insurer Subject to Insolvency Proceedings: A Tool for Practitioners' (2008) 27(3) Journal of Insurance Regulation 37.

[56] See, for example, David P. Schack, 'Reinsurance and Insurer Insolvency: The Problem of Direct Recovery by the Original Insured or Injured Claimant' (1982) 29 UCLA Law Review 872; T. Darrington Semple and Robert M. Hall, 'The Reinsurer's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer' (1986) 21(3) Tort & Insurance Law Journal 407; Christopher M. Sacco, 'Insurer Insolvency: Reinsurers' Right to Offset in Florida – A Comparative Analysis' (2001) 53 Florida Law Review 293.

[57] See, for example, Richard W. Fisher, 'Correcting "Dodd–Frank" to Actually End "Too Big to Fail"' (26 June 2013) <www.dallasfed.org/news/speeches/fisher/2013/~/media/Documents/news/speeches/fisher/2013/fs130626.pdf> accessed 18 March 2018; Peter J. Wallison, 'The Authority of the FSOC and the FSB to Designate SIFIs: Implications for the Regulation of Insurers in the United States after the Prudential Decision' (14 March 2014) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408655> accessed 18 March 2018; Viral V. Acharya, Deniz Anginer and A. Joseph Warburton, 'The End of Market Discipline? Investor Expectations of Implicit Government Guarantees' (February 2016) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1961656> accessed 18 March 2018; Scott E. Harrington, 'Systemic Risk and Regulation: The Misguided Case of Insurance SIFIs' (20 September 2016) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2998646> accessed 18 March 2018; Christina Parajon Skinner, 'Regulating Nonbanks: A Plan for SIFI Lite' (2017) 105 The Georgetown Law Journal 1379; Kathryn L. Dewenter and Leigh A. Riddick, 'What's the Value of a TBTF Guaranty? Evidence from the G-SII Designation for Insurance Companies' (2018) 91 Journal of Banking and Finance 70.

orderly liquidation authority,[58] or emergency lending from the Federal Reserve System.[59]

1.5. Research Methodology

Apart from the issues which are heavily impressed by moral views or values, such as family law issues, many issues can be governed in the same or in a very similar way in legislation in different jurisdictions.[60] The legislature in a certain jurisdiction can often draw inspiration from other jurisdictions when considering introducing new laws or reforming existing laws.[61] Transplanting laws from jurisdictions with useful experience

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[58] See, for example, Hollace T. Cohen, 'Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risks' (2011) 45 University of Richmond Law Review 1143; Brent J. Horton, 'How Dodd–Frank's Orderly Liquidation Authority for Financial Companies Violates Article III of the United States Constitution' (2011) 36 The Journal of Corporation Law 869; Matt Saldaña, 'Parallel Regimes: Bankruptcy and Dodd–Frank's Orderly Liquidation Authority' (2011) 31 Review of Banking & Financial Law 531; Sabrina R. Pellerin and John R. Walter, 'Orderly Liquidation Authority as an Alternative to Bankruptcy' (2012) 98 Federal Reserve Bank of Richmond Economic Quarterly 1; Marc Labonte, 'Systemically Important or "Too Big to Fail" Financial Institutions' (9 September 2014) <https://digitalcommons.ilr.cornell.edu/key_workplace/1328/> accessed 28 January 2019; Thomas W. Merrill and Margaret L. Merrill, 'Dodd–Frank Orderly Liquidation Authority: Too Big for the Constitution?' (2014) 163 University of Pennsylvania Law Review 165; Charles I. Plosser, 'Simplicity, Transparency, and Market Discipline in Regulatory Reform' (8 April 2014) 9 <www.philadelphiafed.org/publications/speeches/plosser/2014/04-08-14-frbp> accessed 18 March 2018.

[59] See, for example, Gary Gorton and Andrew Metrick, 'The Federal Reserve and Panic Prevention: The Roles of Financial Regulation and Lender of Last Resort' (2013) 27(4) Journal of Economic Perspectives 45; Thomas M. Humphrey, 'Arresting Financial Crises: The Fed Versus the Classicals' (6 February 2013) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212175> accessed 4 June 2018; Michael D. Bordo, 'Rules for a Lender of Last Resort: An Historical Perspective' (2014) 49 Journal of Economic Dynamics & Control 126; Congressional Research Service, 'Federal Reserve: Emergency Lending' (27 March 2020) 18 <https://fas.org/sgp/crs/misc/R44185.pdf> accessed 10 April 2020.

[60] K. Zweigert and H. Kötz, *An Introduction to Comparative Law* (3rd edn, Oxford University Press 1998) 40.

[61] Jan M. Smits, 'Comparative Law and its Influence on National Legal Systems' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law* (2nd edn, Oxford University Press 2019)

can be a cost-saving approach to legal reform, which saves time and costly experimentation.[62] In fact, '[m]ost changes in most systems are the result of borrowing'.[63] And the legal system in China is no exception in this aspect. As a developing country, China often learns from developed countries so as to improve its own legal system, especially in the areas of commercial law, financial law, etc. For example, the Enterprise Bankruptcy Act in China, which was enacted in 2006, is just a product of transplantation of laws from western countries, especially the US.[64] Therefore, in recognition of the deficiencies in the CMME mechanism in China, this thesis would also like to take inspiration from other jurisdictions so as to find out how the mechanism in China can be reformed to be more compatible with the special features of insurers. Accordingly, the methodology used in the thesis is comparative law method.

In terms of the legislation relating to the insurance business, it is an area where different jurisdictions can share a lot in common. With the globalisation of the insurance market, there still exist international standard-setting bodies, such as the FSB and the IAIS, which provide guidance on how the insurance business can be

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[62] Jonathan M. Miller, 'A Typology of Legal Transplants: Using Sociology, Legal History and Argentine Examples to Explain the Transplant Process' (2003) 51(4) The American Journal of Comparative Law 839, 845.

[63] Alan Watson, *Legal Transplants: An Approach to Comparative Law* (2nd edn, The University of Georgia Press 1993) 95.

[64] See, for example, Zhijie Jia, 'A Statement on the Enterprise Bankruptcy Act (Draft)' (21 June 2004) <www.npc.gov.cn/wxzl/gongbao/2006-09/26/content_5354979.htm> accessed 15 April 2020; Shuguang Li, 'The Significance, Breakthrough and Impact of the New Enterprise Bankruptcy Act' (2006) 6 The Journal of East China University of Political Science and Law 110.

regulated. This not only contributes to the convergence of the legislation in different jurisdictions, but also stimulates legal transplants across the world.[65] Therefore, it is reasonable to expect that China can learn from other jurisdictions when it comes to ways of reforming the CMME mechanism. Also, it is reasonable to believe that the CMME mechanisms in different jurisdictions will be more in line with each other in the future.

Depending on the relationship between the CMME mechanism and the general insolvency system within a certain jurisdiction, there are two models of CMME mechanisms. One model is that the CMME mechanism is based on the insolvency system for ordinary companies, with special provisions to modify or supplement the insolvency system to accommodate the special features of insurers. Since most insurers exist in the form of a "company", it is natural for a jurisdiction to make use of the insolvency system to deal with troubled insurers if no other system is specifically established. As a consequence, this model is adopted by most jurisdictions, eg the UK,

[65] Michele Graziadei, 'Comparative Law, Transplants, and Receptions' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law* (2nd edn, Oxford University Press 2019) 455-457.

Germany,[66] Japan,[67] and the Netherlands.[68] By contrast, the other model is that the whole CMME mechanism is specifically established for insurers, which is completely independent of the general insolvency system. This model is adopted by only a few jurisdictions, eg the US, France,[69] and Romania.[70] Since the current mechanism in China is based on the general insolvency system, it can be categorised as the former model. However, due to the lack of special consideration for insurers, it is unfeasible to apply many of the measures/procedures within the current mechanism to insurers.[71] That is why it is necessary to examine how the CMME mechanism in China can be reformed to be more compatible with the special features of insurers. In light

[66] For an overview of the CMME mechanism in Germany, see International Monetary Fund, 'Germany – Financial Sector Assessment Program – Insurance Sector Supervision – Technical Note' (June 2016) <www.imf.org/en/Publications/CR/Issues/2016/12/31/Germany-Financial-Sector-Assessment-Program-Insurance-Sector-Supervision-Technical-Notes-44016> accessed 18 May 2017.

[67] For an overview of the CMME mechanism in Japan, see Shinichi Takahashi and others, 'Insurance and Reinsurance in Japan: Overview' (1 December 2019) <https://uk.practicallaw.thomsonreuters.com/0-501-3163?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1#co_anchor_a819642> accessed 1 June 2020. Note: In Japan, a resolution regime was established in 2013 to deal with crises of insurers which pose a threat to financial stability.

[68] For an overview of the CMME mechanism in the Netherlands, see Nicole Stolk, 'The Dutch Recovery and Resolution Regime for Insurers' (25 October 2018) <www.dnb.nl/binaries/NS_tcm46-379693.pdf> accessed 10 May 2019. Note: In the Netherlands, a resolution regime was established in 2019 to deal with crises of insurers which pose a threat to financial stability.

[69] For an overview of the CMME mechanism in France, see International Monetary Fund, 'France – Financial Sector Assessment Program – Technical Note – Key Attributes of Effective Resolution Regimes for Insurance Companies' (October 2019) <www.imf.org/en/Publications/CR/Issues/2019/10/28/France-Financial-Sector-Assessment-Program-Technical-Note-Key-Attributes-of-Effective-48764> accessed 1 June 2020.

[70] For an overview of the CMME mechanism in Romania, see 'Law on the Recovery and Resolution of Insurers (In Brief)' (PwC, November 2015) <www.pwc.ro/en/tax-legal/alerts/law-recovery-and-resolution-insurers.html> accessed 1 June 2020.

[71] For a more detailed discussion, see Chapter 3 in this thesis.

of this, with the aim of coming up with recommendations for the reform of the CMME mechanism in China, it will be helpful to choose CMME mechanisms in other jurisdictions which can represent the two alternative models to carry out a comparative study. Considering the fact that the UK and the US have a long history of developing the CMME mechanisms,[72] and that the insurance markets in the UK and the US are among the largest insurance markets in the world,[73] this thesis chooses the CMME mechanisms in the UK and the US, which respectively represent the two models a CMME mechanism can follow, to carry out a comparative study.

As it was pointed out by leading comparative law scholars K. Zweigert and H. Kötz, '[I]n law, the only things which are comparable are those which fulfil the same function.'[74] In fact, there is not any mechanism which is termed the "CMME mechanism" in the current legislation in China, the UK or the US. The CMME mechanism in this thesis refers to a set of measures/procedures which can serve the crisis management function or the market exit function in dealing with troubled insurers. In a target jurisdiction, all measures/procedures that serve one of these two functions, no matter how they are termed in the legislation, will be regarded as components of the CMME mechanism and thus fall within the scope of the research

[72] Developments of the CMME mechanisms in both the UK and the US date back to the late 19th century. For more information, see Section 4.1 and Section 5.1 in the thesis.

[73] In terms of premiums written, the insurance markets in the US and the UK respectively constitute the 1st and 4th largest insurance markets in the world. See, Swiss Re Institute, 'World Insurance: The Great Pivot East Continues' (4 July 2019) 9 <www.swissre.com/dam/jcr:b8010432-3697-4a97-ad8b-6cb6c0aece33/sigma3_2019_en.pdf> accessed 1 June 2020.

[74] K. Zweigert and H. Kötz, *An Introduction to Comparative Law* (3rd edn, Oxford University Press 1998) 34.

in this thesis. As a consequence, generally speaking, the areas covered by this thesis include the insurance regulatory system, the insolvency system for insurers, the resolution regime for insurers, etc.

It should be noted that while laws can be regarded as a means of achieving social goals, they are inevitably affected by relevant factors in a particular society, being a reflection of the society.[75] As a consequence, laws governing the same or similar issues in different jurisdictions will always differ to a certain extent, and legal transplantation will be successful only when adaption is made to take account of the existing legal institutions and the social environment.[76] Blind transplantation without considering the suitability of certain arrangements in the receiving jurisdiction should always be avoided. Also, not all the laws which are well-functioning in a certain jurisdiction can bring, or at least immediately bring, the similar effects if they are transplanted to other jurisdictions.[77] When it comes to a comparative legal study of the CMME mechanisms in China, the UK and the US, attention should always be paid to differences in social, economic or legal environments in these three countries. It has to be admitted that while in China the insurance industry is still at an early stage of

[75] Nils Jansen, 'Comparative Law and Comparative Knowledge' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law* (2nd edn, Oxford University Press 2019) 294.

[76] See, for example, O. Kahn-Freund, 'On Uses and Misuses of Comparative Law' (1974) 37(1) The Modern Law Review 1, 27; Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, 'The Transplant Effect' (2003) 51(1) The American Journal of Comparative Law 163, 179.

[77] Gerhard Dannemann, 'Comparative Law: Study of Similarities or Differences?' in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law* (2nd edn, Oxford University Press 2019) 421. See also Jonathan M. Miller, 'A Typology of Legal Transplants: Using Sociology, Legal History and Argentine Examples to Explain the Transplant Process' (2003) 51(4) The American Journal of Comparative Law 839, 855.

development and the market is in fact much influenced by the state, in the UK and the US the insurance industry is a highly mature industry and develops in an environment of a free market economy. Determined by these differences, it is unrealistic to expect that all well-functioning arrangements in the CMME mechanism in the UK or in the US can also work well if they are transplanted to China, at least current China. For example, in current China, due to the fact the government (including regulatory authorities) exerts a strong influence on the society, the relevant courts may just follow or rubber-stamp regulatory authorities' decisions if a troubled insurer enters a reorganisation or liquidation, especially at a stage where the courts lack expertise as well as experience in dealing with cases concerning crises of insurers. This means that judicial review or judicial supervision in reorganisation or liquidation may become no more than a formality, which makes it less likely that sufficient judicial safeguards will be provided to relevant parties if they hold they are unfairly treated and would like to challenge the decisions made by the regulatory authorities. Nevertheless, despite the fact that, compared with the UK and the US, China still lacks a highly favourable environment which can facilitate the function of a well-designed CMME mechanism, it is believed that the useful experience learnt from the CMME mechanisms in the UK and the US can still indicate possible directions in which China may move forward in the future.

Since no laws are without their deficiencies, no matter how well the laws in a jurisdiction develop, there will always be some room for improvement or reform. As a consequence, in a comparative legal study, when it comes to taking inspiration from other jurisdictions, not only experience but also lessons may be learnt. And no

recommendation on transplanting laws should be made without carefully analysing the merits and demerits of these laws in their original jurisdictions. Therefore, in an effort to improve the CMME mechanism in China, lessons from the CMME mechanisms in the UK and the US can also be learnt so that the inappropriate or unsatisfactory arrangements in these mechanisms should be avoided when a reform in China is carried out.

In this thesis, with the aim of finding out how the CMME mechanism in China can be reformed to be more compatible with the special features of insurers, a comparative legal study of the CMME mechanisms in China, the UK and the US is conducted. The CMME mechanism in China is analysed first, and the major problems in the current mechanism are identified. Then the CMME mechanisms in the UK and the US are analysed in turn, pointing out the experience and lessons that can be learnt from these two jurisdictions. After that, a comprehensive comparison of the mechanisms in these three jurisdictions is made, and based on the comparison, recommendations are made for the future reform of China's CMME mechanism.

1.6. Outline of the Thesis

This thesis is divided into 7 chapters, working towards finding ways to make the CMME mechanism in China better suit insurers.

Chapter 1 (this chapter) gives a general introduction to the research. Having recognised that there is a lack of special arrangements for insurers in the current CMME mechanism in China, as well as a paucity of research in this area, the thesis

seeks to answer how the mechanism can be reformed to be more compatible with the special features of insurers. In this chapter, in turn, the research background is introduced, the research questions are displayed, the scope of the research is defined, the adopted methodology of comparative legal study is explained, and the review of current legislation and literature is made.

Chapter 2 examines the uniqueness of the CMME mechanism, laying the foundation for further discussion in the later chapters. As a mechanism dealing with crises of insurers, the CMME mechanism should be designed in a way compatible with the special features of insurance and insurers. Following this logic, relevant aspects of insurance and insurers are discussed in turn, revealing the special factors that should be taken into account in the CMME mechanism. Distinct from the resolution regime proposed by the FSB, which is expressly targeted at systemically important insurers, the CMME mechanism discussed in the thesis is applicable to all insurers. Drawing on the existing experience in China, the UK and the US, together with relevant requirements in the ICPs released by the IAIS, a comparison is made between the CMME mechanism and the insolvency system for ordinary companies, which reveals in what ways the mechanism is, or may be, special. Also, the relationship between the CMME mechanism and the equivalent mechanism for banks is discussed, which answers why it is still unfeasible to apply the mechanism for banks directly to insurers.

Chapter 3 analyses the CMME mechanism in China, depicting what the current mechanism is like and pointing out the major problems it contains. The regulatory intervention system (including takeover, revocation liquidation, etc.), the bankruptcy

system (consisting of composition, reorganisation, and bankruptcy liquidation) and the Insurance Security Fund, which are regarded as the major components of the CMME mechanism, are discussed in turn. Generally speaking, the current CMME mechanism is based on the general bankruptcy system, and few efforts have been made to adapt the bankruptcy system for insurers. The inadequacy of special arrangements for insurers in the bankruptcy system and the lack of relevant cases in practice generally reflect the current state of the CMME mechanism. A lot of problems in the current mechanism are identified in the discussion. To solve these problems, some significant questions need to be answered. Just to name a few, what role can the regulatory authorities play during the process of addressing crises of insurers? Are bankruptcy administrators suitable for carrying out bankruptcy procedures of insurers? Is composition as a bankruptcy procedure suitable for dealing with troubled insurers? How will creditors' meetings be held in a bankruptcy procedure? How can takeover and reorganisation be coordinated? How can the Insurance Security Fund's protection function be coordinated with its rescue function? Without clear answers to these questions, it is unrealistic to expect that measures/procedures in the CMME mechanism can be properly carried out under the rule of law. Therefore, a radical reform of the CMME mechanism is needed.

Chapter 4 analyses the CMME mechanism in the UK, aiming to see what experience or lessons can be learnt. The mechanism in the UK is based on the insolvency system for ordinary companies, but a number of modifications have been made to accommodate the special features of insurers. Serving the purpose of this thesis, more

focus will be on the arrangements specific to insurers. With this in mind, the major components of the CMME mechanism are discussed in turn, which include the Proactive Intervention Framework, the insolvency system (consisting of company voluntary arrangement, administration, and winding-up), schemes of arrangement, and the Financial Services Compensation Scheme. The discussion in this chapter will show that despite the modifications made for insurers, some arrangements, which are inherent in the insolvency system but are arguably not compatible with the special features of insurers, remain applicable to insurers. For example, it is insolvency practitioners who will carry out insolvency procedures of insurers and major issues during the process will be subject to creditors' decisions, although to seek creditors' decisions constitutes a real challenge in the case of insurers. In addition, since there is a lack of arrangements designed for the objective of maintaining financial stability, it is doubtful whether crises of insurers can be addressed in an orderly manner if troubled insurers pose systemic risk. Having recognised that the design model adopted in the current CMME mechanism may not be satisfactory, the regulatory authorities are considering whether a special regime different from the insolvency system should be built to deal with troubled insurers.[78]

Chapter 5 analyses the CMME mechanism in the US, aiming to see what experience or lessons can be learnt. In the US, insurers are regulated at the state level, and the

[78] See, for example, HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012) 32; Bank of England, 'The Bank of England's Approach to Resolution' (October 2017) 19.

CMME mechanism is centred on the state insurer receivership system, a completely different system from the federal bankruptcy system for ordinary companies. To complement the state insurer receivership system, which focuses mainly on the objective of policyholder protection, there are still arrangements in the federal legislation designed for the objective of financial stability. Therefore, this chapter in turn discusses the state receivership system (consisting of pre-receivership tools, conservation, rehabilitation and liquidation), the insurance guaranty associations and the relevant regulation at the federal level (including designation of systemically important financial companies, orderly liquidation authority and emergency lending from the Federal Reserve System), which are regarded as major components of the CMME mechanism. Basically, the CMME mechanism in the US, independent of the general bankruptcy system, is a mechanism specific to insurers, which to a large extent ensures that arrangements in the mechanism are generally compatible with the special features of insurers. However, since the objective of policyholder protection and the objective of financial stability are separated due to the separation between the state regulation and the federal regulation, the process of addressing crises will inevitably be hindered to a greater or lesser extent in cases where troubled insurers pose systemic risk.

Chapter 6 makes recommendations on how the CMME mechanism in China can be reformed based on the comparisons of selected aspects between China, the UK and the US. The selected aspects discussed in this chapter, corresponding to problems identified in the current CMME mechanism in China, include frameworks of the CMME

mechanisms, commencement of post-takeover procedures, effects of post-takeover procedures, coordination of procedures, and insurance guarantee schemes and emergency funding plans. Following the discussion, a comprehensive set of recommendations are made on the overall framework of the CMME mechanism in China. Basically, it is recommended that the CMME mechanism in China should be independent of, rather than based on, the general bankruptcy system, which is modelled on the US mechanism rather than the UK mechanism. In the proposed CMME mechanism, pre-takeover measures, takeover, reorganisation and liquidation constitute major measures/procedures insurers may go through if they run into trouble. The Insurance Security Fund can perform the function of protecting policyholders or the function of rescuing insurers during reorganisation or liquidation. In cases where crises of insurers pose a threat to financial stability, the central bank, as the lender of last resort, may still provide emergency lending to the troubled insurers.

Chapter 7, as the concluding chapter, summarises the whole thesis and highlights the major recommendations for the reform of China’s CMME mechanism.

Chapter 2 Uniqueness of the CMME Mechanism

Overview

As a mechanism dealing with crises of insurers, the CMME mechanism should be designed in a way compatible with the special features of insurance and insurers. Following this logic, relevant aspects of insurance and insurers will be discussed in turn, revealing the special factors that should be taken into account in the CMME mechanism. Distinct from the resolution regime proposed by the FSB, which is expressly targeted at systemically important insurers,[79] the CMME mechanism discussed in the thesis is applicable to all insurers. Drawing on the existing experience in China, the UK and the US, together with relevant requirements in the ICPs released by the IAIS, a comparison will be made between the CMME mechanism and the insolvency system for ordinary companies. This comparison not only explains why the general insolvency system alone is not sufficient to deal with troubled insurers, but also reveals in what ways the mechanism is, or may be, special. After that, the relationship between the CMME mechanism and the equivalent mechanism for banks will be discussed, which answers why it is still unfeasible to apply the mechanism for banks directly to insurers.

Since issues covered by this chapter are common in the insurance business,

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[79] FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) para 1.1 <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017.

regardless of jurisdictions, the discussion in this chapter will lay the foundation for the analysis of the CMME mechanisms in China, the UK and the US in the later chapters.

2.1. Insurance

Providing insurance to society is the very reason why insurers exist. The discussion of insurance in this part, from the perspectives of features of insurance and categories of insurance, will not only show the background against which the CMME mechanism is analysed, but also help identify characters specific to the insurance business which should be taken into account in designing or reforming the CMME mechanism.

2.1.1. Features of Insurance

From the legal perspective, 'insurance is generally understood as an arrangement in which an insurer, in exchange for a premium paid by or on behalf of an insured, promises to assume the insured's risk of loss.'[80] When an insured risk crystallises, the insurer will then be obliged to pay insurance benefits to the beneficiary according to the insurance contract (ie insurance policy or policy). As an insured may be different from the person paying the premium or the beneficiary of the policy, in the context of this thesis, the collective term 'policyholder' is used to refer to all these parties for the convenience of expression, except as otherwise specified in the discussion. So in the basic insurance relationship, insurers and policyholders are two main parties.

[80] Kermit L. Hall and David S. Clark, *The Oxford Companion to American Law* (Oxford University Press 2002) 420.

Under the theme of the CMME mechanism, the following features of insurance deserve to be mentioned:

A. A Way of Transferring Risks

Risks are everywhere in daily life. Created by uncertain adverse events, which may be uncertain in terms of whether they will happen or when they will happen, risks bring fortuitous losses to individuals and institutions from time to time. In order to minimise losses possibly caused by risks, risk-averse people are willing to manage their risks in advance. Insurance is definitely one optimal way for risk management, by virtue of which policyholders can transfer risks to insurers, who are professionals in managing risks and have greater capacity to absorb losses. But like any other businesses, insurers are profit-oriented entities, so not all risks will be insured by insurers. Insurable risks normally have these characteristics: (1) there must be a large number of risk exposure units; (2) the loss must be accidental and unintentional; (3) the loss must be determinable and measurable; (4) the loss should not be catastrophic; (5) the chance of loss must be calculable; (6) the premium must be economically feasible.[81]

B. A Pooling Arrangement

Through a certain type of policy, people with exposure to similar risks are pooled by an insurer. A pooling arrangement combines a large number of participants and makes use of their contributions to compensate the participants who actually suffer losses.

[81] George E. Rejda and Michael J. McNamara, *Principles of Risk Management and Insurance* (13th edn, Pearson Education Limited 2017) 42.

In this way, losses spread among all participants, and the average loss is borne by each participant. From the perspective of actuarial science, by virtue of the law of large numbers and based on the previous loss experience, average losses of a group of participants with similar loss probability can be predicted with greater accuracy than actual losses of individuals.[82] Also, '[e]ach participant is not simply transferring risk to someone else. Instead, there is a reduction in risk for each participant. This is the beauty of risk pooling arrangements.'[83] 'The greater the number of people who participate in a pooling arrangement, the greater is the reduction in risk.'[84] As a consequence, with expertise in running the insurance business, insurers could function to diversify risks and reduce losses to the whole society.

C. Premiums in Exchange for Insurance Benefits

In order to join pooling arrangements and transfer risks to insurers, people should in advance pay fair premiums to insurers to become policyholders. Premiums are the consideration provided by policyholders for potential insurance claims against insurers in the future. Generally speaking, insurance claims are contingent in nature, depending on whether insured events specified in policies occur. These events include, for example: property damage, accidents, diseases, death and the reaching of a certain

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[82] George E. Rejda and Michael J. McNamara, *Principles of Risk Management and Insurance* (13th edn, Pearson Education Limited 2017) 41.

[83] Scott E. Harrington and Gregory R. Niehaus, *Risk Management and Insurance* (2nd edn, Stephen M. Patterson 2004) 58.

[84] Scott E. Harrington and Gregory R. Niehaus, *Risk Management and Insurance* (2nd edn, Stephen M. Patterson 2004) 64.

age. Upon the occurrence of insured events, insurers will compensate or indemnify policyholders by providing pecuniary benefits or other relevant benefits pursuant to clauses in policies, relieving the difficult situations policyholders are confronted with. Therefore, all policyholders are potential creditors of insurers. By collecting premiums in advance, insurers are liable for future insurance claims. Due to the fact that there will be a time lag between the collection of premiums and the payment of insurance claims, insurers have got a special inverted production cycle which is different from most other ordinary companies.

2.1.2. Types of Insurance

From different perspectives, there are different classifications of insurance. The distinction between different types of insurance not only requires different statutory and regulatory requirements for insurers offering different types of insurance, but also makes it necessary for different arrangements to be designed in the CMME mechanism.

2.1.2.1. Private Insurance and Government Insurance

According to the provider of insurance services, insurance can be classified into private insurance and government insurance.

Private insurance is mainly provided by commercial insurers.[85] Commercial insurers are profit-oriented entities which run the insurance business, with insurance premiums being a major source of income. As a consequence, not all risks will be

[85] There are still some non-profit mutual insurance associations which also provide private insurance. For more information about “mutual insurance associations”, see Section 2.2.1.2 in this chapter.

insured by commercial insurers. Commercial insurers will provide insurance when they find it possible to make a profit from doing so.

Government insurance is provided under the arrangement of the government, including, for example, social insurance and other special purpose insurance. Social insurance is part of the social security mechanism, which, generally speaking, requires people with incomes to contribute to special funding pools, and provides benefits to the contributors when certain circumstances, especially adverse circumstances, arise. For example, in China, social insurance mainly includes pension insurance, medical insurance, unemployment insurance, occupational injury insurance and maternity insurance. As to special purpose government insurance, it is mainly set up to deal with particular social problems and insure relevant parties against risks specific to them. For example, in China, special purpose government insurance includes deposit insurance, agricultural insurance, etc.

Government insurance is non-profit insurance and provides insurance coverages that commercial insurers are normally unable or unwilling to provide. The risks against which government insurance insure are either too enormous for commercial insurers to bear or too difficult to predict from the actuarial perspective, but the premiums are deliberately set at comparatively low rates. As a consequence, government insurance sometimes suffers a loss in operation and needs to be subsidised by the government. Due to the fact that government insurance is specially established and will be subject to the regulation which is different from that applies to private insurance, this thesis is not going to cover government insurance in the discussion.

2.1.2.2. General Insurance and Long-term Insurance

According to the risks to be insured against, insurance can be classified into general insurance and long-term insurance.[86]

In the UK, both general insurance and long-term insurance are further divided into sub-classes. The sub-classes contained in general insurance include: accident, sickness, land vehicles, railway rolling stock, aircraft, ships, goods in transit, fire and natural forces, damage to property, motor vehicle liability, aircraft liability, liability of ships, general liability, credit, suretyship, miscellaneous financial loss, legal expenses and assistance.[87] And the sub-classes contained in long-term insurance include: life and annuity, marriage and birth, linked long term, permanent health, tontines, capital redemption contracts, pension fund management, collective insurance etc., and social insurance.[88]

With slight differences in both terminologies and substance, in the US, insurance is classified into "property and casualty insurance" and "life and health insurance", respectively corresponding to general insurance and long-term insurance in the UK. The sub-classes contained in property and casualty insurance include: homeowner

[86] Analogous to the classification of general insurance and long-term insurance in the UK, there is "property and casualty insurance" and "life and health insurance" in the US and there is "property insurance" and "life insurance" in China. During the general discussion, this thesis will use terms that are adopted in the UK legislation. But when it comes to the discussion targeted at US or China, terms adopted in that jurisdiction will be used.

[87] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544, sch 1 pt I. (UK)

[88] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544, sch 1 pt II. (UK)

insurance, automobile insurance, dwelling insurance, mobile home insurance, businessowners insurance, transportation insurance, aviation insurance, workers compensation insurance, professional liability insurance, crime insurance, etc. And the sub-classes contained in life and health insurance include: term insurance, whole life insurance, annuities, major medical insurance, hospital-surgical insurance, long-term care insurance, disability-income insurance, etc.

Likewise, in China, insurance is classified into “property insurance” and “life insurance”. Property insurance mainly contains automobile insurance, homeowner insurance, commercial property insurance, accident insurance, credit insurance, agricultural insurance, suretyship, construction insurance, etc. And life insurance mainly contains life insurance, health insurance, annuity, personal accident insurance, etc.

Despite the fact that sub-classes contained in general insurance or long-term insurance vary in different jurisdictions, the underlying philosophy of the classification of general insurance and long-term insurance is similar all over the world. Distinctions between general insurance and long-term insurance mainly show in the following aspects:

A. Principle of indemnity. In general insurance, following the principle of indemnity, it is required that insurance benefits paid to policyholders should not exceed the amount of policyholders’ losses. This principle ensures that policyholders will not profit from the insured losses, thus preventing moral hazard on the part of policyholders. However, in long-term insurance, since life and health are invaluable

and cannot be priced, people can purchase as much long-term insurance as they want and receive insurance benefits according to policy clauses when the insured events take place.

B. Principle of subrogation. In general insurance, if losses are caused by third parties, after insurers indemnify policyholders, the insurers will have the right of subrogation against the third parties. This principle prevents policyholders from filing claims against both insurers and third parties, and thus profiting from the insured losses. So it is in line with the principle of indemnity. However, in long-term insurance, insurers do not have any subrogation rights. Long-term insurance policyholders may not only collect insurance benefits from insurers but also claim damages against those who caused losses.

C. Periods of coverage. Most general insurance policies cover a short term, normally within 5 years. For example, many auto insurance policies just cover 1 year, so policyholders need to renew their policies annually. By comparison, long-term insurance policies cover much longer periods, sometimes even the whole lifetime of the insureds. For example, determined by the nature of life insurance, insurance benefits will be paid when the insureds die, a time which may be 40 or 50 years ahead from the purchase of life insurance policies.

D. Investment elements. Since long-term insurance covers a long period, and insurance benefits policyholders will receive depend on the premiums they have gradually paid, long-term insurance tends to have savings or investment elements. To give an example, how annuities function is that insurers collect periodic premiums

from policyholders for many years and provide a stable income to them when they reach a certain age. In this way, policyholders actually invest for their later years at young ages. To give another example, after coming into existence for a certain period, some long-term insurance policies can be accepted as collateral by insurers or banks for policy loans applied for by policyholders, which provides a way for policyholders to realise the cash value of the policies. If policyholders would like to terminate policies before the policies mature or the insured events occur, they are also entitled to the cash surrender value, subject to a reduction of penalties, if any, according to policy clauses.

As a consequence, from the perspective of actuarial science and accounting, it is necessary to keep general insurance business and long-term insurance business separated. Otherwise, due to the much longer time lag between collection of premiums and payment of insurance claims in long term insurance, funds in long-term insurance pools may be used to make up fund deficiencies in general insurance pools, leading to unfair and disorderly competition in general insurance business. Therefore, it is normally required that general insurance and long-term insurance are written by different insurers.

2.2. Insurers

Definitions or scopes of “insurers” (or “insurance companies”) vary in different jurisdictions. Companies with a similar business scope regulated as insurers in one jurisdiction may not be recognised as insurers in another jurisdiction. For example, in

the US, while health maintenance organisations are insurance companies under New York law, these organisations are not recognised as insurance companies in Florida.[89] This thesis will not try to explore what entities constitute insurers, but generally regard insurers as legal entities that have obligations under policies to policyholders. When it comes to the discussion targeted at a certain jurisdiction, the term "insurers" will be used in accordance with the legislation in that jurisdiction.

2.2.1. Categories of Insurers

From different perspectives, there are different classifications of insurers. Different types of insurers will be, to a certain extent, subject to different regulations.

2.2.1.1. General Insurer, Long-term Insurer and Composite Insurer

According to the types of insurance provided, insurers can be classified into general insurers, long-term insurers, and composite insurers. While general insurers or long-term insurers only write general insurance or long-term insurance respectively, composite insurers write both general insurance and long-term insurance.

In light of different features of general insurance and long-term insurance, in most jurisdictions, insurers are normally only allowed to carry on either general insurance business or long-term insurance business. For example, in China, insurers are forbidden to carry on both property insurance business and life insurance business, with the exception that, with the approval of the China Banking and Insurance

[89] Adam Hodkin, 'Insurer Insolvency: Problems & Solutions' (1992) 20 Hofstra Law Review 727, 745.

Regulatory Commission (CBIRC), property insurers can write short-term health insurance or accidental injury insurance.[90] In the UK, after the Insurance Companies Act 1982 came into effect, regulatory authorities normally will not authorise composite insurers any more, or allow an existing general insurer or long-term insurer to become a composite insurer. Regarding the existing composite insurers in the UK, it is required that they should maintain separate accounts for their general insurance business and long-term insurance business, and profits from the long-term insurance business should only benefit long-term insurance policyholders as if the composite firms were engaged only in long-term insurance business.[91] Therefore, as is common practice nowadays, general insurers and long-term insurers are established separately. Even if there still exist composite insurers, general insurance business and the long-term insurance should also be run as if these two types of business were respectively run by separate general insurers and long-term insurers.

There exist different rules for general insurers and long-term insurers due to their distinctive features. These rules concern not only the normal operation period of insurers, but also the time when insurers become troubled. For example, in light of the nature of long-term insurance, special protection has been provided to long-term insurance policyholders during crises of long-term insurers. To minimise losses long-term policyholders may suffer, it is commonly accepted that the continuance of long-

[90] Insurance Act, art 95. (China)

[91] PRA, 'Rulebook – SII Firms – Composites 2.2 and 3.2' (1 January 2016).

term insurance policies should be sought whenever possible.[92] Following this perception, for example, it is provided in China that when an insurer carrying on life insurance business is in revocation liquidation or bankruptcy liquidation, it should transfer all of its in-force life insurance policies as well as the corresponding reserves to another life insurer; if the insurer fails to reach a transfer agreement with another insurer, the CBIRC will designate a life insurer to be the transferee.[93]

In line with the separation of general insurance business and long-term insurance business, there are also separate fund accounts for general insurance and long-term insurance in insurance guarantee schemes.[94] It is normally required that funds accumulated in the general insurance account or the long-term insurance account in insurance guarantee schemes can only be used, respectively, to deal with crises of general insurers or crises of long-term insurers.

2.2.1.2. Stock Insurer, Mutual Insurance Association, and Lloyd's of London

According to their ownership structures, insurers can mainly be classified into stock insurers, mutual insurance associations, and Lloyd's of London (hereinafter, Lloyd's).

[92] See, for example, Explanatory Notes to the Financial Services and Markets Act 2000, para 432; European Commission, 'White Paper on Insurance Guarantee Schemes' COM (2010) 370, section 3.4; EIOPA, 'Consultation Paper on Proposals for Solvency II 2020 Review: Harmonisation of National Insurance Guarantee Schemes' (9 July 2019) 27 <www.eiopa.europa.eu/sites/default/files/press/news/eiopa-bos-19-259_consultation_paper_on_harmonisation_of_igss.pdf> accessed 9 July 2019.

[93] Insurance Act, art 92. (China)

[94] For a more detailed discussion of insurance guarantee schemes, see Section 2.3.3.4 in this chapter.

The ownership structures determine who will be entitled to dividends when insurers make profits and who will suffer losses in their investment when insurers go bust.

Stock insurers are insurance companies invested in by equity investors. Like in any other limited companies, equity investors will get dividends from profits of stock insurers when the business is booming and bear losses subject to the amount of investment when stock insurers fail.

Mutual insurance associations are entities, not necessarily in the form of companies, owned by policyholders. When people purchase insurance products from mutual insurance associations, they become not only policyholders, but also owners of the mutual insurance associations, having the right to select executives, supervise governance of the entity, receive dividends, collect insurance benefits, etc. With the purpose of mutual assistance, some mutual insurance associations are non-profit, and offer benefits to a specific group of people, such as fraternal insurers in the US.[95]

Lloyd's itself is not an insurer, 'but is the world's leading insurance market that provides services and physical facilities for its members to write specialised lines of insurance'.[96] Syndicates under Lloyd's are much like insurers, and members who have invested in syndicates are much like shareholders who have the ownership of insurers. But some individual members (called Names) who were admitted to the market in the

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[95] Fraternal insurers are non-profit or charitable organisations which provide life and health insurance to their members. See George E. Rejda and Michael J. McNamara, *Principles of Risk Management and Insurance* (13th edn, Pearson Education Limited 2017) 112.

[96] George E. Rejda and Michael J. McNamara, *Principles of Risk Management and Insurance* (13th edn, Pearson Education Limited 2017) 114.

earlier years will have unlimited liability for insurance contracts they underwrite. In the UK, members of Lloyd's are largely subject to self-regulations made by Lloyd's, and most legislation for insurers is not applicable to Lloyd's. With regard to dealing with crises, the mechanism for Lloyd's is also different from the mechanism for insurers. For instance, as is provided in the Insurers (Reorganisation and Winding Up) Regulations 2004, neither the Society of Lloyd's nor members of Lloyd's are subject to the regulations.[97] Therefore, in this thesis, Lloyd's will not be covered in the discussion anywhere else.

2.2.2. Role of Insurers

As key players in the insurance business, insurers perform significant functions in society.

A. Providing an Effective Way of Risk Management

Central to the business of insurers is to sell insurance products to the public, which provides an effective way for the public to manage risks. By pooling a large number of policyholders, insurers can predict overall losses caused by risks with great accuracy, and spread losses among all policyholders, mitigating the loss each policyholder may suffer in the case of adverse events. In this way, insurers protect policyholders from various risks, which may be related to accidents, natural disasters, health problems, premature death, longevity, etc. Policyholders can then have a sense of financial

[97] Insurers (Reorganisation and Winding Up) Regulations 2004, SI 2004/353, reg 3. (UK)

security, and do not need to be anxious so much about unforeseen losses in daily life.[98] In addition, through charging risk-based premiums or supporting loss control programs, insurers can also help reduce the overall risk level of society and mitigate losses that may occur, which definitely benefit society as a whole.[99]

B. Offering Diverse Investment Options

As one facet of the financial convergence process, there are more and more innovative insurance products which combine features of insurance and features of other financial products, such as deposits and securities. For example, since fixed annuities will provide policyholders with a periodic fixed income payment when they reach a certain age, fixed annuities is an appealing form of savings, constituting a substitute for deposits; since variable annuities will provide policyholders with incomes based on the investment performance, purchasing variable annuities is, in essence, not much different from investing in other securities. Therefore, nowadays, insurers, especially long-term insurers, can offer policyholders not only insurance protection, but also diverse investment options. With unique features of innovative insurance products, insurers are attracting more and more customers in the financial market, becoming competitive rivals to other financial institutions, such as banks and investment firms.

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98 Harold D. Skipper, 'Foreign Insurers in Emerging Markets: Issues and Concerns' (January 1997) 9 <www.researchgate.net/publication/241199392_Foreign_Insurers_in_Emerging_Markets_Issues_and_Concerns> accessed 18 August 2018.

99 Harold D. Skipper, 'Foreign Insurers in Emerging Markets: Issues and Concerns' (January 1997) 14 <www.researchgate.net/publication/241199392_Foreign_Insurers_in_Emerging_Markets_Issues_and_Concerns> accessed 18 August 2018.

C. Acting as Active Institutional Investors

By selling insurance products to policyholders and collecting premiums, insurers will amass large amounts of money. Due to the time lag between collecting premiums and paying insurance claims, insurers are able to make use of the money accumulated to invest in the financial market as well as real economy sectors. The types of investments insurers normally make include bonds, shares, mortgages, loans, deposits, infrastructure, real estate, etc. Being an important source of financing, insurers act as active institutional investors in the market.

The significance of the investment function of insurers can be explained from many perspectives. Firstly, investment returns can help insurers meet insurance claims which fall due, cover daily operational expenses and generate profits, thus maintaining the sound and sustainable operation of insurers. In fact, without returns from investments, insurers will always suffer a loss in underwriting insurance.[100] Secondly, with the consideration of expected returns from investments, premium rates can be set at a comparatively low level, making insurance products more acceptable and more attractive to the public. Thirdly, investments make it possible for the amassed large sum of premiums in insurance pools to flow to the areas where funds are most needed, thus increasing the efficiency of financing in the whole society.

[100] For example, in the US, the long-run (1951-2014) average combined ratio (ie incurred losses and expenses as a proportion of premiums earned) of the property and casualty insurance industry is 102.8%; underwriting insurance itself was generally unprofitable as shown in the historical experience, and insurers need to rely on favourable investment results to survive. See IAIS, 'IAIS Global Insurance Market Report 2016' (January 2017) <www.iaisweb.org/page/about-the-iais/annual-report/previous-annual-reports> accessed 1 December 2017.

2.2.3. Regulation of Insurers

For the sake of the public interest, a market should be regulated if the following two conditions are satisfied:

> First, there should be demonstrable market imperfections that lead to a significant deviation between market performance and the competitive market ideal. Second, there should be substantial evidence that the benefits from using the regulatory tool being contemplated will exceed the costs of regulation.[101]

The insurance market is just one of the markets that needs to be regulated. Take the evolution of insurance regulation in the UK as an example:

> In the early days of the development of the law of insurance it was occasionally found that insurers who had taken premiums from insureds would either disappear or prove financially unable to meet legitimate claims against them. Consequently, since 1870 the conduct of insurance business in the UK has been regulated by statute.[102]

Although the origins of insurance regulation vary from jurisdiction to jurisdiction, it is nowadays generally recognised that the need for regulation can be explained from the microprudential perspective and the macroprudential perspective.[103]

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[101] Scott E. Harrington and Gregory R. Niehaus, *Risk Management and Insurance* (2nd edn, Stephen M. Patterson 2004) 107.

[102] Robert Merkin, *Colinvaux's Law of Insurance* (11th edn, Sweet & Maxwell 2016) 15.

[103] See, for example, Samuel G. Hanson, Anil K Kashyap and Jeremy C. Stein, 'A Macroprudential Approach to Financial Regulation' (2011) 25(1) The Journal of Economic Perspectives 3; Wolfgang Bach and Tristan Nguyen, 'On the Systemic Relevance of the Insurance Industry: Is a Macroprudential Insurance Regulation Necessary?' (2012) 2(1) Journal of Applied Finance & Banking 127.

From the microprudential perspective, the main objective of insurance regulation is to protect policyholders.[104] In the relationship between insurers and policyholders, there exists an information asymmetry, and policyholders are generally uninformed compared with insurers. Policyholders generally lack capacity to assess the financial position of an insurer as well as the quality of insurance products an insurer provides.[105] Also, due to the fact that the production cycle of insurance business is inverted, it is difficult for policyholders to monitor the insurer after purchasing insurance products and paying premiums.[106] As a consequence, without necessary regulation, insurers may exploit their advantage over policyholders and pursue undue benefits in a way which jeopardises policyholders' interests. Thus, the need for policyholder protection warrants insurance regulation and, in turn, policyholder protection is entrenched as a main objective of insurance regulation.

From the macroprudential perspective, the main objective of insurance regulation

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[104] IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document' (November 2018) para 64 <www.iaisweb.org/page/consultations/closed-consultations/2019/holistic-framework-for-systemic-risk-in-the-insurance-sector> accessed 15 November 2018.

[105] See, for example, Robert W. Klein, *A Regulator's Introduction to the Insurance Industry* (2nd edn, National Association of Insurance Commissioners 2005) 109; Sharon L. Tennyson, 'Rethinking Consumer Protection Regulation in Insurance Markets' (14 September 2010) 5 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1676418> accessed 15 August 2018; Robert Merkin, *Colinvaux's Law of Insurance* (11th edn, Sweet & Maxwell 2016) 166.

[106] See, for example, Robert W. Klein, *A Regulator's Introduction to the Insurance Industry* (2nd edn, National Association of Insurance Commissioners 2005) 109; Guillaume Plantin and Jean-Charles Rochet, *When Insurers Go Bust: An Economic Analysis of the Role and Design of Prudential Regulation* (Princeton University Press 2007) 97; Simon Debbage and Stephen Dickinson, 'The Rationale for the Prudential Regulation and Supervision of Insurers' (Bank of England, 18 September 2013) 4 <www.bankofengland.co.uk/quarterly-bulletin/2013/q3/the-rationale-for-the-prudential-regulation-and-supervision-of-insurers> accessed 15 August 2018 .

is to maintain financial stability.[107] As important institutional investors, insurers play a significant role in the financial market and the real economy. Through investments and other financial transactions, insurers have established widespread interconnectedness with other financial market participants. How insurers operate will to a certain extent influence the rest of the market. In cases where there exists systemic risk, the crisis of an insurer could even pose a threat to financial stability, causing or exacerbating a systemic crisis.[108] Therefore, it is necessary that insurers are regulated in a way which promotes financial stability and reduces the chance of systemic crises.

Taken together, in order to achieve the objective of protecting policyholders and the objective of maintaining financial stability,[109] the insurance market is a specifically regulated market. Although the scope and extent of insurance regulation vary in

[107] IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document' (November 2018) para 64 <www.iaisweb.org/page/consultations/closed-consultations/2019/holistic-framework-for-systemic-risk-in-the-insurance-sector> accessed 15 November 2018.

[108] See, for example, EIOPA, 'Systemic Risk and Macroprudential Policy in Insurance' (2017) <www.eiopa.europa.eu/sites/default/files/publications/pdfs/003systemic_risk_and_macroprudential_policy_in_insurance.pdf> 10 October 2017; ESRB, 'Recovery and Resolution for the EU Insurance Sector: A Macroprudential Perspective' (August 2017) <www.esrb.europa.eu/pub/pdf/reports/esrb.reports170817_recoveryandresolution.en.pdf> accessed 25 August 2017; IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document' (November 2018) <www.iaisweb.org/page/consultations/closed-consultations/2019/holistic-framework-for-systemic-risk-in-the-insurance-sector> accessed 15 November 2018.

[109] It is commonly accepted that the objective of protecting policyholders and the objective of maintaining financial stability are the two main objectives in the insurance regulation. See, for example, HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012) 28; PRA, 'The Prudential Regulation Authority's Approach to Insurance Supervision' (October 2018) 4; IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) 6 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

different jurisdictions, generally speaking, insurers are subject to a wide range of statutory or regulatory requirements throughout their lifetime, from entry into until exit from the market. These requirements cover various aspects of the operation of insurers, including financial conditions (eg solvency capital, minimum capital, and technical provisions), corporate governance, investment, insurance policy design, risk management, market conducts, information disclosure, etc. It can be said that insurers are under all-round regulation.

2.2.4. Crises of Insurers

Although the more and more developed insurance regulation can reduce the incidence of failures of insurers, there will never be a zero-failure insurance market.[110] Accumulated excessive risks in running insurers will, from time to time, make some insurers fall below statutory or regulatory requirements and thus become troubled, which may lead to their failures. Despite the low incidence, failures of insurers can have a tremendous impact on society, sometimes even contributing to a systemic crisis.

[110] See, for example, European Commission, 'White Paper on Insurance Guarantee Schemes' COM (2010) 370, section 2.1.2; OECD, 'Policyholder Protection Schemes: Selected Considerations' (2013) 9 <www.oecd-ilibrary.org/finance-and-investment/policyholder-protection-schemes_5k46l8sz94g0-en> accessed 31 October 2018; IAIS, 'Issues Paper on Policyholder Protection Schemes' (October 2013) 4 <https://iaisweb.org/page/supervisory-material/issues-papers/file/34282/life-insurance-securitisation-october-2003#> accessed 31 October 2018; EIOPA, 'Consultation Paper on Proposals for Solvency II 2020 Review: Harmonisation of National Insurance Guarantee Schemes' (9 July 2019) 22 <www.eiopa.europa.eu/sites/default/files/press/news/eiopa-bos-19-259_consultation_paper_on_harmonisation_of_igss.pdf> accessed 9 July 2019.

2.2.4.1. Causes of Crises

There is always a combination of causes underlying the crisis of an insurer.[111] Some major causes will be briefly mentioned below.

A. Catastrophic Events

Since insurers set premiums based on the prediction of losses of insured events according to historical experience, the occurrence of unprecedented catastrophic events may sometimes cause losses far beyond what insurers have expected, thereby draining the assets held by insurers and rendering them troubled. For example, in the case of Taisei Fire and Marine Insurance Company, although the insurer was then the 15th largest Japanese non-life insurer and had the solvency margin (ie assets over liabilities) of 815%, the 9/11 terrorist attack in 2001 brought about insurance claims of $2.5 billion against the insurer and eventually led to its failure.[112]

B. Investment Losses

As active institutional investors in the market, insurers are inevitably exposed to

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[111] There is no lack of research on causes of crises of insurers. See, for example, Thomas L. Wenck, 'Insurer Insolvency: Causes, Effects and Solutions' (1987) 10(2) The Journal of Insurance Issues and Practices 35; Committee on Energy and Commerce, 'Failed Promises: Insurance Company Insolvencies' (US House of Representatives 1990); Paul Sharma, 'Prudential Supervision of Insurance Undertakings' (December 2002) <https://knf.gov.pl/knf/pl/komponenty/img/Prudential_supervision_of_insurance_undertakings_18431.pdf> accessed 10 August 2017; EIOPA, 'Failures and Near Misses in Insurance – Overview of the Causes and Early Identification' (2018) <www.eiopa.europa.eu/sites/default/files/publications/pdfs/eiopa_failures_and_near_misses_final_1_0.pdf> accessed 5 December 2018.

[112] The Professional Risk Managers' International Association, 'Taisei Fire and Marine Insurance Co' <www.prmia.org/sites/default/files/references/Taisei_Fire_and_Marine_Insurance_Co_-_090914.pdf> accessed 1 May 2017.

investment risks. Substantial losses in investments may not only cause liquidity problems for insurers during times of market distress, but also lead to insurers' breach of the requirements for financial conditions. The case of American International Group (AIG), an insurance-focused financial holding company, in 2008 is a typical example showing how investment losses could drag an insurance giant down to a major crisis.[113] With the outbreak of crisis in the residential mortgage market, AIG's life insurance subsidiaries and subsidiaries in financial lines suffered great losses in their investments and faced severe liquidity problems. This brought AIG, the head of AIG's whole conglomerate, to the edge of collapse. Given the systemic importance of AIG in society, to mitigate the already existing systemic crisis, the federal government launched one of the most costly government bail-outs in US history, providing $182.3 billion in total to AIG for rescue purposes.[114] Fortunately, the case ended up with a satisfactory result, with AIG restoring to normal conditions and the federal government obtaining appreciable positive returns from its financial assistance.

C. Blind Rapid Growth

The ambition to rapidly develop the insurance business can sometimes be misleading. Blind rapid growth will easily lead to problems such as underpricing, under-reserving, careless underwriting, concentration of risks, etc. In addition, the search for market

[113] For a more detailed discussion of the case of AIG, see Section 5.5.1.2 in this thesis.

[114] US Department of the Treasury, 'Treasury Sells Final Shares of AIG Common Stock, Positive Return on Overall AIG Commitment Reaches $22.7 Billion' (11 December 2012) <www.treasury.gov/press-center/press-releases/Pages/tg1796.aspx> accessed 19 January 2018.

opportunities may also drive insurers to expand into new business areas they are not familiar with, without having due consideration about how to develop in a prudent way. As a consequence, blind rapid growth may bring excessive risks in the operation of insurers, which sometimes contributes to crises, or even ultimate failures, of insurers. For example, the failure of Fire, Auto, and Marine Insurance Company in the UK is a case of this kind. In order to increase its market share and enhance its market status, Fire, Auto, and Marine Insurance Company offered motor insurance at about half the price quoted by its competitors, and promised insurance brokers a 20% commission on premiums they would collect. Due to this unsustainable development strategy, together with the appropriation of the insurer's assets by its founder – Emil Savundra, the insurer failed after existing only for 4 years, from 1963 to 1966.[115]

D. Under-reserving

In order to make sure that insurance claims falling due in the coming period will be fully satisfied, it is necessary for insurers to set aside a certain amount of premiums as reserves, rather than make investments of all collected premiums. As it may be difficult to accurately predict insurance claims, especially those which may occur many years after the collection of premiums, to set a proper level of reserves is never an easy task. With the purpose of making more profits in the short run, however, some insurers deliberately maintain a low level of reserves, without making full preparations for

[115] 'Emil Savundra' (Oxford Dictionary of National Biography) <http://0-www.oxforddnb.com.serlib0.essex.ac.uk/view/article/58162> accessed 1 May 2017.

potential forthcoming claims. As a consequence, reserves held by insurers may turn out to be inadequate, which easily leads to crises of insurers. As the evidence shows, under-reserving is usually an accompaniment to blind rapid growth, which has contributed to a large number of insurer failures.[116]

E. Underpricing

Although underestimates of insured losses may lead to underpricing of certain insurance products, poor product design like this is hardly the main cause of insurers' crises. What often contributes to crises is deliberate underpricing which is a by-product of the insurers' business strategy to scramble for market share. Since collected premiums constitute the basis for insurers to meet insurance claims, the sustained inadequate premium income, if not made up by proceeds from investments, will sooner or later render insurers insolvent. Take Drake Insurance Plc (Drake) for example: in the highly competitive motor insurance market in the UK, Drake sacrificed profitability for market share, offering underpriced insurance products and insuring hard-to-insure categories of motorists (eg people with a poor claims history); as a consequence, gradually, Drake suffered significant erosion in its capital base, and eventually became insolvent in 2000.[117]

F. Mismanagement

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[116] Darrell Leadbettera and Suela Dibra, 'Why Insurers Fail: The Dynamics of Property and Casualty Insurance Insolvency in Canada' (2008) 33 The Geneva Papers on Risk and Insurance 464, 477.

[117] Dan Atkinson, 'Motorists Given a Severe Jolt' (The Guardian, 13 May 2000) <www.theguardian.com/money/2000/may/13/personalfinancenews.jobsandmoney2> accessed 1 May 2017.

Aside from some unforeseen factors, such as catastrophes, or investment losses due to systemic crises, most of other factors contributing to crises of insurers can be attributed to the mismanagement of those who are running the insurers. Mismanagement often lies at the heart of problems such as blind rapid growth, under-reserving, or underpricing, with the mismanagement being a result of, for example, negligence, fraud, inexperience, misjudgement or incompetency. Still, the internal mismanagement problem could 'create an environment where an insurer is more vulnerable to adverse external events.'[118] Even in cases where crises are largely caused by unforeseen factors, such as the case of Taisei Fire and Marine Insurance Company and the case of AIG,[119] the contribution of mismanagement to the crises could also be identified easily. Therefore, as indicated by many studies, mismanagement often constitutes the root cause of crises of insurers.[120]

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[118] Darrell Leadbettera and Suela Dibra, 'Why Insurers Fail: The Dynamics of Property and Casualty Insurance Insolvency in Canada' (2008) 33 The Geneva Papers on Risk and Insurance 464, 475.

[119] For example, in the case of Taisei Fire and Marine Insurance Company, the management did not fully understand the reinsurance transactions the insurer was involved in, thus overlooking the potential risk of the insurer's business. This rendered the insurer less prepared for, and vulnerable to, catastrophic events like the 9/11 terrorist attack, which eventually led to the failure of the insurer. See The Professional Risk Managers' International Association, 'Taisei Fire and Marine Insurance Co' <www.prmia.org/sites/default/files/references/Taisei_Fire_and_Marine_Insurance_Co_-_090914.pdf> accessed 1 May 2017.

[120] See, for example, Wenck, 'Insurer Insolvency: Causes, Effects and Solutions'35; Paul Sharma, 'Prudential Supervision of Insurance Undertakings' (December 2002) <https://knf.gov.pl/knf/pl/komponenty/img/Prudential_supervision_of_insurance_undertakings_18431.pdf> accessed 10 August 2017; Andrew Brown and Bimal Balasingham, 'Leadership and Life Insurance Failures – What Can We Learn about Financial Leadership?' (May 2013) <www.actuaries.asn.au/Library/Events/SUM/2013/7d-Brown.pdf> accessed 10 August 2017; EIOPA, 'Failures and Near Misses in Insurance – Overview of the Causes and Early Identification' (2018)

2.2.4.2. Impacts of Crises

Insurers are involved in a wide range of business activities. Generally speaking, these activities can be classified into core activities and non-core activities. The core activities of insurers include insurance underwriting, reserving, claims settlement, reinsurance, etc.; and the non-core activities include providing financial guarantees, assets lending, issuing credit default swaps, investing in complex structured securities, etc.[121] Crises of insurers will to a certain extent create uncertainties for these activities, and even cause disruption to them. In cases where insurers pose systemic risk, it is also likely that systemic crises will take place. The following discussion will show the impacts that crises of insurers may have, respectively, on policyholders, the financial market and the real economy.

A. On Policyholders

During crises of insurers, the function of insurance may be disrupted. As a consequence, policyholders may lose insurance coverage all of a sudden and suffer losses of insurance benefits to a certain extent. Since insurance is operated based on the law of large numbers, the number of policyholders who will be impacted by a troubled insurer, even if a comparatively small insurer in the insurance market, tends to be vast. For example, back in 1966 in the UK, when Fire, Auto, and Marine Insurance

<www.eiopa.europa.eu/sites/default/files/publications/pdfs/eiopa_failures_and_near_misses_final_1_0.pdf> accessed 5 December 2018.

[121] See, for example, J. David Cummins and Mary A. Weiss, 'Systemic Risk and the U.S. Insurance Sector' (2014) 81(3) The Journal of Risk and Insurance 489,490.

Company failed, some 400,000 motorist policyholders lost their insurance, with the unsettled insurance claims amounting to over £1.25 million.[122] Even if insurance claims can be recovered, usually partially, from the estate of a troubled insurer, the payment will always be delayed during the prolonged process of dealing with the troubled insurer.

Although in a lot of jurisdictions there exist insurance guarantee schemes which can function to protect policyholders when insurers become troubled, normally policyholders are not fully protected and will suffer some losses in the case of failures of insurers. Also, due to the fact that insurance guarantee schemes are built on levies imposed on all insurers in the market, the costs of insurance guarantee schemes will in effect be borne by all policyholders or prospective policyholders in society. As a consequence, the occurrence of crises of insurers, especially failures, will have a negative impact on the public's confidence in the insurance market, which may then lead to a decrease in insurance purchase. This will definitely do harm to the sustainable and sound development of the insurance market as a whole.

B. On the Financial Market

Insurers are deeply involved in financial transactions. As important institutional investors, insurers make enormous investments in bonds, shares, and other securities, providing huge amounts of finance to other financial institutions. Due to this

[122] 'Emil Savundra' (Oxford Dictionary of National Biography) <http://0-www.oxforddnb.com.serlib0.essex.ac.uk/view/article/58162> accessed 1 May 2017.

interconnectedness, crises or failures of insurers will, to a greater or lesser extent, have negative spillover effects on the financial market.

When an insurer becomes troubled, it may be forced to withdraw its investments within a short period. This can cause disruption to fund provision in the financial market and spread the insurer's crisis to its counterparties. What is more, the fire sale of the insurer's assets on a large scale may also contribute to a decrease of the assets' market prices, leading to losses for financial institutions holding similar assets.[123] If crises of insurers pose systemic risk, it is still likely that a systemic crisis will be triggered or an existing systemic crisis will be exacerbated. Just as shown in the case of AIG in 2008, caused by losses in securities lending transactions, life insurance subsidiaries of AIG were trapped in crises which, together with crises of AIG's other financial subsidiaries, contributed to the crisis of AIG's whole conglomerate. Due to AIG's systemic importance in the US and even in the whole world, the crisis of AIG further exacerbated the already serious worldwide financial crisis.[124]

C. On the Real Economy

The disruption to provision of insurance caused by crises of insurers will to a certain extent adversely affect the real economy. The impact will be especially significant in

[123] See, for example, Daniel Schwarcz and Steven L. Schwarcz, 'Regulating Systemic Risk in Insurance' (2014) 81 The University of Chicago Law Review 1569, 1600; IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector' (November 2019) 11 <www.iaisweb.org/page/supervisory-material/financial-stability> accessed 15 November 2019. See also Nicole Boyson, Jean Helwege and Jan Jindra, 'Crises, Liquidity Shocks, and Fire Sales at Financial Institutions' (8 September 2011) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1923802> accessed 25 January 2018.

[124] For a more detailed discussion of the case of AIG, see Section 5.5.1.2 in the thesis.

cases where insurance is essential or compulsory for certain activities, or where there is a lack of other insurers which can provide substitute insurance. Take the case of HIH Insurance Group (HIH) in Australia as an example. When HIH was placed in liquidation in 2001, it was the second largest insurer in Australia, and its insurance subsidiaries dominated the builders' warranty insurance market. Due to the fact that the builders' warranty insurance is compulsory in the building and construction industry, but there were few insurers writing this type of insurance in the market, the failure of HIH caused significant disruption to construction activities for almost one year.[125]

In cases where the crisis of an insurer poses a threat to financial stability, which warrants a government bail-out, it is also likely that losses caused by the troubled insurer will be borne by all taxpayers.

2.3. A Mechanism Dealing with Troubled Insurers

Since it is inevitable that crises of insurers will take place from time to time, having a proper mechanism to deal with troubled insurers becomes a matter of concern. In different jurisdictions, the levels of development of the mechanisms vary, and the mechanisms or the proposed mechanisms may be termed differently. For example, in the US, the mechanism is centred on the "insurer receivership system"; in the UK, the

[125] See, for example, IAIS, 'Insurance and Financial Stability' (November 2011) 48 <www.iaisweb.org/Otherpapers-and-reports-46> accessed 21 March 2018; Australian Government – The Treasury, '3. Aftermath of the HIH collapse' (19 June 2015) <https://treasury.gov.au/publication/economic-roundup-issue-1-2015/economic-roundup-issue-1/the-hih-claims-support-scheme/3-aftermath-of-the-hih-collapse> accessed 15 March 2018.

current mechanism is based on the “insolvency system”, but to establish a “special resolution regime for insurers” is under consideration;[126] and in the EU, a “recovery and resolution framework for insurers” has been proposed.[127] Since the mechanism, no matter how it is termed, mainly performs the crisis management function and the market exit function, this thesis selects the wording “crisis management and market exit mechanism for insurers” (CMME mechanism) to refer to the mechanism in question.

This part will, in turn, explain the significance of having a well-designed CMME mechanism, point out the distinction between the FSB-proposed resolution regime and the CMME mechanism, make a comparison between the CMME mechanism and the general insolvency system, and shed light on the relationship between the CMME mechanism and the equivalent mechanism for troubled banks.

2.3.1. Significance of the CMME Mechanism

Due to the fact that crises or even failures of insurers will take place from time to time, having a well-designed CMME mechanism is vital. Generally speaking, the CMME mechanism is a comprehensive set of measures or procedures which can serve the

[126] See, for example, BOE, ‘The Bank of England’s Approach to Resolution’ (October 2017).

[127] See, for example, EIOPA, ‘Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re)insurers Across the Member States’ (July 2017) <https://register.eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-148_Opinion_on_recovery_and_resolution_for_(re)insurers.pdf> accessed 20 August 2017; ESRB, ‘Recovery and Resolution for the EU Insurance Sector: A Macroprudential Perspective’ (August 2017) <www.esrb.europa.eu/pub/pdf/reports/esrb.reports170817_recoveryandresolution.en.pdf> accessed 25 August 2017.

crisis management function or the market exit function, working either to return troubled insurers back to normal conditions or to eliminate troubled insurers from the market. When an insurer falls below statutory or regulatory requirements and thus becomes a troubled insurer, the crisis management process can be initiated by regulatory authorities to address the crisis of the insurer. If a decision is made by regulatory authorities that it is better to weed the troubled insurer out of the market, the market exit process begins and the insurer as a legal entity will eventually be ended.

In line with the objectives of insurance regulation, the CMME mechanism will also function to protect policyholders and maintain financial stability.[128] From the legal perspective, only with a well-designed CMME mechanism in the legislation, can relevant parties act in an orderly manner when encountering crises of insurers. The legislation, if well-conceived, will provide for suitable measures or procedures to deal with troubled insurers, and clearly set out the responsibilities of regulatory authorities or courts as well as the rights and duties of interested parties during the crisis management process or market exit process of troubled insurers. This can help relevant parties foresee what may happen when insurers become troubled, and also, to a certain extent, ensure that crises of insurers will be addressed in a consistent manner. Otherwise, without feasible or suitable measures or procedures in the CMME mechanism, confusion, chaos or inefficiency will definitely occur in the midst of crises,

[128] For a more detailed discussion of the objectives of the CMME mechanism, see Section 2.3.3.1 in this chapter.

threatening the objective of protecting policyholders or the objective of maintaining financial stability.

The existence of a well-designed CMME mechanism can never guarantee that failures of insurers will not happen, but can provide ways for crises of insurers to be addressed effectively and efficiently, avoiding disorderly failures of insurers. Under such a mechanism, relevant authorities can at their discretion make use of the most appropriate measures or procedures to minimise the negative impacts a troubled insurer would have. In cases where to keep a troubled insurer as a going concern is more desirable, relevant corrective measures or rescue measures should be taken to restore the insurer to normal conditions; but in cases where to eliminate a troubled insurer from the market is more desirable, the insurer should be led to exit the market. Just as pointed out by the UK regulatory authorities, their stance is that 'unsuccessful business models need to be allowed to fail, but that failure should be in an orderly manner so as not to disrupt the provision of core financial services.'[129]

2.3.2. Differing from the FSB-Proposed Resolution Regime

The term "resolution" used in the financial law area may sometimes cause confusion. In different materials, the scope of the "resolution regime" varies. For example, as is clearly put in the Key Attributes proposed by the FSB, '[a]ny financial institution that could be systemically significant or critical if it fails should be subject to a resolution

[129] Paul Fisher, 'Confronting the Challenges of Tomorrow's World' (Bank of England, 3 March 2015) <www.bankofengland.co.uk/publications/Documents/speeches/2015/speech804.pdf> accessed 10 July 2017.

regime that has the attributes set out in this document'.[130] So in the Key Attributes and the relevant documents issued by the FSB, the underlying perception is that the resolution regime is targeted at systemically important financial institutions. Different to the scope of the FSB-proposed resolution regime, as is held by the UK regulatory authorities, "resolution" is a process during which regulatory authorities deal with troubled financial institutions.[131] It means that, in the UK, the resolution regime is applicable to all financial institutions, not just systemically important ones. For example, according to the Banking Act 2009, the bank resolution regime (consisting of the stabilisation options, the bank insolvency procedure, and the bank administration procedure) can be used to deal with crises of all banks, regardless of whether or not they are systemically important.[132] Therefore, due to fact that the term "resolution regime" may refer to regimes with varying scopes, it is important to be aware of how the term is used in a certain context.

In fact, if the term "resolution regime" is used in a way as how it is used in the UK, then the "resolution regime for insurers" will be equivalent to the "crisis management and market exit mechanism for insurers (CMME mechanism)" discussed in this thesis. However, since the FSB-proposed resolution regime has a worldwide influence, and there is a widely-held perception that the resolution regime should apply only to

[130] FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) para 1.1 <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017.

[131] Bank of England, 'The Bank of England's Approach to Resolution' (October 2017) 7.

[132] See Banking Act 2009, ss 1 and 2. (UK)

systemically important financial institutions, this thesis deliberately avoids the term "resolution regime", but chooses the term "CMME mechanism" to refer to the mechanism in question. As a consequence, it is still necessary to clarify how to view the FSB-proposed resolution regime in the context of the CMME mechanism.

Targeted at systemically important insurers, the FSB-proposed resolution regime incorporates a variety of key attributes, which are related to, for example, resolution authority, resolution powers, funding of firms in resolution, and recovery and resolution planning.[133] Despite the significance of this resolution regime, however, major deficiencies can be identified in its design. According to the Key Attributes, the resolution regime should include stabilisation options, which could achieve continuity of systemically important functions of a troubled financial institution, as well as liquidation options, which would provide for the orderly closure and wind-down of all or parts of the financial institution's business.[134] But in the Key Attributes, there is hardly any content relevant to liquidation, leaving it unclear how stabilisation options can be coordinated with liquidation options, and what the relationship is between the resolution regime and the insolvency system, which consists of procedures such as reorganisation (administration) and liquidation (winding-up). Without clear answers

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[133] See FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017.

[134] FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) Preamble <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017.

to these questions, chaos will occur when legislators would like to implement this resolution regime in their own jurisdictions.

For example, chaos occurred when the EIOPA took account of both the FSB-proposed resolution regime and the existing insolvency system and sought to clarify the relationship between them. According to the "Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re)insurers Across the Member States" published by the EIOPA in July 2017, when an insurer is not viable or likely to be non-viable, national authorities can decide to place the insurer into judicial insolvency procedures (conforming to the title of "reorganisation and winding-up of insurance undertakings" in the Solvency II Directive[135]) or in resolution.[136] So it seems that the resolution regime is an alternative to the insolvency system, and a troubled insurer which poses systemic risk may be dealt with by relevant authorities in the resolution regime rather than in the insolvency system. However, under the same design framework, one of the resolution powers that resolution authorities should have is to initiate the liquidation of the whole or any part of a failing insurer.[137] Then, questions can be raised as to whether the liquidation

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[135] Council Directive 2009/138/EC of 25 November 2009 on the Taking-up and Pursuit of the Business of Insurance and Reinsurance (Solvency II) [2009] OJ L 335/1 (hereinafter, Solvency II Directive).

[136] EIOPA, 'Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re)insurers Across the Member States' (July 2017) Annex III, para 4 <https://register.eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-148_Opinion_on_recovery_and_resolution_for_(re)insurers.pdf> accessed 20 August 2017.

[137] EIOPA, 'Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re)insurers Across the Member States' (July 2017) para 111 <https://register.eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-

that resolution authorities may effect is the same liquidation procedure in the insolvency system, and whether the resolution regime is just parallel to the reorganisation procedure in the insolvency system. It is reasonable to infer that the answers to both of these two questions will be "yes" when taking account of the opinions held by the ESRB – the EIOPA's closely cooperative partner institution. In the "Recovery and Resolution for the EU Insurance Sector: A Macroprudential Perspective" issued by the ESRB in August 2017, it is clearly pointed out that the liquidation procedure, which constitutes a main component of the insolvency system, is a commonly used resolution tool.[138] Therefore, it is not difficult to notice that EIOPA's opinion about the relationship between the resolution regime and the insolvency system turns out to be illogical.

The reason why the FSB-proposed resolution regime may cause confusion is arguably rooted in the underlying philosophy of this regime when it was initially put forward. In the Key Attributes, the targets are systemically important financial institutions, and the main objective is to resolve troubled financial institutions in an orderly manner without causing severe systemic disruption.[139] So the focus of the Key Attributes is on rescue aspects (eg resolution powers and resolution fund resources),

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148_Opinion_on_recovery_and_resolution_for_(re)insurers.pdf> accessed 20 August 2017.

[138] ESRB, 'Recovery and Resolution for the EU Insurance Sector: A Macroprudential Perspective' (August 2017) para 88 <www.esrb.europa.eu/pub/pdf/reports/esrb.reports170817_recoveryandresolution.en.pdf> accessed 25 August 2017.

[139] FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) Preamble <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017.

with the link between the resolution regime and the traditional insolvency system being neglected. As a consequence, following the FSB's Key Attributes, it is widely held that only systemically important insurers or insurers above a certain threshold will be subject to the resolution regime, while other insurers remain subject to the insolvency system.[140] However, if the design is like this, there will be a dilemma as to whether the resolution regime can be applied when several insurers, none of which is systemically important, fall into crises simultaneously and collectively pose a threat to financial stability.[141] Therefore, the previously prevalent attitudes towards the FSB-proposed resolution regime need to be corrected.

Fortunately, the IAIS has changed its longstanding attitudes to the FSB-proposed resolution regime. In the "Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document)" (hereinafter, Holistic Framework) released in November 2018, the IAIS began to take the view that all insurers may be subject to the FSB-proposed resolution regime, and measures in the regime can be applied to any

[140] See, for example, EIOPA, 'Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re)insurers Across the Member States' (July 2017) Annex 3, para 10 <https://register.eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-148_Opinion_on_recovery_and_resolution_for_(re)insurers.pdf> accessed 20 August 2017.

[141] The scenario that several insurers, none of which is systemically important, confront crises simultaneously and collectively pose a threat to financial stability has been assumed by the ESRB, the EIOPA, the IAIS, etc. See ESRB, 'Recovery and Resolution for the EU Insurance Sector: A Macroprudential Perspective' (August 2017) para 4; EIOPA, 'Systemic Risk and Macroprudential Policy in Insurance' (2017) 34 <www.eiopa.europa.eu/sites/default/files/publications/pdfs/003systemic_risk_and_macroprudential_policy_in_insurance.pdf> 10 October 2017; IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document' (November 2018) para 23 <www.iaisweb.org/page/consultations/closed-consultations/2019/holistic-framework-for-systemic-risk-in-the-insurance-sector> accessed 15 November 2018.

troubled insurers whenever there is concern about a systemic crisis. However, in the Holistic Framework, since the IAIS focuses merely on addressing systemic crises, it does not clearly point out that there are still some measures in the FSB-proposed resolution regime which can be applied to any troubled insurers without taking into consideration systemic risks. It has to be admitted that some measures incorporated in the resolution regime are proportionate only when applied to insurers which pose systemic risk, such as providing temporary financing for rescue purposes and establishing a bridge insurer to take over a troubled insurer's business. But when it comes to a majority of other measures in this resolution regime, such as suspending a troubled insurer's right to write new business, replacing the management of a troubled insurer, transferring insurance business from a troubled insurer to healthy insurers, and restricting policyholders' rights to surrender insurance contracts, there is no reason why these measures cannot be taken towards a troubled insurer which does not pose systemic risk. In fact, in the IAIS's updated Insurance Core Principles released in November 2019, which are applicable to all insurers, many of these measures have already been included in the ICP 10 (Preventive Measures, Corrective Measures and Sanctions) and the ICP 12 (Exit from the Market and Resolution); and in many jurisdictions, many of these measures have also existed in the current mechanisms dealing with troubled insurers.

Given the above discussion, this thesis is of the opinion that, instead of being a special system merely dealing with systemic crises, the FSB-proposed resolution regime should be regarded as a source of measures which are available to relevant

authorities when confronted with troubled insurers. In a certain case, what measures would be taken will be decided by relevant authorities according to the specific situation of the troubled insurer. With this view, the FSB-proposed resolution regime and the insurer insolvency system (or the equivalent system[142]) can be better coordinated. Due to the fact that the insolvency system (or the equivalent system) may sometimes not suffice to address crises of insurers in a way which ensures that policyholders will be protected and financial stability will be maintained, measures provided in the resolution regime need to be introduced. Based on well-thought-out integration, the insolvency system (or the equivalent system) and the FSB-proposed resolution regime will together form a comprehensive CMME mechanism which is used to deal with all crises of insurers.

2.3.3. Comparison with the Insolvency System for Ordinary Companies

When a company fails or is likely to fail, normally it will enter an insolvency procedure according to general insolvency law. Although most insurers exist in the form of a "company", due to the uniqueness of the insurance business and insurers, the general insolvency system alone is not sufficient to cope with issues relating to troubled insurers, and some arrangements therein may not even be suitable for insurers. Just as pointed out by the ESRB, since regular insolvency procedures may not be able to address crises of insurers in an orderly fashion, a broader set of tools are needed to

[142] For example, the insurer receivership system in the US.

make relevant authorities better prepared for situations involving the distress and default of insurers.[143] In practice, to deal with crises of insurers, each jurisdiction either has a mechanism which is independent of the general insolvency system and specific to insurers, such as the CMME mechanism in the US, or has a mechanism with special provisions for insurers to modify or supplement the general insolvency system, such as the CMME mechanism in the UK. While the general insolvency system, consisting of insolvency procedures, contains only judicial procedures, the CMME mechanism contains not only judicial procedures but also regulatory measures/procedures. In this sense, it can be said that the CMME mechanism is a mechanism with a broader scope than the general insolvency system.

When it comes to why dealing with troubled insurers is, or should be, different from dealing with insolvent ordinary companies, most of the relevant literature just simply argues that the importance of insurers in society requires special treatment.[144] There has hardly ever been any work elaborating on what aspects make dealing with troubled insurers special. Based on the guidance provided by the FSB and the IAIS, as

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[143] ESRB, 'Recovery and Resolution for the EU Insurance Sector: A Macroprudential Perspective' (August 2017), para 3.

[144] See, for example, Adam Hodkin, 'Insurer Insolvency: Problems & Solutions' (1992) 20 Hofstra Law Review 727; David A. Skeel, 'The Law and Finance of Bank and Insurance Insolvency Regulation' (1998) 76(4) Taxas Law Review 723; Martin Čihák and Erlend Nier, 'The Need for Special Resolution Regimes for Financial Institutions – The Case of the European Union' (IMF Working Paper, September 2009) <www.imf.org/external/pubs/ft/wp/2009/wp09200.pdf> accessed 25 March 2017; UNCITRAL, 'Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation' (January 2014) <www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf> accessed 25 March 2017.

well as the experience from China, the UK or the US, this section will point out some major aspects where the CMME mechanism is, or may be, different from the general insolvency system. These differences can not only explain why the general insolvency system alone does not suffice to deal with troubled insurers, but also, in turn, reveal the uniqueness of the CMME mechanism.

2.3.3.1. Objectives

How a mechanism/system will be designed is strongly influenced by the objectives the mechanism/system would like to achieve. Different objectives set in the CMME mechanism and the general insolvency system lie at the root of a lot of differences between them.

Although there is a lack of a common perception of the objectives of the general insolvency system, when it comes to dealing with insolvent ordinary companies, generally speaking, much focus is on protecting the rights of creditors and balancing interests between interested parties.[145] In line with this, for example, the pari passu principle has been established to make sure that similar creditors will be treated fairly

[145] For more discussions relating to the objectives the insolvency system may achieve, see, for example, Elizabeth Warren, 'Bankruptcy Policy' (1987) 54(3) The University of Chicago Law Review 775; Thomas H. Jackson and Robert E. Scott, 'On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain' (1989) 75(2) Virginia Law Review 155; Donald R. Korobkin, 'Contractarianism and the Normative Foundations of Bankruptcy Law' (1993) 71 Texas Law Review 541; Karen Gross, 'Taking Community Interests into Account in Bankruptcy: An Essay' (1994) 72 Washington University Law Quarterly 1031; Vanessa Finch, 'The Measures of Insolvency Law' (1997) 17(2) Oxford Journal of Legal Studies 227; Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) 59 – 63.

and equally during insolvency procedures;[146] creditors' decisions have been required to allow creditors to decide how issues relating to insolvent companies would be dealt with;[147] and creditor committees have been designed for creditors to oversee the process of insolvency procedures.[148]

By comparison, the objectives of the CMME mechanism are different. In line with the objectives of insurance regulation,[149] it is widely recognised that protecting policyholders and maintaining financial stability are the two main objectives in dealing with crises of insurers,[150] although different weight may be put on these objectives in some jurisdictions.[151]

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[146] See, for example, Ian F. Fletcher, *The Law of Insolvency* (5th edn, Sweet & Maxwell 2017) 2.

[147] See, for example, Enterprise Bankruptcy Act, art 61 (China); Insolvency Act 1986, s 4(1) (UK).

[148] See, for example, Enterprise Bankruptcy Act, art 68 (China); Insolvency Act 1986, sch B1 para 57 (UK).

[149] For a more detailed discussion of the objectives of insurance regulation, see Section 2.2.3 in this chapter.

[150] See, for example, HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012); EU-US Dialogue Project Technical Committee, 'Comparing Certain Aspects of the Insurance Supervisory and Regulatory Regimes in the European Union and the United States' (December 2012) <https://content.naic.org/sites/default/files/inline-files/eu_us_dialogue_report_121220.pdf> accessed 1 April 2018; FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017; FSB, 'Developing Effective Resolution Strategies and Plans for Systemically Important Insurers' (June 2016) <www.fsb.org/wp-content/uploads/Final-guidance-on-insurance-resolution-strategies.pdf> accessed 5 March 2017; EIOPA, 'Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re)insurers Across the Member States' (July 2017) <https://register.eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-148_Opinion_on_recovery_and_resolution_for_(re)insurers.pdf> accessed 20 August 2017; ESRB, 'Recovery and Resolution for the EU Insurance Sector: A Macroprudential Perspective' (August 2017); PRA, 'The Prudential Regulation Authority's Approach to Insurance Supervision' (October 2018); IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document' (November 2018) <www.iaisweb.org/page/consultations/closed-consultations/2019/holistic-framework-for-systemic-risk-in-the-insurance-sector> accessed 15 November 2018.

[151] For example, in the US, policyholder protection is regarded as the primary objective, which is normally given more consideration than the objective of financial stability by regulatory authorities. See, for example,

A. The Objective of Policyholder Protection

To redress the imbalance in the relationship between insurers and policyholders, it is necessary that protection should be provided to policyholders in the legislation.[152] The time when insurers become troubled is exactly the time when policyholder protection is most needed. The lack of policyholder protection during crises of insurers would leave a vast number of policyholders in a vulnerable position, which would then cause a loss of public confidence in the insurance market. To avoid this, special arrangements have been designed in the CMME mechanism to ensure that policyholders will be given adequate protection. For example, insurance claims will have a higher ranking than most other claims in the liquidation claims hierarchy;[153] losses suffered by eligible policyholders due to crises of insurers will, to a certain degree, be compensated by the insurance guarantee scheme;[154] as an exception to the automatic stay effect, payment of insurance claims may still continue when an insurer enters a reorganisation procedure;[155] etc.

Bipartisan Policy Center, 'Global Insurance Regulatory Issues: Implications for U.S. Policy and Regulation' (November 2015) <https://bipartisanpolicy.org/wp-content/uploads/2019/03/Global-Insurance-Regulatory-Issues.pdf> accessed 1 April 2018; NAIC, 'Comments on FSB’s Nov. 3, 2015 Consultative Document “Developing Effective Resolution Strategies and Plans for Systemically Important Insurers”' (4 January 2016) <www.naic.org/documents/committees_g_related_naic_comments_on_fsb_res.pdf> accessed 1 April 2018.

[152] For a more detailed discussion, see Section 2.2.3 in this chapter.

[153] See, for example, Insurance Act, art 91 (China); Insurers (Reorganisation and Winding Up) Regulations 2004, SI 2004/353, reg 21, and Insolvency Act 1986, ss 175 and 176ZA (UK); Insurer Receivership Model Act § 801 (US).

[154] See, for example, Insurance Security Fund Regulations, reg 16 (China); PRA, ‘Rulebook – SII Firms – Policyholder Protection 17.2(1), (2)’ (1 October 2015) (UK); Life and Health Insurance Guaranty Association Model Act § 3C(2)a (US).

[155] This is a common practice in the US. See NAIC, ‘Receiver's Handbook for Insurance Company Insolvencies’ (2018) 32.

B. The Objective of Financial Stability

Due to the significant role insurers play in the financial market, crises of insurers will have negative spillover effects on the financial market to a greater or lesser extent. Given the fact that crises of insurers may even pose a threat to financial stability, which could then lead to a systemic crisis, to maintain financial stability has been set as another objective in dealing with troubled insurers. Therefore, it is important that there should be proper measures in the CMME mechanism which can help prevent or mitigate a systemic crisis. For example, bail-in may be imposed on claims of creditors, including policyholders, so as to improve a troubled insurer's solvency condition;[156] an industry-backed fund or even public fund may be used to bail out a troubled insurer so as to keep it as a going concern;[157] etc.

Taken together, since the CMME mechanism has different objectives from those of the general insolvency system, it is unrealistic to expect that the general insolvency system alone can function effectively and efficiently in dealing with troubled insurers.

[156] Generally speaking, there are two types of bail-in: one is to write down debts owed by a troubled insurer, and the other is to convert debts of a troubled insurer into equity. See, for example, FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) para 3.5 <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017.

[157] See, for example, FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) para 6.3 <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017; IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12.2.3 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

2.3.3.2. Regulatory Intervention

Different to insurers and other financial institutions, ordinary companies are not subject to prudential regulation. As a consequence, crisis management of an ordinary company to a large extent falls within the scope of corporate governance, and no authorities will proactively intervene in the operation of the company, regardless of how serious the crisis faced by the company is. The court will be involved when the company becomes or is likely to become insolvent and relevant parties petition for an insolvency procedure. If the petition is granted by the court, normally insolvency practitioners will be appointed to take over the company from its management and carry out the insolvency procedure.[158]

By comparison, due to the uniqueness of the insurance business and the role insurers play in society, insurers are subject to prudential regulation, and thus under regulatory authorities' on-going supervision. There is a comprehensive set of statutory and regulatory requirements insurers should comply with during their daily operation, which include capital requirements, solvency ratio requirements, reserving requirements, investment requirements, information disclosure requirements, etc.[159] From time to time, collected evidence during supervision may show that insurers fall below relevant requirements and thus become troubled. In order to achieve the

[158] See, for example, Enterprise Bankruptcy Act, art 25 (China).

[159] See, for example, IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 14, 15, 16, 17 and 20 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

objective of policyholder protection or the objective of financial stability, regulatory authorities are empowered to take a wide range of measures so that troubled insurers can be restored to normal conditions or crises of insurers can be addressed in an orderly way.[160]

Therefore, insurance regulatory authorities' role in the CMME mechanism is proactive. When identifying crises of insurers during supervision, insurance regulatory authorities can on their own initiative take proper actions to deal with the troubled insurers. Take the stance of Bank of England as an example:

> Our supervisors focus on what matters: they take a forward-looking and judgement-based view of whether insurers' business models and strategy could threaten policyholders or the wider financial sector in future. If we think that management's actions today pose a risk tomorrow, we won't hesitate to step in.[161]

2.3.3.3. Triggers

"Insolvency" is the most common ground for commencing an insolvency procedure. When an ordinary company becomes or is likely to become non-viable (generally speaking, "cash-flow insolvent" or "balance-sheet insolvent"), eligible parties, such as

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[160] See, for example, IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 10 and 12 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019; FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) Section 3 <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017.

[161] Mark Carney, 'Regulating the Insurance Industry to Support the Real Economy' (Bank of England, 22 May 2014) <www.bankofengland.co.uk/publications/Documents/speeches/2014/speech730.pdf> accessed 8 July 2017.

creditors, shareholders or the management of the company, can petition a court of competent jurisdiction for an appropriate insolvency procedure.[162]

However, “insolvency” is not a desirable indicator which can expose crises of insurers on a timely basis. This can be explained from several perspectives. Firstly, it is not very likely that insurers will become cash-flow insolvent if they are not deeply involved in complicated financial transactions, such as securities lending or derivatives, which may lead to immediate large liquidity needs.[163] In the traditional insurance business, insurers normally have an ongoing cash inflow from policyholders, but no ongoing payment obligation, so it is not often that insurers are unable to pay debts falling due even if they are in a poor financial condition.[164] Secondly, due to the fact that insurance claims are contingent, it is never an easy task to tell whether an insurer becomes or is likely to become balance-sheet insolvent.[165] Thus, the difficulty in ascertaining the solvency condition of an insurer can sometimes hinder eligible parties from initiating relevant procedures in the CMME mechanism based on the ground of “balance-sheet insolvency”. Thirdly, as shown in historical experience, a lot of insurers that finally failed had always been solvent in terms of the book value of their capital,[166]

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162 See, for example, Enterprise Bankruptcy Act, arts 2 and 7 (China).

163 IAIS, ‘Holistic Framework for Systemic Risk in the Insurance Sector’ (November 2019) 10 <www.iaisweb.org/page/supervisory-material/financial-stability> accessed 15 November 2019.

164 David A. Skeel, 'The Law and Finance of Bank and Insurance Insolvency Regulation' (1998) 76(4) Taxas Law Review 723, 765. See also Guillaume Plantin and Jean-Charles Rochet, *When Insurers Go Bust: An Economic Analysis of the Role and Design of Prudential Regulation* (Princeton University Press 2007) 44.

165 Al Slavin, 'Reflecting on the Past' (Best’s Review, August 2011) <http://news.ambest.com/articlecontent.aspx?pc=1009&AltSrc=108&refnum=189989> accessed 1 August 2017.

166 James G. Bohn and Brian Hall, 'The Costs of Insurance Company Failures' in David F. Bradford (ed), *The*

so "balance-sheet insolvency" may not occur even when an insurer is trapped in a severe crisis. For example, in the case of Equitable Life Assurance Society in the UK, although the insurer never became cash-flow insolvent or balance-sheet insolvent, in order to maintain solvent run-off,[167] policyholders were repeatedly forced to accept write-down of their insurance benefits, which inflicted heavy losses on policyholders.[168] This also shows that troubled insurers, even if they are still solvent, could cause great harm. Taken together, despite the importance of the standard of "insolvency", "insolvency" should not be set as the only trigger for a certain measure/procedure in the CMME mechanism. Otherwise, it is less likely that desirable outcomes would be achieved if effective measures/procedures could only be initiated after insurers become insolvent.

In line with the statutory and regulatory requirements insurers should comply with during their operation, triggers for a certain measure/procedure in the CMME mechanism should accordingly be more diverse, not just limited to "insolvency". In other words, statutory grounds for commencing a certain measure/procedure against troubled insurers should be set to reflect the statutory or regulatory requirements for insurers. When insurers fall below statutory or regulatory requirements and thus become troubled insurers, appropriate measures/procedures in the CMME

Economics of Property-Casualty Insurance (University of Chicago Press 1998).

[167] For a brief discussion of run-off, see Section 2.3.3.6 in this chapter.

[168] IAIS, 'Insurance and Financial Stability' (November 2011) 44 <www.iaisweb.org/Otherpapers-and-reports-46> accessed 21 March 2018.

mechanism should then be initiated to address the crises of insurers. For example, in the US, grounds for initiating receivership procedures (ie conservation, rehabilitation and liquidation) against troubled insurers are diverse, including impaired financial conditions, improper disposal of property, disqualification of senior managers, malpractice, etc., but not limited only to "insolvency".[169] This makes it possible that crises of insurers can be addressed in a timely and effective manner, thus preventing the crises running wild.

It is commonly believed that the earlier the relevant measures/procedures in the CMME mechanism are initiated against troubled insurers, the better the outcomes that could be achieved and the smaller the losses that could be incurred.[170] Due to high costs involved in dealing with troubled insurers, it may even be the case that originally solvent troubled insurers would eventually become insolvent and inflict losses on creditors.[171] This, from another perspective, explains why grounds for commencing measures/procedures in the CMME mechanism should be diverse and

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[169] Insurer Receivership Model Act § 207. (US)

[170] See, for example, Martin F. Grace, Robert W. Klein and Richard D. Phillips, 'Insurance Company Failures: Why Do They Cost so Much?' (Georgia State University Center for Risk Management and Insurance Research Working Paper No. 03-1, 20 November 2003) 33 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=463103> accessed 1 March 2007; Martin Čihák and Erlend Nier, 'The Need for Special Resolution Regimes for Financial Institutions – The Case of the European Union' (IMF Working Paper, September 2009) 13 <www.imf.org/external/pubs/ft/wp/2009/wp09200.pdf> accessed 25 March 2017; EIOPA, 'Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re)insurers Across the Member States' (July 2017) para 89 <https://register.eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-148_Opinion_on_recovery_and_resolution_for_(re)insurers.pdf> accessed 20 August 2017.

[171] James G. Bohn and Brian Hall, 'The Costs of Insurance Company Failures' in David F. Bradford (ed), *The Economics of Property-Casualty Insurance* (University of Chicago Press 1998).

not limited to “insolvency”. Only with diverse grounds, can relevant measures/procedures be fully utilised to tackle crises of insurers before insolvency eventually takes place. Otherwise, it will always be too late to turn things around or to minimise losses when insurers become insolvent.

2.3.3.4. Insurance Guarantee Schemes

For the purposes of protecting policyholders, and sometimes also for the purposes of maintaining financial stability, many jurisdictions have established insurance guarantee schemes[172] which are funded by the insurance industry, eg the Insurance Security Fund in China, the Financial Services Compensation Scheme in the UK, and insurance guaranty associations in the US. It is believed that the existence of insurance guarantee schemes will instil confidence in the insurance market, and thereby reduce possible contagion effects caused by crises of insurers.[173] Since the time when insurers become troubled and are placed into relevant measures/procedures in the CMME mechanism, is exactly the time when insurance guarantee schemes are most needed to serve their purposes, insurance guarantee schemes’ participation in dealing with troubled insurers constitutes one of the features which distinguishes the CMME

[172] In this thesis, the term “insurance guarantee scheme” is used during the general discussion. It is a synonym for “insurance guarantee fund”, “policyholder protection scheme”, “policyholder protection fund”, “insurance security fund”, etc., used in other materials.

[173] See, for example, OECD, ‘Policyholder Protection Schemes: Selected Considerations’ (2013) 16 <www.oecd-ilibrary.org/finance-and-investment/policyholder-protection-schemes_5k46l8sz94g0-en> accessed 31 October 2018; IAIS, ‘Issues Paper on Policyholder Protection Schemes’ (October 2013) 7 <https://iaisweb.org/page/supervisory-material/issues-papers/file/34282/life-insurance-securitisation-october-2003#> accessed 31 October 2018.

mechanism from the general insolvency system.

In different jurisdictions, insurance guarantee schemes may have different functions.[174] From the observation of this thesis, these functions can be roughly classified into two categories:

A. The function of protecting policyholders (the protection function for short). The protection function means that the insurance guarantee scheme will provide a certain level of protection to eligible policyholders, which can be realised through the ways of making compensation payments to policyholders, maintaining the continuation of insurance policies, setting up bridge insurers to assume insurance policies issued by a troubled insurer, etc.[175] This function not only ensures that losses suffered by protected policyholders will be largely reduced, but also ensures that insurance claims of protected policyholders will be paid on a timely basis, avoiding the otherwise prolonged delay in payment of insurance claims in cases where a moratorium is imposed in a relevant procedure.[176]

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[174] Discussions of functions of insurance guarantee schemes can be found in many works. See, for example, OECD, 'Policyholder Protection Schemes: Selected Considerations' (2013) <www.oecd-ilibrary.org/finance-and-investment/policyholder-protection-schemes_5k46l8sz94g0-en> accessed 31 October 2018; IAIS, 'Issues Paper on Policyholder Protection Schemes' (October 2013) <https://iaisweb.org/page/supervisory-material/issues-papers/file/34282/life-insurance-securitisation-october-2003#> accessed 31 October 2018; EIOPA, 'Consultation Paper on Proposals for Solvency II 2020 Review: Harmonisation of National Insurance Guarantee Schemes' (9 July 2019) <www.eiopa.europa.eu/sites/default/files/press/news/eiopa-bos-19-259_consultation_paper_on_harmonisation_of_igss.pdf> accessed 9 July 2019.

[175] For more detailed discussions, see Part 3.5, Part 4.3 and Part 5.4 in this thesis.

[176] See, for example, EIOPA, 'Consultation Paper on Proposals for Solvency II 2020 Review: Harmonisation of National Insurance Guarantee Schemes' (9 July 2019) 14 <www.eiopa.europa.eu/sites/default/files/press/news/eiopa-bos-19-259_consultation_paper_on_harmonisation_of_igss.pdf> accessed 9 July 2019.

B. The function of rescuing insurers (the rescue function for short). The rescue function means that the insurance guarantee scheme will provide financial assistance to a troubled insurer to keep it as a going concern (ie to bail out the troubled insurer). This can normally be realised through the ways of loans, capital injections, assets purchases, etc. Unlike the protection function which only works to protect eligible policyholders, the rescue function will in effect benefit all interested parties of a troubled insurer, including policyholders, creditors other than policyholders, employees, and even shareholders. Apart from the need for policyholder protection, the justification for having the rescue function also builds on the consideration of minimising losses incurred by troubled insurers, protecting the public interest, maintaining financial stability, etc.[177] While all jurisdictions with insurance guarantee schemes provide for the protection function, only a few have chosen to provide for the rescue function.[178]

Similar to the effect of the rescue function of insurance guarantee schemes, some jurisdictions have in place emergency funding plans[179] which can be utilised to

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[177] See, for example, Explanatory Notes to the Financial Services and Markets Act 2000, para 433 (UK); Insurance Security Fund Regulations, reg 16 (China).

[178] See, for example, IAIS, 'Issues Paper on Policyholder Protection Schemes' (October 2013) <https://iaisweb.org/page/supervisory-material/issues-papers/file/34282/life-insurance-securitisation-october-2003#> accessed 31 October 2018; EIOPA, 'Discussion Paper on Resolution Funding and National Insurance Guarantee Schemes' (July 2018) <www.eiopa.europa.eu/sites/default/files/publications/pdfs/eiopa-cp-18-003_discussion_paper_on_resolution_funding_and.pdf> accessed 31 July 2018.

[179] Note: The term "emergency funding plans" used in the thesis is equivalent to the term "resolution funds" used in some materials. See, for example, FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017; EIOPA, 'Discussion Paper on Resolution Funding and National Insurance Guarantee Schemes' (July 2018) <www.eiopa.europa.eu/sites/default/files/publications/pdfs/eiopa-cp-18-003_discussion_paper_on_resolution_funding_and.pdf> accessed 31 July 2018.

provide financial assistance to troubled insurers. These emergency funding plans are usually funded by central banks or treasuries and are mainly aimed at maintaining financial stability when there is concern about a systemic crisis. For example, in the US, there exists the Orderly Liquidation Fund in the Treasury, which can be used to provide liquidity to troubled insurers in rehabilitation or liquidation, and there is also emergency lending from the Federal Reserve System, which can be used to provide liquidity to troubled but not insolvent insurers so as to help them get over the period of market-wide liquidity strain.[180]

Taken together, targeted at dealing with crises of insurers, there are insurance guarantee schemes or emergency funding plans in the CMME mechanism. These components of the CMME mechanism, in nature, fall outside the scope of the general insolvency system.

2.3.3.5. Creditors' Decision

Due to the special features the insurance business and insurers have, it may be the case that some arrangements in the insolvency system for ordinary companies cannot work out properly when applied to insurers. It is argued in this thesis that "creditors' decision" in the general insolvency system is one of the arrangements which is not suitable for insurers, and thus, ideally, should not be incorporated in the CMME mechanism.

[180] For a more detailed discussion of the Orderly Liquidation Fund in the US, see Section 5.5.2 in this thesis.

In the insolvency system for ordinary companies, the design of "creditors' decision" provides an opportunity for all creditors of an insolvent company to decide major issues relating to the company, which include the company's voluntary arrangement, reorganisation plan, assets distribution plan, proposal for remuneration of insolvency practitioners, etc.[181] Creditors will make a decision by means of voting, with the value of each creditor's vote equal to the amount of his/her claim against the insolvent company. A decision in favour of certain issues normally requires a majority or a vast majority of favourable votes (in value).

However, when it comes to dealing with a troubled insurer, the majority of whose creditors are policyholders, to seek creditors' decisions is demonstrably a real challenge. One reason for this is that since insurance claims are contingent before insured events take place, it is difficult to find an appropriate way to determine claims of policyholders at a given point of time. As a consequence, how to determine the value of each policyholder's vote becomes a challenge if voting is needed in some procedures.[182] Another reason is that since the number of policyholders affected by a troubled insurer tends to be vast, there will not be a very good chance of receiving the required majority of favourable votes from all creditors (including policyholders) so as to achieve a favourable decision on certain issues.[183] Also, it may still be

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[181] The design of "creditors' decision" (or "creditors' meeting") constitutes an integral element of the insolvency system in each jurisdiction.

[182] For more detailed discussions, see, for example, Section 4.2.1.2 and Section 4.2.2.3 in this thesis.

[183] For a more detailed discussion, see, for example, Section 4.2.1.2 in this thesis.

technically difficult, or at least costly, to carry out the decision-making process which involves a vast number of creditors (including policyholders).

Since "creditors' decision" is an arrangement inherent in the general insolvency system, in a jurisdiction where the CMME mechanism is based on the general insolvency system, eg China and the UK, how to apply "creditors' decision" to insurers constitutes a challenge in dealing with crises of insurers. However, this challenge does not exist in the US at all. In the US, the CMME mechanism is centred on the state insurer receivership system, which is completely independent of the general bankruptcy system, and there is no design of "creditors' decision" in the receivership system. When an insurer is placed into a receivership procedure (ie conservation, rehabilitation or liquidation), it is the state insurance regulatory authority who will decide all relevant issues (eg rehabilitation plans, and assets distribution) during the procedure, subject to supervision or prior approval of a court of competent jurisdiction.[184] Therefore, from the US experience, it emerges that a CMME mechanism can function well without containing the arrangement of "creditors' decision". Considering the difficulties "creditors' decision" may bring about in the case of dealing with troubled insurers, it is reasonable to argue that "creditors' decision" should not be incorporated/kept in a well-devised CMME mechanism.

[184] For a more detailed discussion, see Part 5.3 in this thesis.

2.3.3.6. Continuity of Business

Given the special role insurers play in society, crises of insurers may cause massive disruption to relevant business. To minimise the potential adverse impact, in the CMME mechanism, there exist measures which are designed to ensure the whole or a part of business of a troubled insurer can be continued even if the insurer itself will eventually exit from the market.[185] These measures include, among others, portfolio transfer, run-off, and temporary continuity, which are beyond the scope of the insolvency system for ordinary companies and thus contribute to the uniqueness of the CMME mechanism.

Portfolio transfer means that the whole or a part of the insurance business of a troubled insurer will be transferred to other healthy insurers in the market or even to a specially established bridge insurer. For example, long-term insurance policies are among the business that needs to be continued through portfolio transfer upon failures of insurers. Long-term insurance (eg life insurance and annuity) tends to cover a very long period and provides policyholders with an appealing way of financial management from a long-run perspective. With the expectation to get insurance benefits when insured events take place many years later, such as premature death or reaching a certain age, policyholders are willing to pay premiums at a level rate on a

[185] See, for example, IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12.0.7 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

regular basis. In this case, when an insurer having issued long-term insurance policies fails, in the absence of special protection, not only will policyholders lose the insurance coverage and suffer a huge loss in the premiums they have paid over years, but they are unlikely to procure substitute policies with the policy terms similar to those in the original policies (due to ageing, poorer health conditions, etc.). Thus, to maintain the continuity of long-term insurance policies is necessary for the purposes of policyholder protection. It is normally provided in the CMME mechanism in a certain jurisdiction that long-term insurance policies of a troubled insurer should be transferred to other insurers in the event of failure.[186]

With regard to run-off, it means that an insurer will not write new insurance policies any more, and remain as a going concern until all existing insurance policies lapse. When an insurer becomes troubled, regulatory authorities can forbid the insurer to write new business, and let the insurer enter the run-off phase.[187] Run-off may take place whether a troubled insurer is solvent or insolvent. It can be a desirable way to deal with the crisis of an insurer when there is a need to maintain the continuity of insurance coverage or other critical services provided by the insurer, without causing interruption to the existing business.[188]

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[186] See, for example, Insurance Act, art 92 (China); Financial Services and Markets Act 2000, s 376 (UK); Life and Health Insurance Guaranty Association Model Act § 8B (US).

[187] See, for example, IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12.7.4 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

[188] See, for example, FSB, 'Developing Effective Resolution Strategies and Plans for Systemically Important Insurers' (June 2016) <www.fsb.org/wp-content/uploads/Final-guidance-on-insurance-resolution-strategies.pdf>

When a troubled insurer ends up in failure, apart from the policies which would remain in force until their expiration, it is also necessary to allow temporary continuity of other policies for a short period, so that policyholders can have enough time to seek substitute insurance coverage from other insurers in the market.[189] Otherwise, a vast number of policyholders will be left out of insurance coverage all of a sudden, which obviously deviates from the objective of policyholder protection. In cases where insurance is compulsory in nature or is essential to certain activities, such as motor liability insurance or aviation insurance, the sudden termination of insurance policies may even cause disruption to relevant activities in society. Therefore, it is common practice for different jurisdictions to provide in the CMME mechanisms that insurance policies should remain in force at least for a short period of time, eg 30 days in the US,[190] after an insurer is placed into liquidation.

2.3.4. Relationship with the Equivalent Mechanism for Troubled Banks

In contrast to the fact that research on the CMME mechanism for insurers, generally speaking, is still at an early stage of development, there is no lack of research on the equivalent mechanism for banks, and relevant research in the banking area is highly developed. In many jurisdictions, including the UK and the US, a mechanism which is

accessed 5 March 2017.

[189] IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12.0.7 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

[190] Insurer Receivership Model Act § 502B, D. (US)

independent of the general insolvency system has been specifically established to deal with crises of banks.[191] Since both insurers and banks are financial institutions, crises of insurers or banks not only adversely affect a vast number of financial consumers (ie policyholders or depositors), but may also pose a threat to financial stability. Considering these similarities, questions can be raised as to what extent the CMME mechanism for insurers is or should be different from the mechanism for banks, and whether the mechanism for banks can be extended to insurers.

Unlike the relationship between depositors and banks, which allows depositors to withdraw their deposits immediately from banks, in the relationship between policyholders and insurers, policyholders normally have insurance claims against insurers after insured events take place. In terms of long-term insurance, although policyholders can surrender their policies and redeem the cash surrender value, they will probably be charged surrender penalties and wait for a lengthy surrender procedure to be completed before getting payment. As a consequence, while it is very likely that a “bank run” will occur when banks become troubled, which will in turn cause or exacerbate the liquidity pressure on the banks, this is not quite the case when it comes to crises of insurers. Thus, compared with crises of banks, crises of insurers may not develop at such a fast pace, and this allows more time for relevant parties to deal with troubled insurers.[192] There is little doubt that different features between

[191] For example, in the UK, following the 2007–2009 financial crisis, a bank resolution regime has been established to deal with crises of banks. For more information, see the Banking Act 2009.

[192] See, for example, Insurance Europe, 'Why Insurers Differ from Banks' (October 2014) 40

insurers and banks which stem from their different business models should be taken into account when devising the crisis management and market exit mechanisms.

Nevertheless, in terms of the measures/procedures which troubled insurers or banks may go through, it is still reasonable to expect that the CMME mechanism for insurers and the mechanism for banks can have a lot in common. In practice, this has also been proven to be the case. For example, in the EU, in the Directive 2001/17/EC,[193] which concerned the reorganisation and winding up of insurers, and the Directive 2001/24/EC, which concerned the reorganisation and winding up of credit institutions, apart from the provisions relating to the particular activities of insurance or banking, the text of these two directives shared a high degree of similarity.[194] Following this logic, within a certain jurisdiction, if the mechanism for banks is at a higher level of development than the mechanism for insurers, then experience and lessons from the banking area can be drawn upon when a reform of the mechanism for insurers is needed.

Although, as shown in many jurisdictions, it is often the case that the mechanism for insurers differs from the mechanism for banks, it is not impossible that a unified CMME mechanism which is applicable to all financial institutions (including banks and

<www.insuranceeurope.eu/sites/default/files/attachments/Why%20insurers%20differ%20from%20banks.pdf> accessed 13 August 2017.

[193] With the Council Directive 2009/138/EC of 25 November 2009 on the Taking-up and Pursuit of the Business of Insurance and Reinsurance (Solvency II) [2009] OJ L 335/1 (Solvency II Directive) coming into effect, the Directive 2001/17/EC was repealed. And all contents of the Directive 2001/17/EC (except for the preamble) have been incorporated into the Solvency II Directive.

[194] Enrico Galanti, 'The New EC Law on Bank Crisis' (2002) 11 International Insolvency Review 49, 52.

insurers) can be established, with relevant modifications made therein to adapt the mechanism for different types of financial institutions. The framework of a unified CMME mechanism can resemble the framework of the FSB's Key Attributes, which not only contains a common part that is applicable to all financial institutions, but also has tailored provisions specific to a certain type of financial institutions (for example, with the Appendix II – Annex 2 to the Key Attributes targeted only at insurers).[195] However, to establish a unified CMME mechanism needs to be based on abundant research on how to deal with crises of different types of financial institutions. Due to the fact that research on the CMME mechanism for insurers is at an early stage of development, there is still a need to focus on how troubled insurers should be dealt with, which is what this thesis is doing. Therefore, regarding to what extent the mechanism for insurers can be integrated with the mechanisms for other financial institutions (including banks), it remains a topic to be researched further in the future.

2.4. Chapter Summary

As key players in the insurance market, insurers are subject to special regulation. Due to various reasons, such as catastrophic events, investment losses, blind rapid growth and mismanagement, insurers may sometimes run into trouble, falling below statutory or regulatory requirements. Crises, or even failures, of insurers may not only harm the

[195] See FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017.

interests of policyholders, but also adversely affect the financial market or even the real economy. Therefore, it is important to have a well-designed CMME mechanism so that crises of insurers can be addressed in an effective and efficient way.

Different to the FSB's proposed resolution regime, which is only aimed at dealing with crises of systemically important insurers, the CMME mechanism discussed in this thesis is a mechanism that is applicable to all insurers. To accommodate the special features of insurance and insurers, the CMME mechanism should be specifically designed. Differences between the CMME mechanism and the general insolvency system can/may be found in the following aspects:

(1) Objectives

Unlike ordinary companies, insurers are specially regulated. In line with the objectives of insurance regulation, protecting policyholders and maintaining financial stability are regarded as the two main objectives in the CMME mechanism. Obviously, these two objectives are not normal objectives in the general insolvency system.

(2) Regulatory Intervention

While no authorities would proactively intervene in a crisis of an ordinary company, insurance regulatory authorities should take proper actions to address a crisis of an insurer once they realise that the insurer runs into trouble.

(3) Triggers

In the general insolvency system, "insolvency" is the most common ground for commencing an insolvency procedure. However, in the CMME mechanism, it is argued that triggers for a certain measure/procedure should reflect the statutory and

regulatory requirements insurers should comply with, not just limited to “insolvency”.

(4) Insurance Guarantee Schemes

There are insurance guarantee schemes which would perform the function of protecting policyholders or the function of rescuing insurers in the event of crises of insurers. The insurance guarantee schemes’ involvement constitutes one of the features which distinguishes the CMME mechanism from the general insolvency system.

(5) Creditors’ Decision

In the general insolvency system, the design of “creditors’ decision” provides an opportunity for all creditors of an insolvent company to decide major issues relating to the company. However, due to the fact that the majority of an insurer’s creditors are policyholders, to seek creditors’ decisions in the case of an insurer seems to be unfeasible. Thus, it is argued that the design of “creditors’ decision” should not be incorporated in the CMME mechanism.

(6) Continuity of Business

In the CMME mechanism, there exist measures (eg portfolio transfer, run-off, and temporary continuity) which are designed to ensure that the whole or a part of business of a troubled insurer can be continued even if the insurer itself eventually exits from the market.[196] These measures are beyond the scope of the general

[196] IAIS, ‘Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups’ (November 2019) ICP 12.0.7 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

insolvency system, thus contributing to the uniqueness of the CMME mechanism.

Although in many jurisdictions, the mechanism dealing with crises of banks has achieved a higher level of development than the mechanism for insurers, it is still unclear whether and, if so, to what extent the mechanism for banks can be utilised to deal with crises of insurers. In the future, based on sufficient research, it is not beyond the realms of possibility that a unified CMME mechanism which is applicable to all financial institutions (including banks and insurers) will be established, with relevant modifications made therein to adapt the mechanism for different types of financial institutions.

By discussing the relevant aspects which are generally common to CMME mechanisms in different jurisdictions, this chapter lays the foundation for further discussions in the later chapters.

Chapter 3 Analysis of the CMME Mechanism in China

Overview

In this chapter, the analysis of the CMME mechanism in China will be carried out, depicting what the current mechanism is like and pointing out the major problems it has. Basically, the current CMME mechanism is based on the general bankruptcy system. The inadequacy of special arrangements for insurers in the bankruptcy system and the lack of relevant cases in practice generally reflect the current state of the CMME mechanism. In order to have an overall understanding of the current mechanism, the major components of the mechanism will be analysed in detail in turn, which include the regulatory intervention system (consisting of regulatory measures), the bankruptcy system (consisting of composition, reorganisation, and bankruptcy liquidation) and the Insurance Security Fund.

Through the analysis, a lot of problems in the current CMME mechanism can be identified. Due to the inadequacy of special arrangements for insurers and the lack of relevant cases, most of the problems identified in the discussion are not problems that have actually occurred in practice, but problems existing in the form of doubt, uncertainty or ambiguity. Since a lot of arrangements in the current mechanism are arguably not compatible with the special features of insurers, it remains unknown or unclear how relevant issues would be handled, or how different measures/procedures within the mechanism can be carried out in a coordinated manner in the event of a major crisis. Therefore, to better deal with troubled insurers requires a reform to solve

the problems in the current CMME mechanism. To this end, some significant questions need to be answered. For example, what role can the regulatory authorities play during the process of addressing crises of insurers? Is it appropriate to set “insolvency” as the only ground for commencing a bankruptcy procedure of an insurer? Are bankruptcy administrators suitable for carrying out bankruptcy procedures of insurers? How will policyholders be treated in a bankruptcy procedure? How will creditors’ meetings be held in a bankruptcy procedure? Is composition as a bankruptcy procedure suitable for dealing with troubled insurers? How can takeover and reorganisation be coordinated? Is it necessary to have both revocation liquidation and bankruptcy liquidation in the CMME mechanism? How can the Insurance Security Fund’s protection function be coordinated with its rescue function? As the analysis of the CMME mechanism in China proceeds in this chapter, these questions will be raised in turn.

3.1. Current Developments of the CMME Mechanism

Generally speaking, the insurance industry in China is still at an early stage of development. It can be said that only after the reform and opening-up policy was adopted by Chinese government in 1978 did the private insurance business began to develop.[197] On the one hand, in terms of premiums written by insurers, China’s

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[197] Zhuyong Li and Shi Qiao, ‘The Development of Insurance Law in China: Review and Prospect’ (2019) 100 Financial Law Forum 98, 99.

insurance market has already become the second largest insurance market in the world.[198] On the other hand, however, there are currently just around 170 insurers in China,[199] with the number of insurers being much smaller than those in the countries with large insurance markets. This means that, normally, the size of a certain insurer in China is comparatively large, and how an insurer runs will have a great impact on the society, at least at a local level.

Currently, insurers are supervised by the China Banking and Insurance Regulatory Commission (CBIRC).[200] When an insurer falls below statutory or regulatory requirements, it will be subject to regulatory measures taken by the CBIRC according to the Insurance Act and relevant departmental regulations.[201] If an insurer becomes insolvent, in theory, upon the CBIRC's approval or at the CBIRC's own initiative, the insurer can still be brought into a bankruptcy procedure according mainly to the

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[198] Swiss Re Institute, 'World Insurance: The Great Pivot East Continues' (4 July 2019) 9 <www.swissre.com/dam/jcr:b8010432-3697-4a97-ad8b-6cb6c0aece33/sigma3_2019_en.pdf> accessed 1 June 2020.

[199] 'Members' (*Insurance Association of China*) <www.iachina.cn/col/col19/index.html> accessed 1 June 2020.

[200] Before March 2018, insurers were supervised by the commission named the China Insurance Regulatory Commission. After the restructuring of government institutions, the China Insurance Regulatory Commission and the China Banking Regulatory Commission have been merged into the China Banking and Insurance Regulatory Commission (CBIRC). As a consequence, since March 2018, insurers began to be supervised by the commission named the CBIRC. Given the fact that the CBIRC is the successor to the China Insurance Regulatory Commission, which completely substitutes for the China Insurance Regulatory Commission, and the reference to the China Insurance Regulatory Commission in the existing legislation will be automatically regarded as the reference to the CBIRC, no distinctions will be made between these two commissions in this thesis. The "CBIRC" will be used to refer to the commission supervising insurers throughout the thesis, even if the discussions are concerned with events taking place before the restructuring of government institutions.

[201] In China, departmental regulations are enacted by departments under the State Council and constitute one type of legislation.

Enterprise Bankruptcy Act. Thus, the regulatory measures and the bankruptcy procedures constitute the measures/procedures troubled insurers may go through within the CMME mechanism. However, there is a lack of special arrangements for insurers in the bankruptcy system, and the bankruptcy procedures for insurers are almost the same with those for ordinary companies. Considering the special features insurers have, it is argued that the existing bankruptcy system is ill-suited to dealing with troubled insurers. This may partly explain why there has not been any case involving a bankruptcy procedure of an insurer so far.

There exists the Insurance Security Fund (ISF), which constitutes an important source of funding in addressing crises of insurers. The ISF can perform both the function of protecting policyholders (the protection function) and the function of rescuing insurers (the rescue function). In terms of the protection function, the ISF can compensate policyholders or other insurers to which policies issued by a troubled insurer are transferred for their losses incurred by the crisis of the troubled insurer; and in terms of the rescue function, the ISF can provide financial assistance directly to a troubled insurer when the situation requires.[202] In practice, there were 3 cases where the ISF was involved in dealing with troubled insurers (or insurance group companies), all related to the ISF's performing its rescue function.[203] In other words, how the ISF functioned in addressing crises in the insurance industry was just to bail

[202] See Insurance Security Fund Regulations, regs 3 and 16.

[203] For a more detailed discussion, see Part 3.5 in this chapter.

out troubled insurers (or insurance group companies).

Following the model of the FSB-proposed resolution regime, relevant regulatory authorities announced a plan to establish a resolution regime for systemically important financial institutions (including insurers) at the end of 2018, and detailed regulations on this resolution regime are expected to be released in the coming years.[204] Therefore, it is likely in the future that when an insurer designated as a systemically important insurer runs into trouble, the crisis of the insurer will be addressed under the new special resolution regime. As provided in the reform plan, the People's Bank of China,[205] functioning as the lender of last resort under this resolution regime, may provide emergency lending to a troubled systemically important insurer for the sake of financial stability.[206] However, since this reform plan builds on the previously prevalent attitude that the FSB-proposed resolution regime is only applicable to systemically important insurers, if the reform is carried out, the regulatory authorities will find it difficult to answer whether the resolution regime can be applied when several insurers, none of which is systemically important, run into

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[204] The People's Bank of China, China Banking and Insurance Regulatory Commission and China Securities Regulatory Commission, 'The Guidance on Improving the Regulatory System for Systemically Important Financial Institutions' (November 2018) <www.gov.cn/xinwen/2018-11/27/content_5343833.htm> accessed 27 November 2018.

[205] The People's Bank of China is the central bank in China.

[206] The People's Bank of China, China Banking and Insurance Regulatory Commission and China Securities Regulatory Commission, 'The Guidance on Improving the Regulatory System for Systemically Important Financial Institutions' (November 2018) <www.gov.cn/xinwen/2018-11/27/content_5343833.htm> accessed 27 November 2018.

trouble simultaneously and collectively pose a threat to financial stability.[207] Actually, after realising the deficiencies in its original attitude towards the FSB-proposed resolution regime, the IAIS later turned to hold that the FSB-proposed resolution regime should be applicable to all insurers which pose systemic risk.[208] In line with this, the IAIS decided to suspend the designation of G-SIIs since 2018.[209] As a consequence, the reform plan issued by the regulatory authorities in China can be regarded as a product which has been abandoned by the IAIS. Thus, it is better that this reform plan be modified to keep up with the IAIS's updated attitudes before it is eventually carried out in practice.

Taken together, the current CMME mechanism is based on the general bankruptcy system. The inadequacy of special arrangements for insurers in the bankruptcy system and the lack of relevant cases in practice generally reflect the current state of the CMME mechanism in China. Therefore, it can be said that the CMME mechanism has not been well formed, and there is a need for a radical reform of the mechanism. In fact, the regulatory authorities have been considering the reform for years. In 2012, in

[207] For a more detailed discussion, see Section 2.3.2. in this thesis.

[208] See IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document' (November 2018) <www.iaisweb.org/page/consultations/closed-consultations/2019/holistic-framework-for-systemic-risk-in-the-insurance-sector> accessed 15 November 2018.

[209] See IAIS, 'Holistic Framework for Systemic Risk in the Insurance Sector – Public Consultation Document' (November 2018) <www.iaisweb.org/page/consultations/closed-consultations/2019/holistic-framework-for-systemic-risk-in-the-insurance-sector> accessed 15 November 2018; FSB, 'FSB Welcomes IAIS Proposed Insurance Systemic Risk Framework and Decides not to Engage in an Identification of G-SIIs in 2018' (November 2018) <www.fsb.org/2018/11/fsb-welcomes-iais-proposed-insurance-systemic-risk-framework-and-decides-not-to-engage-in-an-identification-of-g-siis-in-2018/> accessed 2 May 2020.

"The 12th Five-Year Plan for Development and Reform of the Financial Industry", the regulatory authorities already appealed to establish a special bankruptcy system for financial institutions and enact "Rules on Crisis Management of Insurers".[210] Since not much progress had been made in this area, in 2019, in "The Plan to Accelerate the Reform of the Market Exit Mechanism", the regulatory authorities reiterated the necessity of reforming the market exit mechanism for financial institutions.[211]

In order to have an overall understanding of the current CMME mechanism in China and find out what problems need to be solved in the future reform, the major components of the mechanism will be analysed in turn in the rest of this chapter.

3.2. The Solvency Regulation System and Regulatory Measures

To ensure that insurers can maintain sound operation, each insurer is required to have at least the minimum solvency capacity which is commensurate with its business scale and risk level.[212] The CBIRC is empowered to establish a solvency regulation system and take relevant regulatory measures towards insurers according to their solvency conditions.[213] Since 2016, a new solvency regulation system has been adopted by the

[210] The People's Bank of China and others, 'The 12th Five-Year Plan for Development and Reform of the Financial Industry' (September 2012) <www.gov.cn/gzdt/2012-09/17/content_2226795.htm> accessed 25 November 2016.

[211] The National Development and Reform Commission and others, 'The Plan to Accelerate the Reform of the Market Exit Mechanism' (July 2019) <www.gov.cn/xinwen/2019-07/16/content_5410058.htm> accessed 16 July 2019.

[212] Insurance Act, art 101.

[213] Insurance Act, art 137.

CBIRC, and insurers are now supervised by category in this system.

According to the “No.10 Regulatory Rules on Insurers' Solvency: Comprehensive Rating of Risks (Supervising by Category)” (hereinafter, No. 10 Rules), insurers will be rated and classified into 4 categories, from Category A to Category D, with insurers in a latter category being in a more adverse condition.[214] Targeted at insurers in different categories, the CBIRC will adopt different regulatory policies and take different regulatory measures. While no special regulatory measure needs to be taken towards an insurer in Category A, targeted at an insurer in Category B, regulatory measures the CBIRC can take include, but are not limited to: (1) alerting the insurer to crises; (2) holding a regulatory conversation; (3) requiring the insurer to make corrections within a specified period; (4) initiating an on-site inspection; and (5) requiring the insurer to submit and implement a plan to avoid falling below the solvency requirements or to improve the crisis management ability.[215] Targeted at an insurer in Category C, apart from regulatory measures which can be taken towards an insurer in Category B, regulatory measures the CBIRC can also take include, but are not limited to: (1)

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[214] As is provided for in the No. 10 Rules, Category A indicates an insurer’s solvency ratio satisfies the normal requirement and there is a low risk level in the operational risk, the strategic risk, the reputation risk and the liquidity risk; Category B indicates an insurer’s solvency ratio satisfies the normal requirement and there is a comparatively low risk level in the operational risk, the strategic risk, the reputation risk and the liquidity risk; Category C indicates an insurer’s solvency ratio does not satisfy the normal requirement, or although an insurer’s solvency ratio satisfies the normal requirement, there is a comparatively high risk level in the operational risk, the strategic risk, the reputation risk and the liquidity risk; Category D indicates an insurer’s solvency ratio does not satisfy the normal requirement, or although an insurer’s solvency ratio satisfies the normal requirement, there is a high risk level in the operational risk, the strategic risk, the reputation risk and the liquidity risk. See No. 10 Rules, r 20.

[215] No. 10 Rules, r 26.

requiring the insurer to adjust the business structure, restricting commercial advertisements, etc.; (2) restricting the business scope, ordering the insurer to transfer insurance business, etc.; (3) requiring the insurer to adjust the asset structure, restricting investments, etc.; (4) requiring the insurer to increase the capital, and restricting the payment of dividends to shareholders; (5) restricting the remuneration level of directors and senior managers; and (6) requiring the insurer to replace certain managers.[216] Targeted at an insurer in Category D, apart from regulatory measures which can be taken towards an insurer in Category C, the CBIRC can also initiate a rectification, prohibit the insurer from writing new business in a part or the whole of its business scope, initiate a takeover, or take any other measure the CBIRC thinks fit.[217]

While many of the regulatory measures targeted at troubled insurers are self-explanatory, "rectification" and "takeover", two regulatory measures with intense effects, need to be clarified. As takeover will be specifically discussed in the next part, only rectification is analysed here. When the CBIRC decides to put an insurer into a rectification, the CBIRC should make an order stating the reasons for the rectification, members of the rectification group and the duration of the rectification, and publicise the order.[218] During the rectification, the rectification group, consisting of insurance professionals selected by the CBIRC and certain persons in the insurer designated by the CBIRC, has the authority to monitor the insurer's day-to-day operation, and the

[216] No. 10 Rules, r 27.

[217] No. 10 Rules, r 29.

[218] Insurance Act, art 140.

management of the insurer should perform their duties under the monitoring of the rectification group.[219] The insurer can conduct business as usual within its business scope, unless it is otherwise ordered by the CBIRC that the insurer should cease some existing business or stop writing new business.[220] As the purpose of a rectification is to restore the troubled insurer to a condition in line with the regulatory requirements, once the insurer has made relevant corrections and removed the need for the rectification, the rectification group should file an application to the CBIRC to terminate the rectification. When the CBIRC approves such an application, the rectification will come to an end and the insurer will return to normal operation.[221] Unlike in takeover, where the control of the troubled insurer will be transferred to a takeover group designated by the CBIRC, the insurer in rectification will still be run by the existing management of the insurer, subject to the monitoring of the rectification group. Thus, it can be said that rectification is a less severe regulatory measure than takeover.

In addition, according to Article 149 of the Insurance Act, if the insurance business licence of an insurer is revoked or the solvency condition of an insurer fails to meet regulatory requirements, in order to safeguard the order of the insurance market or to protect the public interest, the CBIRC can withdraw the insurer and set up a

[219] Insurance Act, arts 140 and 141.

[220] Insurance Act, art 142.

[221] Insurance Act, art 143.

liquidation group to liquidate the insurer.[222] Under this circumstance, the liquidation procedure initiated by the CBIRC will be termed "revocation liquidation". Different from "bankruptcy liquidation" (ie the liquidation procedure provided for in the Enterprise Bankruptcy Act),[223] which is a judicial procedure hosted by a court of competent jurisdiction, revocation liquidation is a purely regulatory measure led by the CBIRC. There is a common perception that as the most severe regulatory measure, revocation liquidation can be used to deal with troubled insurers which are severely in violation of statutory or regulatory requirements but not yet insolvent according to the insolvency standard provided for in the Enterprise Bankruptcy Act.[224] However, since there are no more provisions concerning revocation liquidation, it is unclear how a revocation liquidation will be carried out or what effects a revocation liquidation may have. In addition, different from the current situation where whether or not there is "insolvency" represents a main difference between revocation liquidation and bankruptcy liquidation, this thesis argues that the grounds for commencing a bankruptcy procedure (or the equivalent) against an insurer should be diverse, not limited only to "insolvency".[225] That is to say, a bankruptcy liquidation should be allowed to be used to deal with a troubled insurer even if the insurer is not insolvent

[222] Insurance Act, art 149.

[223] For a more detailed discussion of "bankruptcy liquidation", see Section 3.4.4 in this chapter.

[224] See, for example, Xiang Long, 'The Role of Insurance Regulatory Authorities in the Compulsory Market Exit System for Insurers' (2010) 12 Insurance Studies 51, 55; Ting Zhang, 'A Study on China's Risk Disposal and Market Exit System for Troubled Insurance Companies' in Jingshan Chen and Ting Zhang (eds), *Legal Comments on Crisis Management System for Financial Institutions in East Asia*, vol 1 (Law Press · China 2015).

[225] For more detailed discussions, see Section 2.3.3.3 and Section 6.2.1 in this thesis.

according to the insolvency standard. In this case, it is questionable whether it is necessary to have both revocation liquidation and bankruptcy liquidation in the CMME mechanism.

3.3. Takeover

In the regulatory intervention system, takeover is a severe regulatory measure with the strong effects second only to revocation liquidation. As the term implies, takeover means that the control of a troubled insurer will be taken over by a special group designated by the CBIRC. To date, takeover is the most severe measure/procedure that has been carried out against troubled insurers, but there have only been 2 takeover cases. Due to the inadequacy of provisions about takeover in the legislation, how takeover may be designed or arranged, to a large extent, can only be learnt from the existing cases. Despite the fact that the use of takeover, at the CBIRC's discretion, could somehow settle the crisis in a certain case, the lack of the overall consideration of how takeover can fit in with other measures/procedures in the CMME mechanism, especially reorganisation in the bankruptcy system, will always cause uncertainty or confusion.

As is provided for in Article 144 of the Insurance Act, the CBIRC can initiate a takeover towards an insurer if (1) the solvency condition of the insurer substantially deviates from the standard requirements, or (2) the solvency condition of the insurer may be seriously jeopardised or has already been jeopardised due to the insurer's

violations of laws, and the public interest is thus threatened.[226] To facilitate the implementation of this article, the No.10 Rules further provide that the CBIRC can take over an insurer which is classified as Category D.[227] The CBIRC has been vested with broad discretion in determining relevant issues in takeover. It is provided that members of a takeover group and measures to be taken during a takeover will be determined and publicised by the CBIRC, subject to the limit that the duration of a takeover should not exceed 2 years.[228] Despite the importance and complexity of takeover, there is no more provision in the legislation regarding how takeover should be carried out. Although it was said years ago that the CBIRC intended to enact regulations governing takeover, no such regulations have been enacted so far.[229] As a consequence, the understanding of how a takeover may be carried out comes mainly from the 2 takeover cases that have taken place, ie the takeover of Yongan Property Insurance Company and the takeover of Anbang Insurance Group Company (AIGC).

As to the takeover of Yongan Property Insurance Company, all information made public by the regulatory authority was no more than a takeover order issued on 1 September 1998, the date on which the takeover was officially finished. This takeover order, short in length, just notified the public that Yongan Property Insurance Company had been restored to normal operation after the takeover, but did not contain any

[226] Insurance Act, art 144.

[227] No. 10 Rules, r 29.

[228] Insurance Act, arts 145 and 146.

[229] 'Insurance Security Fund Company's Practice in Dealing with Crises of Insurers' (China Insurance Security Fund Company) <www.cisf.cn/hyyj/bxbzjjgxktyj/1812.jsp> accessed 5 May 2018.

information relating to the process of the takeover. Thus, little about how a takeover may be carried out can be learnt from this case.

As to the takeover of AIGC, on 23 February 2018, the CBIRC issued a takeover order to announce the commencement of the takeover. This takeover order presented a general picture of how a takeover would work, for the first time revealing the CBIRC's attitudes towards the design of "takeover". However, what should be noted is that Anbang Insurance Group Company is not an insurer (ie insurance company) which underwrites policies to policyholders directly, but an insurance-focused financial holding company. The fact that the CBIRC took over AIGC by virtue of Article 144 of the Insurance Act,[230] which only provides for takeover of insurers, reveals the chaotic situation in the current regulatory practice, where no distinction has been made between takeover of insurers and takeover of insurance-focused financial holding companies. Although this thesis will just focus on takeover of insurers (ie insurance companies), it is believed that the CBIRC's attitudes towards takeover of insurers can partially be learnt from the takeover case of AIGC.

In the case of AIGC, due to the fact that Xiaohui Wu, the Chairman of the Board of Directors and the Chief Executive Office of AIGC, was involved in economic crimes and AIGC's solvency condition was seriously jeopardised, the CBIRC decided to initiate a takeover.[231] Following the CBIRC's takeover order, a takeover group comprising

[230] It was clearly stated in the CBIRC's Order on the Takeover of AIGC that the takeover was carried out according to Article 144 of the Insurance Act.

[231] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' (23 February 2018)

members from the regulatory authorities was thus set up to carry out the takeover. The chairman of the takeover group assumed the role as legal representative of AIGC, and the takeover group was empowered to: (1) take over AIGC's property, IT system, accounting books, etc.; (2) employ a professional management team to carry out AIGC's management; (3) decide issues during the daily operation of AIGC; (4) participate in lawsuits, arbitration procedures, and other legal proceedings in the name of IAGC; (5) put forward a crisis management scheme to alleviate AIGC's crisis; (6) assist other authorities to investigate into AIGC's illegal actions; and (7) perform other duties instructed by the CBIRC.[232] In the meantime, the functions of AIGC's shareholders' assembly, board of directors, and board of supervisors were suspended, and managers in AIGC and AIGC's subsidiaries were to perform their duties following the takeover group's instructions.[233]

Since the chairman of the takeover group was a member of the CBIRC and the takeover group was under the supervision and instructions of the CBIRC, in fact it is the CBIRC that had the ultimate authority in deciding issues during the takeover of AIGC. As was required in the takeover order, regarding the takeover and the operation

<www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

[232] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' art 3 <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

[233] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' art 3 <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

of AIGC, the takeover group should report to the CBIRC on a daily basis for the first 3 months of the takeover and then on a weekly basis afterwards.[234] The CBIRC could also issue instructions to the takeover group, and would examine and assess the work done by the takeover group.[235] As to some major issues, the takeover group was still required to seek prior approval from the CBIRC before taking any action. These issues included: (1) to transfer the whole or any part of the business to other insurers; (2) to make changes to the equity structure or the registered capital; (3) to divide the company or merge with others; (4) to transfer the whole or any part of the assets or debts; (5) to waive or assign major rights, or to assume major obligations; (6) to appoint or dismiss employees in important positions; and (7) other issues as specified by the CBIRC.[236]

The duration of AIGC's takeover was initially set as 1 year, from 23 February 2018 to 22 February 2019, during which AIGC conducted business as usual for policyholders.[237] As was provided in the takeover order, upon the expiration of this takeover period, if

[234] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' art 6 <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

[235] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' art 10 <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

[236] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' art 4 <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

[237] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

AIGC recovered to normal conditions after capital injections or asset restructuring, the takeover group would apply to the CBIRC to terminate the takeover; however, if the desired effects of the takeover were not achieved and AIGC did not recover to normal conditions, the CBIRC could extend the takeover by another 1 year.[238] If, after the 2 years' takeover, AIGC still failed to recover to normal conditions, or if, during the takeover period, the takeover group believed that desired effects of the takeover could not be achieved, the CBIRC could terminate the takeover and take other regulatory measures as necessary.[239]

When the first year of the takeover ended on 22 February 2019, since the restructuring of AIGC was still ongoing, the CBIRC extended the takeover for another year.[240] In July 2019, Dajia Insurance Group Company, a brand-new insurance group company mainly funded by the ISF, was established to facilitate the restructuring, and then most of the business of AIGC was transferred to Dajia Insurance Group Company.[241] After the divestiture of AIGC's business, the CBIRC announced the

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[238] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' arts 11 and 12 <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

[239] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' art 12 <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

[240] CBIRC, 'The CBIRC's Notice of the Extension of the Takeover of AIGC' (22 February 2019) <www.cbrc.gov.cn/chinese/newShouDoc/C8890CA68C2E4819B3414E04F3701488.html> accessed 22 February 2019.

[241] CBIRC, 'The Establishment of Dajia Insurance Group Company' (11 July 2019) <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=4991&itemId=915&generaltype=0> accessed 11 July 2019.

termination of the takeover on 22 February 2020, the exact date on which the second year of the takeover ended.[242] With regard to the remaining AIGC, as was planned by the CBIRC, it would be eventually liquidated.[243]

From the CBIRC's takeover of AIGC, the basic design features of takeover as a regulatory measure in the CMME mechanism can be learned. When the CBIRC decides to initiate a takeover, a designated takeover group will be authorised to take over the insurer, replacing the shareholders' assembly, the board of directors, the board of supervisors and the management.[244] Under the supervision and instructions of the CBIRC, the takeover group can adopt a variety of approaches that are necessary to relieve the insurer from the crisis, including, but not limited to, seeking for capital injections, adjusting the business structure, dividing the insurer, merging with other insurers, etc. Although the commencement of a takeover does not indicate any change to debts owed by the insurer or debts owed to the insurer,[245] with the CBIRC's approval, the takeover group may, for example, transfer the whole or any part of the insurer's business to other insurers, or transfer the whole or any part of its assets or

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[242] CBIRC, 'The CBIRC's Notice of the Ending of the Takeover of AIGC' (22 February 2020) <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=891332&itemId=925&generaltype=0 > accessed 22 February 2020.

[243] CBIRC, 'The CBIRC's Notice of the Ending of the Takeover of AIGC' (22 February 2020) <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=891332&itemId=925&generaltype=0 > accessed 22 February 2020.

[244] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

[245] Insurance Act, art 144.

debts.[246]

Since the CBIRC has such extensive powers in dealing with a troubled insurer in takeover, a question can be raised as to how takeover can be coordinated with measures/procedures in the CMME mechanism which are regarded as more severe in effects. As an example, while it is possible for the whole business of a troubled insurer in takeover to be transferred to other insurers, it is not clear how the CBIRC will deal with the remaining troubled insurer which has no more business. Actually, the effects of depriving the troubled insurer of all its business is tantamount to the effects of revoking the licence of the troubled insurer. As another example, since the function of both takeover and reorganisation is to restructure a troubled insurer, seeking to make the insurer recover to normal operation in accordance with the statutory or regulatory requirements, how to coordinate these two types of measures/procedures in the CMME mechanism needs to be well thought out and clearly clarified.[247] Otherwise, the existence of takeover will, to a large extent, eliminate the necessity of initiating reorganisation towards troubled insurers, rendering the reorganisation procedure useless in practice. Therefore, in the reform of the CMME mechanism in the future,

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[246] CBIRC, 'The CBIRC's Order on the Takeover of AIGC' art 4 <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=372742&itemId=925&generaltype=0> accessed 23 February 2018.

[247] See, for example, Yanna Bo, *Research on the Risk Disposal and Market Exit System for Insurance Companies* (Peking University Press 2013) 31; Xiang Long, 'Reforming the Takeover Measure in the Insurance Act' (2013) 12 China Finance 61, 62; Zheng Sai, 'The Balance Between Regulatory Powers and Judicial Powers in Reorganisation of Insurers in China' (2016) 37 The Theory and Practice of Finance and Economics 133, 133; Jianming Sheng and Jing Jia, 'A Study on Pre-Bankruptcy Procedures of Insurers in China' (2015) 12 Law Journal 52, 55.

careful consideration should be given to the coordination between takeover and other measures/procedures.

3.4. The Bankruptcy System

Comprising composition, reorganisation and bankruptcy liquidation, the bankruptcy system for insurers is based on the bankruptcy system for ordinary companies, which is mainly provided for in the Enterprise Bankruptcy Act. Although Article 134 of the Enterprise Bankruptcy Act authorises the State Council[248] to enact administrative regulations[249] on the bankruptcy of financial institutions, no administrative regulation on the bankruptcy of insurers has ever been made so far. As a consequence, the modifications of the bankruptcy system for insurers are mainly shown in the mere 3 articles in the Insurance Act, with Article 90 related to the commencement of a bankruptcy procedure for insurers, Article 91 related to the claims hierarchy in a bankruptcy liquidation and Article 92 related to the transfer of life insurance business in a revocation liquidation or bankruptcy liquidation.[250] The lack of special arrangements for insurers makes it unfeasible for a bankruptcy procedure of an insurer to be carried out, and in fact, no case involving a bankruptcy procedure of an insurer has ever taken place in practice. This should never be the norm in a highly developed and fully competitive insurance market.

[248] The State Council is the central government in China.

[249] In China, administrative regulations are enacted by the State Council and constitute one type of legislation.

[250] See Insurance Act, arts 90 – 92.

With the focus on how troubled insurers may be dealt with in the current bankruptcy system, general issues of the bankruptcy procedures, composition, reorganisation and bankruptcy liquidation will be analysed in turn. Due to the lack of special arrangements for insurers, a lot of major problems can be identified in the current system. How to solve these problems should be the main concern in the reform of the CMME mechanism in the future.

3.4.1. General Issues of the Bankruptcy System

Before analysing bankruptcy procedures (ie composition, reorganisation and bankruptcy liquidation) respectively, some aspects common to these procedures will be discussed in this section, which include commencement of a bankruptcy procedure, effects of a bankruptcy procedure and creditors' meeting.

3.4.1.1. Commencement of a Bankruptcy Procedure

Article 2 of the Enterprise Bankruptcy Act provides for the standard of insolvency for companies. A company will be deemed insolvent if (1) the company is unable to pay its debts as they fall due, and (2) the company's assets are not sufficient to pay all of its debts or the company is apparently unable to pay all the debts.[251] Therefore, the standard of insolvency is a combination of cash-flow insolvency and balance-sheet insolvency. According to this standard, an insolvent company will be a company which is insolvent from both the cash flow perspective and the balance sheet perspective.

[251] Enterprise Bankruptcy Act, art 2.

In cases where a company is insolvent or is likely to become insolvent, the company as the debtor itself has the standing to petition a court of competent jurisdiction for a composition, reorganisation or bankruptcy liquidation, and creditors of the company have the standing to petition for a reorganisation or bankruptcy liquidation.[252] When such a petition is granted by the court, a bankruptcy procedure will commence.

Unlike an ordinary company, an insurer's entry into a bankruptcy procedure will be subject to the decision of the CBIRC. It is specifically provided in the Insurance Act that, upon a finding of insolvency or potential insolvency of an insurer, the insurer or its creditors should obtain prior approval from the CBIRC before petitioning the court for a composition, reorganisation or bankruptcy liquidation.[253] Otherwise, only the CBIRC can petition the court for a reorganisation or bankruptcy liquidation of the insurer.[254] Therefore, without the CBIRC's prior approval or the CBIRC's own initiative, no bankruptcy procedure of an insurer will commence.

However, in the case of insurers, setting the insolvency standard as the only criterion for determining whether a bankruptcy procedure is needed will largely reduce the chance of using bankruptcy procedures to deal with troubled insurers. This is especially the case when the insolvency standard is narrowly set, which requires cash-flow insolvency and balance-sheet insolvency at the same time. Since insurers always have an ongoing source of cash flow from policyholders while no ongoing obligation

[252] Enterprise Bankruptcy Act, art 7.

[253] Insurance Act, art 90.

[254] Insurance Act, art 90.

to pay insurance claims, it is rare that an insurer in normal operation will become cash-flow insolvent.[255] As a consequence, the current arrangements to a large extent impede the commencement of a bankruptcy procedure against an insurer, rendering the bankruptcy procedures less useful, or even useless. Therefore, to better make use of relevant procedures in addressing crises of insurers, triggers for these procedures should be reformed to be more diverse, not limited just to insolvency.

3.4.1.2. Effects of a Bankruptcy Procedure

When the petition for a bankruptcy procedure is granted, the court will appoint a bankruptcy administrator to carry out the procedure.[256] Normally, the bankruptcy administrator will be chosen from the "administrator pool" set up by the court, where law firms, accounting firms, bankruptcy liquidation firms, etc., are pool members.[257] The administrator will take control of the insolvent company and carry out necessary responsibilities during a bankruptcy procedure.

Although the bankruptcy administrator mechanism can work well in the context of ordinary company insolvencies, there is a doubt about the appropriateness of this mechanism when it comes to dealing with troubled insurers. In the case of bankruptcy procedures of ordinary companies, since administrators' main consideration is to protect creditors of the insolvent companies, they may be competent to carry out the

[255] David A. Skeel, 'The Law and Finance of Bank and Insurance Insolvency Regulation' (1998) 76(4) Taxas Law Review 723, 765.

[256] Enterprise Bankruptcy Act, art 13.

[257] Enterprise Bankruptcy Act, art 24.

responsibilities even if they are not familiar with the business in which the insolvent companies engage. However, given the role insurers play in society, objectives of dealing with troubled insurers are more complex, which mainly include protecting policyholders and maintaining financial stability. As a corollary, it is unlikely that tasks of dealing with troubled insurers can be successfully carried out if bankruptcy administrators lack familiarity with the insurance business or lack consideration of financial stability.[258] Additionally, since bankruptcy administrators, such as law firms, accounting firms, and bankruptcy liquidation firms, are business entities from the private sector, to achieve the objective of maintaining financial stability is far beyond their capacity as well as responsibilities. It will not be sensible to rely merely on bankruptcy administrators to cope with crises of insurers which may pose a threat to financial stability. Therefore, it is arguable that bankruptcy administrators may not be the appropriate bodies to carry out relevant procedures for troubled insurers. Authorising someone more competent to carry out these procedures needs to be considered.

To preserve the status quo of an insolvent company, when the petition for a bankruptcy procedure is granted, a moratorium will be imposed on the company. As a consequence, sequestration of the company's property will be lifted, execution against the company or its property will be stayed, and payment made to creditors, subject to

[258] See, for example, Shuguang Li, 'New "Enterprise Bankruptcy Act" and the Design of the Bankruptcy System for Financial Institutions' (2007) 3 China Finance 65, 66; Xiang Long, 'The Role of Insurance Regulatory Authorities in the Compulsory Market Exit System for Insurers' (2010) 12 Insurance Studies, 51, 58.

exceptions, when the moratorium is in force will be regarded as void.[259] Any ongoing lawsuits or arbitration proceedings will also be stayed until the bankruptcy administrator takes control of the company's assets,[260] which provides the administrator with sufficient time to make preparations before participating in relevant proceedings on behalf of the company. Since no exception to the moratorium has been made for insurers, under the current mechanism, the payment of policyholders' insurance claims, as any other creditors' claims, will be stayed once an insurer is put into a bankruptcy procedure.

To prevent some creditors being treated more favourably than others, with regard to the payment made to creditors within 6 months prior to the entry into a bankruptcy procedure, the administrator can apply to the court to cancel the payment and recover the amount paid, unless the payment was made for the benefit of the company or its property.[261] However, when it comes to insurers, since the main obligation of insurers under insurance policies is to pay insurance claims when insured events occur, it will be unreasonable to allow an administrator in a bankruptcy procedure of an insurer to cancel the payment of insurance claims made within 6 months prior to the entry into the procedure and claw back money from policyholders. This should never be the intention of the legislature.

With respect to contracts entered before the petition for a bankruptcy procedure is

[259] Enterprise Bankruptcy Act, arts 16 and 19.

[260] Enterprise Bankruptcy Act, art 20.

[261] Enterprise Bankruptcy Act, art 32.

granted, the administrator is empowered to decide whether to continue or cancel the contracts and inform the counterparties of its decisions. If the administrator does not do this within 2 months after the entry into the bankruptcy procedure, or does not reply to the counterparties' enquiries as to whether the contracts will be continued within 30 days after receiving the enquiries, the contracts will be deemed cancelled.[262] By virtue of this arrangement, the administrator can cherry-pick the contracts and continue those which will benefit the insolvent estate while cancelling others. However, in the case of insurers, it is argued that this arrangement will be in conflict with the objective of protecting policyholders when applied to insurance contracts. This is especially obvious when it comes to long-term insurance contracts, since the cancellation of these contracts made by the administrator will mean that policyholders have to suffer undue losses while the troubled insurer gains unfair benefits. Also, the administrator's decision to cancel insurance contracts will leave a large number of policyholders out of insurance coverage all of a sudden, without giving them any buffer period to seek substitute insurance coverage from other insurers. This will cause chaos in society if the insurance contracts so cancelled are compulsory insurance contracts, such as some auto insurance contracts. Therefore, it will not be sensible if no modification is made to the arrangement in question in the context of dealing with troubled insurers.

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[262] Enterprise Bankruptcy Act, art 18.

3.4.1.3. Creditors' Meeting

At the time when a company becomes or is likely to become insolvent, while shareholders have no or little equity left in the company, creditors have the right to recover their debts from the estate of the company. It is creditors, rather than shareholders, who are entitled to decide issues relating to the company in a bankruptcy procedure. Therefore, there exists the design of "creditors' meeting" in the bankruptcy system, which provides a forum for creditors to make decisions during the process of a bankruptcy procedure. The existence of "creditors' meeting" constitutes a key feature in the general bankruptcy system.

Upon entry into a bankruptcy procedure, creditors of the insolvent company should file claims within a certain period of time so as to become members of the creditors' meeting.[263] As members of the creditors' meeting, creditors are normally entitled to vote in the creditors' meeting.[264] However, as to a creditor whose claim is uncertain, unless the court temporarily attributes an estimated value to the claim for voting purposes, the creditor will have no voting right.[265]

The creditors' meeting is entitled to perform various functions, which include reviewing filed claims, monitoring the bankruptcy administrator, deciding whether or not to cease the operation of the insolvent company's business, approving a composition agreement, approving a reorganisation plan, approving a distribution

[263] Enterprise Bankruptcy Act, art 45.

[264] Enterprise Bankruptcy Act, art 59.

[265] Enterprise Bankruptcy Act, art 59.

arrangement in liquidation, etc.[266] Normally, a resolution of the creditors' meeting will be passed if (1) more than half of creditors participating in the voting process vote in favour of it, and (2) the value of claims of those casting favourable votes is not less than half of the value of all unsecured claims.[267] Once a decision is made by the creditors' meeting, unless it is otherwise overturned by the court, the decision will have a binding effect on all creditors of the insolvent company.[268]

Despite the significance of the design of "creditors' meeting" in the bankruptcy system, it is doubtful whether this design is suitable when it comes to dealing with troubled insurers. Due to the nature of insurance business, before insured events take place, all policyholders can be regarded as potential insurance creditors of an insurer. However, according to the current statutory provision, when an insurer enters a bankruptcy procedure, generally only policyholders who have got crystallised insurance claims against the insurer by the date on which the court grants the petition for the bankruptcy procedure are entitled to vote in the creditors' meeting.[269] Then it remains unanswered as to how to treat policyholders without crystallised claims or how to treat insurance creditors whose claims arise after the court grants the petition but before the creditor's meeting is held. On the one hand, it is unreasonable for policyholders to be bound by decisions of the creditors' meeting in which they have

[266] Enterprise Bankruptcy Act, art 61.

[267] Enterprise Bankruptcy Act, art 64.

[268] Enterprise Bankruptcy Act, art 64.

[269] Enterprise Bankruptcy Act, art 44.

no voting right. On the other hand, it is also unreasonable for insurance creditors with insurance claims arising before the date when the court grants the petition to be subject to a set of arrangements which are different from those for other policyholders. As a consequence, in the case of troubled insurers, a dilemma has been created by the design of "creditors' meeting".

3.4.2. Composition

Composition is a bankruptcy procedure for which only a troubled company as the debtor itself has the standing to petition. It provides the company with an opportunity to achieve a voluntary arrangement with its creditors rather than being subject to a reorganisation or liquidation. However, it is doubtful whether the composition as a procedure in the current CMME mechanism is suitable for insurers.

When a company becomes or is likely to become insolvent, it can either file a petition to the court for a composition so as to enter the bankruptcy process, or file such a petition before the company is declared bankrupt by the court during an existing bankruptcy procedure.[270] A draft composition proposal provided by the company should also be submitted when the petition is filed.[271] If the court grants the petition, it is a bankruptcy administrator who will carry out the procedure, and a creditors' meeting will then be convened to discuss whether to approve the draft composition proposal.[272] Creditors with secured debts are allowed to exercise their

[270] Enterprise Bankruptcy Act, art 95.

[271] Enterprise Bankruptcy Act, art 95.

[272] Enterprise Bankruptcy Act, arts 13 and 96.

rights on the security after the petition is granted.[273]

A composition proposal will be approved by the creditors' meeting if (1) more than half of creditors participating in the voting process vote in favour of it, and (2) the value of claims of those casting favourable votes is not less than two-thirds of the value of all unsecured claims.[274] Upon the approval for the composition proposal being given by the creditor's meeting, the court will decide whether to sanction the proposal. If such sanction is made, the composition procedure will be terminated and the bankruptcy administrator will return the control of the company to its original management.[275] It is the company itself that will implement the composition proposal.[276] However, in cases where the creditors' meeting decides not to approve the composition proposal or the court decides not to sanction the approved proposal, the composition procedure will also be terminated and the court will declare the company bankrupt.[277]

With the sanction of the court, the composition proposal will have a binding effect on the company and its unsecured creditors who have filed their claims.[278] If later the company becomes unable or fails to implement the composition proposal, upon an application being filed by creditors, the court can terminate the implementation

[273] Enterprise Bankruptcy Act, art 96.

[274] Enterprise Bankruptcy Act, art 97.

[275] Enterprise Bankruptcy Act, art 98.

[276] Enterprise Bankruptcy Act, art 98.

[277] Enterprise Bankruptcy Act, art 99.

[278] Enterprise Bankruptcy Act, art 100.

process of the composition proposal and declare the company bankrupt.[279] Then compromises made by unsecured creditors in the composition proposal will be no longer valid, and the creditors' unpaid debts will become debts in the bankruptcy liquidation.[280]

The purpose of a company's applying for a composition is to seek compromises from creditors regarding reduction of debts or deferral of debt payment. But creditors as rational persons are willing to approve a composition proposal only when it places them in a better position than they would be if the company directly entered a bankruptcy liquidation. In the case of a troubled insurer, since most creditors are policyholders and most policyholders are entitled to be compensated by the ISF if they suffer losses in a liquidation,[281] there is hardly any chance that a composition proposal could appeal to policyholders and secure their approval. According to the current rules governing the responsibilities of the ISF, for example, when an individual policyholder suffers a loss[282] in a bankruptcy liquidation of a property insurer, as to the loss of the first 50,000 RMB, the ISF will compensate the policyholder in full, and as to the rest of the loss (the part which is above 50,000 RMB), if any, the ISF will compensate the policyholder 90% of the loss.[283] As a consequence, there is little room for a troubled

[279] Enterprise Bankruptcy Act, art 104.

[280] Enterprise Bankruptcy Act, art 104.

[281] For further discussion, see Part 3.5 in this chapter.

[282] The loss suffered by a policyholder is the difference between the expected benefits under the policy and the dividend the policyholder has been paid in the liquidation. See Insurance Security Fund Regulations, reg 19.

[283] Insurance Security Fund Regulations, reg 19.

insurer to devise a composition proposal which could satisfy the vast majority of creditors while enabling the insurer to survive the crisis.

Due to the existence of the timely and high-proportion compensation from the ISF in a bankruptcy liquidation, it is less likely that a troubled insurer can come up with an appealing composition proposal and secure the approval for it, which requires favourable votes from a vast majority of creditors – a simple majority (in number) of creditors participating in the voting process as well as a vast majority (in value) of all unsecured creditors. Therefore, it is reasonable to question whether it is still necessary to maintain composition in the CMME mechanism.

3.4.3. Reorganisation

In line with its nature as a rescue procedure, reorganisation allows a troubled company to remain as a going concern after a restructuring of the company is made. It is expected that reorganisation will be used to rescue a troubled insurer when the insurer is trapped in a crisis, especially a financial crisis. However, the lack of special consideration for insurers in the current legislation to a large extent makes it impracticable for a reorganisation to be applied to a troubled insurer.

In the case of an ordinary company, when a company becomes or is likely to become insolvent, the company or its creditors can file a petition to the court for a reorganisation.[284] Even if a company is already in a bankruptcy liquidation which was initiated by its creditors, the company or its shareholders with the equity of no less

[284] Enterprise Bankruptcy Act, arts 2 and 7.

than one-tenth of the company's registered equity capital may still petition to convert the bankruptcy liquidation to reorganisation before the company is declared bankrupt.[285] Targeted at insurers, it is especially provided that prior approval from the CBIRC should be obtained before a troubled insurer or its creditors can file a reorganisation petition; otherwise, only the CBIRC itself can file such a petition directly to the court.[286]

When the petition for a reorganisation of a company is granted by the court, the company enters a reorganisation period, which will last until the reorganisation is terminated.[287] During this period, upon the sanction of the court, the company's original management may recover the control of the company from the bankruptcy administrator, and operate the business under the supervision of the bankruptcy administrator.[288] No matter whether it is the company's management or the bankruptcy administrator who takes control of the company, a draft reorganisation plan should be submitted to the court within 6 months starting from the date on which the reorganisation is granted, with an extension of 3 months upon the leave of the court .[289] The draft reorganisation plan should cover the plan for business operation, the classification of debts, the plan for debt adjustment, the plan for debt payment,

[285] Enterprise Bankruptcy Act, art 70.

[286] Insurance Act, art 90.

[287] Enterprise Bankruptcy Act, art 72.

[288] Enterprise Bankruptcy Act, art 73.

[289] Enterprise Bankruptcy Act, art 79.

the implementation period of the reorganisation plan, etc.[290] If the company or the bankruptcy administrator fails to produce such a draft reorganisation plan on time, the court will terminate the reorganisation and declare the company bankrupt.[291] The court may also terminate the reorganisation and declare the company bankrupt if an application to do so is filed by the bankruptcy administrator or other interested parties based on reasonable grounds, such as a finding that the company is unlikely to continue as a going concern.[292]

Whether a draft reorganisation plan will be approved is mainly subject to the decision of the creditors' meeting. After receiving the draft reorganisation plan, the court should convene the creditors' meeting within 30 days.[293] Creditors will be classified into 4 groups for voting purposes, which include the group for secured debts, the group for debts relating to the employees' welfare, the group for unpaid taxes, and the group for ordinary debts.[294] Within each group, the draft reorganisation plan will be approved if (1) more than half of creditors participating in the voting process vote in favour of it, and (2) the value of claims of those casting favourable votes is not less than two-thirds of the value of all claims in that group.[295] The draft reorganisation plan will be approved only when all groups show their approval.[296]

[290] Enterprise Bankruptcy Act, art 81.

[291] Enterprise Bankruptcy Act, art 79.

[292] Enterprise Bankruptcy Act, art 78.

[293] Enterprise Bankruptcy Act, art 84.

[294] Enterprise Bankruptcy Act, art 82.

[295] Enterprise Bankruptcy Act, art 84.

[296] Enterprise Bankruptcy Act, art 86.

An approved reorganisation plan will have a binding effect on the company and its creditors if the plan is later sanctioned by the court.[297] Despite the significance of the decision made by the creditors' meeting, however, the court may still cram down a reorganisation plan which was rejected by the creditors' meeting if an application for a cram-down is file by the company or the bankruptcy administrator.[298] There are safeguards in place ensuring that interested parties will not be unfairly treated by the cram-down. For example, in no circumstance should creditors with ordinary debts receive less dividends in the reorganisation than they would otherwise receive if the company was placed into a bankruptcy liquidation.[299] On the other hand, the court may also decide not to sanction the reorganisation plan even if the plan has been approved by the creditors' meeting. If this is the case, the court will terminate the reorganisation and declare the company bankrupt.[300]

If the reorganisation plan is sanctioned by the court, the reorganisation will be terminated, and the company's management will be responsible for implementing the reorganisation plan.[301] During the implementation period, if it turns out that the company becomes unable to or fails to implement the reorganisation plan, upon an application being filed by the bankruptcy administrator or other interested parties, the court will terminate the implementation process of the reorganisation plan and

[297] Enterprise Bankruptcy Act, art 92.

[298] Enterprise Bankruptcy Act, art 87.

[299] Enterprise Bankruptcy Act, art 87.

[300] Enterprise Bankruptcy Act, art 88.

[301] Enterprise Bankruptcy Act, arts 86 and 89.

declare the company bankrupt.[302] In this circumstance, compromises made by creditors in the reorganisation plan will be no longer valid, and the creditors' unpaid debts will become debts in the bankruptcy liquidation.[303]

Apart from the CBIRC's involvement in the commencement of the procedure, reorganisation for insurers in the current CMME mechanism is completely the same as reorganisation for ordinary companies. Similar to the little likelihood of securing approval for a composition proposal from the creditors' meeting of a troubled insurer,[304] it is also less likely that a reorganisation plan will be approved by all groups of creditors of a troubled insurer, especially by the group for ordinary debts. But since the court may still cram down a reorganisation plan, it is likely that the reorganisation plan will be carried out in dealing with the troubled insurer with the court's compulsion. As a consequence, it emerges that the painstaking process of convening the creditors' meeting may turn out to be meaningless, bringing no utility but expenses and complexities to the reorganisation of an insurer.

In addition, due to the moratorium effects inherent in reorganisation, in the case of an insurer, payment of insurance claims will also be stayed under the current legal framework. Thus, no insurance creditor can get paid before the reorganisation plan is sanctioned by the court and then implemented by the insurer. This means that the payment of insurance claims will be disrupted for the whole reorganisation period.

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[302] Enterprise Bankruptcy Act, art 93.

[303] Enterprise Bankruptcy Act, art 93.

[304] For a discussion relating to creditors' approval in composition, see Section 3.4.2 in this chapter.

Although there exists the ISF, which is expected to protect policyholders during a crisis of an insurer, unfortunately, in the current legislation the ISF has no authority to compensate eligible insurance creditors during a reorganisation. There is little doubt that a prolonged delay of payment of insurance claims in reorganisation will deviate from the objective of protecting policyholders which should be achieved in dealing with troubled insurers.

Despite the significance of reorganisation in the CMME mechanism, due to the lack of consideration of the special features of insurers, the reorganisation procedure under the current legal framework can hardly function well in dealing with troubled insurers. Therefore, it is necessary that a reform should be carried out to tailor the reorganisation procedure for insurers.

3.4.4. Bankruptcy Liquidation

When a company becomes insolvent, the company itself or its creditors have the standing to file a petition to the court for a bankruptcy liquidation.[305] In the case of insurers, prior approval from the CBIRC should be obtained before a troubled insurer or its creditors can file such a petition; otherwise, only the CBIRC can file the petition directly to the court.[306] A bankruptcy liquidation procedure commences when the court grants such a petition, but the actual liquidation process will start if the court later declares the company bankrupt.[307]

[305] Enterprise Bankruptcy Act, art 7.

[306] Insurance Act, art 90.

[307] Enterprise Bankruptcy Act, art 107.

After the declaration of bankruptcy of a company is made by the court, the bankruptcy administrator should draft a property realisation plan as well as an assets distribution plan, which will later be considered by the creditors' meeting.[308] Since there is no special requirement for the approval for these plans, the general rule governing the resolution of the creditors' meeting applies. Thus, a plan will be approved by the creditors' meeting if (1) more than half of creditors participating in the voting process vote in favour of the plan, and (2) the value of claims of those casting favourable votes is not less than half of the value of all unsecured claims.[309] If the creditors' meeting rejects the plan, there is still a likelihood that the court will cram down the plan and bring it into force.[310] Following the sanction of the court, the bankruptcy administrator should realise the company's property or distribute the company's assets according to the plan.[311] A bankruptcy liquidation will be terminated by the court if the assets distribution plan is eventually carried out, or if there is no asset left for further distribution.[312]

In the case of an insurer, in order to protect policyholders in bankruptcy liquidation, preferential treatment has been given to insurance claims during the distribution of the insurer's assets. Generally speaking, the claims hierarchy in liquidation is as follows

[308] Enterprise Bankruptcy Act, arts 111 and 115.

[309] Enterprise Bankruptcy Act, art 64.

[310] Enterprise Bankruptcy Act, art 65.

[311] Enterprise Bankruptcy Act, arts 111 and 116.

[312] Enterprise Bankruptcy Act, art 120.

(in order of priority): (1) bankruptcy expenses, (2) liabilities for common benefits,[313] (3) debts relating to employees' welfare, (4) insurance claims, (5) unpaid taxes, and (6) ordinary debts.[314] Creditors with claims at a lower priority level will be paid only after creditors with claims at a higher priority level have been paid in full. Thus, compared with creditors with ordinary debts, insurance creditors are provided with a higher priority in distribution.

Given the long-term feature of life insurance policies,[315] it is especially provided that when a life insurer is in a revocation liquidation or bankruptcy liquidation, life insurance policies issued by the troubled insurer should be transferred to other life insurers.[316] If the troubled insurer fails to secure the transfer by contracting with other life insurers, the CBIRC will designate certain life insurers as the transferees.[317] As a consequence, the requirement for the transfer of life insurance policies ensures that life insurance policies will be continued despite the liquidation of a life insurer, which provides a high level of protection to life insurance policyholders. However, in a market economy, it is still questionable whether the CBIRC should have the power to designate and force certain life insurers to assume policies issued by the troubled insurer after

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[313] Liabilities for common benefits are the debts or liabilities arising after a bankruptcy procedure commences, which include, among others, the expenses incurred during the operation of the company's business, and the liabilities to those who are injured by the company's belongings. See Enterprise Bankruptcy Act, art 42.

[314] Insurance Act, art 91.

[315] For a more detailed discussion of the long-term nature of life insurance policies, see Section 2.1.2.2 in the thesis.

[316] Insurance Act, art 92.

[317] Insurance Act, art 92.

the troubled insurer fails to find appropriate transferees. Nevertheless, at the current development stage of China's market economy, since many large insurers are state-owned, normally they will be willing to come to the rescue if the CBIRC instructs them to do so.

In bankruptcy liquidation of insurers, apart from issues relating to creditors' meeting which are common to all bankruptcy procedures,[318] problems under the current arrangement mainly derive from the poorly conceived coordination between bankruptcy liquidation and other components of the CMME mechanism. For example, there currently exist two types of liquidation, ie revocation liquidation and bankruptcy liquidation, but it remains unknown how these two procedures can be coordinated with each other. Although there has not been any case involving an insurer revocation liquidation or an insurer bankruptcy liquidation, it is commonly recognised that revocation liquidation can be initiated when a troubled insurer is still solvent while bankruptcy liquidation can be initiated when a troubled insurer is insolvent.[319] However, as is provided in the Insurance Security Fund Regulations, the ISF should function to compensate policyholders when a troubled insurer's assets are inadequate to pay all insurance claims in revocation liquidation or bankruptcy liquidation,[320] so it

[318] For a more detailed discussion of creditors' meeting, see Section 3.4.1.3 in this chapter.

[319] See, for example, Xiang Long, 'The Role of Insurance Regulatory Authorities in the Compulsory Market Exit System for Insurers' (2010) 12 Insurance Studies 51, 55; Ting Zhang, 'A Study on China's Risk Disposal and Market Exit System for Troubled Insurance Companies' in Jingshan Chen and Ting Zhang (eds), *Legal Comments on Crisis Management System for Financial Institutions in East Asia*, vol 1 (Law Press · China 2015).

[320] Insurance Security Fund Regulations, regs 16, 19 and 21.

seems that a troubled insurer in revocation liquidation may also be insolvent. As a consequence, it is doubtful whether it is necessary to have two types of liquidation in the CMME mechanism. This doubt makes more sense in a context where it is argued that the grounds for commencing a bankruptcy liquidation should be diverse, but not limited just to "insolvency".[321]

3.5. Insurance Security Fund

In order to protect policyholders and resolve crises in the insurance industry, the Insurance Security Fund (ISF) was set up in 2005.[322] Then in 2008, the China Insurance Security Fund Company (CISFC), a solely state-owned company, was established to assume the responsibility for raising, managing and using the ISF.[323] As an indispensable part of the CMME mechanism, when confronted with crises of insurers, the ISF (or the CISFC)[324] can perform both the function of protecting policyholders and the function of rescuing insurers. The function of protecting policyholders mainly means when an insurer is placed into a revocation liquidation or bankruptcy liquidation and its assets are inadequate to pay insurance claims, the ISF can compensate policyholders or other insurers to which policies issued by the troubled

[321] For a more detailed discussion, see Section 3.4.1.1 in this chapter.

[322] See Insurance Security Fund Regulations (2004). The Insurance Security Fund Regulations (2004) was replaced by the currently effective Insurance Security Fund Regulations in 2008.

[323] Insurance Security Fund Regulations, reg 6.

[324] In this thesis, unless otherwise specified, "the ISF" will be used in a general sense, which sometimes also refers to "the CISFC".

insurer are transferred.[325] And the function of rescuing insurers means when an insurer is facing a significant crisis, which may seriously jeopardise the public interest and financial stability, the ISF can provide financial assistance directly to the troubled insurer.[326] The analysis of the ISF in this part will be focused on how the ISF (or the CISFC) may perform these functions in dealing with troubled insurers.

Rather than just being the manager of the ISF, the CISFC is also authorised to monitor risks in the insurance industry.[327] There is an information-sharing mechanism between the CBIRC and the CISFC, and the CBIRC will periodically provide the CISFC with operational information of insurers, which facilitates the CISFC to assist the CBIRC in supervising insurers.[328] When the crisis of an insurer is identified, the CISFC can also make recommendations to the CBIRC on how to deal with the crisis.[329] Considering the fact that the CISFC itself is supervised by the CBIRC and will follow the CBIRC's instructions – if any – during the operation, it can be said that the CISFC is in effect an institution subordinate to the CBIRC, and functions as a quasi-regulatory authority.

There are two classes of fund within the ISF: the property insurance security fund and the life insurance security fund. These two classes of fund are raised respectively by imposing levies on property insurers and life insurers, and should be managed and

[325] See Insurance Security Fund Regulations, regs 3 and 16.

[326] See Insurance Security Fund Regulations, regs 3 and 16.

[327] Insurance Security Fund Regulations, reg 8.

[328] Insurance Security Fund Regulations, reg 11.

[329] Insurance Security Fund Regulations, reg 8.

used separately.[330] Insurers should contribute to the ISF according to their premium income and, when it is necessary, the CISFC may also raise funds by various means after a financing plan is proposed by the CBIRC and then approved by the State Council.[331] In order to make use of the ISF, the CBIRC should, in consultation with relevant authorities, propose a crisis management plan to the State Council, and only after the State Council approves the CBIRC's proposal, can the CISFC allocate and distribute funds according to the crisis management plan.[332] As a consequence, how the ISF will be used in dealing with troubled insurers mainly depends on decisions of the CBIRC, subject to the State Council's approval, and the CISFC just serves to implement the approved crisis management plan.

In terms of the ISF's function of protecting policyholders, the ways in which the ISF may work differ between its dealing with property insurers and with life insurers. When it comes to a property insurer, if the insurer is placed into a revocation liquidation or bankruptcy liquidation and its assets are inadequate to pay insurance claims, the property insurance security fund will be used to compensate policyholders pursuant to the following rules:

(1) as for the loss[333] suffered by a policyholder which is no more than 50,000

[330] Insurance Security Fund Regulations, regs 4 and 18.

[331] Insurance Security Fund Regulations, regs 10 and 14.

[332] Insurance Security Fund Regulations, reg 17.

[333] The loss suffered by a policyholder is the difference between the expected benefits under the policy and the dividend the policyholder has been paid in the liquidation. See Insurance Security Fund Regulations, reg 19. But it should be noted that this provision is not desirable and needs to be corrected in the future. One reason is that, under the current arrangement, the way the loss is calculated means that the ISF will normally make a

RMB, the ISF will compensate the policyholder in full; (2) as for the loss suffered by an individual policyholder which is more than 50,000 RMB, the ISF will compensate the policyholder for 50,000 RMB plus 90% of the part above 50,000 RMB; and as for the loss suffered by an institutional policyholder which is more than 50,000 RMB, the ISF will compensate the policyholder for 50,000 RMB plus 80% of the part above 50,000 RMB.[334]

When it comes to a life insurer, since it is required that all life insurance policies issued by the troubled insurer should be transferred to other life insurers if the troubled insurer is placed into a revocation liquidation or bankruptcy liquidation,[335] the life insurance security fund will be used to compensate the transferee insurers accordingly rather than make compensation payments directly to policyholders. The life insurance security fund will pay compensation pursuant to the following rules:

(1) as for the policies held by individual policyholders, the compensation amount paid to a transferee insurer should not exceed 90% of the insurance benefits provided for in the original policies; (2) as for the policies held by institutional

compensation payment to a policyholder after he/she receives a dividend in liquidation. This means a significant delay in payment of insurance claims, which obviously deviates from the commonly accepted aim of ensuring timely payment of insurance claims. Another reason is that this provision (ie reg 19) is not compatible with the provision concerning the assignment of rights from a policyholder to the ISF before a dividend is paid to the policyholder in liquidation (ie reg 24). This is because if the compensation the ISF should pay to a policyholder is based on the loss so defined, the ISF will never know how much it should pay to the policyholder when the policyholder assigns his/her rights, which definitely takes place before the dividend is paid. Thus, there is an apparent contradiction between these provisions.

[334] Insurance Security Fund Regulations, reg 19.

[335] Insurance Act, art 92.

policyholders, the compensation amount paid to a transferee insurer should not exceed 80% of the insurance benefits provided for in the original policies.[336]

In addition, it is also provided that after the CBIRC decides to revoke the licence of an insurer or before a petition for a bankruptcy procedure of an insurer is filed with the court, a policyholder can assign his/her rights against the insurer relating to the insurance claim to the ISF and receive compensation from the ISF in advance, leaving the ISF with the rights so assigned to claim against the insurer.[337] If it eventually turns out that the recovery received by the ISF from the insurer exceeds the amount the ISF paid to the policyholder, the ISF should return the difference to the policyholder.[338]

Since the ISF has never functioned to compensate policyholders or transferee insurers, it is not known how arrangements in the current legislation may work in practice. However, many doubts or questions can be raised just by analysing the current statutory or regulatory provisions. As an example, it is not logically understandable why a policyholder would like to assign the rights against the insurer to the ISF so as to get compensation "before the petition for a bankruptcy procedure of an insurer is filed with the court".[339] As a matter of fact, the time when an insurer

[336] Insurance Security Fund Regulations, reg 21.

[337] Insurance Security Fund Regulations, reg 24. It should be noted that there must be a fault in reg 24. It is not clear why this regulation provides that "before a petition for a bankruptcy procedure of an insurer is filed with the court", a policyholder can assign his/her rights against the insurer relating to the insurance claim to the ISF and receive compensation from the ISF. This is because it does not make sense for policyholders to assign their rights to the ISF if there is no petition at all for a bankruptcy procedure. See Xiang Long, 'Improving the Insurance Security Fund's Function of Protecting Policyholders' (2011) 3 Insurance Studies 96, 99.

[338] Insurance Security Fund Regulations, reg 24.

[339] Xiang Long, 'Improving the Insurance Security Fund's Function of Protecting Policyholders' (2011) 3

is in a bankruptcy procedure (ie the time after the petition for a bankruptcy procedure of an insurer is filed with the court) is the very time when policyholders need the ISF's compensation. As another example, since the loss suffered by a policyholder with a property insurance policy is the difference between the expected benefits under the policy and the dividend the policyholder has been paid in the liquidation, and the calculation of the ISF's compensation is based on the "loss" so defined,[340] how can the ISF know the amount for which it should compensate the policyholder who assigns the rights during the liquidation process before the dividend is eventually paid? That is to say, there is a contradiction between the definition of "loss" for which the ISF should compensate and the arrangement for compensating a policyholder who assigns the rights before the dividend is paid in liquidation. Therefore, it is not difficult to infer that illogicality or ambiguities existing in the current legislation will hinder the ISF from performing the function of protecting policyholders. Without relevant corrections or clarifications, it is unrealistic to expect that the current arrangements will be well carried out in practice.

With regard to the ISF's function of rescuing insurers, it means that the ISF can directly provide financial assistance to troubled insurers. But in the current legislation there are no special provisions about the measures that can be taken by the CISFC when performing this function. Since there have been three cases where the ISF

Insurance Studies 96, 99.

[340] Insurance Security Fund Regulations, reg 19.

performed the rescue function, ie the New China Insurance Company case, the China United Insurance Group Company case and the AIGC case, the analysis of these cases can show a general picture about how this function may be fulfilled in practice. Therefore, these three cases will be briefly introduced as follows:

(1) The New China Insurance Company case. In 2007, in order to expel the shareholders involved in the embezzlement of the company's assets, the ISF acted to acquire shares held by these shareholders, and thus became the largest shareholder of the company, holding 38.815% of the shares.[341] Then in November 2009, after the company had recovered to normal conditions which were in line with the regulatory requirements, the ISF sold all these shares and withdrew from the crisis management process.[342]

(2) The China United Insurance Group Company case. In order to restore the company's solvency condition, the ISF injected 6 billion RMB into the company's capital in March 2012 and assisted the company to receive a capital injection of 7.81 billion RMB from a strategic investor in September 2012.[343] With the company recovering to normal conditions, the ISF gradually sold the company's shares it held. In January 2018, after selling all the company's shares, the ISF completely withdrew

[341] CISFC, 'The CISFC's Participation in the Crisis Management of New China Insurance Company' <www.cisf.cn/fxcz/czzq/czal/1456.jsp> accessed 17 May 2018.

[342] CISFC, 'The CISFC's Participation in the Crisis Management of New China Insurance Company' <www.cisf.cn/fxcz/czzq/czal/1456.jsp> accessed 17 May 2018.

[343] CISFC, 'The CISFC's Participation in the Crisis Management of China United Insurance Group Company' <www.cisf.cn/fxcz/czzq/czal/1781.jsp> accessed 17 May 2018.

from the crisis management process.[344]

(3) The AIGC case. After AIGC, an insurance group company, was placed into takeover in February 2018, the CBIRC expelled the shareholders who had cheated in the process of investing into the company, and wrote off all their shares.[345] In order to maintain AIGC's capital at the level in line with its registered capital (61.9 billion RMB), the ISF and another two strategic investors were called in to replenish the company's capital, with the ISF contributing to 98.23% of the company's capital.[346] In July 2019, Dajia Insurance Group Company, a brand-new insurance group company mainly funded by the ISF, was established.[347] Later, AIGC's shares in some of its subsidiaries (ie Anbang Life Insurance Company, Anbang Pension Insurance Company, Anbang Assets Management Company) were all transferred to Dajia Insurance Group Company; and Dajia Property Insurance Company, as a subsidiary of Dajia Insurance Group Company, was established to acquire the majority of the property insurance business in Anbang Insurance Property Company.[348] After the restructuring of AIGC

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[344] CISFC, 'The CISFC's Participation in the Crisis Management of China United Insurance Group Company' <www.cisf.cn/fxcz/czzq/czal/1781.jsp> accessed 17 May 2018.

[345] CBIRC, 'Looking for Strategic Investors to Take Over the Shares of AIGC Held by the CISFC' <http://bxjg.circ.gov.cn/web/site0/tab7927/info4103853.htm> accessed 17 May 2018.

[346] CBIRC, 'The CBIRC Approves the Amendment to AIGC's Articles of Association' (22 June 2018) <http://bxjg.circ.gov.cn/web/site0/tab5168/info4111006.htm> accessed 22 June 2018.

[347] CBIRC, 'The Establishment of Dajia Insurance Group Company' (11 July 2019) <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=4991&itemId=915&generaltype=0> accessed 11 July 2019.

[348] CBIRC, 'The Establishment of Dajia Insurance Group Company' (11 July 2019) <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=4991&itemId=915&generaltype=0> accessed 11 July 2019.

during the two years' takeover period, the CBIRC announced the termination of the takeover in February 2020, and the ISF, as the largest shareholder of Dajia Insurance Group Company, is currently seeking to withdraw from the rescue process by selling out the shares it holds in Dajia Insurance Group Company.[349]

From the limited public information about the three rescue cases, it emerges that the ISF will inject capital into or buy out certain shareholders of a troubled insurer as an interim approach to the crisis management, and will later withdraw from the rescue process by selling out the shares it holds after the insurer revives. In the case of AIGC, a new insurance group company, mainly funded by the ISF, was also established by the CBIRC to acquire the shares/business of AIGC during the rescue process.

Although the existing cases show that with the use of funds in the ISF, the CBIRC can manage to resolve crises of insurers at its discretion on a case-by-case basis, some major problems can be easily identified, or some doubts can be raised, with respect to the current practice. For example, as there are no special provisions about under what circumstances the ISF can intervene for rescue purposes, the existence of the ISF's rescue function in fact constitutes an implicit guarantee for troubled insurers and the interested parties. The overreliance on financial assistance from the ISF, ie bail-out, can easily create moral hazard problems in the insurance market,[350] and this should

349 CBIRC, 'The CBIRC's Notice of the Ending of the Takeover of AIGC' (22 February 2020) <www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=891332&itemId=925&generaltype=0 > accessed 22 February 2020.

350 For discussions of moral hazard problems insurance guarantee schemes may create, see, for example, OECD, 'Policyholder Protection Schemes: Selected Considerations' (2013) 17 <www.oecd-ilibrary.org/finance-and-

never be the result a well-designed insurance guarantee scheme is expecting. As another example, while there are restrictions on the amount of compensation the ISF can pay to policyholders or transferee insurers when an insurer is in revocation liquidation or bankruptcy liquidation, there are no restrictions on the financial assistance the ISF can provide to a troubled insurer. It remains unknown how the ISF's function of protecting policyholders can be coordinated with its function of rescuing insurers. Given the fact that when the ISF performed the rescue function, as was shown in the previous cases, all creditors, or even shareholders, of a troubled insurer would be fully protected, there is a concern that the overreliance on the ISF's rescue function will make its protection function, together with the limits on the compensation amounts, turn out to be of little use or even useless. As a third example, since it is a principle that the property insurance security fund can only be used to deal with crises of property insurers and the life insurance security fund can only be used to deal with crises of life insurers,[351] it is doubtful whether this principle was followed and, if so, how it was followed when the ISF provided financial assistance to an insurance group company, such as China United Insurance Group Company and AIGC, which is a holding company of a life insurer, a property insurer and other subsidiaries. Taken together, due to the lack of careful consideration of the ISF's rescue function in

investment/policyholder-protection-schemes_5k46l8sz94g0-en> accessed 31 October 2018; IAIS, 'Issues Paper on Policyholder Protection Schemes' (October 2013) 7 <https://iaisweb.org/page/supervisory-material/issues-papers/file/34282/life-insurance-securitisation-october-2003#> accessed 31 October 2018.

[351] Insurance Security Fund Regulations, reg 18.

the current legislation, the ways in which the ISF performed this function in practice may not benefit the whole insurance market in the long run, despite the fact that measures taken on an ad hoc basis may lead to a resolution of a certain crisis. Therefore, it is necessary that the ISF's rescue function should be well designed and clear rules governing this function should be set up in the future.

3.6. Chapter Conclusion

Despite being the second largest insurance market in the world,[352] China's insurance market is still at an early stage of development[353] and there is a comparatively small number of insurers operating in the market.[354] When it comes to the CMME mechanism, in the current legal framework, it is based on the general bankruptcy system. The major components of the CMME mechanism include the regulatory intervention system (consisting of regulatory measures), the bankruptcy system (consisting of composition, reorganisation, and bankruptcy liquidation) and the Insurance Security Fund. Mainly due to the lack of consideration of the special features of insurers, a lot of problems can be identified in the current mechanism. Since few relevant cases have ever occurred, most of the problems exist in the form of doubt,

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[352] Swiss Re Institute, 'World Insurance: The Great Pivot East Continues' (4 July 2019) 9 <www.swissre.com/dam/jcr:b8010432-3697-4a97-ad8b-6cb6c0aece33/sigma3_2019_en.pdf> accessed 1 June 2020.

[353] For more information about the history of the insurance industry as well as the insurance regulation, see Zhuyong Li and Shi Qiao, 'The Development of Insurance Law in China: Review and Prospect' (2019) 100 Financial Law Forum 98, 99.

[354] 'Members' (*Insurance Association of China*) <www.iachina.cn/col/col19/index.html> accessed 1 June 2020.

uncertainty or ambiguity, rather than being exposed in practice.

In the regulatory intervention system, there is an escalation ladder of regulatory measures that can be taken by the CBIRC when confronted with troubled insurers, which include, among others, restriction orders, correction orders, rectification, takeover, and revocation liquidation.[355] However, despite the significance and complexity of takeover and revocation liquidation, there are few provisions in the legislation about how these two measures should be arranged. This may not only hinder the process of dealing with troubled insurers, but also make it difficult to figure out the relationship between measures/procedures with similar functions. For example, it is not clear how takeover can be coordinated with reorganisation in the CMME mechanism, and it is questionable if it is necessary to have both revocation liquidation and bankruptcy liquidation in the CMME mechanism. In practice, takeover is the most severe measure that has been taken against troubled insurers. As shown in the existing takeover cases, the CBIRC had great power in carrying out takeover, subject to few pre-determined statutory provisions or regulations.[356] There is little doubt that this makes the dealing with crises of insurers less predictable.

As to the current bankruptcy system for insurers, it is basically the same as the bankruptcy system for ordinary companies, and few modifications have been made to accommodate the special features of insurers. Under the current arrangements, an

[355] For a more detailed discussion, see Part 3.2 and Part 3.3 in this chapter.

[356] For a more detailed discussion, see Part 3.3 in this chapter.

insurer may be placed into composition, reorganisation, or liquidation when it becomes or is likely to become insolvent, and it is bankruptcy administrators who will carry out the procedure, with major issues subject to decisions of the creditors' meeting during the process. However, it is argued that the lack of special arrangements for insurers either makes it unfeasible for these procedures to be carried out, or makes it unlikely for desirable outcomes to be achieved. This can partly explain why no bankruptcy procedure of an insurer has ever taken place. Therefore, to make the bankruptcy system suitable for dealing with troubled insurers, many questions need to be further considered. For example, is it appropriate to set "insolvency" as the only ground for commencing a bankruptcy procedure of an insurer? Are bankruptcy administrators suitable for carrying out bankruptcy procedures of insurers? How will policyholders be treated in a bankruptcy procedure? How will creditors' meetings be held in a bankruptcy procedure? Is composition as a bankruptcy procedure suitable for dealing with troubled insurers?

As an important source of funding for addressing crises of insurers, the ISF can perform the function of protecting policyholders or the function of rescuing insurers during the process of regulatory measures or bankruptcy procedures. While the protection function means that policyholders will be protected to a certain degree when an insurer is in liquidation, the rescue function means that a troubled insurer will be bailed out without causing losses to its creditors.[357] Due to the lack of

[357] For a more detailed discussion, see Part 3.5 in this chapter.

clarification, it is not clear how these two functions can be coordinated in dealing with troubled insurers. In practice, only the rescue function has been performed by the ISF. Although the rescue of a troubled insurer carried out by the ISF may help address a certain crisis, recurring rescues can cause moral hazard problems, thus doing harm to the long-term development of the insurance market. As a consequence, it is necessary that the circumstances where the ISF can perform the rescue function should be restricted, and the coordination between the rescue function and the protection function should be carefully designed. Also, since it was proposed by the regulatory authorities at the end of 2018 that the People's Bank of China, as the lender of last resort, may provide emergency lending to troubled insurers to avoid systemic crises,[358] it is still necessary that the ISF's rescue function and the central bank's function of emergency lending should be coordinated.

Taken together, it can be said that the CMME mechanism has not been well formed in China. As a consequence, when confronted with an insurer trapped in a serious crisis, generally speaking, the CBIRC would either avoid the failure of the insurer by bailing it out, like in the case of AIGC, or just stand by and let the insurer run off in an unhealthy condition. In the case of Sino-French Life Insurance Company, although the insurer became insolvent in 2017, with the solvency ratio falling to -16130.78% at the end of

[358] The People's Bank of China, China Banking and Insurance Regulatory Commission and China Securities Regulatory Commission, 'The Guidance on Improving the Regulatory System for Systemically Important Financial Institutions' (November 2018) <www.gov.cn/xinwen/2018-11/27/content_5343833.htm> accessed 27 November 2018.

2019, no measure/procedure has been initiated by the CBIRC to deal with the insurer's crisis.[359] The insurer currently remains in insolvent run off, strangely with frequent financial support from its shareholders to keep the run off continuing.[360] It is reasonable to infer from the Sino-French Life Insurance Company case that, due to the lack of special arrangements for insurers in the current CMME mechanism, the CBIRC itself might not even know how to carry out appropriate measures/procedures towards a troubled, or even insolvent, insurer. In fact, having recognised the deficiencies in the current mechanism, regulatory authorities have been calling for a reform of the mechanism for years.[361]

Although in current China, with the insurance market being much influenced by the state, no tremendous chaos has been triggered by crises of insurers, the lack of a well-designed CMME mechanism should not continue as the norm in a society governed by the rule of law. Therefore, to better deal with crises of insurers in China, it is necessary that a radical reform should be carried out to make the CMME mechanism more compatible with the special features of insurers. In order to achieve a successful reform, careful consideration should be given to whether China should have a CMME

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[359] Sino-French Life Insurance Company, 'Solvency Report in the Fourth Quarter of 2019' <www.sfli.com.cn/cms-web/resource/sinofrench/2020/1/22/1579662511504.pdf> accessed 10 March 2020.

[360] See Sino-French Life Insurance Company, 'Solvency Report in the Fourth Quarter of 2019' <www.sfli.com.cn/cms-web/resource/sinofrench/2020/1/22/1579662511504.pdf> accessed 10 March 2020.

[361] See, for example, The People's Bank of China and others, 'The 12th Five-Year Plan for Development and Reform of the Financial Industry' (September 2012) <www.gov.cn/gzdt/2012-09/17/content_2226795.htm> accessed 25 November 2016; The National Development and Reform Commission and others, 'The Plan to Accelerate the Reform of the Market Exit Mechanism' (July 2019) <www.gov.cn/xinwen/2019-07/16/content_5410058.htm> accessed 16 July 2019.

mechanism which is based on the general bankruptcy system, like the mechanism in the UK, or a CMME mechanism which is completely independent of the general bankruptcy system, like the mechanism in the US.

Chapter 4 Analysis of the CMME Mechanism in the UK

Overview

This chapter will conduct research on the CMME mechanism in the UK so as to see what experience or lessons can be learnt. The UK CMME mechanism is largely based on the insolvency system for ordinary companies. Considering the uniqueness of insurers, a number of modifications have been made to the general insolvency system to facilitate the application of insolvency procedures to insurers. With the focus on the special arrangements which have been made to accommodate the special features of insurers, the major components of the CMME mechanism will be analysed in turn, including the proactive intervention framework, company voluntary arrangement (CVA), administration, winding-up, schemes of arrangement, and the Financial Services Compensation Scheme (FSCS).

For comparison purposes in this thesis, regarding the CMME mechanism in the UK, the following points need to be highlighted:

a. There is no regulatory takeover in the CMME mechanism, and it is insolvency practitioners who will take over troubled insurers when insurers are in insolvency procedures.

b. Although CVA is applicable to insurers, there is hardly any case relating to a CVA of an insurer. Based on the analysis of relevant factors, it is doubtful whether CVA as an insolvency procedure is suitable for insurers.

c. Like in an insolvency procedure of an ordinary company, creditors' decisions

should be sought on major issues in an insolvency procedure of an insurer. However, to value policyholders' voting rights and to seek decisions from a vast number of creditors (including policyholders) always pose a challenge in an insolvency procedure of an insurer.

d. Grounds for compulsory winding-up are broadly set, so it is not necessary that a company wound up by court order should be insolvent. When it comes to insurers, it may also be the case that an insurer is wound up when its permission to effect or carry out insurance contracts has been cancelled or when the court thinks it is just and equitable to do so.[362]

e. When dealing with a petition for winding up an insurer which is unable to pay its debts, instead of making a winding-up order the court is empowered to reduce the value of one or more of the insurer's contracts at its discretion.[363] It remains unknown how this arrangement can be coordinated, in logic, with other measures with the effect of restructuring the troubled insurer's debts, which are subject to creditors' decisions.

f. The FSCS mainly performs the function of protecting policyholders (eg by means of paying compensation to policyholders or securing continuity of insurance policies), but scarcely performs the function of rescuing insurers (by means of providing financial assistance to troubled insurers).[364]

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362 Financial Services and Markets Act 2000, s 367(3).

363 Financial Services and Markets Act 2000, s 377.

364 For a more detailed discussion, see Part 4.3 in this chapter.

Taken together, in the UK CMME mechanism, although a lot of efforts have been made to adapt the general insolvency system for insurers, there still exist arrangements which are inherent in the insolvency system but are arguably not suitable for insurers. In addition, since there is a lack of arrangements designed for the objective of maintaining financial stability, it is doubtful whether crises of insurers can be addressed in an orderly manner if troubled insurers pose systemic risk. Having recognised that the design model adopted in the current CMME mechanism may not be satisfactory, the regulatory authorities are considering whether a special regime different from the insolvency system should be built to deal with troubled insurers.[365]

4.1. Framework of the CMME Mechanism

There is a long history of the insurance market in the UK.[366] The special consideration of how to deal with troubled insurers can be traced back to the beginning of the regulation of insurers. The Life Assurance Companies Act 1870, as a response to constant failures of life insurance companies in earlier years, was enacted to put life insurance companies under regulation for the interests of policyholders.[367] It was especially provided in the Life Assurance Companies Act 1870 that policyholders would have the standing to petition the court for a winding-up if a life insurance company

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[365] See, for example, HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012) 32; Bank of England, 'The Bank of England's Approach to Resolution' (October 2017) 19.

[366] For more information, see Robert L. Carter and Peter Falush, *The British Insurance Industry Since 1900: The Era of Transformation* (Palgrave Macmillan 2009).

[367] Robert Merkin, *Colinvaux's Law of Insurance* (11th edn, Sweet & Maxwell 2016) 872.

became insolvent. Since then, the insolvency system for insurers formed in a model which can be characterised as making modifications for insurers based on the general insolvency system. Then the Assurance Companies Act 1909, applicable to both life insurance companies and non-life insurance companies, extended the policyholders' right to petition for a winding-up of an insurance company to the non-life insurance business area. Afterwards, the Assurance Companies (Winding-up) Act 1933 was specifically enacted to deal with insolvency issues of insurance companies, according to which, most importantly, the regulator was entitled to petition the court for a winding-up of an insolvent insurance company. Following the path of early developments, the model of the insolvency system for insurers remains unchanged, based on the general insolvency system while with modifications to accommodate the special features of insurers. Therefore, it can be said that the CMME mechanism in the UK is largely based on the insolvency system for ordinary companies.

Nowadays, the UK has the 4th largest insurance market in the world, and there are more than 400 domestic insurers operating in the market.[368] All insurers are supervised by the Prudential Regulation Authority (PRA), in terms of prudential supervision, and the Financial Conduct Authority (FCA), in terms of conduct supervision.[369] During the operation of insurers, they sit in one of the 5 stages

[368] Association of British Insurers, 'UK Insurance & Long-Term Savings – Key Facts' (December 2019) 3 <www.abi.org.uk/globalassets/files/publications/public/key-facts/key_facts_2019_spread.pdf> accessed 26 June 2020.

[369] See Financial Services and Markets Act 2000, pt IA.

designed in the PRA Proactive Intervention Framework,[370] which indicates different levels of their proximity to failure. The Proactive Intervention Framework provides for various regulatory measures which can be taken at different stages, and measures available at a higher stage tend to have more intrusive and intense effects. At Stage 1, as risk to viability of an insurer is low, the insurer will just go through the normal supervisory risk assessment, and no special regulatory measure needs to be taken. At Stage 2, when vulnerabilities in an insurer's financial position are identified, the PRA may review the insurer's risk profile, realign the regulatory capital requirements, and impose restrictions on the insurer's activities. At Stage 3, when there are significant threats to an insurer's safety and soundness, the insurer may be required to initiate some recovery actions, which include capital raising, asset disposal, business transfer, etc., and the PRA may also set requirements with regard to, for example, changes to the insurer's management or the board, limits on asset disposal or capital distribution, restrictions on existing or planned activities, or even remove the insurer's authorisation to carry out new business. At Stage 4, when there is a real risk that an insurer will fail to meet the Threshold Conditions,[371] the insurer should accelerate and complete recovery actions, and the PRA will prepare for resolution of the insurer,

[370] These 5 stages are: Stage 1 – low risk to viability of insurer; Stage 2 – moderate risk to viability of insurer; Stage 3 – risk to viability absent action by the insurer; Stage 4 – imminent risk to viability of insurer; Stage 5 – insurer in resolution or being actively wound up. See PRA, 'The Prudential Regulation Authority's Approach to Insurance Supervision' (October 2018) 29.

[371] The Threshold Conditions for insurers are mainly set in Part 1D of the Schedule 6 to the Financial Services and Markets Act 2000.

including commencing an administration or a liquidation.[372] At Stage 5, since recovery actions cannot lead to desirable outcomes, the PRA can take the initiative to petition the court for an appropriate insolvency procedure and then monitor the process as the procedure is carried out by insolvency practitioners. In summary, when an insurer becomes troubled, appropriate regulatory measures or insolvency procedures will be initiated to deal with the crisis brought by the insurer.

Since insolvency procedures are judicial procedures in nature, different from regulatory measures which fall within the remit of regulators, it can be said that while Stage 5 is a court-based stage, other stages are regulator-led stages. In Stages 2 to 4, a troubled insurer still remains under the control of its existing management, but should carry out recovery actions according to the PRA's requirements so as to mitigate risks that have been identified. Normally the PRA just highlights issues of concern and the outcomes it wishes to see, and the ways to achieve these outcomes will be decided by the insurer, although under some circumstances the PRA may choose to be directive in terms of the actions required.[373] However, when an insurer moves to Stage 5 and an insolvency procedure thus commences, the management of the insurer will be taken over by certain insolvency practitioners, and measures to be taken will be largely subject to the court's consent or orders. Although the regulators can participate in the whole process of an insolvency procedure, it is the court that plays a decisive role in

[372] Note: It is reasonable to infer that when the term "resolution" is used in the Proactive Intervention Framework, it mainly refers to resolving crises of troubled insurers through insolvency procedures.

[373] PRA, 'The Prudential Regulation Authority's Approach to Insurance Supervision' (March 2016) 62.

determining how the troubled insurer will be dealt with.

Under the current legal framework, insolvency or quasi-insolvency procedures insurers may go through are much the same as those for ordinary companies, which include CVA, receivership, administration, winding-up and schemes of arrangement.[374] But there are relevant modifications made to these procedures to facilitate their application to insurers, and there also exists the FSCS which is ready to perform the function of protecting policyholders or the function of rescuing insurers in due course in these procedures. Due to these arrangements, provisions relating to insolvency procedures for insurers are contained not only in general insolvency laws, but also in relevant laws targeted at insurers. To be more specific, relevant provisions can be found in a variety of enactments, such as the Insolvency Act 1986, the Financial Services and Markets Act 2000, the Insurers (Winding-up) Rules 2001, the Insurers (Reorganisation and Winding-up) Regulations 2004, the Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, the Insolvency (England and Wales) Rules 2016, and the Prudential Regulation Authority Rulebook. Therefore, to get an overall picture of the CMME mechanism requires researching into a wide range of enactments systemically.

4.2. The Insolvency System for Insurers

[374] It should be noted that a scheme of arrangement is not an insolvency procedure in nature. But since it is an approach widely adopted in dealing with troubled insurers, with the actual effect of reorganising insurers, it can be regarded as a quasi-insolvency procedure.

With the focus on how insolvency procedures are adapted for insurers, CVA, administration and winding-up will be analysed in turn. In addition, due to the fact that schemes of arrangement have been widely used in dealing with troubled insurers in practice, which have an actual effect similar to that of an insolvency procedure, the analysis will also be made with regard to how schemes of arrangement could function during crises of insurers.

Although receivership as a procedure provided for in the general insolvency law is also applicable to insurers, it is not believed to be a procedure by virtue of which crises of insurers can be fully addressed. In normal circumstances, when a receiver (including administrative receiver) of certain property of a company is appointed, his main duty is to realise the assets to satisfy the claim of the secured creditor who appointed him or on whose behalf he was appointed.[375] Therefore, generally speaking, receivership is merely a procedure available for secured creditors to exercise their rights in relation to charges. Since receivership is beyond the scope of the comparative study in this thesis, the thesis is not going to discuss receivership any further.

4.2.1. Company Voluntary Arrangement

Although CVA is provided for in the Insolvency Act 1986, it is not required that a company seeking to make use of a CVA should be proved insolvent. Stand-alone CVA

[375] For discussions of receivership, see, for example, John Armour and Sandra Frisby, 'Rethinking Receivership' (2001) 21(1) Oxford Journal of Legal Studies 73; John Armour, Audrey Hsu and Adrian Walters, 'The Costs and Benefits of Secured Creditor Control in Bankruptcy: Evidence from the UK' (2012) 8(1) Review of Law and Economics 101.

can be regarded as a debtor-in-possession company rescue procedure, by virtue of which a financially distressed company could reach a voluntary arrangement with its creditors while the management of the company still remains in control and the core business of the company still keeps running. Therefore, CVA is always attractive to directors of a financially distressed company who would like to pull the company out of the crisis.

Despite the existence of CVA as an insolvency procedure since 1986, there have hardly been any cases relating to CVA of an insurer. Revolving around how CVA may work in the event of crises of insurers, the analysis in this section will reveal that while the advantages CVA normally has may not appear when it comes to dealing with troubled insurers, some design inherent in CVA may turn out to hinder CVA from being successfully applied to insurers. Therefore, it is questionable whether CVA as a rescue procedure is suitable for insurers.

4.2.1.1. Commencement of a CVA

To initiate a CVA, directors of a company need to make a proposal of the voluntary arrangement for a composition in satisfaction of its debts or a scheme of arrangement of its affairs.[376] The proposal should provide for some person (known as "the nominee"), who is a qualified insolvency practitioner, to act in relation to the voluntary arrangement either as trustee or otherwise for the purposes of supervising its

[376] Insolvency Act 1986, s 1(1).

implementation.[377] If the nominee holds that the proposed voluntary arrangement has a reasonable prospect of being approved and implemented, and the proposal should be considered by a meeting of the company and by the company's creditors, he should submit a report stating such opinions to a court of competent jurisdiction.[378] Unless the court otherwise directs, the nominee should summon a meeting of the company[379] to consider the proposal and should seek a decision from the company's creditors[380] as to whether they approve the proposal by means of a qualifying decision procedure.[381] Apart from stand-alone CVAs, a CVA proposal may also be made by the administrator or the liquidator when the company is already in administration or winding-up,[382] and in this case, normally the administrator or the liquidator will also function as the nominee in relation to the CVA.

In a stand-alone CVA, there can normally be a moratorium which imposes

[377] Insolvency Act 1986, s 1(2).

[378] Insolvency Act 1986, s 2(2).

[379] The meeting of the company may be attended by all members of the company, every officer or former officer of the company whose presence the nominee thinks is required, and other directors of the company. But only members with voting rights are entitled to vote, and the value of a member for the purposes of voting is determined by reference to the number of votes conferred on that member by the company's articles. See Insolvency (England and Wales) Rules 2016, SI 2016/1024, rr 2.30 and 2.35.

[380] In a qualifying decision procedure, generally speaking, only creditors with unsecured debts have the right to vote in the procedure. If the creditor's debt is wholly secured, the value he holds for voting purposes is nil; and if the creditor's debt is partly secured, the value he holds for voting purposes is the value of the unsecured part. See Insolvency (England and Wales) Rules 2016, SI 2016/1024, rr 15.28(5) and 15.31(4)(5).

[381] Insolvency Act 1986, s 3(1)(3). Qualifying decision procedures include correspondence, electronic voting, virtue meeting, physical meeting and any other decision-making procedure which enables all creditors who are entitled to participate in the making of the decision to participate equally. See Insolvency Act, s 246ZE; Insolvency Act, sch 8 para 8A; Insolvency (England and Wales) Rules 2016, SI 2016/1024, pt 15.

[382] Insolvency Act 1986, s 1(3).

restrictions on payments or enforcement of relevant debts, initiation of other insolvency procedures etc.[383] However, when it comes to insurers, it is expressly provided in the legislation that insurers are excluded from being eligible for a moratorium during a CVA.[384] The reason for the exclusion, as once pointed out by the Insolvency Service,[385] is to avoid negative effects on the functioning and integrity of the insurance market.[386] Although the exclusion has the implication that insurance claims should be paid as usual when an insurer is in CVA, which is in line with the objective of policyholder protection, the lack of a moratorium during the process, on the other hand, makes it less likely for a CVA of an insurer to be realised. This is largely because the lack of a moratorium in a CVA cannot prevent creditors (including policyholders) petitioning for an administration or a winding-up of the insurer. Since there exists the FSCS which will function to make compensation payments to eligible policyholders when the insurer is in administration or winding-up,[387] policyholders have incentives to take action to lead the insurer to an administration or a winding-up if the proposal of the voluntary arrangement fails to offer them better treatment than what they would receive from the FSCS in administration or winding-up. As a

[383] For more information about the effects of a moratorium, see Insolvency Act 1986, pt A1 ch 4.

[384] Insolvency Act 1986, sch ZA1 para 3.

[385] The Insolvency Service is an executive agency of the Department for Business, Energy and Industrial Strategy. See the Insolvency Service, 'About Us' <www.gov.uk/government/organisations/insolvency-service/about> accessed 20 October 2017.

[386] The Insolvency Service, 'Proposals for a Restructuring Moratorium – a Consultation' (July 2010) Annex B para B.3.

[387] For a more detailed discussion, see Part 4.3 in this chapter.

consequence, it is very likely that while the goal of a CVA of an insurer cannot be achieved, costs of multiple insolvency procedures are unnecessarily incurred.

In normal circumstances, one advantage of using a CVA lies in the fact that the core business of a company can be operated as usual and thus the business income will bring the company cash inflow.[388] But due to the unique business model insurers have, this advantage may not exist in a CVA of an insurer. In the case of an ordinary company, since how the normal business model works is that customers make payments after receiving products or services provided by the company, customers will not be much influenced if the company they are transacting with is going through a CVA. This means that, to a large extent, business between the company and customers can continue as usual despite a CVA. However, situations will be different when it comes to an insurer. Since how the insurance business model works is that policyholders should pay premiums to an insurer in advance and the insurer is then obliged to pay insurance claims upon the occurrence of specified insured events, policyholders, being customers of the insurer, are also the insurer's creditors or potential creditors. If an insurer proposes a CVA, it usually means that the insurer is seeking compromises from policyholders due to its inability to pay insurance claims fully or on time. So if at this point the insurer is still allowed to continue business as usual, including to write new insurance policies to generate business income, then more policyholders will get involved in the insurer's trouble, which obviously deviates from the objective of

[388] House of Commons, 'Briefing Paper – Company Voluntary Arrangements' (December 2015) pt 3.

policyholder protection. Apart from this, it is also unrealistic to expect that prospective policyholders will still be willing to purchase insurance from the insurer if they are aware of the fact that the insurer is in CVA. In fact, regulatory authorities will normally ban an insurer from writing new insurance policies if the insurer becomes seriously troubled. Just as shown in the current Proactive Intervention Framework, if an insurer moves to Stage 4, a stage when there is a real risk that the insurer will fail to meet the Threshold Conditions, the PRA will consider removing the insurer's authorisation to write new business.[389] Therefore, in the case of an insurer, a CVA may not have the normally expected effects since there is little chance that the insurer will have cash inflow through writing new business.

4.2.1.2. Approval for the Proposal

Whether a voluntary arrangement proposal will be approved (with or without modifications), is subject to the decision of the company's creditors as well as the decision of the company's members, and the creditors' decision should be made before the members' decision.[390] In a qualifying decision procedure for the creditors' decision, the proposal (with or without modifications) will be approved when three-quarters or more (in value) of those responding vote in favour of it, unless more than half of the total value of the unconnected creditors vote against it.[391] In a meeting of

[389] PRA, 'The Prudential Regulation Authority's Approach to Insurance Supervision' (October 2018) 30.

[390] Insolvency Act 1986, s 4(1); Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 2.28.

[391] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 15.34. As to "unconnected creditors", according to r 15.34(5), '(a) a creditor is unconnected unless the convener or chair decides that the creditor is

the company for its members' decision, subject to any express provision to the contrary in the articles of the company, a resolution will be passed when a majority (in value) of those voting vote in favour of it.[392] If the decision taken by the company's creditors differs from that taken by the company meeting, the creditors' decision takes precedence. But a member of the company can apply to the court for a change, and the court may then either order the members' decision to have effect instead of the creditors' decision, or make such other order as it thinks fit.[393]

Specific to insurers, it is provided that when the proposed voluntary arrangement includes a composition in satisfaction of any insurance debts, and a distribution to the insurer's creditors so as to terminate the whole or any part of the business of the insurer, the company's members or its creditors should not approve any proposal under which any insurance debt is to be paid otherwise than in priority to the debts of the insurer which are not insurance debts or preferential debts.[394] This makes sure that insurance debts will also have priority over most other unsecured debts during a

connected with the company; (b) in deciding whether a creditor is connected reliance may be placed on the information provided by the company's statement of affairs or otherwise in accordance with these Rules; and (c) the total value of the unconnected creditors is the total value of those unconnected creditors whose claims have been admitted for voting.'

[392] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 2.36.

[393] Insolvency Act 1986, s 4A(3)(6).

[394] Insurers (Reorganisation and Winding Up) Regulations 2004, SI 2004/353, reg 33. In this regulation, it is provided that "insurance debt" means a debt to which a UK insurer is, or may become liable, pursuant to a contract of insurance, to a policyholder or to any person who has a direct right of action against that insurer, and includes any premium paid in connection with a contract of insurance (whether or not that contract was concluded) which the insurer is liable to refund; "preferential debts" means debts falling into two categories: (1) contributions to occupational pension schemes and state scheme premiums; (2) remuneration, etc., of employees.

CVA, which is consistent with the priority insurance debts will have in the claims hierarchy if the insurer is wound up.[395]

However, given the uniqueness of the insurance business, there are still some challenges if the nominee of a CVA would like to seek approval for the voluntary arrangement proposal from an insurer's creditors. For example, one challenge lies in how to calculate policyholders' voting rights, and another challenge lies in how to obtain the required majority of favourable votes. In turn, these two major challenges will be analysed as follows:

A. Calculating Policyholders' Voting Rights

It is never an easy task to calculate policyholders' voting rights in a qualifying decision procedure, and there are no special rules for CVA in this respect. In a stand-alone CVA, the general principle of calculating creditors' voting rights is that votes are decided by the amount of creditors' claims at the decision date.[396] As to a debt of an unliquidated or unascertained amount, the debt should be valued at £1 for the purposes of voting unless the nominee decides to put a higher value on it.[397] Due to the nature of insurance business, before insured events take place, all policyholders are contingent or prospective creditors of an insurer, which means that apart from policyholders with crystallised insurance claims by the decision-making date, most policyholders will be

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[395] For a more detailed discussion of the priority of insurance debts in the claims hierarchy in winding-up, see Section 4.2.3.2 in this chapter.

[396] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 15.31(1)(d).

[397] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 15.31(3).

deemed to have debts of unliquidated or unascertained amounts. As a consequence, according to the current statutory arrangement, a vast number of policyholders may just have voting rights of £1 value when participating in the decision procedure in a CVA. This inevitably leads to an outcome that the decision will be made largely based on the will of creditors (including policyholders) with debts of ascertained amounts, since each of their voting rights may carry a value which is thousands of times, or even more, of the value carried by the voting right of a policyholder without a crystallised insurance claim. There is little doubt that this will dampen a majority of policyholders' enthusiasm for participating in the decision procedure when an insurer is in a CVA, despite that they still have to be bound by the result of the decision procedure.

B. Obtaining the Requisite Majority of Favourable Votes

As mentioned earlier, the voluntary arrangement proposal will be approved only when three-quarters or more (in value) of those responding vote in favour of it.[398] But it is argued that in a CVA of an insurer, it will be next to impossible to obtain the requisite majority of favourable votes from creditors of the insurer.[399] Normally in a CVA of an ordinary company, incentives for creditors to consent to the proposed voluntary arrangement are largely based on the consideration that they do not want to lose a customer and would like to see the continuation of steady business,[400] which is due

[398] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 15.34.

[399] William Goddard, 'The Revolution of the Times: Recent Changes in UK Insurance Insolvency Laws and the Implications of Those Changes Viewed from a US Perspective' (2003) 10(1) Connecticut Insurance Law Journal 139, 144.

[400] Company Rescue Ltd, 'Expert Guide to The Company Voluntary Arrangement Process' 63

to the fact that creditors of an ordinary company are usually the company's suppliers of goods or services. However, the situation will be different when it comes to insurers. Since the majority of creditors of an insurer are policyholders, ie customers of the insurer, there are no such incentives for them to maintain the relationship with an insurer which is in a CVA. Instead, some policyholders may even seek to surrender policies for the best of their interests. Thus, from the standpoint of policyholders, the incentives to approve the proposed voluntary arrangement so as to maintain a business relationship seem to be missing in the case of an insurer.

In addition, in a CVA, the voluntary arrangement proposal will be attractive only when it places creditors in a better position than they would be if the company was wound up directly. But due to the existence of the FSCS, it is less likely that a voluntary arrangement proposal can provide more appealing arrangements for policyholders. When an insurer enters an administration, or a winding up, most policyholders will be entitled to a high level of protection provided by the FSCS.[401] For example, for most types of general insurance contracts, the level of protection the FSCS will provide to eligible policyholders is 90% of the insurance claims, and for long-term insurance contracts, etc., that level is 100% of the insurance claims.[402] As a consequence, the existence of the high-level policyholder protection scheme leaves little room for an

<www.companyrescue.co.uk/fileadmin/uploads/cr/Documents/Company-voluntary-arrangement-CVA-guide-v2.pdf> accessed 20 November 2017.

[401] PRA, 'Rulebook – SII Firms – Policyholder Protection 18.2' (3 July 2015).

[402] PRA, 'Rulebook – SII Firms – Policyholder Protection 17.2' (1 October 2015).

insurer to come up with a voluntary arrangement proposal which could appeal to policyholders. Therefore, in a CVA of an insurer, it seems unrealistic to expect that the required majority of favourable votes can be obtained from the insurer's creditors so as to achieve the approval for a voluntary arrangement proposal.

4.2.1.3. Effects of a CVA

When a voluntary arrangement proposal is approved, the nominee will report the result to the court and the voluntary arrangement will have a binding effect on every creditor who was entitled to vote in the qualifying decision procedure, or who would have been so entitled if he had had notice of the qualifying decision procedure.[403] Then the nominee, if not replaced by another qualified person in accordance with the modified arrangement, will function as the supervisor to implement the approved voluntary arrangement.[404] If eventually the voluntary arrangement is carried out successfully and the company recovers from the financial distress, the CVA process will come to an end and the company would return to normal operation; but if the goal of the CVA cannot be achieved, then the company may be brought into an administration or a winding-up for further treatment.

However, a decision of the approval for a voluntary arrangement may still be challenged after it has been made. The nominee, or a person who was entitled to vote at the meeting of the company or in the qualifying decision procedure, may present

[403] Insolvency Act 1986, ss 4(6), 4(6A) and 5(2).

[404] Insolvency Act 1986, ss 4(2) and 7(2).

such a challenge by applying to the court within 28 days after the decision of the approval is reported to the court; and a person who was not given notice of the qualifying decision procedure may present such a challenge by applying to the court within 28 days since he became aware that the relevant qualifying decision procedure had taken place.[405] Specific to insurers, the right to challenge the decision of the approval has also been conferred on the PRA and the FCA.[406] The challenge so presented may be based on the ground that the voluntary arrangement unfairly prejudices the interests of a creditor, member or contributory of the company, or that there has been some material irregularity in relation to the meeting of the company, or in relation to the relevant qualifying decision procedure.[407]

While the right of challenge provides more protection to interested parties, it may also bring uncertainty to a voluntary arrangement for a long period. This is especially the case when it comes to an insurer. Due to the nature of insurance business, many insurance creditors are unidentified before insured events take place. New insurance creditors which emerge after the approval for a voluntary arrangement will also be bound by the voluntary arrangement. Then if any of these insurance creditors believes that he has grounds to challenge the approval for the voluntary arrangement, he can do so within 28 days since he becomes aware of the relevant qualifying decision procedure. As a consequence, there is a likelihood, in theory, that the voluntary

[405] Insolvency Act 1986, s 6(2)(3).

[406] Financial Services and Markets Act 2000, s 356.

[407] Insolvency Act 1986, s 6(1).

arrangement will be challenged by newly emerging insurance creditors from time to time during its implementation, making the effectiveness of the voluntary arrangement uncertain.[408]

4.2.2. Administration

As part of the company rescue culture, administration provides a possible way for a financially distressed company to be rescued as a going concern. But due to the fact the objectives an administration may seek to achieve are various, the administration of a company may just turn out to be a procedure functioning as an orderly transition to a winding-up or a dissolution of the company. Before the Financial Services and Markets Act 2000 was enacted, since there had already existed some regulatory powers which could be used to assist troubled insurers to rehabilitate under the supervision of regulatory authorities, insurers were excluded from being eligible for administration for a long time.[409] Considering the inadequacy of measures dealing with troubled insurers, the exclusion was finally lifted by the Financial Services and Markets Act 2000 and the Treasury was empowered to make modifications to administration for insurers.[410]

Revolving around how administration of an insurer may be carried out, this section will examine administration from four aspects: the commencement of administration,

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[408] Nigel Montgomery, Gabriel Moss and Tom Smith, 'England' in Gabriel Moss and others (eds), *Cross-Frontier Insolvency of Insurance Companies* (Sweet & Maxwell 2001).

[409] Department of Trade and Industry (now the Department for Business, Energy and Industrial Strategy), 'Proposals for Dealing with Insolvent Non-life Insurance Companies'（December 1994) para 10.

[410] Financial Services and Markets Act 2000, s 360.

the effects of administration, the process of administration and the ending of administration. The discussion will show that compared with administration for ordinary companies, special arrangements have been designed for insurers to accommodate their features. For example, it is especially provided that regulatory authorities have the standing to take part in the process, the continuity of long-term insurance contracts should be maintained, and the administrator should assist the FSCS to compensate policyholders. However, there are still some major problems under the current design framework. As an example, since the majority of an insurer's creditors are policyholders – most of whose claims are contingent or prospective at a given time – how to calculate their voting rights when seeking creditors' decisions becomes a challenge for administrators. It is also difficult for approval for relevant issues to be obtained from a vast number of creditors (including policyholders). As another example, while most significant issues during administration should be subject to creditors' decisions, the reduction of the value of long-term insurance contracts will only be subject to decisions of the court.[411] It is not clear how these two distinct arrangements (ie the creditors' decision and the court's decision) can be coordinated in logic.

4.2.2.1. Commencement of Administration

The administration of a company commences when an insolvency practitioner is

[411] Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, SI 2010/3023, sch para 2.

appointed as the administrator to manage the company's affairs, business and property.[412] For an ordinary company, there are three ways through which the appointment of an administrator can be made: appointment by the court, appointment by the holder of a floating charge, and appointment by the company or its creditors.[413] But when it comes to an insurer, following the requirement made in the EU Directive on the reorganisation and winding-up of insurance undertakings,[414] it is specially provided that the appointment of an administrator should only be made by an order of the court.[415] That is to say, the administration of an insurer will commence only if the court so orders.

In the case of an ordinary company, the company, directors of the company, creditors of the company[416] and so on, have the standing to apply to the court for an administration order.[417] In line with the fact that insurers are regulated financial institutions, the legislation also vests the insurance regulators, ie the PRA and the FCA, with the right to apply for an administration of an insurer.[418] Upon such an application, the court may make an administration order only if it is of the opinion that the company is or is likely to become unable to pay its debts, and that the administration

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[412] Insolvency Act 1986, sch B1 para 1.

[413] Insolvency Act 1986, sch B1 paras 10, 14 and 22.

[414] Council Directive 2001/17/EC of 19 March 2001 on the reorganisation and winding-up of insurance undertakings [2001] OJ L 110/28, which was repealed and incorporated in the Solvency II Directive.

[415] Insurers (Reorganisation and Winding Up) Regulations 2004, SI 2004/353, reg 12(3)(a).

[416] Creditors of the company include contingent creditors and prospective creditors. See Insolvency Act 1986, sch B1 para 12(4).

[417] Insolvency Act 1986, sch B1 para 12(1).

[418] Financial Services and Markets Act 2000, s 359.

order is reasonably likely to achieve the purpose of administration.[419] Otherwise, the court may make any other order that it thinks appropriate, including a winding-up order to liquidate the company.[420]

There are three layers of objectives designed for administration and, generally speaking, the objective in a higher layer has priority over the objective in a lower layer. In order of precedence, these three layers of objectives are:

(a) rescuing the company as a going concern;

(b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration);

(c) realising property in order to make a distribution to one or more secured or preferential creditors.[421]

The administrator must perform his functions with objective (a) unless he thinks either that it is not reasonably practicable to achieve this objective, or that objective (b) would achieve a better result for the company's creditors as a whole.[422] Only when the administrator thinks that it is not reasonably practicable to achieve either objective (a) or objective (b), and that the interests of the creditors of the company as a whole would not be unnecessarily harmed, the administrator may perform his functions with objective (c).[423] Specific to insurers, policyholder protection constitutes an extra

[419] Insolvency Act 1986, sch B1 para 11.

[420] Insolvency Act 1986, sch B1 para 13(1).

[421] Insolvency Act 1986, sch B1 para 3(1).

[422] Insolvency Act 1986, sch B1 para 3(3).

[423] Insolvency Act 1986, sch B1 para 3(4).

objective the administrator should bear in mind during the administration of an insurer. In order to better protect policyholders and avoid causing significant delays in paying insurance benefits to policyholders,[424] the administrator is obliged to provide any necessary assistance to the scheme manager of the FSCS, so that the scheme manager can administer the compensation scheme in relation to contracts of insurance, and secure continuity of insurance in relation to contracts of long-term insurance.[425] This means that no matter which objective in objectives (a) to (c) the administrator chooses to achieve in an administration, the administrator should always cooperate with the FSCS to provide protection to eligible policyholders.

Apart from having the standing to apply for an administration of an insurer, the PRA and the FCA can still participate throughout the process after an administration commences. For example, the PRA or the FCA is entitled to be heard at any relevant hearing of the court, to receive any materials required to be sent to creditors, to attend any meeting or decision procedure for creditors, and to apply to the court for a scheme of arrangement to be sanctioned if such an arrangement is proposed between the insurer and its creditors.[426] In addition, when noticing that the administrator's action or proposed action may unfairly harm the interests of members or creditors of the troubled insurer, or that the administrator is not performing his functions as quickly or

[424] HM Treasury, 'Proposals to Strengthen the Administration Regime for Insurers' (1 November 2010).

[425] Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, SI 2010/3023, sch para 1.

[426] Financial Services and Markets Act 2000, s 362.

as efficiently as is reasonably practicable, the PRA or the FCA can still apply to the court to challenge that action.[427]

4.2.2.2. Effects of Administration

When an administration order is made by the court, the administrator so appointed will take over the company to carry out the administration. The management of the company, in effect, will thus be suspended, and may not exercise any management power without the consent of the administrator.[428] It may also be the case that the management of the company will be changed during the administration, as the administrator is empowered to appoint or remove any directors of the company, or to employ or dismiss any employees of the company.[429] In fact, the administrator has extensive powers in administering the company, and may do anything necessary or expedient for the management of the affairs, business and property of the company.[430] For example, powers enjoyed by the administrator include: the power to take possession of, collect and get in the property of the company; the power to sell or otherwise dispose of the property of the company; the power to raise or borrow money for the company; the power to bring or defend any action or other legal proceedings in the name and on behalf of the company; the power to carry on the

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[427] Financial Services and Markets Act 2000, s 362; Insolvency Act 1986, sch B1 para 74.

[428] Insolvency Act 1986, sch B1 para 64.

[429] Insolvency Act 1986, sch B1 para 61 and sch 1 para 11.

[430] Insolvency Act 1986, sch B1 para 59(1).

business of the company; etc.[431]

There will be moratorium effects in administration. As a consequence, for example, without the consent of the administrator or the permission of the court, no legal process can be instituted or continued against the company or property of the company, and no step may be taken to enforce security over the company's property.[432] Although in normal circumstances, payments to creditors should also be stayed, the administrator and the court can exercise discretion given by the legislation to bring about exceptions. It is possible that unsecured creditors will receive payments of their debts during the administration, if the court gives permission or if the administrator thinks so doing may assist to achieve the purpose of administration.[433] By virtue of this, in the case of the administration of an insurer, in order to achieve the objective of policyholder protection, it is likely for payments of insurance claims to be made without interruption or without significant delay.

Targeted at insurers, to keep in line with the requirement for continuing long-term insurance business in winding-up, the Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010 transplanted relevant provisions made for the winding-up procedure to the administration procedure.[434] While the administrator must not effect any new insurance contracts without the

[431] See Insolvency Act 1986, sch 1.

[432] Insolvency Act 1986, sch B1 para 43.

[433] Insolvency Act 1986, sch B1 paras 65 and 66.

[434] For a more detailed discussion of continuing long-term insurance business in winding-up, see Section 4.2.3.2 in this chapter.

approval of the PRA or the FCA, the administrator must carry on long-term insurance business with a view to the business being transferred as a going concern to other insurers, unless the court orders otherwise.[435] During the process, the scheme manager of the FSCS may also function to provide necessary support to achieve the goal of securing continuity of long-term insurance contracts.[436] However, the continuity in this circumstance does not necessarily mean that long-term insurance contracts will remain intact, since the court still has the power to reduce the value of one or more of the long-term insurance contracts, subject to terms and conditions as the court thinks fit.[437] Unlike dealing with other issues in relation to varying creditors' rights which is required to seek creditors' decisions in advance, there is no requirement for the court to obtain creditors' approval before reducing the value of long-term insurance contracts. However, as the value of long-term insurance contracts constitutes the core interest of long-term insurance policyholders, if it is not required that decisions from creditors should be sought before long-term insurance benefits are written down, then to what extent does the design of "creditors' decision" still make sense in the administration of a long-term insurer? In other words, the design of the court's power to write down policyholders' benefits in effect largely reduces the

[435] Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, SI 2010/3023, sch para 2.

[436] Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, SI 2010/3023, sch para 1.

[437] Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, SI 2010/3023, sch para 2.

significance the normal design of "creditors' decision" can have in the administration of a long-term insurer. It is still unclear how these two pieces of design can be coordinated in logic.

Different from the duty to continue long-term insurance business, discretion has been given to the administrator with regard to how general insurance business will be dealt with in an administration. In fact, it was once also proposed that the administrator should be required to secure continuity of general insurance contracts during an administration. But in light of the fact that general insurance contracts are generally of a short-term nature and it is easy for policyholders to obtain substitutes from other insurers, the legislation eventually did not choose to impose such a duty on administrators, but left them with latitude in deciding the way general insurance policyholders would be treated in administration.[438] This is also different from the provision about how general insurance contracts should be dealt with in winding-up. While in winding-up, general insurance contracts will automatically terminate when a winding-up commences,[439] in administration, it may be the case that general insurance contracts lapse as the coverage periods expire, general insurance contracts are transferred to other insurers, or substitute insurance contracts are issued by other insurers to provide continuous insurance coverage to policyholders.[440]

[438] HM Treasury, 'Proposals to Strengthen the Administration Regime for Insurers' (1 November 2010).

[439] For more information about how general insurance contracts will be dealt with in winding-up, see Section 4.2.3.2 in this Chapter.

[440] HM Treasury, 'Proposals to Strengthen the Administration Regime for Insurers' (1 November 2010).

4.2.2.3. Process of Administration

In normal circumstances, the administrator should make a statement setting out proposals for achieving the purpose of administration within the period of 8 weeks beginning with the day on which the company enters administration, or within the period which is extended by the court.[441] These proposals showing how the administration will be carried out are subject to the decision of the company's creditors. By means of a qualifying decision procedure or the deemed consent procedure,[442] the administrator should seek a decision from the company's creditors as to whether they approve the proposals.[443] It is likely that the company's creditors will approve the administrator's proposals without modification or with modification consented to by the administrator, or that the company's creditors will reject the proposals.[444] If the proposals are approved, the administrator should implement the proposals and manage the company's affairs, business and property according to the proposals.[445] However, if the company's creditors reject the proposals, the court may bring the administration to an end or make any order it thinks appropriate.[446]

Generally speaking, a decision of approval is made by creditors when a majority (in

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[441] Insolvency Act 1986, sch B1 paras 49 and 107.

[442] The deemed consent procedure is a procedure where the creditors will be treated as having made the decision which is proposed by the administrator if less than 10% in value of the creditors object to the proposed decision. See Insolvency Act 1986, s 246ZF.

[443] Insolvency Act 1986, sch B1 para 51(1).

[444] Insolvency Act 1986, sch B1 para 53.

[445] Insolvency Act 1986, sch B1 para 68.

[446] Insolvency Act 1986, sch B1 para 55.

value) of those voting have voted in favour of the proposed decision.[447] The value of creditors' voting rights corresponds to the amounts of their unsecured debts, which normally should be claimed by creditors with proofs.[448] In administration, each creditor's debt for voting purposes will be calculated as at the date on which the company entered administration, less any amounts paid to the creditor after that date or any adjustment by way of set-off.[449] A creditor with a debt of an unliquidated or unascertained amount may vote if the administrator puts an estimated minimum value on the debt for voting purposes.[450]

In the case of an insurer, since most insurance debts are contingent or prospective, how to calculate policyholders' voting rights poses a challenge for the administrator. Unlike in the winding-up procedure where there are special provisions guiding how to value policyholders' rights,[451] there is no special provision about valuing policyholders' rights in administration. In fact, when drafting the Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, the Treasury once proposed to align the method of valuing policyholders' rights in administration with the equivalent method adopted in winding-up. But after taking account of most of the responses received during the consultation period, the government eventually

[447] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 15.34(1).

[448] Insolvency (England and Wales) Rules 2016, SI 2016/1024, rr 15.9(1) and 15.31.

[449] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 15.31(1)(a).

[450] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 15.31(2).

[451] For a more detailed discussion of how policyholders' rights will be valued in winding-up, see Section 4.2.3.2 in this chapter.

decided not to impose a duty on administrators to apply the valuation rules analogous to those for winding-up, leaving administrators with flexibility to choose the method to be used in valuing policyholders' rights.[452] Thus, although no particular provision has been made in this regard, it is reasonable to infer that the government will expect the administrator to follow the valuation method adopted in winding-up in the absence of a better method.

However, due to the fact that the objectives of administration are different from those of winding-up, more difficulties may arise in valuing policyholders' rights for voting purposes in administration. For example, unlike in winding-up where general insurance contracts will normally terminate, general insurance contracts will continue to be in force in administration. As a consequence, unlike the situation where claims of a large proportion of policyholders are fixed in winding-up, claims of policyholders change all the time during the administration process, since insured events may take place from time to time and insurance claims will thus be filed with the insurer. While it is fair that policyholders' voting rights based on insurance claims are calculated as on the liquidation date, it seems unfair if policyholders' voting rights are just calculated according to their debts as at the date on which the insurer enters administration. There is no reason why the insurance claims occurring after the date on which the insurer enters administration should be treated differently from the insurance claims

[452] See Explanatory Memorandum to the Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, para 8.2; HM Treasury, 'Proposals to Strengthen the Administration Regime for Insurers' (1 November 2010).

accrued as on that date. Therefore, it will always be a tough task for the administrator to find an appropriate way to value general policyholders' rights for voting purposes in the administration.

4.2.2.4. Ending of Administration

When an administration comes to an end, the company might be returned to its original management after surviving the crisis, brought into a winding-up, or dissolved directly. Generally speaking, with regard to an administration where the administrator is appointed by a court order, the administration will be terminated mainly through one of these three ways: automatic termination, termination by an order of the court, or termination by registration of a notice in the registrar of companies.

The administration of a company will terminate automatically at the end of the period of one year beginning with the date on which the administrator is appointed, unless the period is extended by an order of the court, or by consent of the company's creditors.[453] Considering the complexity involved in dealing with insurers, it is specifically provided that in the case of insurers, the period in question is 30 months.[454]

Instead of waiting for the appointment to be ceased, an administrator may take the initiative to terminate the administration, either by making an application to the court or by sending a notice to the registrar of companies. With regard to making an

[453] Insolvency Act 1986, sch B1 paras 76 and 78. It is worth noting that if the administration period is extended by consent of the company's creditors, the extension period should not exceed one year.

[454] Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, SI 2010/3023, sch para 6.

application to the court for the termination, it is provided that the administrator should do so if he thinks the purpose of administration cannot be achieved, or he thinks the company should not have entered administration, or the company's creditors decide that he must make the application.[455] In the case of an administration where the administrator is appointed by a court order, the administrator is also required to apply to the court for terminating the administration when he thinks that the purpose of administration has been sufficiently achieved.[456] Upon the administrator's application, the court may provide for the appointment of an administrator to cease to have effect from a specified time or make any decisions as the court thinks appropriate.[457] With regard to sending a notice to the registrar of companies for the termination, the administrator may by doing so convert the administration to a creditor's voluntary winding-up or a dissolution. Where the administrator thinks that after making full payments to secured creditors, a distribution will be made to unsecured creditors, the administrator may send a notice to the registrar of companies to convert the administration to a creditor's voluntary winding-up; then upon the registration of the notice by the registrar of companies, the appointment of the administrator will cease to have effect, and the company will thus enter a creditor's voluntary winding-up.[458] But where the administrator thinks that

[455] Insolvency Act 1986, sch B1 para 79 (2).

[456] Insolvency Act 1986, sch B1 para 79 (3).

[457] Insolvency Act 1986, sch B1 para 79 (1)(4).

[458] Insolvency Act 1986, sch B1 para 83.

there are no further distributable assets to be paid to creditors,[459] the administrator should send a notice to the registrar of companies to convert the administration to a dissolution; then upon the registration of the notice by the registrar of companies, the appointment of the administrator will cease to have effect, and the company is deemed to be dissolved at the end of the period of three months beginning with the date of registration of the notice.[460]

To terminate the administration of an insurer, in addition to the administrator's initiative, the Secretary of State can still petition the court for a winding-up order on the ground of the public interest, and the PRA and the FCA are also empowered to petition the court for a winding-up order.[461] Then if the court decides to make a winding-up order upon the petition, the administration will be converted into a compulsory winding-up consequently. Therefore, in theory, if the Secretary of State, the PRA or the FCA is not satisfied with the work done by the administrator in administration, they can initiate a compulsory winding-up to replace the administration.

4.2.3. Winding-up

Winding-up, as a market exit approach, is always available for insurers. As early as in

[459] Although the wording used in the provision is that "If the administrator of a company thinks that the company has no property which might permit a distribution to its creditors, …", the courts held that this should be read as though the words "or no further distributable assets" were included in the context. See Ian F. Fletcher, *The Law of Insolvency* (5th edn, Sweet & Maxwell 2017) 570.

[460] Insolvency Act 1986, sch B1 para 84.

[461] Insolvency Act 1986, sch B1 para 82(1).

the Life Assurance Companies Act 1870, there were already special provisions adapting the winding-up procedure for insurers. In this section, revolving around how a winding-up of an insurer may work, the discussion will show that, based on general insolvency law, special provisions have been made to, for example, describe the role of the regulators during the process, emphasise the continuation of long-term insurance business, provide detailed guidance to value policyholders' claims and give priority to policyholders' claims in the claims hierarchy. Although most of the modifications help make the winding-up procedure more suitable for insurers, some confusion has also been created. For example, as the court is empowered to reduce the value of the insurer's contracts so as to keep the insurer as a going concern rather than make a winding-up order,[462] and the court is also empowered to reduce the value of long-term insurance contracts when continuing long-term insurance business in winding-up, without seeking creditors' decisions in either of these situations,[463] it remains a question how these arrangements can be logically coordinated with the normal arrangements under which creditors' decisions should be sought on significant issues in an insolvency procedure.

4.2.3.1. Commencement of Winding-up

There are two types of winding-up: voluntary winding-up and compulsory winding-up, either of which can lead to distributing a company's assets to its creditors and ending

[462] Financial Services and Markets Act 2000, s 377.

[463] Financial Services and Markets Act 2000, s 376(8)(9).

the company as a legal entity. The most noteworthy difference between them is that while the court may not get involved much in a voluntary winding-up, the court will preside over a compulsory winding-up. This difference is largely shown in the commencement of a winding-up. In many other aspects, common rules are shared by voluntary winding-up and compulsory winding-up.

(1) Voluntary Winding-up

By means of passing a resolution by the general meeting, a company can take the initiative to enter a voluntary winding up. Generally speaking, if the company is still solvent, it will enter a members' voluntary winding-up, and if the company is insolvent, it will enter a creditors' voluntary winding-up.[464] In either case, an insolvency practitioner from the private sector will be appointed as the liquidator to carry out the voluntary winding-up. By virtue of a voluntary winding-up, a company can exit the market either because of the adjustment in its business strategy, or as a means of tackling financial difficulties it is facing. Given the fact that a voluntary winding-up does not require much involvement of the court, it will cost much less, in terms of expenses and time, compared with a compulsory winding-up. So the voluntary winding-up procedure is always an appealing procedure for a company which seeks to exit the market on its own initiative. But after a voluntary winding-up commences, creditors, contributories, or the official receiver may still petition the court to convert the

[464] Insolvency Act 1986, ss 89 and 90.

voluntary winding-up into a compulsory winding-up.[465]

When it comes to the voluntary winding-up of insurers, the distinctive feature mainly lies in the involvement of the regulators. For an insurer which effects or carries out contracts of long-term insurance, it may not be wound up voluntarily without the consent of the PRA.[466] For a general insurer, when it is in a voluntary winding-up, the PRA or the FCA is entitled to receive any materials required to be sent to creditors, to attend any meeting or decision procedure for creditors, to be heard at any hearing of the court in relation to the voluntary winding up, to refer any relevant issue to the court for decision, even to petition the court to convert the voluntary winding-up into a compulsory winding-up, etc.[467]

Although it seems appropriate for a healthy insurer to exit the market through a voluntary winding-up following its adjustment in the business strategy, it is doubtful whether a troubled insurer should still be allowed to enter a voluntary winding-up. Actually, when the government proposed to reform the insolvency system for non-life insurers in 1994, there already existed consideration of withdrawing an insolvent insurer's right to petition for a voluntary winding-up.[468] Thus, in this thesis, the discussion of the winding-up procedure will focus mainly on compulsory winding-up. In fact, many aspects to be discussed are common to both compulsory winding-up and

[465] Insolvency Act 1986, ss 116 and 124(5).

[466] Financial Services and Markets Act 2000, s 366(1).

[467] Financial Services and Markets Act 2000, s 365.

[468] Department of Trade and Industry (now the Department for Business, Energy and Industrial Strategy), 'Proposals for Dealing with Insolvent Non-life Insurance Companies' (December 1994), para 71.

voluntary winding-up.

(2) Compulsory Winding-up

To initiate a compulsory winding-up of a company, a petition should be presented to the court either by the company, the directors, creditors (including those with contingent or prospective claims),[469] contributories, or the Secretary of State.[470] A compulsory winding-up commences when the court grants the petition and issues a winding-up order. There are various circumstances in which the court may issue a winding-up order towards a company, including the circumstance where the company has resolved that it should be wound up by the court, the company is unable to pay its debts, it is just and equitable to wind up the company, etc.[471] Thus, factors considered in these circumstances are inclusive. Except for one circumstance which concerns a company's inability to pay its debts, other circumstances make no reference to the financial condition of a company.

There are two standards to test if a company is unable to pay its debts: the cash-flow insolvency standard and the balance-sheet insolvency standard. According to the cash-flow insolvency standard, a company is deemed unable to pay its debts –

[469] Generally speaking, a contingent claim is a claim the debtor having an obligation to pay upon the occurrence of an uncertain event in the future, and a prospective claim is a claim the debtor having an obligation to pay at a certain time in the future. Therefore, while whether a contingent claim will eventually crystallise is uncertain, a prospective claim will definitely mature at some point. See Winter v IRC [1961] 3 All ER 855. See also Re Northern Counties of England Fire Insurance Company [1880] 17 Ch. D. 337; Re Liberty International Plc [2010] 6 WLUK 313.

[470] Insolvency Act 1986, s 124.

[471] Insolvency Act 1986, s 122.

[(a)] if a creditor to whom the company is indebted in a sum exceeding £750 then due has served on the company a written demand (in the prescribed form) requiring the company to pay the sum so due and the company has for 3 weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor, or

(b) if, in England and Wales, execution or other process issued on a judgement, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part, or

(c) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.[472]

According to the balance-sheet insolvency standard, a company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.[473] So despite the fact that a company can still pay the debts as they fall due, if there is evidence showing the company is insolvent from the balance-sheet perspective, the company may also be deemed unable to pay its debts. As a consequence, when a company becomes unable to pay its debts according to either of these two standards, a compulsory winding-up can be initiated against the company.

[472] Insolvency Act 1986, s 123(1).

[473] Insolvency Act 1986, s 123(2).

Specific to insurers, modifications have been made to involve regulators in the process. As is provided, the PRA or the FCA also has the standing to petition the court for a winding-up of an insurer.[474] On such a petition, the court may grant a winding-up if (a) the insurer's permission to effect or carry out insurance contracts has been cancelled by the PRA, (b) the insurer is unable to pay its debts,[475] or (c) the court is of the opinion that it is just and equitable that the insurer should be wound up.[476] By virtue of this, it is likely that the PRA or the FCA will initiate a compulsory winding-up against an insurer which seriously falls below statutory or regulatory requirements, regardless of whether or not the insurer is insolvent. Also, if the petition for a winding-up of an insurer is presented to court by any other person, a copy of the petition must be served on the PRA or the FCA by the petitioner.[477] After the compulsory winding-up commences, the PRA or the FCA is still entitled to be heard at any relevant hearing of the court, to receive any materials required to be sent to creditors, to attend any meeting or decision procedure for creditors, to apply to the court for a scheme of arrangement to be sanctioned if such an arrangement is proposed between the insurer and its creditors, etc.[478]

When dealing with a petition for a winding-up of an insurer which has been proved

[474] Financial Services and Markets Act 2000, s 367(1)(1A).

[475] In addition to the standards which apply to all companies, an insurer will also be deemed unable to pay its debts if the insurer is in default on an obligation to pay a sum due and payable under an insurance contract. See Financial Services and Markets Act 2000, s 367(4)(5).

[476] Financial Services and Markets Act 2000, s 367(3).

[477] Financial Services and Markets Act 2000, s 369.

[478] Financial Services and Markets Act 2000, s 371.

to be unable to pay its debts, instead of making a winding-up order the court is empowered to reduce the value of one or more of the insurer's contracts, subject to terms and conditions as the court thinks fit.[479] As a consequence, the court has broad discretion in deciding whether to keep the insurer as a going concern by writing down the contract value of the insurer's creditors or to grant the winding-up petition. The court's power here has its origins in the Life Assurance Companies Act 1870. It is held that with the use of this power by the court, the interests of policyholders may be better served, since policyholders can maintain their contractual rights on a continuing, albeit reduced, basis, rather than just be entitled to dividends when distribution is made in liquidation.[480] In the case of *Capital Annuities Ltd* in 1978, it was established by the court that: (1) what can be reduced are prospective debts under insurance contracts, but not debts which have accrued at the date of the winding-up petition and not debts or liabilities of any other kind; (2) the court has jurisdiction to order a proposed reduction without directing meetings of policyholders or any further advertisement or communication with them; and (3) the reduction in contracts does not need to conform to the principle of pari passu, as long as the court thinks the reduction is equitable.[481] Although the case was then regarded as a test case, whether it is appropriate to follow all the main conclusions reached in this case remains a question, especially in the current insurance market after more than 40 years of

[479] Financial Services and Markets Act 2000, s 377.

[480] *Re Capital Annuities Ltd* [1978] 3 All ER 704.

[481] *Re Capital Annuities Ltd* [1978] 3 All ER 704.

development.

As a matter of fact, it is now widely accepted that writing down debts of a troubled financial institution constitutes an effective “bail-in” option which can be utilised to tackle crises in the financial market.[482] When it comes to reducing the value of contracts of an insurer, in accordance with the normal design, the debts on which reduction may be imposed are not limited to the prospective debts under insurance contracts, but are the debts under contracts of all kinds, regardless of whether or not the debts have accrued.[483] For example, debts of debenture holders of a troubled insurer are believed to be a significant type of debt which may be written down for the purposes of rescuing an insurer. Therefore, it is reasonable to expect that with the existing statutory power of “reducing the value of contracts instead of winding up”, the court can use its discretion to write down any kind of contractual debts of a troubled insurer, rather than just contingent or prospective debts under insurance contracts. On the other hand, however, it is also reasonable to argue that the effect of

[482] See, for example, John C. Coffee, 'Bail-ins Versus Bail-outs: Using Contingent Capital to Mitigate Systemic Risk' (23 October 2010) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1675015> accessed 25 November 2017; Jianping Zhou and others, 'From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions' (IMF Stuff Discussion Note, 24 April 2012) <www.imf.org/external/pubs/ft/sdn/2012/sdn1203.pdf> accessed 25 November 2017; Jennifer Donohue, 'Section 377 of the Financial Services and Markets Act 2000 and Bank "Bail-in": Insurance Wine in Bank Bottles!' (2013) 28(5) Butterworths Journal of International Banking & Financial Law 263; Shinya Kobayashi, 'Statutory Bail-in for an Orderly Resolution of Insurers' (2017) 10(2) Journal of Risk Management in Financial Institutions 164.

[483] See, for example, FSB, ‘Key Attributes of Effective Resolution Regimes for Financial Institutions’ (October 2014), Appendix II – Annex 2 paras 4.4 and 4.5 <www.fsb.org/wp-content/uploads/r_141015.pdf> accessed 5 March 2017; IAIS, ‘Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups’ (November 2019) ICP 12.7 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

this power is conflicting with the effect of administration. Since reduction of the value of contracts in fact constitutes a restructuring of an insurer's debts and the decision of this restructuring entirely rests with the court, without the need to seek approval from creditors in advance, it remains unclear how this arrangement can be coordinated with the administration procedure, where a restructuring of an insurer's debts will be subject to the decision of creditors.

4.2.3.2. Effects of Winding-up

If the court grants the petition for a winding-up and thus makes a winding-up order, in most circumstances, the winding-up is deemed to commence at the time when the petition is presented.[484] Various moratorium effects will occur as a consequence. As is provided, after the commencement of a compulsory winding-up, any disposition of the company's property will be void, unless the court otherwise orders, and any attachment, sequestration, distress or execution put in force against the estate or effects of the company will also be void.[485] When a winding-up order has been made, no action or proceeding should be proceeded with or commenced against the company or its property, except by leave of the court.[486] Also, at any time after the presentation of a winding-up petition, and before a winding-up order has been made, the company or any of its creditors or contributories may still apply to the relevant

[484] Insolvency Act 1986, s 129.

[485] Insolvency Act 1986, ss 127 and 128.

[486] Insolvency Act 1986, s 130.

court to stay or restrain any existing action or proceeding which is against the company.[487]

On the making of a winding-up order, the official receiver automatically becomes the liquidator of the company and will continue in office until such time as an insolvency practitioner from the private sector is appointed, if any, as the liquidator.[488] Regardless of whether the official receiver remains as the liquidator, the official receiver has the duty to investigate the causes of the failure of the company or other affairs of the company, and to make such report to the court as he thinks fit.[489] The functions of the liquidator in a compulsory winding-up are to secure that the assets of the company are got in, realised and distributed to the company's creditors and, if there is a surplus, to the persons entitled to it.[490] Correspondingly, a wide range of powers which may be necessary for winding up the company's affairs and distributing its assets are vested in the liquidator, such as the power to pay creditors, the power to make any compromise, the power to bring or defend any legal proceeding on behalf of the company, and the power to carry on the business of the company as may be necessary.[491]

The liquidator may also apply to the court to appoint a special manager to deal with the company's business or property, if it appears to the liquidator that there is a need

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[487] Insolvency Act 1986, s 126.

[488] Insolvency Act 1986, s 136.

[489] Insolvency Act 1986, s 132.

[490] Insolvency Act 1986, s 143.

[491] See Insolvency Act 1986, sch 4.

for such an appointment in consideration of the nature of the business or property of the company, or the interests of the company's creditors or contributories or members generally.[492] Unlike a liquidator, who should be qualified as an insolvency practitioner, any person who is deemed suitable for the task can be appointed as a special manager. Upon the appointment, the special manager will have such powers as may be entrusted to him by the court, even powers enjoyed by the liquidator.[493] By virtue of this, in the case of an insurer, it is possible that persons with expertise in actuarial science or finance may be appointed as special managers to assist the liquidator to carry out the winding-up.

In order to participate in the winding-up, a creditor should submit a proof of the debt, unless the court orders otherwise or the debt is a small debt which does not exceed £1,000.[494] After examination, the liquidator may either admit the proof or reject the proof in whole or in part.[495] If the creditor is dissatisfied with the liquidator's decision, the creditor may apply to the court for the decision to be reversed or varied.[496] The amount of the debt so admitted by the liquidator will not only form the basis of the creditor's right to receive a dividend in the distribution, but also represent the value of the creditor's voting right in relevant decision procedures during the winding-up process. The liquidator may seek a decision on any matter from the

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[492] Insolvency Act 1986, s 177(1)(2).

[493] Insolvency Act 1986, s 177(3)(4).

[494] Insolvency (England and Wales) Rules 2016, SI 2016/1024, rr 14.1(3) and 14.3.

[495] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 14.7.

[496] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 14.8(1).

company's creditors, and must do so if it is requested by one-tenth in value of the creditors.[497] Unless it is otherwise provided, a decision will be made by creditors when a majority (in value) of those voting have voted in favour of the proposed decision.[498] All efforts made in a winding-up are working towards the distribution of the debtor company's assets among creditors. So when it is appropriate, the liquidator should pay dividends to the creditors according to the claims hierarchy as well as the pari passu principle.

Targeted at insurers, modifications have been made mainly in the following aspects:

A. Continuation of Long-term Insurance Business

Given the nature of long-term insurance contracts, it is the norm that in the winding-up of an insurer, except for effecting new insurance contracts, the liquidator will carry on long-term insurance business with a view to its being transferred as a going concern to another insurer or other insurers, unless the court otherwise makes a stop order to discontinue the long-term business.[499] In order to make the continuation of long-term business possible, if the court thinks fit, it may reduce the value of one or more of the long-term insurance contracts, with such terms and conditions that are deemed appropriate.[500] To this end, an independent actuary may be appointed to investigate whether it is desirable to continue the long-term insurance contracts or whether it is

[497] Insolvency Act 1986, s 168(2).

[498] Insolvency (England and Wales) Rules 2016, SI 2016/1024, r 15.34(1).

[499] Financial Services and Markets Act 2000, s 376(2)(3).

[500] Financial Services and Markets Act 2000, s 376(8)(9).

necessary to impose reductions on the long-term insurance contracts for the purposes of successful continuation of them.[501]

It is required that assets and liabilities of long-term insurance business of an insurer should be separated from those of other business.[502] In winding-up, assets of the long-term insurance business should only be used to meet liabilities of the long-term insurance business, and assets of the other business should only be used to meet liabilities of the other business, unless there is an excess of assets in either type of the business.[503] In cases where no stop order has been made by the court, if a decision needs to be sought from creditors, only creditors with liabilities of the long-term business can participate in a decision procedure relating to long-term business assets, and, likewise, only creditors of the other business can participate in a decision procedure relating to the other business assets.[504] Whenever the long-term insurance business is transferred as a going concern to another insurer or other insurers, or substitute policies are issued by another insurer or other insurers, assets attached to the long-term insurance business should also be transferred to those insurers.[505] If a special manager is needed for the interests of policyholders of the long-term insurance business, the liquidator may apply to the court for the appointment of a special

[501] Financial Services and Markets Act 2000, s 376(10).

[502] Insurers (Winding Up) Rules 2001, SI 2001/3635, rr 5, 9 and 10.

[503] Insurers (Winding Up) Rules 2001, SI 2001/3635, rr 11 and 13.

[504] Insurers (Winding Up) Rules 2001, SI 2001/3635, r 24.

[505] Insurers (Winding Up) Rules 2001, SI 2001/3635, r 11.

manager to deal with relevant issues.[506]

Great discretion has been given to the court in deciding how to deal with long-term insurance business in winding-up, and there is no requirement for the court to consult creditors before making a decision. During the period of continuing long-term insurance business, before a stop order is made, the court may permit to pay dividends to creditors whose debts fell due before the liquidation date,[507] or to long-term insurance policyholders even if their debts fell due on or after the liquidation date.[508] This constitutes a major exception to the stay effect a winding-up will have in normal circumstances and functions to keep long-term insurance business running without interruption, minimising the adverse effects a winding-up of an insurer may bring to policyholders. In addition, as mentioned earlier, in order to make the continuation of long-term insurance contracts feasible, the court may even reduce the value of one or more of the long-term insurance contracts, with such terms and conditions as it thinks fit.[509] Just as creditors will always bear losses to a certain extent when a company is insolvent, reducing the value of the continuing long-term insurance contracts functions to produce similar effects, distributing losses among long-term insurance policyholders when an insurer is in winding-up. Thus, it is acceptable if the court

[506] Financial Services and Markets Act 2000, s 376(4) – (7).

[507] The liquidation date refers to the date of the winding-up order or the date on which a resolution for the winding up of the company is passed by the members of the company (or the policyholders in the case of a mutual insurance company) and, if both a winding-up order and winding-up resolution have been made, the earlier date. See Insurers (Winding Up) Rules 2001, SI 2001/3635, r 2.

[508] Insurers (Winding Up) Rules 2001, SI 2001/3635, r 23.

[509] Financial Services and Markets Act 2000, s 376(8)(9).

reduces the value of the long-term insurance contracts to an appropriate extent, albeit in a way which does not require prior approval of creditors. However, as most policyholders are eligible for the FSCS's protection, and will be entitled to receive the compensation payment of 100% of their long-term insurance claims from the FSCS when an insurer is in winding-up,[510] it remains unknown from provisions in the current legislation how the court's power of reducing the value of the long-term insurance contracts can be coordinated with the full protection the FSCS should provide to long-term insurance policyholders. In other words, if the court decides to reduce the value of the continuing long-term insurance contracts, then policyholders will be entitled only to reduced insurance benefits, making the goal of the FSCS's 100% protection unachievable.

B. Valuation of Insurance Claims

Unlike valuing most claims in the winding-up of an ordinary company, which is carried out based on examining proofs of debts filed by creditors, valuing insurance claims in the winding-up of an insurer, generally speaking, is largely a process of determining the present value of insurance contracts as on a certain date. Except in cases where losses insured under general insurance policies occur before the liquidation date, there is no requirement for policyholders to prove the amounts of insurance claims in the winding-up, and the value of insurance claims will be determined by the liquidator based on records held by the insurer according to relevant rules set in the Insurers

[510] For a more detailed discussion of the FSCS's protection function, see Part 4.3 in this chapter.

(Winding Up) Rules 2001.

There are mainly three sets of rules in relation to when and how insurance claims will be valued by the liquidator. The first set is targeted at general insurance policies, which provides that policies will terminate on the liquidation date and, generally speaking, the value of policies upon the termination will equal the amounts of unearned premiums, unless the amounts repayable on early termination of policies according to the terms of policies are greater than the amounts of unearned premiums.[511] The second set is targeted at long-term insurance policies in cases where no stop order has been made, which mainly provides that apart from claims under policies that have fallen due for payment before the liquidation date, the value of policies will equal the present value of policies on the liquidation date.[512] The third set is targeted at long-term insurance policies in cases where a stop order has been made, which mainly provides that policies will terminate on the date the stop order is made, and apart from claims under policies which have fallen due for payment before the date of the stop order, the value of policies will equal the present value of policies on the date of the stop order.[513] After insurance policies are valued, the liquidator should give notice to policyholders, and policyholders will be bound by the value unless the court otherwise orders.[514] Where the liquidator looks for a decision from

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[511] See Insurers (Winding Up) Rules 2001, SI 2001/3635, r 6 and sch 1.

[512] See Insurers (Winding Up) Rules 2001, SI 2001/3635, r 7, and schs 2, 3 and 4.

[513] See Insurers (Winding Up) Rules 2001, SI 2001/3635, r 8 and sch 5.

[514] Insurers (Winding Up) Rules 2001, SI 2001/3635, r 22.

the insurers' creditors during the winding-up process, the value enjoyed by policyholders will also be the value of their voting rights in a decision procedure.[515]

C. Claims Hierarchy

Before the Insurers (Reorganisation and Winding Up) Regulations 2003[516] came into effect, the claims hierarchy of an insurer in the winding-up was the same as that of an ordinary company, and policyholders were treated like any other unsecured creditors in the distribution process. In order to provide policyholders with more protection, the Insurers (Reorganisation and Winding Up) Regulations 2003, implementing the EU Directive on the reorganisation and winding-up of insurance undertakings,[517] carried out a reform to give insurance debts a priority over most other unsecured debts.

Generally speaking, in the winding-up of an insurer, the order of priority in the distribution is as follows: (1) expenses of the winding up, (2) preferential debts,[518] (3) debts secured by floating charges, (4) insurance debts, (5) all other debts.[519] Debts with a higher priority will be paid in full before debts with a lower priority can be paid, and within the same order of priority debts will be treated equally. Since policyholders form the majority of creditors of an insurer, it is often the case that assets of the insurer

[515] Insurers (Winding Up) Rules 2001, SI 2001/3635, r 22(6).

[516] Note: On 18th February 2004, the Insurers (Reorganisation and Winding Up) Regulations 2003 was revoked and entirely replaced by the Insurers (Reorganisation and Winding Up) Regulations 2004.

[517] Council Directive 2001/17/EC of 19 March 2001 on the reorganisation and winding-up of insurance undertakings [2001] OJ L 110/28, which was repealed and incorporated in the Solvency II Directive.

[518] Preferential debts include contributions to occupational pension schemes, remuneration of employees, etc. See Insolvency Act 1986, ss 175 and 386, and sch 6.

[519] See Insurers (Reorganisation and Winding Up) Regulations 2004, SI 2004/353, reg 21; Insolvency Act 1986, ss 175 and 176ZA.

in winding-up are not sufficient to meet all insurance debts held by policyholders. Then insurance debts will abate in equal proportions according to the pari passu principle.[520]

Where there is a floating charge, it is required that a prescribed part of the net property, which is otherwise available for claims of secured creditors, should be allocated for the satisfaction of unsecured debts.[521] In such a circumstance, insurance debts will also be paid out of the prescribed part in priority to all other unsecured debts.[522]

Therefore, by virtue of the priority in the claims hierarchy, claims of policyholders are accorded special treatment in the distribution of an insurers' assets in winding-up. This is in line with the objective of policyholder protection which should be pursued in dealing with troubled insurers.

4.2.4. Scheme of Arrangement

A scheme of arrangement is a compromise or arrangement which is proposed between a company and its creditors or members, or any class of its creditors or members.[523] Due to the fact that before the Financial Services and Markets Act 2000, administration was not allowed to be applied to insurers, the industry gradually developed a way of using schemes of arrangement to address crises of insurers so as to achieve better

520 Insurers (Reorganisation and Winding Up) Regulations 2004, SI 2004/353, reg 21 (4).

521 For more information about the "prescribed part", see Insolvency Act 1986 (Prescribed Part) Order 2003, SI 2003/2097.

522 Insurers (Reorganisation and Winding Up) Regulations 2004, SI 2004/353, reg 21(7).

523 Companies Act 2006, s 895(1).

results than directly winding up troubled insurers.[524] In the last few decades, schemes of arrangement constituted the most frequently adopted approach to dealing with crises of insurers. However, due to the changes in laws as well as the regulatory authorities' attitudes in recent years, it is not clear to what extent schemes of arrangement can still function in dealing with troubled insurers in the future. In this section, the analysis will show how schemes of arrangement may be applied in the case of crises of insurers.

4.2.4.1. Process of a Scheme of Arrangement

Unlike CVA, administration and winding-up, which are insolvency procedures mainly provided for in the Insolvency Act 1986 and designed to deal with troubled companies, schemes of arrangement are measures provided for in part 26 of the Companies Act 2006 and can be used for different purposes, eg merger, acquisition, division and crisis management. In the case of dealing with a troubled insurer, a scheme of arrangement is often used by the insurer to reach a compromise with its creditors, so that the insurer can run off in an orderly manner over a couple of years, or bring early closure to the insurance business and exit the market in a relatively speedy way. Since a scheme of arrangement itself does not have any moratorium effects, to prevent creditors from taking any action against the insurer or its property during the preparation of the scheme, a scheme of arrangement is usually used after the entry

[524] Nigel Montgomery, Gabriel Moss and Tom Smith, 'England' in Gabriel Moss and others (eds), *Cross-Frontier Insolvency of Insurance Companies* (Sweet & Maxwell 2001).

into a provisional liquidation. Normally, upon a petition for a winding-up and an application for the appointment of a provisional liquidator, the court may appoint a provisional liquidator, who will then act as the scheme administrator to prepare a scheme of arrangement. As a result, the combination of a provisional liquidation and a scheme of arrangement produces the effects similar to those of an insolvency procedure. Thus, it is fair to say that a scheme of arrangement functions as a quasi-insolvency procedure in the current CMME mechanism.

There are three stages in promoting a scheme of arrangement between an insurer and its creditors.[525] At the first stage, upon an application for summoning a meeting or meetings of creditors to consider the proposed scheme, the court will determine whether or not there should be more than one meeting and how the meeting or meetings should be summoned, so as to 'ensure that those who are to be affected by the compromise or arrangement proposed have a proper opportunity of being present (in person or by proxy) at the meeting or meetings'.[526] Creditors with different rights should be grouped into different classes for the purposes of different meetings, and each class 'must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest'.[527] Following the court's summoning order, at the second stage, the meeting or meetings of creditors will be summoned to vote on the proposed scheme. The

[525] See *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241, [2002] BCC 300.

[526] *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241, [2002] BCC 300.

[527] *Sovereign Life Assurance Co (In Liquidation) v Dodd* [1892] 2 QB 573 (QB).

scheme will be approved if a majority in number representing 75% in value of the creditors present and voting (in person or by proxy) at the meeting, or at each meeting, vote in favour of the scheme.[528] Upon the approval for the scheme from creditors, at the third stage, an application should be made to the court for sanctioning the scheme. Although the court has unfettered discretion to decide whether to sanction the scheme, it is rare that the court goes against the creditors' approval and refuses to sanction the scheme.[529] But if it comes to the court's observation at this stage that the meeting or meetings of creditors have not been properly constituted, the court may still reach a conclusion that it has no jurisdiction to sanction the scheme at all.[530] Upon the sanction of the court, the scheme will have a binding effect on the insurer and the creditors affected by the scheme (normally referred to as the scheme creditors), no matter whether or not they have voted at the meetings of creditors.

Although there are no provisions in the primary legislation about the role regulatory authorities (ie the PRA and the FCA) should play in relation to a scheme of arrangement promoted by an insurer, regulatory authorities expect the insurer to communicate with them in advance so as to ensure that the scheme will be consistent with regulatory objectives of safety and soundness and policyholder protection.[531] So when an insurer is contemplating a scheme, it should provide details of the proposed

[528] Companies Act, s 899(1).

[529] *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621 (Ch), [2006] BCC 14.

[530] See *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621 (Ch), [2006] BCC 14.

[531] See PRA, 'The Prudential Regulation Authority's Approach to Schemes of Arrangement Proposed by PRA-Authorised Insurers under Part 26 of the Companies Act 2006' (April 2014).

scheme to the regulatory authorities before filing any application to the Court, and, after assessing the proposed scheme, the regulatory authorities will express their views as to whether they have any objection to it.[532] The opinions from the regulatory authorities will be an important consideration at the later stage when the court decides whether the scheme should be sanctioned.

The approval of creditors' meetings constitutes a prerequisite for the effectiveness of a scheme. But in the case of a troubled insurer, there exist major challenges in relation to creditors' meetings due to the special nature of insurance business. These challenges mainly arise from two sources:

A. Classification of Creditors

Since the rights of creditors (including policyholders) against the insurer may be different, what has to be determined is whether creditors should be grouped into different classes for different meetings and, in case of an affirmative answer, what class a certain creditor should fall into. Decisions of this kind have to be made on a case-by-case basis, and in different circumstances, creditors of a particular type may be treated differently. For example, while in *Re Hawk Insurance Co Ltd*, a case where the insurer was insolvent, the court hearing the case held that policyholders with incurred but not

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[532] PRA, 'Consultation Paper: Schemes of Arrangement by General Insurance Firms' (September 2013) para 2.7.

reported claims[533] should fall into the single class together with other creditors,[534] in *Re British Aviation Insurance Co Ltd*, a case where the insurer was solvent, the court hearing the case was of the opinion that policyholders with incurred but not reported claims had different rights from policyholders with accrued claims, and thus should fall into a separate class.[535] It is important that in each case the creditors' meeting or meetings are properly constituted, otherwise the court may not have jurisdiction to sanction the scheme. Just as in *Re British Aviation Insurance Co Ltd*, when the court, at the third stage of the scheme promotion, found that the creditors' meetings had not been properly constituted, the court concluded it had no jurisdiction to sanction the scheme, making the whole process of promoting the scheme turn out in vain, causing a tremendous waste of time and expenses.

B. A Vast Number of Policyholders

Since there may be hundreds of thousands or even millions of policyholders in an insurer, if the number of policyholders affected by a scheme is like these, it is unrealistic to expect that creditors' meetings can be held to accommodate such a huge number of policyholders who may possibly show up, let alone to obtain votes in favour of the scheme from the requisite majority. In fact, a scheme between an insurer and its creditors was usually achieved after the insurer had been running off for a couple

[533] Generally speaking, incurred but not reported claims are insurance claims which have occurred but have not been reported to the insurer. There exist incurred but not reported claims when insured events (eg exposure to asbestos) have taken place but claims are yet to be confirmed or reported.

[534] *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241, [2002] BCC 300.

[535] *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621 (Ch), [2006] BCC 14.

of years. With most policies lapsing or being commuted during the run-off period, the number of creditors (including policyholders) involved in the scheme can thus be significantly reduced. Just as it was once pointed out by the Financial Services Authority,[536] '[t]he longer business has been in run-off, the more stable and suitable for scheming it is likely to become.'[537] As an example, in the case of Stronghold Insurance Company, the insurer ceased to write new business in 1985 and, after 33 years' run-off and with efforts in the meantime to reach commutations with creditors, in 2018 the insurer proposed a scheme towards the remaining 245 potential creditors so as to seek the finality of dealing with potential future insurance claims.[538]

Although cases in the past showed that the use of a scheme of arrangement, in combination with run-off or provisional liquidation, or both, could eventually settle the crisis of a troubled insurer when there was a relatively small number of policyholders left in the insurer's business, eg thousands of policyholders or even less,[539] it does not mean that the approach of this kind will be feasible, effective or

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[536] Financial Services Authority was the former financial regulatory authority in the UK, whose responsibilities have been taken over by the PRA and the FCA since 1 April 2013.

[537] Financial Services Authority, 'FSA Process Guide to Decision Making on Schemes of Arrangement for Insurance Firms' (July 2007). It should be noted that this "guide" was replaced by 'The Prudential Regulation Authority's Approach to Schemes of Arrangement Proposed by PRA-Authorised Insurers under Part 26 of the Companies Act 2006' issued in April 2014, so the opinions of the Financial Services Authority in the guide may not be held by the PRA or the FCA nowadays.

[538] See *Re Stronghold Insurance Company Ltd* [2018] EWHC 2909 (Ch), [2019] 2 BCLC 11. It is worth noting that when the insurer began running off in 1985, it was a healthy insurer satisfying all statutory and regulatory requirements. But later the insurer turned to be a troubled one since it could not meet the Minimum Capital Requirement imposed by the Solvency II Directive, which led to its proposing a cut-off scheme in 2018.

[539] For example, in the case of Independent Insurance Company, when the insurer was put into a provisional liquidation in June 2001, there were around 190,000 policyholders and in excess of 50,000 outstanding insurance

efficient when applied to a troubled insurer with a vast number of policyholders. Also, it is still questionable whether it is proper to allow an insurer to run off over years, regardless of whether or not the run-off takes place in a provisional liquidation, after it becomes troubled or even insolvent.[540] If the answer is no, then a lengthy period of run-off can no longer be used as a strategy prior to a scheme of arrangement so as to reduce the number of creditors to be involved in the scheme. In this circumstance, it remains a question whether it is still feasible or effective to adopt a scheme of arrangement in addressing crises of insurers.

4.2.4.2. Effects of a Scheme of Arrangement

There are mainly two types of schemes used by troubled insurers: the run-off scheme (also known as reserving scheme) and the cut-off scheme (also known as valuation scheme). A run-off scheme means an insurer keeps running off, but creditors (including

claims. After 14 years' run-off in the process of provisional liquidation (during the period while all actions towards the insurer or its property were stayed, policyholders protected by the FSCS were able to receive compensation from the FSCS), the insurer proposed a scheme of arrangement in June 2015, and eventually secured the scheme binding around 6000 creditors. See Oxera Consulting Ltd, 'Insurance Guarantee Schemes in the EU – Comparative Analysis of Existing Schemes, Analysis of Problems and Evaluation of Options' (November 2007) 91 <https://ec.europa.eu/info/sites/info/files/insurance-guarantee_schemes-oxera-study_en.pdf> accessed 10 August 2019; PwC, 'Independent Insurance Company Limited (in Scheme of Arrangement) ("Independent") – Joint Scheme Administrators Announce a First and Final dividend' (28 April 2017) <www.pwc.co.uk/press-room/press-releases/Independent-Insurance-Company-Limited-Joint-Scheme-Administrators-announce-a-first-and-final-dividend.html> accessed 10 August 2019.

[540] In the case of Stronghold Insurance Company, when the insurer operating in a run-off for 33 years became unable to meet the Minimum Capital Requirement imposed by the Solvency II Directive, it was required by the PRA and the FCA to produce a plan to bring closure to the run-off. Thus, it is reasonable to infer that in times of the Solvency II Directive, the PRA and the FCA do not allow a troubled insurer to run off anymore if it falls below the Minimum Capital Requirement. For a more detailed discussion, see Section 4.2.4.2 in this chapter.

policyholders) with crystallised claims can only receive payments at a certain percentage provisionally, so as to make sure that there will be sufficient reserves to meet potential claims in the future. A cut-off scheme means claims of an insurer's creditors (including policyholders) will be valued as on a certain cut-off date, with estimated value put on uncertain or contingent claims, and the corresponding dividends will be paid once and for all, thus bringing a finality to the relationship between the insurer and the scheme creditors. Usually, a couple of years' run-off of an insurer, whether or not by virtue of a run-off scheme, precedes a cut-off scheme. The intention of this is to ensure that the insurer can collect most reinsurance recoveries from its reinsurers, since reinsurers are normally just willing to pay reinsurance benefits when insurance claims settled by the insurer crystallise in the ordinary course. Due to the fact that a cut-off scheme inevitably involves estimating the value of uncertain or contingent claims of policyholders, the insurer may not be entitled to collect reinsurance recoveries if what it paid to policyholders was based on estimated amounts according to the scheme. As a consequence, in normal circumstances, an insurer will seek a cut-off scheme only after all or most reinsurance recoveries have been collected during the period of run-off.[541]

"[S]chemes were originally used for insolvent insurers as a more flexible and cost-effective alternative to a liquidation, and gradually they have been used more

[541] Peter Fidler, 'Schemes of Arrangement for Insolvent Insurance Companies in the United Kingdom: Current Developments' (1995) 3(1) International Insurance Law Review 18.

extensively by solvent insurers seeking to conclude all or part of their business."[542] In cases where an insurer is insolvent, creditors with claims admitted in a scheme can only get partial payments, but where an insurer is solvent, creditors with claims admitted in a scheme will get full payments. While the use of a scheme by an insolvent insurer is a means of settling the crisis, the use of a scheme by a solvent insurer is usually out of commercial reasons, including withdrawing from all or certain lines of the insurance business, extracting capitals from the insurer and returning them to shareholders, etc.

However, it is questionable whether solvent insurers sound in operation should be allowed to exit the market, wholly or partly, by virtue of cut-off schemes, since the adoption of a scheme means that dissentient creditors who constitute the minority in the creditors' meeting or meetings will be forced to compromise their legitimate rights. This issue was considered in *Re British Aviation Insurance Co Ltd*. The court hearing the case held that since the essence of the cut-off scheme of the solvent insurer was to retransfer risks, against which policyholders had already paid to insure, from the insurer to policyholders, with the purpose of returning capitals to shareholders, it was unfair to compel dissentient creditors to be bound by the scheme which sacrificed their rights to those of shareholders.[543] After this case, the incidence of cut-off schemes adopted by solvent insurers has significantly declined, and when sanction of

[542] Financial Services Authority, 'FSA Process Guide to Decision Making on Schemes of Arrangement for Insurance Firms' (July 2007), para 2.

[543] *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621 (Ch), [2006] BCC 14.

a court is sought with regard to such a scheme, the court would like the petitioner to have sufficient grounds justifying why the minority creditors should be bound by the decision made by the majority.[544] In line with the courts' opinions, when evaluating schemes of arrangement, the PRA's attitude is that:

> a. For insurance firms which meet regulatory capital requirements, the PRA's starting point will be that the use of a scheme is unlikely to be compatible with its statutory objectives, other than where there are compelling reasons to take a different approach in order to secure an appropriate degree of policyholder protection or where alternative safeguards are put in place to ensure an acceptable level of continuity of cover for dissenting policyholders.
>
> b. For insurance firms which do not meet regulatory capital requirements, are insolvent or where other doubts exist about whether sufficient assets will remain available to meet liabilities to policyholders in full, the PRA's starting point will be that the use of a scheme may be consistent with its statutory objectives.[545]

As a consequence, while cut-off schemes can still be used by troubled insurers which have failed to meet regulatory capital requirements, it is less likely that such schemes will be adopted by financially sound insurers in the future.

With regard to run-off schemes, although there have been cases that insolvent

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[544] *Scottish Lion Insurance Co Ltd, Petitioners* [2009] CSOH 127, [2010] SLT 100.

[545] PRA, 'Consultation Paper: Schemes of Arrangement by General Insurance Firms' (September 2013) para 2.9.

insurers made use of run-off schemes to run off the business over years before entering winding-up eventually,[546] it is questionable whether a troubled insurer, let alone an insolvent insurer, should still be allowed to run off. As is often the case, a troubled insurer will be put into a provisional liquidation and the provisional liquidator will first seek to promote a run-off scheme, largely based on the consideration of letting insurance claims crystallise in the normal way and collecting reinsurance recoveries accordingly. When the run-off scheme becomes effective, the provisional liquidation will terminate and the insurer will enter the normal run-off phase. During the run-off, in order to make sure that there will be sufficient assets to treat potential claims equally in the future, creditors with crystallised claims can only get partial payments, which is at a percentage declared by the insurer. However, practice of this kind will unnecessarily protract the process of dealing with troubled insurers, leaving the insurer remaining in the market for years in abnormal status, and no finality of settlements can be achieved between the insurer and each creditor until all potential claims crystallise or a cut-off scheme is reached.

The regulatory authorities' attitudes towards the insolvent run-off seem to have

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[546] It may still be the case that after an insurer is in run-off for years by virtue of a run-off scheme, a cut-off scheme will be promoted to bring finality to the long-tail insurance business, and a winding-up will follow when the implementation of the cut-off scheme comes to an end. As an example, in the case of Orion Insurance Company and The London and Overseas Insurance Company (due to the fact that cross guarantees in favour of each other's policyholders exist between these two insurers, they are dealt with in the same schemes), a run-off scheme became effective on 7 March 1997, and a cut-off scheme superseding the previous run-off scheme became effective on 14 January 2016. See PwC, 'OIC Run-Off Limited and The London & Overseas Insurance Company Limited' <www.pwc.co.uk/services/business-restructuring/insights/brs-uk-ins-assignment-oic-run-off-limited-formerl-the-orion-insurance-company-plc.html> accessed 11 August 2019.

changed after the Solvency II Directive came into force, since it is required by the directive that the regulatory authority should withdraw an insurer's authorisation if the insurer does not comply with the Minimum Capital Requirement[547] and is unable to restore within 3 months.[548] For example, in the case of the Stronghold Insurance Company, when the insurer, which had been operating in a solvent run-off since 1985, was found unable to meet the Minimum Capital Requirement, it was required by the PRA and the FCA to produce a plan to bring closure to the run-off, which led to its promoting a cut-off scheme in 2018.[549] Following the logic shown in this case, it is reasonable to infer that regulatory authorities no longer allow a troubled insurer which falls below the Minimum Capital Requirement to remain in the market and run off its business. Thus, it seems there is little chance that regulatory authorities will be in favour of a run-off scheme proposed by an insurer which is in serious trouble, let alone an insolvent insurer.

Based on the foregoing analysis, if there is any case in relation to a scheme of arrangement of a troubled insurer in the future, most probably the case will be in relation to a cut-off scheme. The reasons why this type of scheme has been widely used in practice as an alternative to a direct winding-up mainly lie in the flexibility and efficiency it has. For example, while in a winding-up all claims should be converted into

[547] The Minimum Capital Requirement is a minimum level of security below which the amount of financial resources should not fall. See Solvency II Directive, preamble.

[548] Solvency II Directive, art 144.

[549] See *Re Stronghold Insurance Company Ltd* [2018] EWHC 2909 (Ch), [2019] 2 BCLC 11.

sterling at the exchange rate prevailing on the date when the winding-up commences, a scheme allows creditors to receive payments of claims in a foreign currency, so that currency risks to which overseas policyholders may be exposed are avoided; while in a winding-up cash assets of the insurer should be deposited in the Insolvency Services Account and subject to investment restrictions, funds under a scheme can be invested in a flexible way, making it possible that more yields will be produced; while in a winding-up creditors are allowed to appeal to the court to resolve any disputes, a scheme can provide for an adjudication procedure as the only method to settle claim disputes, by virtue of which a lot of time and costs may be saved.[550] Despite the strengths cut-off schemes may have compared with a direct winding-up, the extensive use of schemes by troubled insurers will lead to the consequence that while the rules established in the legislation directed at dealing with troubled insurers are largely avoided (such as special rules for administration or winding-up of insurers), huge costs are incurred every time when approaches are devised in each scheme on a case-by-case basis. Additionally, due to the fact that schemes adopted in different cases may differ a lot, it is difficult for interested parties to have clear expectations as to how they will be treated when an insurer becomes troubled. This should not be the situation the

[550] See, for example, 'Proposal in Relation to a Scheme of Arrangement Between Orion Insurance Company Plc, The London & Overseas Insurance Company Plc and Their Respective Scheme Creditors' (20 November 1996) <www.oicrun-offltd.com/documents/OIC%20Run%20Off%20Limited%20Scheme%20Document%20Part%201.pdf> accessed 13 August 2019; ‘Proposal in Relation to a Scheme of Arrangement Pursuant to Part 26 of the Companies Act 2006 Between Stronghold Insurance Company Limited and Its Scheme Creditors' (9 November 2018) <https://strongholdinsco.wordpress.com/home-page/> accessed 13 August 2019.

legislature would like to see. Therefore, it is worth rethinking what role schemes of arrangement should play in the CMME mechanism.

Actually, due to the change in regulatory authorities' attitudes towards run-off of a troubled insurer, it is unclear to what extent the use of cut-off schemes will be influenced. As is shown in the existing cases, most cut-off schemes took place after insurers had been running off for a couple of years, in which case the number of creditors involved in a scheme could be kept at such a level that made it possible for creditors' meetings to be convened and the creditors' approval for the scheme to be obtained. However, since it becomes less likely that a troubled insurer will be allowed to run off, it seems unrealistic to expect that creditors' meetings can be held and the approval for a cut-off scheme can be obtained if there are still a vast number of policyholders. Therefore, it remains to be seen in the future how cut-off schemes may work in dealing with troubled insurers.

4.3. Financial Services Compensation Scheme

Following a series of failures of insurers in 1960s and 1970s, in order to better protect policyholders' interests, the Policyholders Protection Scheme was established under the Policyholders Protection Act 1975.[551] Later when the Financial Services Compensation Scheme (FSCS), as a consolidated compensation scheme for different

[551] Robert L. Carter and Peter Falush, *The British Insurance Industry Since 1900: The Era of Transformation* (Palgrave Macmillan 2009) 196.

financial service sectors, was established under the Financial Services and Markets Act 2000, the Policyholders Protection Scheme was replaced by the FSCS, with the insurance sub-scheme within the FSCS assuming the role of the previous Policyholders Protection Scheme. The FSCS is operated by the scheme manager, a body corporate independent of regulatory authorities.[552] Targeted at the insurance market, the FSCS is expected to advance the safety and soundness of insurers, as well as contribute to securing an appropriate degree of policyholder protection.[553]

The FSCS adopts an ex-ante fund policy, and levies may be imposed on insurers at any time to ensure that funds held by the FSCS are able to meet the expected expenses.[554] Separate accounts are maintained for the long-term insurance class and the general insurance class, which, respectively, deal with the funds held to the credit of each class and the liability of that class.[555] By virtue of the raised funds, the FSCS can perform both the function of protecting policyholders (eg by means of paying compensation to policyholders or securing continuity of insurance policies), and the function of rescuing insurers (by means of providing financial assistance to troubled insurers), although it is not common that the function of rescuing insurers is performed in practice.

Regarding the protection function of the FSCS, generally speaking, the FSCS covers

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[552] Financial Services and Markets Act 2000, s 212.

[553] PRA, 'Statement of Policy – Policyholder Protection' (April 2015) para 2.

[554] PRA, 'Rulebook – SII Firms – Policyholder Protection 21.9' (3 July 2015).

[555] PRA, 'Rulebook – SII Firms – Policyholder Protection 21.16' (3 July 2015).

most individual and small business policyholders for their claims under general insurance policies, and most policyholders (including large businesses) for their claims under long-term insurance policies.[556] When an insurer is determined by the FSCS to be in default,[557] unless the FSCS seeks continuity of the relevant insurance policy, the FSCS should pay compensation to an eligible policyholder within 3 months, or within 6 months if an extension is granted by the PRA, from the date the amount of compensation is calculated.[558] There are no upper limits on the amounts of compensation, but the levels of the FSCS protection vary depending on the types of insurance policies. With regard to a general insurance policy, if the claim is under compulsory insurance or professional indemnity insurance, or arises from the death or incapacity of the policyholder due to injury, sickness, or infirmity, the FSCS will cover 100% of the claim; and in all other cases, the FSCS will cover 90% of the claim.[559] With regard to a long-term insurance policy, the level of the FSCS cover is 100% of the claim.[560]

[556] See PRA, 'Rulebook – SII Firms – Policyholder Protection 7 – 9'. In terms of compulsory insurance policies, all policyholders are covered by the FSCS.

[557] Generally speaking, the FSCS may determine an insurer to be in default when the insurer is the subject of one or more of the following proceedings: (1) the passing of a resolution for a creditors' voluntary winding up; (2) a determination by a relevant authority that the insurer appears unable to meet claims against it and has no early prospect of being able to do so; (3) the appointment of a liquidator or administrator, or provisional liquidator or interim manager; (4) the making of an order by a court of competent jurisdiction for a winding up or an administration; or (5) the approval for a company voluntary arrangement. See PRA, 'Rulebook – SII Firms – Policyholder Protection 10' (3 July 2015).

[558] PRA, 'Rulebook – SII Firms – Policyholder Protection 16.1' (3 July 2015).

[559] PRA, 'Rulebook – SII Firms – Policyholder Protection 17.2(1)' (1 October 2015).

[560] PRA, 'Rulebook – SII Firms – Policyholder Protection 17.2(2)' (1 October 2015).

As a condition on making a compensation payment of the claim (or any part of it) to a policyholder, the FSCS normally requires the policyholder to assign all the rights against the troubled insurer or any third party related to the claim to the FSCS, so that the FSCS substituting for the policyholder can claim against the troubled insurer or any third party to pursue recoveries of the compensation so paid.[561] In cases where the assignment of any rights from the policyholder to the FSCS is ineffective for any reason, the FSCS can still be automatically subrogated to the policyholder's rights in relation to the claim, and it is required that the policyholder irrevocably and unconditionally appoint the FSCS as the agent in exercising the rights.[562] Regardless of whether the rights obtained by the FSCS are by virtue of assignment or subrogation, the FSCS will have the rights equivalent to those policyholders had. Thus, claims made by the FSCS against the insurer in winding-up will also have priority, as insurance claims have in the claims hierarchy, over most other unsecured claims.[563] If it eventually turns out that the recoveries received by the FSCS exceed the amounts of compensation paid to policyholders, the FSCS should return the differences to policyholders accordingly.[564]

Considering the special nature of long-term insurance,[565] the protection function of

[561] See PRA, 'Rulebook – SII Firms – Policyholder Protection 12' (3 July 2015). See also FSCS, 'Insurance Payment Terms' <www.fscs.org.uk/your-claim/terms-and-conditions/insurance-payment-terms/> accessed 5 September 2019.

[562] See PRA, 'Rulebook – SII Firms – Policyholder Protection 13' (3 July 2015). See also FSCS, 'Insurance Payment Terms' <www.fscs.org.uk/your-claim/terms-and-conditions/insurance-payment-terms/> accessed 5 September 2019.

[563] Insurers (Reorganisation and Winding Up) Regulations 2004, SI 2004/353, reg 32.

[564] PRA, 'Rulebook – SII Firms – Policyholder Protection 14.4' (3 July 2015).

[565] For a more detailed discussion of long-term insurance, see Section 2.1.2.2 in this thesis.

the FSCS is usually performed in the way of maintaining the continuation of long-term insurance policies, rather than paying compensation to policyholders after long-term insurance policies are terminated in the winding-up of an insurer. When encountering a long-term insurer which is in default, the FSCS should first manage to secure continuity of long-term insurance policies if it is practicable to do so and the FSCS is of the opinion that it would be beneficial to the generality of policyholders.[566] To this end, the FSCS may take any appropriate measures to secure or facilitate the transfer of long-term insurance policies from the troubled insurer to other insurers, or to secure the issue of policies by other insurers to policyholders in substitution for their policies issued by the troubled insurer.[567] Normally, when the FSCS is seeking to secure continuity of long-term insurance policies, it will secure 100% of the benefits under the policies.[568] But if, following an independent actuary's written recommendation, the FSCS is satisfied that any of the benefits provided for under the long-term insurance policies are or may be excessive,[569] it may reduce or disregard the benefits accordingly.[570]

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[566] PRA, 'Rulebook – SII Firms – Policyholder Protection 4.1' (3 July 2015).

[567] PRA, 'Rulebook – SII Firms – Policyholder Protection 4.2' (3 July 2015).

[568] See PRA, 'Rulebook – SII Firms – Policyholder Protection 4.3 and 6.1' (3 July 2015).

[569] A benefit is deemed excessive if at the time when an insurer decided to confer or to offer to confer that benefit, no reasonable and prudent insurer would choose to do so given the premiums payable and other contractual terms. See PRA, 'Rulebook – SII Firms – Policyholder Protection 20.6(2)' (3 July 2015).

[570] PRA, 'Rulebook – SII Firms – Policyholder Protection 20.7' (3 July 2015). It is worth noting that when calculating the amounts of insurance claims for the purposes of paying compensation, the FSCS may also reduce or disregard the excessive benefits under insurance policies following an independent actuary's written recommendation.

Apart from the situation where an insurer is determined by the FSCS to be in default, the FSCS may also play its role in the situation where an insurer is in financial difficulties, so that the FSCS can, at its discretion, take more flexible measures before an insurer is in default.[571] In the face of an insurer in difficulties, the FSCS may not only manage to secure continuity of insurance policies (through the way of securing or facilitating the transfer of the insurance business from the troubled insurer to other insurers, or securing the issue of policies by other insurers to policyholders in substitution for their policies issued by the troubled insurer), but also give assistance to the troubled insurer to enable it to continue to effect or carry out insurance policies.[572] While the measures taken by the FSCS to secure continuity of insurance policies can be regarded as a way of performing the function of protecting policyholders, the measures to give assistance to the troubled insurer in effect mean

[571] Generally speaking, an insurer is in financial difficulties if: (1) a liquidator, administrator, provisional liquidator, administrative receiver or interim manager is appointed to the insurer; (2) there is a finding by a court of competent jurisdiction that the insurer is unable to pay its debts; (3) a resolution is passed for winding up of the insurer, unless a declaration of solvency has been made; (4) the PRA determines that the insurer is likely to be unable to satisfy insurance claims against it; (5) approval is given to any company voluntary arrangement made by the insurer; (6) the insurer makes a composition or arrangement with any one or more of its creditors providing for the reduction of, or deferral of payment of, the liabilities or benefits provided for under insurance policies; (7) the insurer is dissolved or struck off from the Register of Companies; or (8) a receiver is appointed over particular property of the insurer. By comparison, it emerges that the scope of the circumstances indicating that an insurer is in financial difficulties is broader than the scope of the circumstances under which an insurer may be determined by the FSCS to be in default, with the latter one covered by the former one. Only if the FSCS does not choose to take relevant measures to deal with an insurer in financial difficulties (according to chapter 5 of the Policyholder Protection Part in the PRA Rulebook), the FSCS may determine the insurer to be in default (according to chapter 10 of the Policyholder Protection Part in the PRA Rulebook) and take measures targeted at an insurer in default. See PRA, 'Rulebook – SII Firms – Policyholder Protection 5 and 10' (3 July 2015).

[572] PRA, 'Rulebook – SII Firms – Policyholder Protection 5.2' (3 July 2015).

that the FSCS is performing the function of rescuing the troubled insurer. Since rescuing a troubled insurer will have the effect of benefiting all relevant parties of the troubled insurer, which is somewhat beyond the FSCS's basic purpose of protecting the interests of policyholders, the FSCS is always cautious about taking any measures of this kind. It is expected that, before performing the rescue function, the FSCS should be satisfied that any measures taken would normally cost less than paying compensation to policyholders, and the assistance offered to the troubled insurer should not materially benefit persons other than policyholders, especially shareholders or directors of the troubled insurer.[573] As a consequence, it is the exception rather than the norm that the FSCS provides financial assistance directly to a troubled insurer.

Once the FSCS decides to take relevant measures towards an insurer in financial difficulties, the measures may be taken on such terms the FSCS considers appropriate, including terms reducing or deferring payment of insurance claims.[574] Consistent with the levels of protection the FSCS will provide when an insurer is in default, measures taken by the FSCS when an insurer is in financial difficulties will cover: 100% of benefits under long-term insurance policies; 100% of benefits under the general insurance policies which are compulsory insurance policies or professional indemnity insurance policies, or with which claims arising from the death or incapacity of policyholders due

[573] See Financial Services and Markets Act 2000, s 217(4); Explanatory Notes to the Financial Services and Markets Act 2000, para 434.

[574] PRA, 'Rulebook – SII Firms – Policyholder Protection 5.1(2)' (3 July 2015).

to injury, sickness, or infirmity; and at least 90% of benefits under other general insurance policies.[575] Thus, in terms of most general insurance policies, even if the continuity of these policies is secured by virtue of the FSCS's intervention, it is only guaranteed that policyholders can receive at least 90% of their insurance claims or future insurance benefits. But if the FSCS secures less than 100% of any benefit under general insurance policies, the FSCS must ensure that any future premiums policyholders shall pay will be reduced proportionately.[576]

4.4. Chapter Conclusion

In a free market economy in the UK, it is normal to see insurers enter or exit the market. Targeted at troubled insurers, since the beginning of insurance regulation, the UK has established a CMME mechanism which is based on the general insolvency system.[577] Currently, measures/procedures contained in the CMME mechanism include the proactive intervention framework, CVA, administration, winding-up, and schemes of arrangement. The FSCS will mainly perform the function of protecting policyholders amid these measures/procedures.

To accommodate the special features of insurers, modifications have been made to adapt the insolvency procedures (ie CVA, administration and winding-up) for insurers.

[575] PRA, 'Rulebook – SII Firms – Policyholder Protection 6.1' (3 July 2015); PRA, 'Rulebook – SII Firms – Policyholder Protection 6.2' (1 October 2015).

[576] PRA, 'Rulebook – SII Firms – Policyholder Protection 6.3' (3 July 2015).

[577] For a more detailed discussion, see Part 4.1 in this chapter.

For example, grounds for winding up insurers are diverse, including, among others, the cancelling of an insurer' permission to effect or carry out insurance contracts;[578] while payment of creditors' claims will be stayed in administration or winding-up, eligible policyholders can receive compensation from the FSCS;[579] long-term insurance contracts, unlike other contracts, will normally be continued in administration or winding-up;[580] special rules have been made to provide guidance on how insurance claims should be calculated in winding-up;[581] and insurance claims are accorded a high priority in the winding-up claims hierarchy.[582] All these modifications, in line with the objective of protecting policyholders, work to facilitate the application of insolvency procedures to insurers.

In practice, however, most existing cases of troubled insurers have been dealt with through schemes of arrangement – a procedure which can produce similar effects to an insolvency procedure when used together with provisional liquidation,[583] leaving the special rules for administration or winding-up of insurers seldom used. Since schemes of arrangement are designed on a case-by-case basis, not only would huge costs be incurred every time, but inconsistencies in treatment of interested parties in different cases may also be brought about. However, due to the changes in laws as well

[578] For a more detailed discussion, see Section 4.2.3.1 in this chapter.

[579] For a more detailed discussion, see Part 4.3 in this chapter.

[580] For a more detailed discussion, see Section 4.2.2.2 and Section 4.2.3.2 in this chapter.

[581] For a more detailed discussion, see Section 4.2.3.2 in this chapter.

[582] For a more detailed discussion, see Section 4.2.3.2 in this chapter.

[583] For a more detailed discussion, see Section 4.2.4 in this chapter.

as the regulatory authorities' attitudes in recent years, it is not clear to what extent schemes of arrangement can still function in dealing with troubled insurers in the future.

Despite the efforts to adapt the insolvency system for insurers, it is argued in this chapter that some arrangements inherent in the insolvency system are not compatible with the special features of insurers, which will to a greater or lesser extent hinder the process of addressing crises of insurers. As an example, although CVA is an appealing company rescue procedure, the reflection on CVA indicates that it is not feasible for this procedure to be applied to insurers, and in practice there is hardly any relevant case. As another example, it is insolvency practitioners who carry out insolvency procedures, and major issues during the process are subject to creditors' decisions, but to seek creditors' decisions constitutes a real challenge in the case of insurers. This is because there always exist difficulties in calculating policyholders' voting rights and obtaining approval from a vast number of creditors (including policyholders). Confusion has also been caused by the inconsistencies in the requirement for creditors' decisions. Since the court, at its own discretion, can write down insurers' contracts to avoid making a winding-up order,[584] and can also write down long-term insurance contracts when their continuity is secured in administration,[585] it is unknown how these arrangements can be coordinated, in logic, with the normal requirement for

[584] Financial Services and Markets Act 2000, s 377.

[585] Financial Services and Markets Act 2000 (Administration Orders Relating to Insurers) Order 2010, SI 2010/3023, sch para 2.

creditors' decisions during the process of insolvency procedures. In addition, although regulatory authorities are vested with the standing to initiate and participate in the insolvency procedures, they have no authority to lead the process. As a consequence, there is no guarantee that dealing with troubled insurers by insolvency practitioners in insolvency procedures will be in line with the regulatory authorities' objectives of insurance supervision, or that the consistency will be maintained in different cases of addressing crises of insurers. Taken together, since some arrangements inherent in the insolvency system are not suitable for insurers, building the CMME mechanism on the general insolvency system might not be an ideal choice.

Although it is held by the regulatory authorities that the objective of protecting policyholders and the objective of maintaining financial stability are the two main objectives to be pursued in dealing with troubled insurers,[586] there is still a lack of special arrangements for maintaining financial stability in the current CMME mechanism. Admittedly, there is a possibility that the Bank of England, functioning as the lender of last resort, might provide emergency liquidity assistance to troubled financial institutions (including insurers) to safeguard financial stability,[587] but no public information indicates that an insurer has ever obtained such emergency lending. Since the Bank of England's function of the lender of last resort is deliberately provided for in an ambiguous way so as to prevent moral hazard, no more detailed

[586] See, for example, HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012) 28; PRA, 'The Prudential Regulation Authority's Approach to Insurance Supervision' (October 2018) 4.

[587] Financial Services Act 2012, s 58 and s 61.

arrangements can be learnt from materials open to the public.[588] As a consequence, due to the lack of special arrangements, doubts have been raised as to whether the current CMME mechanism, mainly based on the insolvency system, is sufficient to deal with troubled insurers which could pose a threat to financial stability.[589]

In an ideal CMME mechanism, all arrangements within the mechanism should be designed in a way which is compatible with the special features of insurers. However, in the current CMME mechanism in the UK, determined by the fact that the mechanism is based on the general insolvency system, there inevitably exist some arrangements which are inherent in the insolvency system but are arguably not suitable for insurers. Having recognised deficiencies in the current mechanism, the International Monetary Fund once recommended that the UK should work to develop a special integrated regime for dealing with troubled insurers.[590] In fact, the regulatory authorities in the UK also acknowledge that the design model adopted in the current CMME mechanism may not be satisfactory. They have been considering for years whether a special regime different from the insolvency system should be built to deal with troubled insurers.[591]

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[588] International Monetary Fund, 'United Kingdom – Financial Sector Assessment Program – Review of the Bank of England's Liquidity Provision Framework – Technical Note' (June 2016) 7 <www.imf.org/en/Publications/CR/Issues/2016/12/31/United-Kingdom-Financial-Sector-Assessment-Program-Review-of-the-Bank-of-Englands-Liquidity-43970> accessed 18 May 2017.

[589] HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012) 29.

[590] International Monetary Fund, 'United Kingdom – Financial Sector Assessment Program – Insurance Sector – Technical Note' (June 2016) 25 <www.imf.org/en/Publications/CR/Issues/2016/12/31/United-Kingdom-Financial-Sector-Assessment-Program-Insurance-Sector-Technical-Note-43969> accessed 18 May 2017.

[591] See, for example, HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012) 32;

Chapter 5 Analysis of the CMME Mechanism in the US

Overview

This chapter will conduct research on the CMME mechanism in the US so as to see what experience or lessons can be learnt. Centred on the insurer receivership system in each state, the US CMME mechanism is completely independent of the bankruptcy system for ordinary companies. With the focus on the aspects special for insurers, the major components of the CMME mechanism will be analysed in turn, which include the state receivership system (consisting of pre-receivership tools, conservation, rehabilitation and liquidation), the insurance guaranty associations, and the relevant regulation at the federal level.

For comparison purposes in this thesis, regarding the CMME mechanism in the US, the following findings need to be highlighted:

a. Grounds for commencing a receivership procedure are diverse, and only the insurance commissioner can petition the court for receivership.[592]

b. Once a court order of a receivership procedure is entered, the insurance commissioner functioning as receiver will take over the troubled insurer and carry out the receivership under the supervision of the court.[593]

c. The insurance commissioner is empowered to decide all issues during the process

Bank of England, 'The Bank of England's Approach to Resolution' (October 2017) 19.

[592] For a more detailed discussion, see Section 5.2.2 in this chapter.

[593] For more detailed discussions, see Section 5.2.3 and Section 5.2.4 in this chapter.

of a receivership procedure, subject to the court's approval or review. No creditors' decision is required to be sought before the receiver takes or proposes an action, but interested parties can apply to the court to challenge the receiver's action or proposed action.[594]

d. There is not a procedure analogous to company voluntary arrangements, and an insurer's attempt to systemically compromise with creditors will suffice to trigger a receivership procedure.[595]

e. In conservation or rehabilitation, despite the general stay effects, insurance claims against the insurer, unlike most other claims, are often paid as usual without any disruption.[596]

f. Insurance guaranty associations will mainly perform the function of protecting policyholders, ie providing coverage to eligible policyholders when an insurer in liquidation is insolvent.[597]

g. To complement the state insurer receivership system, which is focused on the objective of policyholder protection, arrangements are made in the federal legislation to pursue the objective of financial stability. When a troubled insurer poses systemic risk, there is still a possibility that the insurer might receive financial assistance from the Orderly Liquidation Fund or the Federal Reserve System.[598]

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594 For a more detailed discussion, see Section 5.2.4 in this chapter.

595 Insurer Receivership Model Act § 207R.

596 For a more detailed discussion, see Section 5.2.4 in this chapter.

597 For a more detailed discussion, see Part 5.4 in this chapter.

598 For a more detailed discussion, see Section 5.5.2 in this chapter.

All in all, independent of the general bankruptcy system, the CMME mechanism in the US is a mechanism specific to insurers, and arrangements in the mechanism are generally compatible with the special features of insurers.

5.1. Framework of the CMME Mechanism

The US has the largest insurance market in the world,[599] and there are currently around 6000 authorised insurers.[600] It has long been the case that insurers are regulated at the state level during the whole life span from their birth to demise.[601] In the McCarran–Ferguson Act enacted in 1945,[602] Congress made it crystal clear that:

> [t]he continued regulation and taxation by the several States of the business of insurance is in the public interest, and silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.[603]

Therefore, although debates about federal insurance regulation versus state insurance regulation have existed for long, what has been established by Congress is that insurers are supervised by state regulatory authorities, and issues relating to the insurance

[599] Swiss Re Institute, 'World Insurance: The Great Pivot East Continues' (4 July 2019) 9 <www.swissre.com/dam/jcr:b8010432-3697-4a97-ad8b-6cb6c0aece33/sigma3_2019_en.pdf> accessed 1 June 2020.

[600] NAIC, '2019 Insurance Department Resources Report – Volume One' (October 2020) 35 <www.naic.org/prod_serv/STA-BB-20-01.pdf> accessed 7 October 2020.

[601] See NAIC, 'State Insurance Regulation – History, Purpose and Structure' <www.naic.org/documents/consumer_state_reg_brief.pdf> accessed 18 February 2018.

[602] McCarran–Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015).

[603] McCarran–Ferguson Act § 1, 15 U.S.C. § 1011.

business are mainly governed by the state legislation.[604]

With regard to troubled insurers, the federal Bankruptcy Act of 1867 was applicable to moneyed business and commercial corporations, which, initially, were interpreted to include insurance companies; but in the amended Bankruptcy Act of 1898, Congress changed the description of the included class and granted the privilege of bankruptcy to corporations engaged principally in manufacturing, trading, printing, publishing, mining or mercantile pursuits, thereby excluding insurance companies from the purview of the Act; although the Amendment of 1910 restored the wording of the Act of 1867 to make bankruptcy available to "any moneyed, business, or commercial corporation" again, this Amendment maintained the exclusion of insurance companies, making it clear that insurance companies were not eligible for voluntary bankruptcy or involuntary bankruptcy under the Act.[605] The reason for the exclusion, as was

[604] For debates about federal insurance regulation versus state insurance regulation, see, for example, Sandra B. McCray, 'Federal Preemption of State Regulation of Insurance: End of a 200-Year Era?' (1993) 23(4) Publius: The Journal of Federalism 33; Rufus E. Brown, 'Constitutional Limits on State Insurance Regulation' (1994) 29 Tort & Insurance Law Journal 651; Etti G. Baranoff and Dalit Baranoff, 'Trends in Insurance Regulation' (2003) 24(3) Review of Business 11; Scott E. Harrington, 'Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation' (10 August 2006) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=923605> accessed 18 February 2018; Jeffrey E. Thomas, 'Insurance Perspectives on Federal Financial Regulatory Reform: Addressing Misunderstandings and Providing a View from a Different Paradigm' (2010) 55(3) Villanova Law Review 773.

[605] See *SIMS v. FIDELITY ASSUR. ASS'N*, 129 F.2d 442, 448 (4th Cir. 1942). The then effective provision in the Bankruptcy Act which prevented domestic insurance companies from filing for bankruptcy, ie 11 U.S.C. § 22 (1910) (repealed in 1978), read, 'Section 4. Who May Become Bankrupts. (a) Any person, except [an]... insurance... corporation… shall be entitled to the benefits of this Act as a voluntary bankrupt. (b)… and any moneyed, business, or commercial corporation except [an] insurance... corporation... may be adjudged an involuntary bankrupt.' See Adam Hodkin, 'Insurer Insolvency: Problems & Solutions' (1992) 20 Hofstra Law Review 727, 729.

assumed, probably '[l]ay in the public or quasi-public nature of the business, involving other interests than those of creditors, in the desirability of unarrested operation, the completeness of state regulation, including provisions for insolvency, and the inappropriateness of the bankruptcy machinery to their affairs.'[606] Following this route, the Bankruptcy Act of 1978 also clearly provided that domestic insurance companies would be excluded from the purview of the federal bankruptcy laws, which remains in effect so far.[607] As it is pointed out in the senate report, this is because insurance companies are '[b]odies for which alternate provision is made for their liquidation under various state regulatory laws'.[608] 'Although conclusory, this rationale has been adopted by many authorities, primarily because it is the only statement of congressional intent in this area.'[609] As a consequence, unlike ordinary companies, insurers are not subject to the federal Bankruptcy Code, but the relevant state laws. Determined by this, the CMME mechanism in the US is completely independent of the general bankruptcy system.

In order to coordinate insurance regulation in different states, there exists the National Association of Insurance Commissioners (NAIC) functioning as the US standard-setting and regulatory support organisation, which is governed by chief

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[606] *SIMS v. FIDELITY ASSUR. ASS'N*, 129 F.2d 442, 448 – 449 (4th Cir. 1942).

[607] As is provided in 11 U.S.C. § 109: … (b) A person may be a debtor under chapter 7 of this title only if such person is not … a domestic insurance company, bank, savings bank, cooperative bank…; … (d) Only a railroad, a person that may be a debtor under chapter 7 of this title… may be a debtor under chapter 11 of this title.

[608] 'Senate Report No. 95-989' <www.law.cornell.edu/uscode/text/11/109> accessed 20 February 2018.

[609] Adam Hodkin, 'Insurer Insolvency: Problems & Solutions' (1992) 20 Hofstra Law Review 727, 729.

insurance regulators (normally called insurance commissioners) from the 50 states, the District of Columbia and five US territories.[610] The NAIC has enacted a variety of model acts for regulating the insurance industry, and states normally adopt these model acts in their laws, albeit deviating from the models to some extent. In terms of the CMME mechanism, the most relevant model acts made by the NAIC are Administrative Supervision Model Act, Insurer Receivership Model Act, Life and Health Insurance Guaranty Association Model Act, and Property and Casualty Insurance Guaranty Association Model Act. Based on these acts, it can be said that the US has established a CMME mechanism which is centred on the state-based insurer receivership system. In such a system, when there is a troubled insurer, by making use of one of the three receivership procedures, ie conservation, rehabilitation or liquidation, the state insurance commissioner can take over the insurer to address the crisis under the supervision of the receivership court.

Over the years, the NAIC has developed the insurer receivership system through the updated model acts, from the Uniform Insurers Liquidation Act, to the Insurers Rehabilitation and Liquidation Model Act, and then to the Insurer Receivership Model Act (IRMA).[611] Although the IRMA, enacted in 2005 and amended in 2007, is the most updated version of the model act relating to the receivership system and replaces the previous model acts, not so many states have reformed their receivership systems to

[610] See ‘About the NAIC’ <www.naic.org/index_about.htm> accessed 15 April 2018.

[611] NAIC, ‘Receiver's Handbook for Insurance Company Insolvencies’ (2018) 5.

keep up with the IRMA.[612] However, since the IRMA represents the latest development in the receivership system in the US, updating the previous model acts after taking account of experience or lessons learnt from states' practice, the analysis in this chapter will be based on the IRMA when it comes to receivership of insurers.

Due to the fragmented patterns of state insurance regulation, there is a lack of consideration of the whole country's financial stability in each state.[613] And the state insurer receivership system merely focuses on the objective of protecting policyholders, without taking into account the objective of maintaining financial stability.[614] As a consequence, when a troubled insurer poses systemic risk, by virtue of the insurer receivership system alone, the state insurance commissioner may not be able to address the crisis in an orderly manner without posing a threat to the financial stability of the US or even the world. The 2007–2009 financial crisis, especially the case of American International Group, Inc. (AIG) during the period, just exposed this inherent deficiency in the state-based insurance regulation. In response to the financial crisis, for the purposes of promoting financial stability and preventing systemic crises, reforms were carried out at the federal level and the Dodd–Frank Wall Street Reform and Consumer Protection Act (hereinafter, Dodd–Frank Act)[615] was

612 Insurer Receivership Model Act, Appendix.

613 See, for example, John Tatom, 'A Report to the Federal Insurance Office' (September 2011) 22 <https://mpra.ub.uni-muenchen.de/34621/> accessed 25 March 2018; Daniel Schwarcz and Steven L. Schwarcz, 'Regulating Systemic Risk in Insurance' (2014) 81 The University of Chicago Law Review 1569, 1576.

614 See Insurer Receivership Model Act § 101E.

615 Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12 and 15 U.S.C.).

thus enacted. In these reforms, relevant arrangements at the federal level were made to complement the state-based insurance regulation. For example, when a troubled insurer poses a threat to financial stability, emergency lending from the Federal Reserve System may be provided to the insurer, or orderly liquidation authority may be utilised to address the crisis of the insurer.[616]

Taken together, independent of the federal bankruptcy system, the CMME mechanism in the US is centred on the state insurer receivership system. There are still arrangements at the federal level designed for the objective of maintaining financial stability, complementing the state insurer receivership system which merely focuses on the objective of protecting policyholders. Therefore, the analysis of the CMME mechanism in the US in the rest of this chapter will revolve around the state insurance receivership system and the relevant federal arrangements.

5.2. General Issues of the Receivership System

There are three receivership procedures in the state receivership system: conservation, rehabilitation and liquidation. Receivership of a troubled insurer will be initiated in the domiciliary state of the insurer, subject to the laws of the domiciliary state.[617] Although ancillary receivership may also be initiated in any other state where the troubled insurer undertakes business, the ancillary receivership will only have effects

[616] For further discussion, see Section 5.5.2 in this chapter.

[617] "Domiciliary state" means the state in which an insurer is incorporated or organised, or, in the case of an alien insurer, its state of entry. See Insurer Receivership Model Act § 104H.

on the insurer's property or records located in that state, ancillary to the receivership of the domiciliary state. As interstate coordination is unique to the US, which is beyond the scope of this thesis, this chapter will not touch interstate issues, but will focus on how the receivership system is designed to deal with troubled insurers within a domiciliary state.

Before analysing receivership procedures respectively, which will be done so in Part 5.3, this part (Part 5.2) will first discuss some general issues of the state receivership system, which include the pre-receivership tools and the selected issues common to receivership procedures, ie commencement of receivership, functions of a receiver, and general effects of receivership.

5.2.1. Pre-Receivership Tools

Administrative supervision and seizure, respectively provided for in the NAIC's Administrative Supervision Model Act and the IRMA, are two main procedures which may be used by the state insurance commissioner to deal with a troubled insurer before there is a need to initiate a receivership procedure. Seizure is deemed a more intense procedure than administrative supervision. While a troubled insurer will remain under the control of its management when it is in administrative supervision, it will be taken over, wholly or partly, by the insurance commissioner if a seizure order is issued.

5.2.1.1. Administrative Supervision

The insurance commissioner can intervene proactively to put an insurer into

administrative supervision upon one of the grounds that:

(1) the insurer's condition renders the continuance of its business hazardous to the public or to its insureds; (2) the insurer has or appears to have exceeded its powers granted under its certificate of authority and applicable law; (3) the insurer has failed to comply with the applicable provisions of the insurance code; (4) the business of the insurer is being conducted fraudulently; or (5) the insurer gives its consent.[618]

An administrative supervision order will be issued by the insurance commissioner on an ex parte basis, with no ex ante administrative hearing being required, but subject to administrative review pursuant to the state administrative appeal procedures.[619] The commissioner will furnish the insurer with a written list of the requirements to abate the determination of administrative supervision, and the insurer should take measures to comply with the requirements of the commissioner within 60 days or a period of time designated by the commissioner.[620]

During administrative supervision, the insurer's operation is subject to restrictions imposed by the insurance commissioner on a case-by-case basis. Some restrictions are related to management of the insurer's assets, and it may be the case that the insurer is not allowed to dispose of, convey or encumber any of its assets or its business in force, to withdraw any of its bank accounts, to lend any of its funds, to invest any of its

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[618] Administrative Supervision Model Act § 3A.

[619] Administrative Supervision Model Act § 3B.

[620] Administrative Supervision Model Act § 3B, C.

funds, to transfer any of its property, to incur any debt, obligation or liability, or to merge or consolidate with another company, etc.[621] Some restrictions are related to the continuance of the insurer's business, and it may be the case that the insurer is not allowed to approve new premiums or renew any policies, to enter into any new reinsurance contract or treaty, to terminate any insurance policy (except for non-payment of premiums due), or to release, pay or refund premium deposits, accrued cash or loan values, unearned premiums, or other reserves on any insurance policy, etc.[622] There are also restrictions related to treatment of the insurer's management, so it may be the case that the insurer is not allowed to make any material change in management, or to increase salaries and benefits of officers or directors or the preferential payment of bonuses, dividends or other payments deemed preferential, etc.[623] Unless otherwise approved by the insurance commissioner, the restrictions imposed on the insurer should always be complied with.

Once the grounds giving rise to administrative supervision have been removed, the commissioner should release the insurer from administrative supervision.[624] But if such grounds still exist at the end of the specified administrative supervision period, the commissioner may either extend the administrative supervision period,[625] or take further measures, such as petitioning the court for a seizure order or a receivership

[621] Administrative Supervision Model Act § 5.

[622] Administrative Supervision Model Act § 5.

[623] Administrative Supervision Model Act § 5.

[624] Administrative Supervision Model Act § 3E.

[625] Administrative Supervision Model Act § 3D.

order to place the insurer into seizure or receivership. However, it is not necessary that administrative supervision should precede the petition for a seizure order or a receivership order.[626] If the circumstance requires, the commissioner can seek to place the troubled insurer into seizure or receivership without having any administrative supervision procedure in advance.

As the insurance commissioner has the authority to decide all relevant issues during administrative supervision, administrative supervision is a regulatory procedure in nature. Compared with normal supervision of an insurer conducted by the insurance commissioner, administrative supervision can be regarded as an enhanced supervision measure, which is used to tackle problems of the insurer at an early stage when a crisis emerges. Due to the fact that administrative supervision allows the troubled insurer itself to make corrections pursuant to the insurance commissioner's requirements, it is a measure with less intense effects than seizure or receivership, the commencement of which means the insurer will be taken over by the commissioner.

5.2.1.2. Seizure

Seizure is an interim procedure which allows the insurance commissioner to take over a troubled insurer at short notice. By alleging that there are grounds which would justify a receivership procedure against a troubled insurer,[627] and that the interests of policyholders, creditors or the public will be endangered by delay, the insurance

[626] Administrative Supervision Model Act § 7.

[627] Grounds for receivership will be discussed in Section 5.2.2 in this chapter.

commissioner can petition a court of competent jurisdiction for a seizure order, which will give the commissioner the authority to take possession and control of all or a part of the property, books, accounts, documents and other records of the insurer, and of the premises occupied by the insurer.[628] The purpose of this procedure is to let the commissioner "make an immediate hands-on determination of an insurer's condition as well as preserve and protect its assets."[629] Since the action should be carried out swiftly, a seizure order will be issued by the court on an ex parte basis, subject to a hearing and review if the insurer proceeded against files such a petition after the fact.[630]

The duration of seizure will be initially set as a period which the court deems necessary for the insurance commissioner to ascertain the condition of the insurer, and the court may modify the duration at its discretion as the process proceeds.[631] During the period, as per the seizure order, the insurer may be enjoined from disposing of its property or transacting its business, except with the written consent of the commissioner.[632] Since the procedure is designed to maintain the status quo of a troubled insurer and allow some time for the commissioner to decide whether or not to petition for a receivership procedure,[633] the court should vacate the seizure order

[628] Insurer Receivership Model Act § 201A, B.

[629] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 7.

[630] Insurer Receivership Model Act § 201B, F.

[631] Insurer Receivership Model Act § 201D.

[632] Insurer Receivership Model Act § 201B.

[633] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 7.

and return the insurer back to its management if the commissioner fails to commence a receivership procedure after having a reasonable opportunity to do so.[634] The seizure order will also be vacated if a receivership procedure is needed, and a receivership order will replace the seizure order to govern the process dealing with the troubled insurer.[635]

As the period of seizure is an interim period, to avoid incurring extensive public distrust towards the insurer at this stage, all records and other documents relating to the seizure should remain confidential, unless it is otherwise ordered by the court or requested by the insurer that the matter be made public.[636] The confidentiality of the procedure can help prevent causing irreparable harm to the insurer's business if the commissioner acts in good faith but errs in seizing the insurer, or if the commissioner succeeds in resolving the insurer's difficulties efficiently within a short time.[637] Thus, under the ideal circumstance, the insurer will be released from the seizure order and resume normal operation without public knowledge.

Since the commencement of seizure means troubled insurers will be taken over, wholly or partly, by the insurance commissioner, seizure is a procedure having more intense effects on insurers than administrative supervision. A troubled insurer placed into seizure is normally in a situation which may not be handled well by means of

[634] Insurer Receivership Model Act § 201D.

[635] Insurer Receivership Model Act § 201D.

[636] Insurer Receivership Model Act § 206A.

[637] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 7.

administrative supervision. As grounds for seizure echo those for receivership, it is very likely that a seizure will turn out to be a prelude to a receivership procedure. Since a court of competent jurisdiction is involved in issuing a seizure order and supervising the commissioner's action, seizure is in nature a judicial procedure rather than a regulatory measure. Nevertheless, the insurance commissioner still plays a key role during the process.

5.2.2. Commencement of Receivership

When pre-receivership tools are not sufficient to tackle problems of a troubled insurer, based on relevant statutory grounds, the insurance commissioner can petition the court for an appropriate receivership procedure, ie conservation, rehabilitation or liquidation.

The IRMA has listed 22 grounds for commencing a receivership procedure, which cover various aspects of insurers' operation. All these grounds are common to conservation, rehabilitation and liquidation, and each ground alone suffices to justify the commencement of a receivership procedure.[638] Among the grounds, some are related to financial conditions of insurers, which include: the insurer is impaired;[639] the insurer is insolvent;[640] the insurer is about to become insolvent;[641] the insurer

[638] Insurer Receivership Model Act § 208.

[639] Insurer Receivership Model Act § 207A.

[640] Insurer Receivership Model Act § 207B.

[641] Insurer Receivership Model Act § 207C. As is provided, an insurer is about to become insolvent if it is reasonably anticipated that the insurer will not have liquid assets to meet its next 90 days' current obligations.

failed to make good any deficiency in its capital or surplus within a given time;[642] the insurer failed to provide documents or other pertinent material adequate for the determination of its financial condition;[643] the insurer systematically attempted to compromise with creditors on the ground that it is financially unable to pay its obligations in full;[644] the property of the insurer has been improperly or illegally dealt with;[645] etc. Some other grounds are related to the management of insurers, which include: the insurer is in the control of a person who is dishonest, untrustworthy or lacking in insurance company managerial experience or capability;[646] the insurer has failed promptly and effectively to withdraw powers of a person with executive authority if the person refused to be examined by the insurance commissioner or refused to divulge pertinent information;[647] etc. What is more, some grounds concern insurers' compliance with other statutory or regulatory requirements, which include: the insurer, within the previous 5 years, has wilfully and continuously violated its charter, insurance laws, or any valid order of the insurance commissioner;[648] the insurer has failed to file its annual report or other financial reports within the required time frame;[649] etc. In addition, there is still a ground which seems to have a catch-all

[642] Insurer Receivership Model Act § 207D.

[643] Insurer Receivership Model Act § 207G.

[644] Insurer Receivership Model Act § 207R.

[645] See Insurer Receivership Model Act § 207E, J.

[646] Insurer Receivership Model Act § 207K.

[647] Insurer Receivership Model Act § 207L.

[648] Insurer Receivership Model Act § 207P.

[649] Insurer Receivership Model Act § 207S.

effect, allowing the insurance commissioner to initiate a receivership procedure if, upon good cause shown, it is not in the best interest of the policyholders, creditors or the public to proceed with the conduct of the business of the insurer.[650]

Unlike grounds for bankruptcy procedures for ordinary companies, which focus mainly on “insolvency”, grounds for receivership procedures for insurers are much more diverse, taking account of a wide range of requirements insurers should comply with. This reflects the fact that the insurance business is a specifically regulated business, and insurers will be subject to more stringent statutory or regulatory requirements. However, despite the existence of a variety of statutory grounds for commencing receivership, it emerges that regulatory authorities have focused on the insolvency aspect for too long.[651] While it has to be admitted that “insolvency” constitutes an important ground for commencing receivership, other grounds should never be neglected. This is because an insurer’s insolvency is always a result of accumulated effects of non-compliance with other requirements, and the lack of attention paid to the aspects other than insolvency at an early stage of the crisis will not help prevent deterioration of the solvency condition of the insurer, which may eventually lead to insolvency. As a result, in the absence of insolvency, the regulatory authorities’ delay in adopting receivership may not effectively prevent further losses,

[650] Insurer Receivership Model Act § 207H.

[651] Al Slavin, 'Reflecting on the Past' (Best’s Review, August 2011) <http://news.ambest.com/articlecontent.aspx?pc=1009&AltSrc=108&refnum=189989> accessed 1 August 2017.

and thus may not achieve the optimal outcome in addressing crises.[652] Therefore, it would be better if the regulatory authorities could make full use of the statutory grounds for receivership and initiate an appropriate receivership procedure against a troubled insurer in a timely manner, without waiting until the insurer finally becomes insolvent. Also, since it may sometimes be difficult to prove the insolvency of an insurer, it is argued that issuing a formal regulatory order to a financially impaired insurer, and then having the insurer fail to adhere, can provide black-and-white grounds for receivership, which is regarded as a more viable alternative to proving insolvency.[653] This approach just represents one of the ways of making use of grounds other than "insolvency" to initiate a receivership procedure.

Where there exist one or more grounds for commencing receivership, the insurance commissioner has the exclusive standing to petition the court for a receivership procedure.[654] No court will have jurisdiction to entertain any receivership procedure commenced by any other person.[655] Upon such a petition being filed by the insurance commissioner, the troubled insurer will have the opportunity to file an answer at a summary hearing before the court makes a judgement.[656] Once the court issues an order on the petition, the order will be final, subject to an appeal which should be

[652] See Debra J. Hall and Robert M. Hall, 'Insurance Company Insolvencies: Order out of Chaos' (1993) 12(2) Journal of Insurance Regulation 145, 151.

[653] Al Slavin, 'Reflecting on the Past' (Best's Review, August 2011) <http://news.ambest.com/articlecontent.aspx?pc=1009&AltSrc=108&refnum=189989> accessed 1 August 2017.

[654] Insurer Receivership Model Act § 208.

[655] Insurer Receivership Model Act § 105A.

[656] Insurer Receivership Model Act § 202D, E.

taken within 5 days of entry of the judgement.[657]

As the insurance commissioner is the only person eligible to commence a receivership procedure, there is concern about the appropriateness of this arrangement. This is because the insurance commissioner is exactly the same person responsible for supervising insurers, and a need for receivership of troubled insurers may just indicate the inadequacy or negligence of the insurance supervision, so the insurance commissioner sometimes may be reluctant to initiate receivership.[658] There is no lack of evidence of regulatory forbearance of this kind in practice.[659] Nevertheless, in a highly competitive insurance market nowadays, with private rating agencies actively playing their roles, it is believed that crises of insurers will be discovered and revealed at an early stage, which makes it less likely for the regulatory authority to ignore the need for receivership if the situation so requires.[660] Thus, while it is still appropriate to reserve the legal standing for commencing receivership for the insurance commissioner, it would be better if there were some arrangements in place ensuring that commencement of receivership will not be unduly delayed or hindered

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[657] Insurer Receivership Model Act §§ 204A and 205B.

[658] See, for example, Debra J. Hall and Robert M. Hall, 'Insurance Company Insolvencies: Order out of Chaos' (1993) 12(2) Journal of Insurance Regulation 145, 150; David A. Skeel, 'The Law and Finance of Bank and Insurance Insolvency Regulation' (1998) 76(4) Taxas Law Review 723, 735.

[659] See, for example, Stewart Economics Inc., 'Managing Insurer Insolvency 2003: Updating the 1988 Report' (September 2003) 40 <www.stewarteconomics.com/Insolvency%202003.pdf> accessed 1 April 2018; Bruce M. Friedman, 'The Rise and Fall of Mission Insurance Company' (AIRROC Matters, 2011) 39 <www.airroc.org/assets/docs/matters/nl_airroc_summer_2011_web.pdf> accessed 1 April 2018.

[660] Stewart Economics Inc., 'Managing Insurer Insolvency 2003: Updating the 1988 Report' (September 2003) 40 <www.stewarteconomics.com/Insolvency%202003.pdf> accessed 1 April 2018.

due to regulatory forbearance.

5.2.3. Receiver

Upon the court's issuance of a receivership order, the insurance commissioner will assume the role of receiver, taking possession and control of the insurer.[661] The authority of directors, officers and managers of the insurer will then be suspended, unless otherwise redelegated by the receiver, and the receiver, under the general supervision of the court, will have extensive authority to direct and manage, to hire and discharge employees, and to deal with the property and business of the insurer.[662] Any present or former manager, director, employee, etc., or any other relevant person should cooperate with the receiver, which includes but is not limited to, to reply promptly in writing to any inquiry from the receiver requesting a reply, and to promptly make available to the receiver any records, information or property of or pertaining to the insurer.[663] Any person who fails to cooperate with the receiver, or obstructs or interferes with the receiver in the receivership may even be sentenced to a fine or imprisonment, or both.[664]

Since the insurance commissioner, the chief insurance regulator of a state, may not be available to undertake everyday operation of a receivership procedure, a special deputy or other assistants are often appointed as an agent of the receiver to help deal

[661] See Insurer Receivership Model Act §§ 301A, 401A and 501A.

[662] See Insurer Receivership Model Act §§ 302C, 401A and 402A.

[663] Insurer Receivership Model Act § 110A.

[664] Insurer Receivership Model Act § 110D.

with issues in the receivership.[665] As a consequence, receivership procedures are normally operated by insurance regulatory authorities, outside contractors, or special bureaus.[666] For example, in New York, although the Superintendent of the Department of Financial Services (the equivalent of the insurance commissioner provided for in the IRMA) will be appointed receiver in every insurer receivership, it is the New York Liquidation Bureau, a special bureau operating separately from the Department of Financial Services, that will in fact have responsibilities for carrying out receivership procedures.[667]

In an insurer receivership procedure, unlike a private trustee, the receiver still represents the state to address the crisis occurring in the insurance industry. As was once pointed out by the Supreme Court of California,

> [w]hen there is insolvency or such situation as would make the further transaction of business by the insurer hazardous to its policyholders, its creditors, or to the public, the commissioner, with the aid of the Attorney General, shall institute a proceeding in the superior court placing him in possession of the company's property and seeking such other order as the interest of the policyholders, creditors, and public may require. … The commissioner is a state officer, performing duties enjoined upon him by statute, and in their performance

[665] Insurer Receivership Model Act § 209C.

[666] See Francine L. Semaya and William K. Broudy, 'A Primer on Insurance Receiverships' (2010) 40 The Brief 22, 24.

[667] 'The New York Liquidation Bureau' <www.nylb.org/home.htm> accessed 2 April 2018.

he acts on behalf of the state.[668]

Therefore, rather than being merely a successor to the troubled insurer, the commissioner still acts, at the same time, as an officer of the state enforcing its regulatory power and as the representative of the policyholders and other creditors of the insurer.[669]

5.2.4. Effects of Receivership

Generally speaking, the commencement of a receivership procedure normally means a stay of the commencement or continuation of a judicial, administrative or other action or proceeding against the insurer in receivership, which was or could have been commenced before the commencement of the receivership, until the receivership is closed or dismissed.[670] The actions or proceedings that will be stayed include: to enforce a judgement obtained before the commencement of the receivership;[671] to

[668] *MITCHELL v. TAYLOR*, S. F. 15191 (Cal. 1935).

[669] Karl L. Rubinstein, 'The Legal Standing of an Insurance Insolvency Receiver: When the Shoe Doesn't Fit' (2003) 10 Connecticut Insurance Law Journal 309, 320. See also Robert L. Margolis, 'In Major Victory for Insurance Company Receivers Illinois Appellate Court Deals Severe Blow to Imputation and in Pari Delicto Affirmative Defenses' (2009) 18(4) The Insurance Receiver 16, 19.

[670] Insurer Receivership Model Act § 108C, F. Note: The reason for staying all litigation procedures against the insurer for the whole receivership period is that drafters of the IRMA would like to make sure that all claims against the insurer are handled by the receiver in a consistent manner in receivership, and the receivership court has the exclusive jurisdiction in determining claim disputes the insurer is involved in. However, doubts have been raised about this arrangement, as it means that efforts, time and money put in the existing litigation procedures will all be wasted once the receivership commences. For more discussions relating to this issue, see, for example, John N. Gavin, 'Competing Forums for the Resolution of Claims Against an Insolvent Insurer' (1988) 23(3) Tort & Insurance Law Journal 604; Adam Hodkin, 'Insurer Insolvency: Problems & Solutions' (1992) 20 Hofstra Law Review 727; Peter H. Bickford, 'A Quiet Tyrant: The Insurers Rehabilitation and Liquidation Model Act' (1995) 7(11) Mealey's Litigation Reports 1.

[671] Insurer Receivership Model Act § 108C(2).

exercise control over property or records of the insurer;[672] to collect, assess or recover a claim against the insurer that arose before the commencement of the receivership;[673] to terminate or revoke an insurance licence;[674] etc. However, despite the general rule of stay, in conservation or rehabilitation, if the insurer is believed to be solvent, insurance claims against the insurer will normally be paid as usual without any disruption; but when necessary, a stay may still be imposed on policy surrenders or policy loans.[675] Even if the stay is imposed on the payment of insurance claims, there will always be hardship exceptions allowing eligible policyholders to get a pre-determined percentage or amount of the payment.[676] This makes sure that policyholders facing financial hardship will not be subject to the disruption of payment of insurance claims in conservation or rehabilitation.

The commencement of a receivership procedure also means a troubled insurer will be taken over by the receiver, and the receiver will then have great discretion in operating the insurer to address the insurer's crisis under the court's supervision.[677] The receivership order issued by the court will specify the receiver's authority, and

[672] Insurer Receivership Model Act § 108C(3).

[673] Insurer Receivership Model Act § 108C(5).

[674] Insurer Receivership Model Act § 108C(7).

[675] See, for example, Francine L. Semaya and William K. Broudy, 'A Primer on Insurance Receiverships' (2010) 40 The Brief 22, 29; Iain A.W. Nasatir and Christopher M. Maisel, 'Beware of Rehabilitation Plans' (2013) 22(2) The Insurance Receiver 19, 20. See also Jonathan D. Rose, 'Financial Crises at Insurance Companies: Learning from the Demise of the National Surety Company During the Great Depression' (2017) 24(3) Financial History Review 239, 250.

[676] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 32.

[677] See Insurer Receivership Model Act §§ 301A, 401A and 501A.

prior approval of the court should be sought if certain actions proposed by the receiver are beyond its authority.[678] A person can make a request to be placed on the service list to receive notice of matters filed by the receiver to the court.[679] When the receiver files an application of proposed action to the court, the receiver should provide notice of the application to all persons on the service list.[680] Any party in interest objecting to the application can file an objection with the receivership court specifying the grounds within a given time.[681] If an objection is filed in time, the court may hold a hearing to decide whether to approve the receiver's application.[682] Therefore, while there is no need for the receiver to seek approval or opinions from interested parties before proposing any action, the proposed actions are subject to challenges by interested parties in front of the receivership court. In other words, although it is not interested parties who decide how their interests in the troubled insurer will be dealt with, judicial safeguards are in place to ensure that interested parties will not be unfairly treated by the receiver. But if the receivership court later approves the receiver's application and, upon a motion by the receiver, determines that the objection was frivolous or filed merely for delay or for other improper purpose, the

[678] See, for example, Order of Rehabilitation of Reliance Insurance Company (The Commonwealth Court of Pennsylvania, 29 May 2001); Order of Rehabilitation of Frontier Insurance Company (Supreme Court of the State of New York, 10 October 2001); Order of Rehabilitation of Atlantic Mutual Insurance Company (Supreme Court of the State of New York, 14 September 2010); Order of Liquidation of Penn Treaty Network America Insurance Company (The Commonwealth Court of Pennsylvania, 1 March 2017).

[679] Insurer Receivership Model Act § 107A.

[680] Insurer Receivership Model Act § 107B(1), (2).

[681] Insurer Receivership Model Act § 107B(3).

[682] Insurer Receivership Model Act § 107B(5).

court may order the objecting party to pay the receiver's reasonable costs and fees of defending the action.[683]

Since there will be a tremendous change in the operation of insurers when receivership commences, it seems that both the management of insurers and regulatory authorities tend to avoid the occurrence of receivership. However, what needs to be clarified is that 'receiverships are not intrinsically bad'.[684] From the perspective of the management of insurers, the goal of operating insurers should be set to keep insurers running in a healthy condition and avoid breaching statutory or regulatory requirements. But when an insurer falls into a crisis to the extent that there are triggers for receivership, instead of trying to resist receivership, what the management should do is to cooperate with regulatory authorities in a receivership procedure to solve problems faced by the insurer and prevent further deterioration of the situation. For example, in the case of liquidation of Integrity Insurance Company, to protect the assets of the insurer, the management actively cooperated with the regulatory authority to commence a receivership procedure, and no objection was expressed by the management to the regulatory authorities' involvement.[685] In addition, from the perspective of regulatory authorities, with the aim of protecting

[683] Insurer Receivership Model Act § 107B(5).

[684] Holly Bakke and Doug Hartz, 'New Perspectives on Insurer Insolvency' (2003) 12(3) The Insurance Receiver 12, 12.

[685] For more information about the case of liquidation of Integrity Insurance Company, see Constance D. O'Mara, 'Integrity Insurance in Liquidation: Interview of Richard White, Deputy Liquidator Integrity Insurance Company' (AIRROC Matters, 2011) 16 <www.airroc.org/assets/docs/matters/nl_airroc_summer_2011_web.pdf> accessed 1 April 2018.

policyholders and/or maintaining financial stability, when identifying an insurer crisis, the regulatory authorities should proactively take appropriate measures according to the situation. If there are triggers for receivership, regulatory authorities should initiate an appropriate receivership procedure in a timely manner and get the crisis under control, rather than showing regulatory forbearance to the troubled insurer. Thus, receivership is not a procedure that regulatory authorities should avoid, but an effective tool the regulatory authorities should make full use of to achieve the aim of insurance supervision.

5.3. Receivership Procedures

There are three types of receivership procedures: conservation, rehabilitation and liquidation. Upon a finding of any grounds that could justify receivership, the insurance commissioner can petition a court of competent jurisdiction to place a troubled insurer into an appropriate type of receivership procedure. It is not necessary that conservation should precede rehabilitation or liquidation, or rehabilitation should precede liquidation.[686] Once the petition is granted by the court, the insurance commissioner will be appointed as the receiver to take over the troubled insurer and carry out the procedure under the supervision of the court. With the involvement of the court, receivership procedures are judicial procedures in nature. But given the extensive authority enjoyed by the insurance commissioner during the process, it can

[686] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 7.

still be said that it is the insurance commissioner that takes the leading role in receivership procedures.

In this part, conservation, rehabilitation and liquidation will be analysed respectively, showing how these receivership procedures are designed for the purposes of addressing crises of insurers.

5.3.1. Conservation

When there exist any grounds for commencing a receivership procedure against a troubled insurer, the insurance commissioner can petition a court of competent jurisdiction for conservation. A conservation order issued by the court will appoint the insurance commissioner as the conservator and empower the conservator to take over the insurer.[687] Substituting for the insurer's existing management, the conservator will administer the insurer under the general supervision of the court, and may take any necessary or appropriate action to reform and revitalise the insurer, including but not limited to cancelling insurance policies (other than life or health insurance or annuities), or transferring insurance policies to a solvent assuming insurer.[688] Accountings should be made to the court by the conservator at such intervals specified in the conservation order, but no less frequently than semi-annually.[689]

With all information of the troubled insurer accessible after the takeover, the conservator will conduct a comprehensive analysis to determine if it could correct the

[687] Insurer Receivership Model Act § 301A.

[688] See Insurer Receivership Model Act §§ 301A and 302C.

[689] Insurer Receivership Model Act § 301B.

problems that led to the issuance of the conservation order and restore the insurer to private management and normal operations.[690] Within 180 days of the conservation order, unless otherwise extended by the court for another 180 days, the conservator should apply to the court to release the insurer from the conservation and return it to normal operations, or to place the insurer into rehabilitation or liquidation.[691] The intention of having conservation as a receivership procedure is "to allow a limited amount of time for the insurance commissioner to determine whether rehabilitation or liquidation would be preferable", and "[a]void using rehabilitation merely for preparing the estate for the entry of a liquidation order".[692] Therefore, when it is not clear whether a troubled insurer could be rehabilitated, the insurance commissioner can make use of conservation to take control of the insurer and then conduct further analysis.[693] It can be said that conservation functions as a transitional process. However, even the drafters of the IRMA have doubts about whether powers of the conservator are too broadly set.[694] Since the insurance commissioner, subject to the court supervision, has the authority to take any necessary or appropriate action to reform and revitalise the insurer in conservation,[695] there is no difference between conservation and rehabilitation in this regard. As a consequence, a further doubt can

[690] Insurer Receivership Model Act § 302A.

[691] Insurer Receivership Model Act § 302A, B.

[692] Insurer Receivership Model Act, Proceedings Citations §§ 301 and 302.

[693] Insurer Receivership Model Act, Proceedings Citations § 301.

[694] Insurer Receivership Model Act, Proceedings Citations § 302.

[695] Insurer Receivership Model Act § 302C.

be raised as to whether conservation is substantively different from rehabilitation.

As some states use the term "conservation" to refer to the procedure analogous to "seizure" under the IRMA and have no procedure in place equivalent to "conservation" under the IRMA,[696] it is necessary to make a comparison between conservation and seizure so as to clarify their differences and see how the IRMA manages to coordinate these two procedures. To this end, the following aspects merit attention:

A. Although a common aim of both procedures is to let the insurance commissioner ascertain the condition of a troubled insurer before making informed decisions, seizure is a more temporary procedure than conservation. The purpose of setting up a seizure is to immediately control a troubled insurer and maintain the status quo, preventing diversion of funds or destruction of records.[697] There is a possibility that only a part of, not necessarily all of, the property, premises, books, accounts, documents, and other records of the insurer are taken over by the insurance commissioner according to the seizure order.[698] In comparison, the purpose of conservation goes a step further. The commencement of conservation means the insurance commissioner will take over the entire insurer and then make a comprehensive analysis regarding whether to initiate rehabilitation or liquidation.[699] Although no specific time limit is set in the IRMA for seizure, since the time limit for

[696] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 6.

[697] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) ii.

[698] Insurer Receivership Model Act § 201B.

[699] Insurer Receivership Model Act § 302A.

conservation is 180 days, with an additional 180 days if otherwise approved, it is reasonable to assume that the period of a seizure ordered by the court would be much less than 180 days.

B. A seizure order will be made forthwith by the court on an ex parte basis, which makes it possible for the insurance commissioner to take over a troubled insurer or any part of it without any delay.[700] In comparison, a conservation order can only be made after a summary hearing and trial, so dozens of days are needed before these formalities are completed and the insurance commissioner can finally take over a troubled insurer.[701]

C. During a seizure, the management of the insurer is still in position, but will be enjoined from disposing of the insurer's property or transacting the insurer's business without the written consent of the insurance commissioner.[702] In comparison, the commencement of conservation means that the management of the troubled insurer will be suspended, and the insurance commissioner will have broad discretion to administer the insurer under the court's supervision.[703]

D. To avoid causing harm to an insurer's business by a seizure order issued by the court on an ex parte basis, the seizure will be kept confidential under normal circumstances.[704] In comparison, in order to keep interested parties informed,

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[700] Insurer Receivership Model Act § 201B.

[701] For more information, see Section 5.2.2 in this chapter.

[702] Insurer Receivership Model Act § 201B.

[703] Insurer Receivership Model Act §§ 301A and 302C.

[704] Insurer Receivership Model Act § 206A.

matters related to conservation, generally speaking, should be made public from the commencement of the conservation.[705]

Taken together, within the receivership framework in the IRMA, seizure and conservation serve different functions and complement each other. A conservation order can be entered with or without a seizure order in advance. The existence of both of these two procedures makes it possible for the insurance commissioner to deal with troubled insurers in a more flexible and effective way.

5.3.2. Rehabilitation

Upon the petition by the insurance commissioner for rehabilitation of an insurer, a court of competent jurisdiction may issue a rehabilitation order appointing the commissioner as the rehabilitator to take over the insurer.[706] The rehabilitator will then administer the insurer under the general supervision of the court, and can take any necessary or appropriate action to reform and revitalise the insurer, which includes but is not limited to cancelling insurance policies (other than life or health insurance or annuities), or transferring insurance policies to a solvent assuming insurer.[707] Accountings should be made to the court by the rehabilitator at such intervals specified in the rehabilitation order, but no less frequently than semi-annually, and each accounting should include a report concerning the rehabilitator's opinion as to the likelihood that a rehabilitation plan will be prepared and the timetable for doing

[705] See Insurer Receivership Model Act §§ 107 and 301.

[706] Insurer Receivership Model Act § 401A.

[707] Insurer Receivership Model Act §§ 401A and 402A.

so.[708]

Constituting a major difference from conservation, rehabilitation requires the rehabilitator to file a rehabilitation plan regarding the troubled insurer with the court for approval within 1 year after the entry of the rehabilitation order or such further time as the court may allow.[709] The rehabilitation plan should be fair and equitable to all parties concerned, and provide no less favourable treatment of a claim than would occur in liquidation, unless the holder of that particular claim agrees otherwise.[710] Once a rehabilitation plan is filed, any party in interest can object to the plan, and after hearings as the court may prescribe, the receivership court may either approve or disapprove the plan proposed by the rehabilitator, or may modify it and approve it as modified.[711] With the court approval, the rehabilitator should carry out the plan as approved.[712]

At any time during rehabilitation, if the aim of rehabilitation has been accomplished and grounds for rehabilitation no longer exist, the rehabilitator or the directors of the insurer can petition the court for an order terminating the rehabilitation, or the court may enter such an order on its own motion, so as to return the insurer to normal operations.[713] But if the rehabilitator believes further attempts to rehabilitate an

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708 Insurer Receivership Model Act § 401B.

709 Insurer Receivership Model Act § 403A.

710 Insurer Receivership Model Act §§ 403A and 403C.

711 Insurer Receivership Model Act §§ 403A and 403B.

712 Insurer Receivership Model Act § 403A.

713 Insurer Receivership Model Act § 404C.

insurer would be futile, or would substantially increase the risk of loss to creditors, policyholders or the public, the rehabilitator can move for an order of liquidation.[714] As the payment of insurance claims may be suspended during rehabilitation, in order to better protect the interests of policyholders, it is also provided that if the payment of policy obligations is suspended in substantial part for a period of 6 months at any time after the appointment of the rehabilitator and the rehabilitator has not filed a proposed rehabilitation plan for court approval, the rehabilitator should petition the court for an order of liquidation, or should at least seek an order for a longer suspension period.[715]

Since rehabilitation can function to remedy problems of a troubled insurer, to run off the insurer’s business without entering liquidation, or to prepare the troubled insurer for liquidation, there is a tendency that the insurance commissioner will first commence rehabilitation rather than go directly into liquidation.[716] But as it is not uncommon that rehabilitation are eventually converted to liquidation, the excessive use of rehabilitation in the first place may turn out to be a waste of time and resources.[717] This is also the reason why “conservation” as an interim procedure is devised in the IRMA, which aims to prevent the insurance commissioner from using

[714] Insurer Receivership Model Act § 404A.

[715] Insurer Receivership Model Act § 404B.

[716] See, for example, Iain A.W. Nasatir and Christopher M. Maisel, 'Beware of Rehabilitation Plans' (2013) 22(2) The Insurance Receiver 19, 20; NAIC, ‘Receiver's Handbook for Insurance Company Insolvencies’ (2018) 8.

[717] Debra J. Hall and Robert M. Hall, 'Insurance Company Insolvencies: Order out of Chaos' (1993) 12(2) Journal of Insurance Regulation 145, 172.

rehabilitation merely as a pit stop for liquidation.[718] However, as both conservation and rehabilitation mean that the insurance commissioner as the receiver can take any necessary or appropriate action to reform and revitalise the insurer,[719] differences between conservation and rehabilitation seem to only lie in procedural aspects rather than substantive aspects, with conservation normally ending within 180 days while rehabilitation requiring a rehabilitation plan to be filed for approval normally within 1 year.[720]

5.3.3. Liquidation

When it comes to liquidation of troubled insurers, in line with the objective of policyholder protection, preferential treatment is given to policyholders. For example, insurance policies may still continue in force for a certain period after the liquidation order is entered;[721] policyholders are entitled to receive compensation from insurance guaranty associations if the insurer in liquidation is found insolvent;[722] claims of policyholders and claims of insurance guaranty associations enjoy a high priority in the claims hierarchy;[723] etc. The discussion in this section will show how liquidation is specially designed to deal with troubled insurers.

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[718] Insurer Receivership Model Act, Proceedings Citations § 301.

[719] Insurer Receivership Model Act §§ 302C and 402A.

[720] Insurer Receivership Model Act §§ 302A and 403A.

[721] Insurer Receivership Model Act § 502B, D.

[722] For a more detailed discussion, see Part 5.4 in this chapter.

[723] Insurer Receivership Model Act § 801.

5.3.3.1. Entry into Liquidation

Upon the petition by the insurance commissioner for liquidation of a troubled insurer, a court of competent jurisdiction may issue a liquidation order appointing the commissioner as the liquidator to take over the insurer.[724] If the ground for the petition lies in the insolvency of the insurer, the commissioner should also include a request for a judicial declaration of insolvency in the petition, and the court can make the declaration of insolvency at any time after relevant notice and hearing.[725] With the court's appointment, the liquidator will have extensive powers to administer the troubled insurer as long as actions taken are necessary or appropriate for the accomplishment of or in aid of the purpose of liquidation.[726] Full discretion has been accorded to the liquidator to deal with property or claims with a value not exceeding the lesser of $1,000,000 or 10% of the general assets of the insurer' estate (the court may still increase this threshold when it is necessary), and in other circumstances, prior approval of the court should be obtained before any actions are taken by the liquidator.[727]

Generally speaking, the rights and liabilities between the insurer and its creditors (including policyholders), shareholders, or other interested persons become fixed as of the date the order of liquidation is entered or the date otherwise fixed by the court

[724] Insurer Receivership Model Act § 501A.

[725] Insurer Receivership Model Act § 501D.

[726] Insurer Receivership Model Act § 504C.

[727] Insurer Receivership Model Act § 504D(1), (2).

(collectively termed as “fixing date”), with exceptions for rights and liabilities under insurance policies.[728] There will be different treatment for different types of insurance policies. As to life and health insurance policies covered by insurance guaranty associations, these policies will continue in force, subject to the terms of the policies (including any terms restructured pursuant to a court-approved rehabilitation plan), to the extent necessary to permit the insurance guaranty associations to discharge their statutory obligations.[729] As to life and health insurance policies which are not covered by guaranty associations, or property and casualty insurance policies, these policies will continue in force, unless further extended by the liquidator with the court approval, until the earlier of:

[(1)] 30 days from the date of entry of the liquidation order;

(2) the date of expiration of the policy coverage;

(3) the date the insured has replaced the insurance coverage with equivalent insurance with another insurer or otherwise terminated the policy;

(4) the date the liquidator has effected a transfer of the policy obligation to other solvent insurers; or

(5) the date proposed by the liquidator and approved by the receivership court to cancel coverage.[730]

As a corollary, special protection has been provided for policyholders. By virtue of

[728] Insurer Receivership Model Act § 501B.

[729] Insurer Receivership Model Act § 502D.

[730] Insurer Receivership Model Act § 502B, D.

the exceptions to the normal "fixing date" provision, policyholders with life and health insurance policies covered by insurance guaranty associations will be able to continue their policies without sudden disruption, and policyholders with other insurance policies will have a buffer period to make appropriate arrangements before their insurance coverage is terminated due to the commencement of liquidation.[731] In addition, since the liquidator still has the authority to transfer policies of the troubled insurer to other solvent assuming insurers, it may also be the case that policyholders seamlessly form an insurance relationship with the assuming insurers.[732] In this circumstance, policyholders will remain covered by insurance without disruption despite the liquidation of the troubled insurer.

5.3.3.2. Claims and Priority

In liquidation, the liquidator will determine creditors' claims and then make payments according to the claims hierarchy. Claims of policyholders have priority over most other unsecured claims in the claims hierarchy, and eligible policyholders are still entitled to receive compensation from insurance guaranty associations when an insurer in liquidation is declared insolvent.[733] In order to facilitate insurance guaranty associations' functions, preferential treatment is also given to the insurance guaranty

[731] See, for example, Douglas Hartz, 'Warr Penn – Warping the Statute' (2019) 26(2) The Insurance Receiver 4, 9.

[732] Insurer Receivership Model Act § 504A(5).

[733] For a more detailed discussion of the functions of insurance guaranty associations, see Part 5.4 in this chapter.

associations during the process of distributing the insurer's estate. A more detailed discussion of determination of claims and payment of claims is as follows:

(1) Determination of Claims

After a troubled insurer is placed in liquidation, creditors (including policyholders) should file claims as well as proofs of the claims with the liquidator. Exceptions have been made to claims for cash surrender values or other investment values in life insurance and annuities and for any other policies insuring the lives of persons.[734] Since relevant information of these insurance claims is normally possessed by the insurer, there is no need for policyholders to file proofs of these claims unless the liquidator expressly requires.[735] The liquidator will review all claims duly filed and make determinations as to allow, disallow or compromise claims.[736] Considering the fact that the assets of a troubled insurer may not be sufficient to satisfy claims of all classes,[737] the liquidator is not required to process claims for any class until it appears reasonably likely that the property will be available for a distribution to that class.[738] This definitely helps the liquidator avoid unnecessary work. In fact, it is often the case that even insurance claims cannot be fully paid in liquidation of an insurer, so creditors with claims in a lower claim class than insurance claims will normally receive nothing

[734] Insurer Receivership Model Act § 701A.

[735] Insurer Receivership Model Act § 701A.

[736] Insurer Receivership Model Act § 703A.

[737] For a more detailed discussion of claim classes, see Section 5.3.3.2.(2) in this chapter.

[738] Insurer Receivership Model Act § 703K.

at all.[739]

Due to the nature of the insurance business, insurance claims filed with the liquidator may be contingent or unliquidated at the time of filing.[740] A contingent claim may be allowed if the proof of the insurer's obligation to pay is reasonably satisfactory to the liquidator, and an unliquidated claim may be allowed if its amount has been determined.[741] For the sake of efficiency, when the amount of an unliquidated claim remains undetermined for long, the valuation of the unliquidated claim may be made by estimate based on an accepted method, and then the estimated amount will become the amount of the claim that is allowed.[742] Likewise, contingent claims may also be estimated in this manner.[743] Additionally, in consideration of administrative convenience, the receivership court may set a maximum de minimis amount, and the liquidator should disallow claims that are for or determined to be for de minimis amounts which are equal to or less than the maximum de minimis amount.[744]

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[739] See, for example, Brian J. Hall, 'Regulatory Free Cash Flow and the High Cost of Insurance Company Failures' (2000) 67(3) The Journal of Risk and Insurance 415, 417.

[740] According to the Insurer Receivership Model Act § 705A, a claim is contingent if the accident, casualty, disaster, loss, event or occurrence insured, reinsured or bonded against occurred on or before the fixing date, but the act or event triggering the company's obligation to pay has not occurred as of that date (for more information about the "fixing date", see Section 5.3.3.1 in this chapter.); a claim is unliquidated if the insurer's obligation to pay has been established, but the amount of the claim has not been determined.

[741] Insurer Receivership Model Act § 705B, C.

[742] Insurer Receivership Model Act § 705C.

[743] John C. Craft and William C. Jolley, 'Missouri Appellate Opinion in Holland-America Receivership Case Affirms Receiver's Power to Estimate Unliquidated Claims, Including IBNR Losses, to Aid Recovery of Reinsurance Assets' (1996) 5(3) The Insurance Receiver 14, 19.

[744] Insurer Receivership Model Act § 703H.

The liquidator will provide notice of the claim determination to each claimant, setting forth the amount of the claim allowed by the liquidator and the priority class of the claim.[745] Dissenting claimants can submit written objections to the liquidator within 45 days after the notice was mailed, setting out reasons for the objections.[746] If the liquidator does not alter the determination of a claim as a result of the objection, the liquidator should ask the receivership court for a hearing, and the final disposition of the disputed claim by the court will be deemed a final judgement subject to appeal.[747]

(2) Payment of Claims

In the claims hierarchy provided for in the IRMA, secured claims have priority over all unsecured claims, and unsecured claims are classified into 13 classes with different levels of claim priority.[748] Payment of unsecured claims will be made in accordance with the order of claim priority, so that claims of a certain class will be paid in full or adequate funds will be retained for their payment before claims of an inferior class are paid.[749] If the assets are not sufficient to satisfy all claims of a certain class, then claims within this class will be paid on a pro rata basis.[750] Generally speaking, claim classes are designed as follows:

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[745] Insurer Receivership Model Act § 703B.

[746] Insurer Receivership Model Act § 703C.

[747] Insurer Receivership Model Act § 707B, D.

[748] Insurer Receivership Model Act §§ 710 and 801.

[749] Insurer Receivership Model Act § 801.

[750] Insurer Receivership Model Act § 801.

Class 1. The costs and expenses of administration of the receivership;

Class 2. The reasonable expenses of a guaranty association, including overhead, salaries and other general administrative expenses allocable to the receivership;

Class 3. Most claims under policies of insurance, and all other claims incurred in fulfilling the statutory obligations of a guaranty association not included in Class 2, including but not limited to payments on covered claims;

Class 4. All claims under policies of insurance for mortgage guaranty, financial guaranty or other forms of insurance offering protection against investment risk, or warranties;

Class 5. Claims of the federal government not included in Classes 3 or 4;

Class 6. Debts due employees for services or benefits;

Class 7. Claims of other unsecured creditors not included in Classes 1 through 6, including claims under reinsurance contracts, claims of guaranty associations for assessments not paid by the insurer, etc.;

Class 8. Claims of any state or local governments, and claims for services rendered and expenses incurred in opposing a formal delinquency proceeding;

Class 9. Claims for penalties, punitive damages or forfeitures;

Class 10. Late filed claims that would otherwise be classified in Classes 3 through 9;

Class 11. Surplus notes, capital notes or contribution notes, etc.;

Class 12. Interest on allowed claims of Classes 1 through 11;

Class 13. Claims of shareholders or other owners.[751]

It is evident that claims of insurance guaranty associations and claims of policyholders enjoy a high level of priority in the claims hierarchy, with the claim of expenses of an insurance guaranty association even having priority over claims of policyholders.

Also, insurance guaranty associations still enjoy preferential treatment during the distribution process. As is provided in the IRMA, within 120 days after the entry of an order of liquidation, and at least annually thereafter, the liquidator should apply to the court for approval to make early access payments out of the general assets of the insurer to the affected guaranty associations, unless there are no assets available to be distributed.[752] If distributable assets are sufficient, the amounts of early access payments need not be limited to the claims and expenses which have been paid by the guaranty associations, so long as the amounts will not be in excess of the anticipated entire claims of the guaranty associations falling in Class 2 and Class 3.[753] Amounts advanced will be deemed advances against distributions on claims of the guaranty associations, and the guaranty associations are liable to return to the liquidator the amounts that may be required to pay claims of secured creditors and claims within Classes 1 through 3.[754] It is reasonable to assume that the design of early

[751] Insurer Receivership Model Act § 801.

[752] Insurer Receivership Model Act § 803B.

[753] Insurer Receivership Model Act § 803A(3).

[754] Insurer Receivership Model Act §§ 803A(1) and 803F.

access payments in the IRMA is linked to the ex-post assessment approach normally adopted by insurance guaranty associations.[755] Given the fact that a guaranty association will assess its member insurers after the insolvency of an insurer takes place and thus may not have sufficient funds in place to make compensation payments to policyholders, it is necessary to allow guaranty associations to get early access payments from the insolvent insurer so as to make it possible for the guaranty associations to perform their functions. In this sense, the preferential treatment in distribution designed for guaranty associations is in line with the objective of policyholder protection, which to a large extent ensures that policyholders will not suffer a significant delay in receiving insurance payments when an insolvent insurer is in liquidation.

5.3.3.3. Termination of Liquidation

In order to make the most of the property held by a troubled insurer and maximise payments which relevant parties could receive from the distribution, a sale of the insurer's entity and/or charter may be proposed by the liquidator in liquidation. It can only be carried out after the receivership court approves.[756] To achieve the sale, the corporate entity or charter, together with any licences to do business and such assets as the liquidator deems appropriate to the transaction, will be separated from the

[755] For a more detailed discussion of assessments of insurance guaranty associations, see Part 5.4 in this chapter.

[756] Insurer Receivership Model Act § 503C.

remaining estate in liquidation, and be sold to one or more buyers.[757] Once the sale is completed, the corporate entity or charter so transferred will be free and clear from the claims or interest of the troubled insurer's creditors (including policyholders) and stockholders, and proceeds from the sale would become a part of the property of the remaining estate in liquidation.[758] Through this way, more cash can be brought into the remaining estate, increasing the assets that are available to be distributed to creditors of the troubled insurer.

After all assets of a troubled insurer justifying the expense of collection and distribution have been collected and distributed, the liquidator will apply to the court to terminate the liquidation.[759] However, at any time after the termination of liquidation, the insurance commissioner or other interested parties are still allowed to petition the receivership court to reopen the liquidation based on good cause, eg the discovery of additional property of the liquidated insurer.[760] The liquidation will be reopened if the court is satisfied that there is justification to do so.[761] It can be said that, with the terminated liquidation of an insurer reopening in exceptional cases, the purpose of liquidation will be better served.

5.4. Insurance Guaranty Associations

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[757] Insurer Receivership Model Act § 503B.

[758] Insurer Receivership Model Act § 503B, C.

[759] Insurer Receivership Model Act § 902.

[760] Insurer Receivership Model Act § 903.

[761] Insurer Receivership Model Act § 903.

In order to "provide limited, but substantial, coverage for less sophisticated policyholders who are ill-equipped to fend for themselves in connection with their decision to purchase and retain their policies",[762] there exist insurance guaranty associations, who are indispensable players in the CMME mechanism.

In line with the US state-based insurance regulation, insurance guaranty associations are established in each state, under the supervision of the insurance commissioner. A certain insurance guaranty association in a state is mainly responsible for protecting covered insurance claims held by residents of the state.[763] According to the types of insurance products covered by the associations, in each state there are the Life and Health Insurance Guaranty Association and the Property and Casualty Insurance Guaranty Association. Correspondingly, the NAIC has adopted the Life and Health Insurance Guaranty Association Model Act and the Property and the Casualty Insurance Guaranty Association Model Act, which set the models for state laws governing these two types of insurance guaranty associations.

All life and health insurers within a state are members of the Life and Health Insurance Guaranty Association, and all property and casualty insurers within a state are members of the Property and Casualty Insurance Guaranty Association.[764] Member insurers are required to pay assessments to guaranty associations to maintain

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[762] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 327.

[763] See Life and Health Insurance Guaranty Association Model Act § 3; Property and Casualty Insurance Guaranty Association Model Act § 5H.

[764] See Life and Health Insurance Guaranty Association Model Act § 6; Property and Casualty Insurance Guaranty Association Model Act § 6.

the daily operation of the associations as well as to support the associations' functions in dealing with troubled insurers. While most states have adopted the ex-post assessment approach, which means the guaranty associations will assess insurers necessary amounts after the insolvency of an insurer takes place, New York has adopted the ex-ante assessment approach, allowing guaranty associations to assess member insurers quarterly so as to maintain the guaranty fund with at least a scale of 150 million dollars all the time.[765]

In this part, the discussion will respectively show how a Life and Health Insurance Guaranty Association and a Property and Casualty Insurance Guaranty Association may function when facing crises of troubled insurers. Basically, while a Life and Health Insurance Guaranty Association can perform both the function of protecting policyholders (through providing coverage to policyholders in liquidation) and the function of rescuing insurers (through providing financial assistance to troubled insurers in conservation or rehabilitation), a Property and Casualty Insurance Guaranty Association can only perform the function of protecting policyholders.

5.4.1. Life and Health Insurance Guaranty Association

For the purposes of protecting policyholders of troubled life and health insurers, the Life and Health Insurance Guaranty Association as a non-profit legal entity under the immediate supervision of the insurance commissioner has been established in each state, and all life and health insurers within a state are members of the guaranty

[765] New York Insurance Law § 7603(b), (c).

association and should pay assessments as required.[766] The guaranty association can not only perform the function of protecting policyholders when an insurer is insolvent, but also perform the function of rescuing insurers when an insurer is impaired. It is specifically provided in the Life and Health Insurance Guaranty Association Model Act that an insurer is impaired when it is under an order of conservation or rehabilitation but not declared insolvent, and an insurer is insolvent when it is under an order of liquidation with a finding of insolvency.[767] However, as the terms "impaired" and "insolvent" so defined do not cover all possible situations, it is not clear from the provisions as to whether the guaranty association can intervene, and, if it can, how to intervene, when an insurer under an order of conservation or rehabilitation is insolvent, or when an insurer under an order of liquidation is solvent.

Generally speaking, the Life and Health Insurance Guaranty Association provides coverage to policyholders for direct insurance policies, such as life insurance, health insurance, annuities, etc.[768] To avoid using funds of the guaranty association to protect sophisticated investors who are deemed to have the capacity to protect their own interests, exclusions are clearly made. For example, policies or portions of policies which are not guaranteed by the insurer, or under which the risk is borne by policyholders, such as variable annuities and variable life insurance, are expressly

[766] Life and Health Insurance Guaranty Association Model Act § 6.

[767] Life and Health Insurance Guaranty Association Model Act §§ 5K and 5L.

[768] Life and Health Insurance Guaranty Association Model Act §§ 3A(6) and 3B(1).

excluded from the coverage of the guaranty association.[769] Also, there still exist upper limits for coverage the guaranty association provides. For example, with respect to one life, regardless of the number of policies, the upper limits for coverage are:

(i) $300,000 in life insurance death benefits, but not more than $100,000 in net cash surrender and net cash withdrawal values for life insurance;

(ii) For health insurance benefits:

(I) $100,000 for coverage not defined as disability income insurance or health benefit plans or long-term care insurance, including any net cash surrender and net cash withdrawal values;

(II) $300,000 for disability income insurance and long-term care insurance;

(III) $500,000 for health benefit plans;

(iii) $250,000 in the present value of annuity benefits, including net cash surrender and net cash withdrawal values.[770]

When an insolvent insurer is put into liquidation, to perform the function of protecting policyholders, the guaranty association can, in its discretion, provide monies, pledges, loans, notes, guarantees, or other means reasonably necessary to guarantee, assume, reissue, or reinsure (or cause to be guaranteed, assumed, reissued, or reinsured) the policies of the insolvent insurer, or to assure payment of the

[769] Life and Health Insurance Guaranty Association Model Act § 3B(2)a. See also NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 322.

[770] Life and Health Insurance Guaranty Association Model Act § 3C(2)a.

contractual obligations of the insolvent insurer.[771] By virtue of these means, the guaranty association will provide coverage to policyholders either through making compensation payments to policyholders or securing the continuity of insurance policies. As an example, with respect to non-group policies, before the policies are terminated in liquidation, the guaranty association will assure payment of insurance benefits for claims incurred not later than the earlier of the next renewal date (if any) or 1 year, but in no event less than 30 days, from the date on which the guaranty association becomes obligated.[772] This ensures that policyholders can receive insurance payments as usual at least for 30 days after an insurer enters liquidation without suffering a sudden termination of insurance benefits. As another example, with respect to non-group policies by virtue of which policyholders have a right to continue an individual policy in force until a specified age or for a specified time, the guaranty association should make available substitute coverage on an individual basis by issuing an alternative policy at actuarially justified rates, subject to prior approval of the insurance commissioner.[773] Any alternative policy issued by the guaranty association should provide coverage of a type similar to that of the policy issued by the insolvent insurer, and should have a reasonable premium rate without considering any changes in the health of the insured after the original policy was last

[771] Life and Health Insurance Guaranty Association Model Act § 8B(1).

[772] Life and Health Insurance Guaranty Association Model Act § 8B(2)(a).

[773] Life and Health Insurance Guaranty Association Model Act § 8B(2)(c), (d).

underwritten.[774] In this way, policyholders will always be entitled to the long-term insurance coverage with premiums at around the previous premium levels.

Upon receiving benefits from the guaranty association,[775] policyholders will be deemed to have assigned all relevant rights under the covered policies to the guaranty association to the extent of the benefits received, so that the guaranty association will be entitled to seek recovery from the troubled insurer or from persons causing insured losses.[776] Also, the guaranty association can even exercise the powers that troubled insurers have.[777] Premiums due for coverage after entry of an order of liquidation of an insolvent insurer will belong to and be payable at the direction of the guaranty association, and non-payment of premiums within 31 days after the date required will terminate the guaranty association's obligations to provide further coverage.[778] If the situation requires, the guaranty association may still file for actuarially justified rate or premium increases for covered policies, or impose temporary moratoriums or liens on payments of cash values and policy loans, or on any other right to withdraw funds with respect to covered policies, etc.[779] As it is essential for the guaranty association to take action when an insurer in liquidation is found insolvent, the failure of the guaranty

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[774] Life and Health Insurance Guaranty Association Model Act § 8B(2)(e).

[775] The benefits policyholders may receive include payments of or on account of contractual obligations, continuation of coverage, or provision of substitute or alternative policies, contracts, or coverages. See Life and Health Insurance Guaranty Association Model Act § 8K(1).

[776] Life and Health Insurance Guaranty Association Model Act § 8K(1) – (3).

[777] Life and Health Insurance Guaranty Association Model Act § 8L(6).

[778] Life and Health Insurance Guaranty Association Model Act § 8C, D.

[779] Life and Health Insurance Guaranty Association Model Act §§ 8F and 8L(9).

association to do so within a reasonable period of time will result in the situation that the insurance commissioner has all the powers and duties of the guaranty association relating to dealing with the insolvent insurer.[780]

Although the primary objective of the guaranty association is to provide coverage to eligible policyholders when an insurer is in liquidation with a finding of insolvency (ie to perform the function of protecting policyholders), the guaranty association is also empowered to provide financial assistance directly to an insurer in conservation or rehabilitation (ie to perform the function of rescuing insurers).[781] Upon the approval by the insurance commissioner, the guaranty association may act to guarantee, assume, reissue, or reinsure (or cause to be guaranteed, assumed, reissued, or reinsured) any or all of the policies of the impaired insurer, or otherwise provide monies, pledges, loans, notes, guarantees or other means which are proper to effectuate these actions, and assure payment of the contractual obligations of the impaired insurer pending these actions.[782] However, whatever actions the guaranty association takes in conservation or rehabilitation of an insurer, the actions will have the effect of bailing out the troubled insurer, benefiting all interested persons rather than just protecting covered policyholders. Since "bail-out" somewhat deviates from the purpose of establishing the guaranty association, in practice, guaranty associations have traditionally been extremely reluctant to provide funding before the

[780] Life and Health Insurance Guaranty Association Model Act § 8H.

[781] Life and Health Insurance Guaranty Association Model Act § 8 (Drafting Note).

[782] Life and Health Insurance Guaranty Association Model Act § 8A.

commencement of a liquidation of an insolvent insurer.[783]

To raise funds necessary to carry out the powers and duties of the guaranty association, two classes of assessments will be imposed on member insurers: Class A assessments for the purposes of meeting administrative and legal costs and other expenses of the guaranty association, and Class B assessments for the purposes of providing coverage to policyholders of impaired or insolvent insurers.[784] While Class A assessments may be authorised and called whether or not related to a particular impaired or insolvent insurer, Class B assessments will not be authorised or called until it is necessary to deal with an impaired or insolvent insurer.[785] With respect to Class B assessments, in order to help insurers recoup the payment of assessments, it is provided that an insurer can offset against its premium, franchise or income tax liability to the state 20% of the amount of the assessment for each of the 5 calendar years following the year in which the assessment was paid.[786] As a corollary, losses incurred by troubled insurers will be eventually borne by the whole state, namely the taxpayer of the state.[787]

Since it may still be the case that the guaranty association provides financial assistance to an insurer in conservation or rehabilitation, when this happens, the state

[783] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 321.

[784] Life and Health Insurance Guaranty Association Model Act § 9B.

[785] Life and Health Insurance Guaranty Association Model Act §§ 9B and 9C(5).

[786] Life and Health Insurance Guaranty Association Model Act § 13A.

[787] See James Barrese and Jack M. Nelson, 'Some Consequences of Insurer Insolvencies' (January 1993) <www.researchgate.net/publication/257384925_Some_Consequences_of_Insurer_Insolvencies> accessed 8 August 2018.

is in effect bailing out the impaired insurer with the use of public funds. But moral hazard from the perspective of insurers can somewhat be mitigated due to the restrictions imposed on insurers. As is required in the IRMA, before all the payments, expenses and interest thereon are repaid to the guaranty association, an insurer subject to a receivership procedure should not be returned to, or have any of its assets returned to, the control of its private management or shareholders, unless otherwise provided in a plan approved by the guaranty association.[788] Thus, it is unlikely that the private management or shareholders of the troubled insurer can easily get away from the crisis without suffering any losses but leave the burden of trouble only to the state. In addition, given the fact that the guaranty association rarely provides financial assistance to an insurer in conservation or rehabilitation, it is reasonable to believe that the management or shareholders of an insurer will not normally count on the guaranty association for a bail-out if the insurer is trapped in a crisis.

5.4.2. Property and Casualty Insurance Guaranty Association

To avoid excessive delay in payment of insurance claims and to minimise financial loss to policyholders because of the insolvency of an insurer, the Property and Casualty Insurance Guaranty Association has therefore been established.[789] Unlike the Life and Health Insurance Guaranty Association which can perform both the function of protecting policyholders and the function of rescuing insurers, the Property and

[788] Insurer Receivership Model Act § 901.

[789] Property and Casualty Insurance Guaranty Association Model Act § 2.

Casualty Insurance Guaranty Association can only perform the function of protecting policyholders. In other words, how the Property and Casualty Insurance Guaranty Association may function is to make compensation payments to covered policyholders when an insurer is under an order of liquidation with a finding of insolvency.[790] The legislature intentionally '[p]recludes the use of property and casualty insurance guaranty fund resources as bail-out funds to be used in an attempt to rehabilitate – rather than liquidate – the company.'[791]

All types of direct property and casualty insurance, with the exception of title insurance, ocean marine insurance, etc., are covered by the Property and Casualty Insurance Guaranty Association.[792] When an insurer is under an order of liquidation with a finding of insolvency, the guaranty association will be obligated to pay covered claims existing prior to the order of liquidation, and claims arising within 30 days after the order of liquidation is issued (but before policies are cancelled or replaced by policyholders, or before policies expire, if these happen within 30 days after the order of liquidation is issued).[793] There are upper limits on the coverage the guaranty association can provide. For example, with respect to the return of unearned premiums, the limit is $10,000 per policy, and with respect to most other covered claims, the limit is $500,000 per claimant.[794] Unlike dealing with life/health policies,

[790] Property and Casualty Insurance Guaranty Association Model Act § 5I.

[791] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 313.

[792] Property and Casualty Insurance Guaranty Association Model Act § 3.

[793] Property and Casualty Insurance Guaranty Association Model Act § 8A(1)a.

[794] Property and Casualty Insurance Guaranty Association Model Act § 8A(1)a.

which normally requires the continuity of these policies, dealing with property/casualty policies normally involves imposing a termination on property/casualty policies and returning unearned premiums to policyholders. However, to avoid a sudden interruption of the insurance coverage policyholders have, the continuation of property/casualty policies for a certain period after the issuance of the order of liquidation is necessary. For this purpose, a buffer period of 30 days is provided, giving policyholders of an insolvent insurer some time to seek substitute policies from other insurers.

Once policyholders receive claims payments from the guaranty association, they will be deemed to have assigned any rights under policies to the guaranty association to the extent of the benefits they received.[795] Then the guaranty association will not only have the right to file a claim against the estates of the insurer in liquidation for the amounts paid on covered claims, but also have the right to pursue and retain salvage and subrogation recoverables related to covered claims from those causing insured losses.[796] Since the rights assigned by policyholders are limited to the extent of the benefits they receive from the guaranty association, when it comes to the case that a policyholder has a claim beyond the upper limit the guaranty association can cover, the policyholder will still have the right to claim against the estate of the insurer in liquidation for the difference of amounts between the insurance claim and the

[795] Property and Casualty Insurance Guaranty Association Model Act § 12A.

[796] Property and Casualty Insurance Guaranty Association Model Act §§ 8A(2) and 12C.

payment made by the guaranty association.

The Property and Casualty Insurance Guaranty Association will assess property and casualty insurers the amounts necessary to carry out duties of paying covered insurance claims in liquidation of an insolvent insurer and the amounts necessary for the guaranty association's daily operation.[797] According to provisions in each state, the insurers so assessed may recoup the assessments through either policyholder surcharges, or increased rates and premiums for policies, or offset against tax liabilities.[798] While the recoupment of assessments through policyholder surcharges, or increased rates and premiums for policies, means that losses caused by the insolvency of a property/casualty insurer will be eventually borne by all policyholders, the recoupment of assessments through tax offset means the losses will in effect be absorbed by the general public of the state.

5.5. Regulation at the Federal Level

Despite the NAIC's efforts to harmonise insurance laws and coordinate supervisory activities among states, the state-based insurance regulation system is sometimes found weak in dealing with insurers doing business in multiple states or insurers being subsidiaries of a financial conglomerate with the nation-wide influence. This situation was extraordinarily highlighted in the 2007–2009 financial crisis. Although the

[797] Property and Casualty Insurance Guaranty Association Model Act § 8A(3).

[798] Property and Casualty Insurance Guaranty Association Model Act § 17.

financial crisis generally had limited impacts on the insurance industry and policyholders (except for certain annuity products in the life insurance industry or the financial and mortgage guaranty lines in the property and casualty insurance industry)[799] and relatively few receiverships of insurers occurred during the crisis period,[800] the bailouts of several insurance-focused financial conglomerates, especially the American International Group, Inc. (AIG), by the federal government reignited debates over the necessity of supervising the insurance industry at the federal level. Responding to this, reforms were carried out in the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) to enhance the federal government's authority to monitor the insurance industry and to deal with financial crises. However, these reforms did not mean to replace the state-based insurance regulation system, but supplemented the existing system with arrangements concerning supervision or resolution of insurance holding companies or insurance groups. As this thesis focuses just on the crisis management and market exit mechanism dealing with insurers, the companies underwriting direct insurance policies to policyholders, the analysis of supervision or resolution of insurance holding companies or insurance groups will revolve around the arrangements which are

[799] United State Government Accountability Office, 'Insurance Markets: Impacts of and Regulatory Response to the 2007–2009 Financial Crisis' (June 2013) 9.

[800] During the period of 2007–2009, 22 life insurers and 34 property/casualty insurers were put into receivership. There was no marked increase in the number of receiverships in this period compared with other years. See United State Government Accountability Office, 'Insurance Markets: Impacts of and Regulatory Response to the 2007–2009 Financial Crisis' (June 2013) 17.

relevant to how troubled insurers may be affected.

In this part, the federal reactions to crises in the insurance industry during the 2007–2009 financial crisis and the subsequent reforms in the Dodd–Frank Act will be discussed in turn.

5.5.1. Federal Reactions During the 2007–2009 Financial Crisis

Due to the US subprime crisis, financial companies involved in relevant transactions were adversely affected to a greater or lesser extent, triggering the 2007–2009 worldwide financial crisis.[801] During this period, a great number of financial companies ended up in failures, including the world-famous investment bank Lehman Brothers, and many others were facing severe crises which put them on the brink of failure, including the insurance giant AIG. In order to prevent deterioration of the situation and turn around the world economy, the federal government intervened to provide financial assistance to a number of troubled financial companies for rescue purposes. That is to say, instead of standing by and watching the troubled financial companies go bust, the federal government bailed them out of the crises.

5.5.1.1. A Brief Overview of Financial Assistance in the Insurance Industry

During the 2007–2009 financial crisis, financial assistance from the federal level was provided mainly through two channels: (1) by virtue of section 13(3) of the Federal

[801] For a discussion of causes of the 2007–2009 financial crisis, see The Financial Crisis Inquiry Commission, 'The Financial Crisis Inquiry Report' (January 2011).

Reserve Act, the Federal Reserve set up various emergency lending programmes, which provided emergency loans to eligible financial institutions; (2) by virtue of the Emergency Economic Stabilization Act of 2008, the Treasury set up the Troubled Asset Relief Program (TARP), which provided capital injections into troubled giant financial institutions.[802]

In terms of the insurance sector, financial assistance was provided to a number of insurance companies or insurance holding companies to help them get over the crisis. For example, Hartford Financial Services Group, Inc. and Lincoln National Corporation, financial holding companies that own large insurers, respectively received $3.4 billion and $950 million from the TARP; MetLife, Inc., the life industry’s largest company in terms of premiums written, by virtue of its role as a bank holding company, accessed $18.9 billion in short-term funding through the Federal Reserve’s Term Auction Facility; 10 insurance holding companies obtained $68.8 billion in the Federal Reserve’s Commercial Paper Funding Facility; and 6 insurance companies or insurance holding companies borrowed over $3.6 billion through the Federal Reserve’s Term Asset-Backed Securities Loan Facility.[803]

Also, with the combined financial commitment of $182.3 billion from the Federal

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[802] See, for example, United State Government Accountability Office, 'Ongoing Challenges and Guiding Principles Related to Government Assistance for Private Sector Companies' (August 2010); United State Government Accountability Office, 'Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance' (21 July 2011).

[803] United State Government Accountability Office, ‘Insurance Markets: Impacts of and Regulatory Response to the 2007–2009 Financial Crisis’ (June 2013) 46–48.

Reserve and the Treasury, the rescue of AIG represented one of the costliest bailouts in the US history.[804] To have a general understanding of how the federal government functioned in dealing with crises in the insurance industry, analysis of the bailout of AIG will be made as follows.

5.5.1.2. The Bailout of AIG

AIG was then the largest insurance-focused financial holding company in the world, with subsidiaries of 71 US-based insurers and 176 other financial services companies (including non-US insurers) operating in over 130 countries.[805] The crisis of AIG derived mainly from two sources: one is the credit default swap (CDS) transactions conducted by AIG Financial Products Corp. (AIGFP), a noninsurance subsidiary;[806] the other is the securities lending programmes participated by AIG's life insurance subsidiaries.[807] Due to the subprime crisis, AIGFP's CDS portfolio experienced massive write-downs in 2007 and 2008, which caused a large number of additional collateral

[804] US Department of the Treasury, 'Treasury Sells Final Shares of AIG Common Stock, Positive Return on Overall AIG Commitment Reaches $22.7 Billion' (11 December 2012) <www.treasury.gov/press-center/press-releases/Pages/tg1796.aspx> accessed 19 January 2018.

[805] Eric R. Dinallo, 'Lessons Learned from AIG for Modernizing Insurance Regulation' in John H. Biggs and Matthew P. Richardson (eds), *Modernizing Insurance Regulation* 45 (John Wiley & Sons 2014).

[806] In a credit default swap (CDS) transaction, the purchaser of protection pays the issuer of protection a fee for a certain period and receives in return a promise that if a third party cannot pay its debts to the purchaser of protection, the purchaser of protection will be made whole by the issuer of protection. AIGFP plays the role of the issuer of protection in transactions. See Congressional Oversight Panel, 'The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy' (10 June 2010) 213.

[807] In a securities lending transaction, the owner of securities lends securities to the borrower in exchange for a fee, and the borrower often provides cash as collateral for the borrowing. AIG's life insurance subsidiaries play the role of the lender of securities in transactions. See Congressional Oversight Panel, 'The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy' (10 June 2010) 231.

posting requirements made by counterparties of AIGFP, thus creating a liquidity problem for AIG. Being aware of AIG's potential crisis, a lot of counterparties of AIG's life insurance subsidiaries in securities lending programmes decided to terminate borrowing securities and get back cash collateral they had once posted, worsening the liquidity problem of AIG's whole conglomerate. Subsequently, AIG was downgraded by credit rating agencies, further intensifying the vicious spiral – causing more losses in the CDS transactions and securities lending programmes and bringing about more serious cash shortages.[808] Upon failure of raising external financing from capital markets, AIG was facing insolvency.

However, AIG was believed to be a systemically important financial institution in society. According to the Treasury and the Federal Reserve,

> AIG provides insurance protection to more than 100,000 entities, including small businesses, municipalities, 401(k) plans, and Fortune 500 companies who together employ over 100 million Americans. AIG has over 30 million policyholders in the US and is a major source of retirement insurance for, among others, teachers and non-profit organisations. The company also is a significant counterparty to a number of major financial institutions.[809]

[808] More detailed analysis of causes of the AIG crisis can be found in, for example, William K. Sjostrum, 'The AIG Bailout' (2009) 66(3) Washington and Lee Law Review 943; Congressional Oversight Panel, 'The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy' (10 June 2010); Maurice R. Greenberg and Lawrence A. Cunningham, *The AIG Story* (John Wiley & Sons 2013).

[809] 'US Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan' (02 March 2009) <www.federalreserve.gov/newsevents/pressreleases/other20090302a.htm> accessed 19 January 2018.

In light of this, the Treasury and the Federal Reserve decided to provide financial assistance to AIG for rescue purposes. In other words, the federal government chose to bail out AIG.

Through different rescue programmes, AIG and its subsidiaries got access to loans as well as capital infusions from the federal government. For example, the Federal Reserve Bank of New York created two special purpose vehicles, Maiden Lane II LLC and Maiden Lane III LLC, and made loans to these special purpose vehicles to deal with, respectively, the crisis of securities lending programmes faced by AIG's life insurance subsidiaries and the crisis of CDS transactions faced by AIGFP; and the Treasury, by virtue of TARP, successively contributed $69.8 billion in purchasing preferred stock or common stocks of AIG.[810] In total, the financial assistance AIG received from the Federal Reserve and the Treasury amounted to $182.3 billion.[811] Fortunately, the bailout eventually led to a satisfactory outcome. After a series of efforts of restructuring, AIG gradually restored to normal conditions, and both the Treasury and the Federal Reserve finally got positive returns from AIG's repayments or the sale of AIG's stock.[812]

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[810] For more information about the rescue of AIG, see, for example, United State Government Accountability Office, 'Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc.' (31 October 2011); United State Government Accountability Office, 'Troubled Asset Relief Program: Government's Exposure to AIG Lessens as Equity Investments Are Sold' (7 May 2012).

[811] US Department of the Treasury, 'Treasury Sells Final Shares of AIG Common Stock, Positive Return on Overall AIG Commitment Reaches $22.7 Billion' (11 December 2012) <www.treasury.gov/press-center/press-releases/Pages/tg1796.aspx> accessed 19 January 2018.

[812] By 11 December 2012, when the Treasury sold final shares of AIG stock, the positive return for the Treasury and the Federal Reserve amounted to, respectively, $5.0 billion and $17.7 billion. See US Department of the

Although AIG, as a savings and loan holding company, was subject to consolidated supervision conducted by the Office of Thrift Supervision from 1999 to March 2010,[813] the unprecedented crisis, as strong evidence, indicated the weaknesses and ineffectiveness of the supervision at the level of holding companies. However, as to the insurance subsidiaries of AIG, like other insurance companies, they are supervised by insurance commissioners of their domiciliary states. Despite the crises faced by some life insurance subsidiaries, as the then Insurance Superintendent for New York pointed out, 'the capital of the AIG group's licenced US insurers was certainly sufficient to ensure the orderly operation of the AIG insurance companies.'[814] In fact, in early 2007, concerned about the crisis in the subprime mortgage market, state insurance regulators began requiring that securities lending programmes be wound down and the holding company provide a guarantee to the life insurance companies to make up for any losses that had been incurred.[815] To this end, by September 2008, the holding company had provided the guarantee of slightly more than $5 billion.[816] Also, since property/casualty insurance subsidiaries basically remained stable, as AIG's crisis

Treasury, 'Treasury Sells Final Shares of AIG Common Stock, Positive Return on Overall AIG Commitment Reaches $22.7 Billion' (11 December 2012) <www.treasury.gov/press-center/press-releases/Pages/tg1796.aspx> accessed 19 January 2018.

[813] Note: With the Dodd–Frank Act coming into force, the Office of Thrift Supervision was dissolved in 2010.

[814] Eric R. Dinallo, 'Lessons Learned from AIG for Modernizing Insurance Regulation' in John H. Biggs and Matthew P. Richardson (eds), *Modernizing Insurance Regulation* 46 (John Wiley & Sons 2014).

[815] Eric R. Dinallo, 'Lessons Learned from AIG for Modernizing Insurance Regulation' in John H. Biggs and Matthew P. Richardson (eds), *Modernizing Insurance Regulation* 56 (John Wiley & Sons 2014).

[816] Eric R. Dinallo, 'Lessons Learned from AIG for Modernizing Insurance Regulation' in John H. Biggs and Matthew P. Richardson (eds), *Modernizing Insurance Regulation* 56 (John Wiley & Sons 2014).

unfolded, the New York State Insurance Department, the primary regulator of 10 of AIG's insurance subsidiaries, even propose to allow AIG to temporarily access about $20 billion of excess surplus assets in its property/casualty insurance companies and inject the money to increase the capital of life insurance companies, making life insurance companies become subsidiaries of property/casualty insurance companies.[817] But this proposal was dropped and never came into effect after the federal government intervened to bail out AIG.

The case of AIG shows that in order to prevent or alleviate a systemic crisis and maintain financial stability, the federal government may function to rescue troubled financial institutions. In the insurance sector, given the fact that insurance companies are regulated at the state level and bailouts for the purposes of maintaining financial stability will be carried out at the federal level, coordination and cooperation between the state insurance regulator and the federal government is indispensable in the case of a systemic crisis. Needless to say, this adds more difficulties in dealing with troubled insurance companies. Despite the fact that the case of AIG represented a successful bailout, there is widespread concern over moral hazard problems that may be caused by the phenomenon of "too big to fail".[818] As a consequence, following the 2007–2009

[817] Eric R. Dinallo, 'Lessons Learned from AIG for Modernizing Insurance Regulation' in John H. Biggs and Matthew P. Richardson (eds), *Modernizing Insurance Regulation* 59 (John Wiley & Sons 2014).

[818] See, for example, Scott E. Harrington, 'The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation' (2009) 74(4) The Journal of Risk and Insurance 785, 804; Hollace T. Cohen, 'Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risks' (2011) 45 University of Richmond Law Review 1143, 1147; Sabrina R. Pellerin and John R. Walter, 'Orderly Liquidation Authority as an Alternative to Bankruptcy' (2012) 98 Federal Reserve Bank of Richmond Economic Quarterly 1, 6.

financial crisis, reforms were carried out in the Dodd–Frank Act to prevent the federal government from initiating bailouts.

5.5.2. Reforms in the Dodd–Frank Act

Prompted by the 2007–2009 financial crisis, sweeping reforms were carried out in the financial law area, and the Dodd–Frank Act was thus enacted '[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ''too big to fail'', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.'[819]

Revolving around how the CMME mechanism was impacted by the reforms, this section will in turn discuss designation of systemically important financial companies, orderly liquidation authority, and emergency lending from the Federal Reserve System.

5.5.2.1. Designation of Systemically Important Financial Companies

With the purpose of monitoring the financial stability of the US and promoting market discipline, the Financial Stability Oversight Council (FSOC) was established.[820] If the FSOC determines that material financial distress at the non-bank financial companies, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of these companies, could pose a threat to the financial stability of the US, the FSOC has the authority to designate the companies to be subject to the enhanced

[819] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[820] Dodd–Frank Act § 112(a)(1), 12 U.S.C. § 5322(a)(1).

supervision of the Board of Governors of the Federal Reserve System (hereinafter, Board of Governors).[821] The companies so designated are deemed to pose systemic risk in the US and thus are normally referred to as systemically important financial companies. In terms of the insurance sector, AIG, Prudential Financial, Inc. and MetLife, Inc., three insurance-focused financial holding companies, have once been designated by the FSOC. But no such designation remains now, with MetLife, Inc. successfully challenging the designation and the FSOC rescinding the designations of AIG and Prudential Financial, Inc. following their restructuring.[822]

For the purposes of enhanced supervision, the Board of Governors is required to establish prudential standards for – as well as the early remediation of financial distress of – the FSOC designated companies.[823] But so far, neither enhanced prudential standards for systemically important insurance-focused holding companies, nor early remediation rules for systemically important financial companies, have been published.[824] Nevertheless, with regard to dealing with troubled systemically

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[821] Dodd–Frank Act § 113(a)(1), 12 U.S.C. § 5323(a)(1).

[822] With regard to AIG, the FSOC made the designation on 8 July 2013, and rescinded the designation on 29 September 2017. With regard to Prudential Financial, Inc., the FSOC made the designation on 19 September 2013, and rescinded the designation on 17 October 2018. See ‘Designations’ (US Department of the Treasury) <www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx> accessed 25 January 2018. With regard to MetLife, Inc., the FSOC made the designation on 18 December 2014, but MetLife, Inc. successfully challenged the designation at the US District Court in March 2016. Then the FSOC appealed the District Court’s decision. But in January 2018, MetLife and the FSOC filed a joint motion to dismiss the appeal. See Hazel Bradford, 'MetLife, FSOC End Legal Case over SIFI Designation' (19 January 2018) <www.pionline.com/article/20180119/ONLINE/180119843/metlife-fsoc-end-legal-case-over-sifi-designation> accessed 25 January 2018.

[823] See Dodd–Frank Act §§ 165(b)(1) and 166(a), 12 U.S.C. §§ 5365(b)(1) and 5366(a).

[824] For public comments, the Board of Governors published the proposed rules ‘Enhanced Prudential

important financial companies, the basic idea is that regulatory measures imposed on a company should become more stringent as the financial condition of the company declines. These regulatory measures may include: at early stages of the financial decline, limits on capital distributions, acquisitions, and asset growth; and at later stages of the financial decline, a capital restoration plan, capital-raising requirements, and limits on transactions with affiliates, management changes, and asset sales.[825]

Due to the fact that the Board of Governors is just the supervisor of the FSOC designated systemically important companies, and functionally regulated subsidiaries of a designated company are under the supervision of their primary regulators, coordination and cooperation between the Board of Governors and these regulators are important, especially during the period of a crisis. If the Board of Governors determines that a condition, practice, or activity of a subsidiary does not comply with the regulations or orders prescribed by the Board of Governors, or otherwise poses a threat to the financial stability of the US, the Board of Governors may recommend the primary regulator of the subsidiary to initiate a supervisory action or an enforcement proceeding.[826] If the primary regulator does not take supervisory or enforcement action against the subsidiary that is acceptable to the Board of Governors within 60 days, the Board of Governors may then take the recommended supervisory or

Standards and Early Remediation Requirements for Covered Companies' on 5 January 2012 and published the proposed rules "Enhanced Prudential Standards for Systemically Important Insurance Companies" on 14 June 2016. But neither of these rules has come into force so far.

[825] Dodd–Frank Act § 166(c), 12 U.S.C. § 5366(c).

[826] Dodd–Frank Act § 162(b)(1), 12 U.S.C. § 5362(b)(1).

enforcement action by itself.[827] Therefore, when it comes to the insurance area, since insurance companies' primary regulators are insurance regulatory authorities of their domiciliary states, the Board of Governors, normally, will not exercise regulatory authority directly towards insurance companies, even if crises occur at both the holding company level and the insurance subsidiary level. Upon a finding of noncompliance of relevant regulations or orders by an insurance company which is a subsidiary of an FSOC designated company, the Board of Governors should always seek cooperation with the state insurance regulator.

Contrary to the objective of ending the "too big to fail" problem which the Dodd–Frank Act is intended to achieve, the authority of the FSOC to designate systemically important financial companies is argued to perpetuate "too big to fail" in effect.[828] Since the market normally has the perception that the government will not stand by and let a designated company fail, it can be said that a designated company is actually accorded an implicit guarantee from the government.[829] As a consequence, the financing costs for a designated company will be lower than its non-designated

[827] Dodd–Frank Act § 162(b)(2), 12 U.S.C. § 5362(b)(2).

[828] See, for example, John Tatom, 'A Report to the Federal Insurance Office' (September 2011) 22 <https://mpra.ub.uni-muenchen.de/34621/> accessed 25 March 2018; Richard W. Fisher, 'Correcting "Dodd–Frank" to Actually End "Too Big to Fail"' (26 June 2013) 8 <www.dallasfed.org/news/speeches/fisher/2013/~/media/Documents/news/speeches/fisher/2013/fs130626.pdf > accessed 18 March 2018.

[829] Viral V. Acharya, Deniz Anginer and A. Joseph Warburton, 'The End of Market Discipline? Investor Expectations of Implicit Government Guarantees' (February 2016) 2 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1961656> accessed 18 March 2018.

competitors, bringing a competitive advantage to the designated company.[830] On the other hand, since the designation will lead to enhanced supervision, designated companies have to bear more costs in complying with more stringent regulatory requirements, which brings a competitive disadvantage to these companies.[831] Although it is believed that the advantages brought by the designation will outweigh the disadvantages,[832] there are still incentives for the designated companies to challenge the designation or to pursue the de-designation so as to avoid extra regulatory costs.[833] For a company with the designation successfully challenged or rescinded, the company could then retain the reputation of being too big to fail while staying out of enhanced supervision.[834] Therefore, the designation of systemically

[830] See, for example, Scott E. Harrington, 'The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation' (2009) 74(4) The Journal of Risk and Insurance 785, 807; Peter J. Wallison, 'The Authority of the FSOC and the FSB to Designate SIFIs: Implications for the Regulation of Insurers in the United States after the Prudential Decision' (14 March 2014) 13 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408655> accessed 18 March 2018; Scott E. Harrington, 'Systemic Risk and Regulation: The Misguided Case of Insurance SIFIs' (20 September 2016) 14 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2998646> accessed 18 March 2018.

[831] See, for example, Scott E. Harrington, 'Insurance Regulation and the Dodd–Frank Act' (14 March 2011) 11 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1783904> accessed 18 March 2018; Peter J. Wallison, 'The Authority of the FSOC and the FSB to Designate SIFIs: Implications for the Regulation of Insurers in the United States after the Prudential Decision' (14 March 2014) 13 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2408655> accessed 18 March 2018; Scott E. Harrington, 'Systemic Risk and Regulation: The Misguided Case of Insurance SIFIs' (20 September 2016) 14 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2998646> accessed 18 March 2018.

[832] See Kathryn L. Dewenter and Leigh A. Riddick, 'What's the Value of a TBTF Guaranty? Evidence from the G-SII Designation for Insurance Companies' (2018) 91 Journal of Banking and Finance 70.

[833] See, for example, Christina Parajon Skinner, 'Regulating Nonbanks: A Plan for SIFI Lite' (2017) 105 The Georgetown Law Journal 1379, 1397; Daniel Schwarz and David Zaring, 'Regulation by Threat: Dodd–Frank and the Nonbank Problem' (2017) 84 The University of Chicago Law Review 1813, 1854.

[834] Hester Peirce and James Broughel, *Dodd–Frank What It Does and Why It's Flawed* (The Mercatus Center at George Mason University 2012) 28.

important financial companies turns out to be a controversial arrangement that merits further consideration by the legislature. In fact, no such designation exists at present. It remains to be seen how this arrangement will develop in the future.

5.5.2.2. Orderly Liquidation Authority

In the 2007–2009 financial crisis, there were only two options to tackle the crisis of a non-bank financial company which may pose a threat to financial stability: one was to bail out the company through government support, like the case of AIG, and the other was to resolve the company under the Bankruptcy Code, like the case of Lehman Brothers.[835] But neither of these options could bring desirable results, with the adoption of bail-out likely undermining market discipline and exposing taxpayers to losses, and the use of the Bankruptcy Code possibly leading to crisis contagion and threatening financial stability.[836] In light of this, Title II of the Dodd–Frank Act creates the orderly liquidation authority as a third alternative, which vests the Federal Deposit Insurance Corporation (FDIC) with great powers to liquidate a systemically important financial company in a manner that mitigates financial stability risk and minimises moral hazard.[837] The orderly liquidation authority functions as a backstop option, and

[835] US Department of the Treasury, 'Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation' (October 2009) 76.

[836] See, for example, Sabrina R. Pellerin and John R. Walter, 'Orderly Liquidation Authority as an Alternative to Bankruptcy' (2012) 98 Federal Reserve Bank of Richmond Economic Quarterly 1; Marc Labonte, 'Systemically Important or "Too Big to Fail" Financial Institutions' (9 September 2014) <https://digitalcommons.ilr.cornell.edu/key_workplace/1328/> accessed 28 January 2019.

[837] Dodd–Frank Act § 204(a), 12 U.S.C. § 5384(a).

a financial company will be put into orderly liquidation only when the adoption of bankruptcy procedures may pose a threat to financial stability.[838] Once the orderly liquidation authority is exercised against a financial company, it will have the effects of precluding the application of the Bankruptcy Code.[839]

Taking account of 7 findings, which include “the financial company is in default or in danger of default”, “the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States”, “no viable private sector alternative is available to prevent the default of the financial company”, etc.,[840] the Secretary of the Treasury, in consultation with the President, can decide to put a financial company into orderly liquidation (hereinafter, such a company will be termed as a covered financial company),[841] and appoint the FDIC as receiver to carry out the orderly liquidation.[842] Then the FDIC will take over the assets and control of the covered financial company, and may take any appropriate measures to achieve the orderly liquidation of the company, hardly subject to consent of interested parties or oversight of courts.[843] For example, in dealing with creditors’ claims against a covered financial company, the

[838] US Department of the Treasury, ‘Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation’ (October 2009) 78; US Department of the Treasury, ‘Orderly Liquidation Authority and Bankruptcy Reform’ (February 2018) 2.

[839] Dodd–Frank Act § 202(c), 12 U.S.C. § 5382(c); Dodd–Frank Act § 208(a), 12 U.S.C. § 5388(a).

[840] Dodd–Frank Act § 203(b), 12 U.S.C. § 5383(b).

[841] Note: An insured depository institution will not be a “covered financial company” in this sense. See Dodd–Frank Act § 201(a)(8).

[842] Dodd–Frank Act § 204(b), 12 U.S.C. § 5384(b).

[843] See Dodd–Frank Act § 210, 12 U.S.C. § 5390.

FDIC has broad discretion in deciding the way and amounts of claim payment, and may even treat similarly situated creditors differently as long as the amounts creditors receive are not less than what they would have received if the company was liquidated under the Bankruptcy Code.[844] Also, with regard to failing subsidiaries of a covered financial company, the FDIC is authorised to appoint itself as receiver of the subsidiaries, and treat these subsidiaries as if they are covered financial companies.[845] Different from the Bankruptcy Code, under which either rehabilitation or liquidation can be chosen to deal with a troubled company, Title II of the Dodd–Frank Act is confined only to liquidation. The lack of flexibility in this regard, however, is argued to preclude the possibility of rehabilitating a covered financial company in a manner which might achieve more desirable outcomes in times of financial crisis.[846]

Due to the fact that insurance companies are regulated at the state level and will be subject to the state receivership system, exception has been made so that state laws relating to receivership will still apply even if an insurance company is determined to be a covered financial company under Title II of the Dodd–Frank Act.[847] Upon the determination by the Secretary of the Treasury that an insurance company becomes a covered financial company, the state insurance regulator should, within 60 days, file a

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[844] Dodd–Frank Act § 210(b)(4), 12 U.S.C. § 5390(b)(4).

[845] Subsidiaries of this kind do not include the subsidiaries which are insured depository institutions, insurance companies, or covered brokers or dealers. See Dodd–Frank Act §§ 210(a)(1)(E) and 201(a)(9).

[846] See, for example, Edward F Greene, 'Dodd–Frank and the Future of Financial Regulation' (2011) 2 Harvard Business Law Review Online 79, 87; Matt Saldaña, 'Parallel Regimes: Bankruptcy and Dodd–Frank's Orderly Liquidation Authority' (2011) 31 Review of Banking & Financial Law 531, 536.

[847] Dodd–Frank Act § 203(e)(1), 12 U.S.C. § 5383(e)(1).

petition with the appropriate state court to place the insurance company into rehabilitation or liquidation according to state laws; otherwise, the FDIC will have the authority to stand in the place of the state insurance regulator to file such a petition.[848] No matter whether the petition is filed by the state insurance regulator or the FDIC, it is the state insurance regulator who will be appointed as receiver of the insurance company and will carry out the receivership according to state laws.[849] As to subsidiaries of a covered insurance company which are not themselves insurance companies, the FDIC may still perform as receiver to carry out the orderly liquidation of the subsidiaries under Title II of the Dodd–Frank Act.[850] As a consequence, dealing with covered insurance companies is distinct from other covered financial companies, subject to different laws. While other covered financial companies will definitely end up in liquidation, it is still possible for covered insurance companies to be put into rehabilitation rather than liquidation. However, it remains unknown why differences exist in this regard.

In order to facilitate the adoption of the orderly liquidation authority, the Orderly Liquidation Fund has been established in the Treasury.[851] Under the management of the FDIC, the Orderly Liquidation Fund can be used to provide liquidity to a covered financial company in orderly liquidation, which may be achieved by means of making

[848] Dodd–Frank Act § 203(e)(3), 12 U.S.C. § 5383(e)(3).

[849] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 637.

[850] Dodd–Frank Act § 203(e)(2), 12 U.S.C. § 5383(e)(2).

[851] Dodd–Frank Act § 210(n)(1), 12 U.S.C. § 5390(n)(1).

loans to the company, purchasing assets of the company, assuming or guaranteeing the obligations of the company, etc.[852] But since the FDIC is prohibited from taking an equity interest in or becoming a shareholder of any covered financial company,[853] the Orderly Liquidation Fund will not be used to inject capital into any company. This makes the Orderly Liquidation Fund distinct from the TARP adopted by the Treasury during the 2007–2009 financial crisis. The fund used in orderly liquidation will come from obligations issued by the FDIC to the Secretary of the Treasury, with a certain interest rate that will yield a return to the Secretary of the Treasury.[854] If recoveries from the estate of a covered company cannot fully repay the Secretary of the Treasury within 60 months, unless otherwise extended, of the date of issuance of the obligations, the FDIC may charge risk-based assessments on eligible financial companies so as to make the full repayment.[855] In this way, any loss to the Orderly Liquidation Fund will be borne by the financial industry, but not the taxpayer.

Although there has not yet been any orderly liquidation cases in practice, the FDIC has developed a "single point of entry" strategy in implementing its orderly liquidation authority.[856] Under this strategy, when a crisis of a financial group/conglomerate

[852] See Dodd–Frank Act § 204(d), 12 U.S.C. § 5384(d).

[853] Dodd–Frank Act § 206, 12 U.S.C. § 5386.

[854] Dodd–Frank Act § 210(n)(5), 12 U.S.C. § 5390(n)(5).

[855] Financial companies subject to the assessments include: (1) bank holding companies with total consolidated assets equal to or greater than $50,000,000,000; and (2) nonbank financial companies supervised by the Board of Governors. See Dodd–Frank Act § 210(o)(1), 12 U.S.C. § 5390(o)(1).

[856] FDIC, 'Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy' (Federal Register Vol. 78 No. 243, 18 December 2013) 76614ff.

warrants an orderly liquidation, the FDIC will be appointed as receiver of the top-tier holding company to carry out the orderly liquidation, while the operation of most of its subsidiaries will continue as usual.[857] A bridge company will be established by the FDIC, and most assets of the holding company will be transferred to the bridge company, which primarily include the holding company's investments in and loans to its subsidiaries.[858] Claims of shareholders and most creditors against the holding company will be left in the holding company to be liquidated, and will be satisfied by securities representing equity or debt of a new holding company which will succeed the bridge company as the FDIC's control of the bridge company ends.[859] In this way, shareholders and creditors of the holding company to be liquidated will bear the losses of the company according to the claims hierarchy, and creditors will be bailed in to capitalise the new holding company.[860] During the process, if the bridge company or its subsidiaries cannot get access to sufficient funding from the private markets, the FDIC may still make use of the Orderly Liquidation Fund to provide liquidity support so as to avoid contagion of the crisis.[861] Given these arrangements, somewhat contrary

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[857] FDIC, 'Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy' (Federal Register Vol. 78 No. 243, 18 December 2013) 76615.

[858] FDIC, 'Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy' (Federal Register Vol. 78 No. 243, 18 December 2013) 76616.

[859] FDIC, 'Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy' (Federal Register Vol. 78 No. 243, 18 December 2013) 76619.

[860] FDIC, 'Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy' (Federal Register Vol. 78 No. 243, 18 December 2013) 76619.

[861] FDIC, 'Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy' (Federal Register Vol. 78 No. 243, 18 December 2013) 76617.

to the argument that Title II of the Dodd–Frank Act precludes the possibility of rehabilitating a covered financial company, there also exists doubt that the orderly liquidation is actually rehabilitation in disguise.[862] In effect, the holding company will be restructured and eventually succeeded by a new holding company, usually with shares of the original holding company written off and debts bailed in; but subsidiaries of the holding company, including troubled ones, could remain largely untouched, and with the liquidity support from the bridge company or the Orderly Liquidation Fund, shareholders or creditors of the troubled subsidiaries may be fully bailed out.[863] Therefore, Title II of the Dodd–Frank Act has been widely criticised for enshrining, rather than ending, "too big to fail" in the legislation.[864]

Unlike bankruptcy procedures which are judicial procedures, orderly liquidation is an administrative procedure in nature, with the FDIC having great discretion, hardly subject to judicial oversight. Concerns have been raised about this intense intervention by regulatory authorities into issues relating to private rights, and even the

[862] See, for example, House Committee on Financial Services, 'Who Is Too Big to Fail: Does Title II of the Dodd–Frank Act Enshrine Taxpayer-Funded Bailouts?' (US House of Representatives 2013) 68 and 71; Richard W. Fisher, 'Correcting "Dodd–Frank" to Actually End "Too Big to Fail"' (26 June 2013) 9 <www.dallasfed.org/news/speeches/fisher/2013/~/media/Documents/news/speeches/fisher/2013/fs130626.pdf > accessed 18 March 2018.

[863] FDIC, 'Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy' (Federal Register Vol. 78 No. 243, 18 December 2013) 76623.

[864] See, for example, House Committee on Financial Services, 'Who Is Too Big to Fail: Does Title II of the Dodd–Frank Act Enshrine Taxpayer-Funded Bailouts?' (US House of Representatives 2013) 60 and 71; House Committee on Financial Services, 'Failing to End "Too Big to Fail": An Assessment of the Dodd–Frank Act Four Years Later' (US House of Representatives 2014) 59.

constitutionality of the orderly liquidation authority has been questioned.[865] Responding to critiques, the Treasury recommended to build a bankruptcy process specific to financial companies in Chapter 14 of the Bankruptcy Code, which would be the first resort when dealing with troubled financial companies, and to reform the orderly liquidation authority to correct some perceived serious defects, retaining it as a last resort in case the use of Chapter 14 could not address systemic risk concerns.[866] Still, since any financial company may be put into orderly liquidation under Title II of the Dodd–Frank Act,[867] especially in times of financial crisis, there is always uncertainty about whether bankruptcy or orderly liquidation will be used to deal with a troubled financial company. Thus, instead of having two parallel systems, it would be better if there was only one tailored system for all troubled financial companies, regardless of whether they pose systemic risk.[868]

Nevertheless, whatever future reform concerning the orderly liquidation authority will be carried out, troubled insurance companies will still be subject to the

[865] See, for example, Brent J. Horton, 'How Dodd–Frank's Orderly Liquidation Authority for Financial Companies Violates Article III of the United States Constitution' (2011) 36 The Journal of Corporation Law 869; Hester Peirce and James Broughel, *Dodd–Frank What It Does and Why It's Flawed* (The Mercatus Center at George Mason University 2012) 38; Thomas W. Merrill and Margaret L. Merrill, 'Dodd–Frank Orderly Liquidation Authority: Too Big for the Constitution?' (2014) 163 University of Pennsylvania Law Review 165.

[866] See US Department of the Treasury, 'Orderly Liquidation Authority and Bankruptcy Reform' (February 2018).

[867] Hester Peirce and James Broughel, *Dodd–Frank What It Does and Why It's Flawed* (The Mercatus Center at George Mason University 2012) 36.

[868] See, for example, Matt Saldaña, 'Parallel Regimes: Bankruptcy and Dodd–Frank's Orderly Liquidation Authority' (2011) 31 Review of Banking & Financial Law 531, 537; Charles I. Plosser, 'Simplicity, Transparency, and Market Discipline in Regulatory Reform' (8 April 2014) 9 <www.philadelphiafed.org/publications/speeches/plosser/2014/04-08-14-frbp> accessed 18 March 2018.

receivership system at the state level. But if an insurance company is determined to be a covered company under Title II of the Dodd–Frank Act, then in addition to the objective of protecting policyholders inherent in normal receivership, the receiver also has to pursue the objective of maintaining the financial stability of the US when carrying out the receivership of the covered insurance company.[869] In this circumstance, effective coordination and cooperation between the receiver and federal authorities are important for achieving desirable results.[870] In addition, it may still be the case that the FDIC uses the Orderly Liquidation Fund to provide liquidity in rehabilitation or liquidation of a covered insurance company.[871] As a corollary, there is a possibility that, with the financial assistance from the Orderly Liquidation Fund, a covered insurance company will survive the rehabilitation and recover to normal operation. In other words, in theory, Orderly Liquidation Fund can be used directly to bail out a covered insurance company. It is a mystery why the Dodd–Frank Act, which aims at ending "to big to fail", has made such an exception for insurance companies.

5.5.2.3. Emergency Lending from the Federal Reserve System

To avoid the reoccurrence of bail-outs of troubled financial companies by the Federal Reserve as in the 2007–2009 financial crisis, the Dodd–Frank Act amended section 13(3) of the Federal Reserve Act, imposing more restrictions on the Federal Reserve's

[869] See NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 633.

[870] See NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 656.

[871] 12 C.F.R. § 380.6 (2011).

function of the lender of last resort.[872]

Under the revised section 13(3), the Federal Reserve is only allowed to extend credit to participants in an emergency lending programme or facility with broad-based eligibility when facing unusual and exigent circumstances.[873] A programme or facility will not be considered to have broad-based eligibility if:

> [(A)] it is designed for the purpose of assisting one or more specific companies to avoid orderly liquidation under the Dodd–Frank Act, or any other federal or state insolvency proceeding, including by removing assets from the balance sheet of one or more such company; (B) it is designed for the purpose of aiding one or more failing financial companies; or (C) fewer than five companies would be eligible to participate in the programme or facility.[874]

As a consequence, emergency lending programmes targeted at specific troubled financial companies, just like the Maiden Lane II and the Maiden Lane III programmes for AIG in 2008, will be no more allowed in the era of post-Dodd–Frank.

With the approval of the Secretary of the Treasury, the Board of Governors can establish such a programme or facility, and provide liquidity to eligible companies.[875]

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[872] See, for example, Gary Gorton and Andrew Metrick, 'The Federal Reserve and Panic Prevention: The Roles of Financial Regulation and Lender of Last Resort' (2013) 27(4) Journal of Economic Perspectives 45, 60; Congressional Research Service, 'Federal Reserve: Emergency Lending' (27 March 2020) 18 <https://fas.org/sgp/crs/misc/R44185.pdf> accessed 10 April 2020.

[873] 12 U.S.C. § 343(3)(A).

[874] 12 C.F.R. § 201.4(d)(4) (2016).

[875] 12 U.S.C. § 343(3)(B)(iv).

Consistent with the classical theory of the lender of last resort,[876] it is clearly required in the revised section 13(3) that the Federal Reserve should not extend credit to any company that is insolvent or to any company that is borrowing for the purpose of lending the proceeds of the loan to a company that is insolvent.[877] For this purpose, a company will be deemed insolvent if:

> [(A)] it is in the orderly liquidation under the Dodd–Frank Act or any other federal or state insolvency proceeding; (B) it is generally not paying its undisputed debts as they become due during the 90 days preceding the date of borrowing under the programme or facility; or (C) the Federal Reserve otherwise determines that it is insolvent.[878]

Upon a finding by the Federal Reserve that a company having obtained credit in a programme or facility is or has become insolvent, the company will not be eligible for any new extension of credit from the programme or facility until such time as the Federal Reserve determines that it is no longer insolvent.[879] In cases where the company enters an insolvency proceeding, if the Federal Reserve incurs a realised net loss on the loan, the Federal Reserve will be entitled to a claim equal to the amount of the realised net loss against the company in the insolvency proceeding, and the claim

[876] For more discussions of the classical theory of the lender of last resort, see, for example, Thomas M. Humphrey, 'Arresting Financial Crises: The Fed Versus the Classicals' (6 February 2013) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212175> accessed 4 June 2018; Michael D. Bordo, 'Rules for a Lender of Last Resort: An Historical Perspective' (2014) 49 Journal of Economic Dynamics & Control 126.

[877] 12 C.F.R. § 201.4(d)(5)(i) (2016).

[878] 12 C.F.R. § 201.4(d)(5)(iii) (2016).

[879] 12 C.F.R. § 201.4(d)(5)(vi) (2016).

will have priority over most other unsecured claims.[880] Under this arrangement, when it comes to insurance companies, insurance companies facing liquidity problems may get access to the Federal Reserve's emergency lending if there exist concerns about financial stability. But once an insurance company is placed in a receivership proceeding under state laws, it will lose eligibility for the emergency lending of this kind.

Since the role the Federal Reserve may play in times of financial crisis is "the lender of last resort", the Federal Reserve should obtain evidence that the participant in a programme or facility is unable to secure adequate credit accommodations from other banking institutions before extending any credit.[881] In order to protect the taxpayer from losses, all credit extended under a programme or facility must be endorsed or otherwise secured to the satisfaction of the Federal Reserve.[882] In addition, in order to compensate the taxpayer for the risks taken in lending in the unusual and exigent circumstances, the Board of Governors will set the interest rate of a programme or facility at a penalty level, higher than the market rate in normal circumstances, as well as require the payment of any fees, penalties, charges or other consideration which is

[880] See 12 U.S.C. § 343(3)(E). It should be noted that although this provision only mentions that a Federal Reserve bank will have a claim equal to the amount of the realised net loss against a financial company which is designated as a covered company in orderly liquidation according to the Dodd–Frank act, it is believed that there should be similar arrangements when it comes to the situation where a Federal Reserve bank has a claim against a company which is in any other insolvency or quasi-insolvency proceeding.

[881] 12 U.S.C. § 343(3)(A).

[882] 12 C.F.R. § 201.4(d)(6) (2016).

determined to be appropriate.[883] Through these arrangements, the aim of the legislation is to ensure that emergency lending provided by the Federal Reserve is 'for the purpose of providing liquidity to the financial system, and not to aid a failing financial company'.[884]

However, there are always challenges in striking a balance between ending public bailouts and making use of the lender of last resort function to avoid systemic crises. On the one hand, despite the efforts of the Dodd–Frank Act to largely limit the Federal Reserve's flexibility in providing emergency lending compared to the Federal Reserve's practice in the 2007–2009 financial crisis, there is still doubt as to whether the restrictions can prevent the Federal Reserve from carrying out bailouts.[885] For example, although it is required that an emergency lending programme or facility should have broad-based eligibility and provide liquidity to an identifiable market or sector of the financial system,[886] it may turn out that a programme or facility with broad-based eligibility are designed by the Federal Reserve with the aim of rescuing a targeted troubled company.[887] On the other hand, since no insolvent companies are eligible for the Federal Reserve's emergency lending and companies in relevant insolvency proceedings will be deemed insolvent, it may also be the case that

[883] 12 C.F.R. § 201.4(d)(7) (2016).

[884] 12 U.S.C. § 343(3)(B)(i).

[885] House Committee on Financial Services, 'Failing to End "Too Big to Fail": An Assessment of the Dodd–Frank Act Four Years Later' (US House of Representatives 2014) 83.

[886] 12 C.F.R. § 201.4(d)(4)(ii) (2016).

[887] House Committee on Financial Services, 'Failing to End "Too Big to Fail": An Assessment of the Dodd–Frank Act Four Years Later' (US House of Representatives 2014) 83.

emergency lending cannot be fully utilised to maintain financial stability. For example, when a troubled insurance company is in conservation or rehabilitation under state receivership laws, the Federal Reserve will not be allowed to make use of emergency lending to facilitate recovery or reorganisation of the insurance company. As a consequence, the Federal Reserve may sometimes find its hands tied in times of systemic crisis.

5.6. Chapter Conclusion

Comprising the state insurer receivership system as well as the relevant federal regulation, the CMME mechanism in the US is a mechanism specific to insurers, which is completely independent of the bankruptcy system for ordinary companies. While the insurer receivership system at the state level is focused on the objective of protecting policyholders, the relevant arrangements at the federal level are focused on the objective of maintaining financial stability. By virtue of the CMME mechanism, the US has rich experience in dealing with troubled insurers, and no other country is comparable with the US in this respect.[888] By the end of 2019, there were 40 rehabilitations as well as 181 liquidations in progress.[889]

In line with the fact that insurers are regulated in each state, the CMME mechanism is centred on the state insurer receivership system. Since the insurer receivership

[888] 'A Look Abroad (Interview)' (2019) 26(1) The Insurance Receiver 4, 5.

[889] NAIC, '2019 Insurance Department Resources Report – Volume One' (October 2020) 49-50 <www.naic.org/prod_serv/STA-BB-20-01.pdf> accessed 7 October 2020.

system is tailored for insurers, arrangements in this system are generally compatible with the special features of insurers. The state insurance commissioner takes a leading role in dealing with troubled insurers, and there are pre-receivership tools (ie administrative supervision and seizure) and receivership procedures (ie conservation, rehabilitation or liquidation) available for the state commissioner to make use of. There is not a procedure analogous to the company voluntary arrangement, and an insurer's attempt to systemically compromise with creditors will suffice to trigger a receivership procedure.[890] Grounds for commencing a receivership procedure are diverse, covering various aspects of insurers' operation, such as financial conditions, management, and compliance with laws.[891] Upon a finding of one or more of these grounds, the state insurance commissioner has the exclusive standing to petition the court to put a troubled insurer into a receivership procedure.[892] Following the court receivership order, the state insurance commissioner will be appointed as receiver and will carry out the receivership under the supervision of the court.[893] The receiver has broad discretion during the process and can decide all relevant issues without seeking creditors' decisions, but subject to the court approval or review. To protect policyholders, in conservation or rehabilitation, despite the general stay effects, insurance claims against the insurer, unlike most other claims, will normally be paid as

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[890] Insurer Receivership Model Act § 207R.

[891] For a more detailed discussion, see Section 5.2.2 in this chapter.

[892] Insurer Receivership Model Act § 208.

[893] For a more detailed discussion, see Section 5.2.3 in this chapter.

usual without any disruption.[894] There are still insurance guaranty associations which mainly perform the function of protecting policyholders. In cases where an insurer in liquidation is insolvent, insurance guaranty associations will function to provide coverage to eligible policyholders subject to the statutory limits.[895]

However, due to the fragmented patterns of state insurance regulation, state insurance regulators lack the perspective and capacity to safeguard financial stability.[896] In light of this, after the 2007–2009 financial crisis, relevant arrangements have been made at the federal level for the sake of financial stability. The FSOC was thus established and vested with the authority to designate systemically important financial companies, which will be subject to the enhanced supervision of the Board of Governors.[897] But since the designation will in effect go against the objective of ending "too big to fail", this arrangement has attracted widespread criticism. At present, there is no designation of systemically important financial companies, and it remains to be seen how this arrangement will develop in the future. In cases where a troubled insurer poses systemic risk, it is indispensable that the state insurance regulators should work closely with the federal government to address the crisis. When an insurer is determined by the Secretary of the Treasury to be a covered

[894] For a more detailed discussion, see Section 5.2.4 in this chapter.

[895] For a more detailed discussion, see Part 5.4 in this chapter.

[896] See, for example, John Tatom, 'A Report to the Federal Insurance Office' (September 2011) 22 <https://mpra.ub.uni-muenchen.de/34621/> accessed 25 March 2018; Daniel Schwarcz and Steven L. Schwarcz, 'Regulating Systemic Risk in Insurance' (2014) 81 The University of Chicago Law Review 1569, 1576.

[897] For a more detailed discussion, see Section 5.5.2.1 in this chapter.

financial company which should be subject to the orderly liquidation, although the troubled insurer will still be dealt with in rehabilitation or liquidation according to state receivership laws, the receiver is expected to pursue not only the objective of protecting policyholders, but also the objective of maintaining financial stability.[898] There is still a possibility that the Orderly Liquidation Fund might be used to provide liquidity to the insurer in rehabilitation or liquidation.[899] Also, in the event of a liquidity strain in the financial market, the Federal Reserve System can set up emergency lending programme or facility with broad-based eligibility. It is likely that troubled but not insolvent insurers (not in receivership procedures) will receive liquidity support through the emergency lending programme or facility.[900] Although doubts have been raised as to whether the use of the Orderly Liquidation Fund or emergency lending from the Federal Reserve System constitutes an actual public bailout, given the restrictions and safeguards designed in these financial assistance arrangements, it is reasonable to believe that the chance of taxpayer bailouts will be reduced, if not eliminated.

All in all, with an escalation ladder of well-thought-out measures/procedures, the CMME mechanism in the US suffices to address crises of insurers of varying sizes. Due to its independence from the general bankruptcy system, the CMME mechanism can be designed or improved in a way which is most tailored for insurers, without

[898] See NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 633.

[899] For a more detailed discussion, see Section 5.5.2.2 in this chapter.

[900] For a more detailed discussion, see Section 5.5.2.3 in this chapter.

incorporating any elements in the general bankruptcy system which are not compatible with the special features of insurers. However, since the two main objectives of the CMME mechanism are separated, with the state receivership system focused on the objective of policyholder protection and the relevant federal arrangements focused on the objective of financial stability, the process of addressing crises will be hindered to a greater or lesser extent if troubled insurers pose systemic risk.[901]

[901] See International Monetary Fund, 'United State – Financial Sector Assessment Program – Review of the Key Attributes of Effective Resolution Regimes for the Banking and Insurance Sectors – Technical Note' (July 2015) 18 <www.imf.org/en/Publications/CR/Issues/2016/12/31/United-States-Financial-Sector-Assessment-Program-Review-of-the-Key-Attributes-of-Effective-43056> accessed 15 June 2018.

Chapter 6 Recommendations on the CMME Mechanism in China Based on the Comparison

Overview

This chapter will make recommendations on how the CMME mechanism in China can be reformed based on the comparisons of selected aspects between China, the UK and the US. These aspects include frameworks of the CMME mechanisms, commencement of post-takeover procedures, effects of post-takeover procedures, coordination of procedures, and insurance guarantee schemes and emergency funding plans. Following the analysis of these aspects respectively, a set of recommendations will be provided on the overall framework of the CMME mechanism in China.

Basically, it is recommended that the CMME mechanism in China should be independent of, rather than based on, the general bankruptcy system, which is modelled on the CMME mechanism in the US. In the proposed CMME mechanism, pre-takeover measures, takeover, reorganisation and liquidation constitute major measures/procedures troubled insurers may go through, and the Insurance Security Fund may perform either the protection function or the rescue function during the process. In cases where troubled insurers pose systemic risk, it is still possible that emergency lending might be provided by the People's Bank of China for rescue purposes.

6.1. Frameworks of the CMME Mechanisms

The CMME mechanisms in the UK and the US represent two typical models: while the mechanism in the UK is largely based on the general insolvency system, the mechanism in the US is completely independent of the general bankruptcy system. It can be said that the current CMME mechanism in China is more like the UK model, with bankruptcy laws for ordinary companies applicable to insurers. But unlike the UK, where there have been modifications to the general insolvency system to accommodate the special features of insurers since 1870,[902] in China there is still a lack of due consideration in the current legislation about how troubled insurers may be dealt with in bankruptcy procedures. To avoid uncertainties when crises of insurers occur, it is necessary that the CMME mechanism in China should be reformed to be more compatible with the special features of insurers. In recognition of this, a comparative study of the CMME mechanisms in China, the UK and the US is carried out in this thesis, so that inspiration can be taken from the UK and the US models when the reform of the mechanism in China is in contemplation.

Based on the analysis in Chapters 3 to 5, a general comparison of the frameworks of the current CMME mechanisms in China, the UK and the US is made in the chart below:

[902] For a more detailed discussion, see Part 4.1 in this thesis.

Component \ Jurisdiction	China	UK	US
Pre-takeover Tools	Proactive Intervention Measures		
Regulatory Takeover	Takeover	N/A	(1) Seizure Order (2) Conservation
Voluntary Arrangement	Composition	(1) Company Voluntary Arrangement (2) Scheme of Arrangement	N/A
Reorganisation	Reorganisation	Administration	Rehabilitation
Liquidation	(1) Revocation Liquidation (2) Bankruptcy Liquidation	Winding-up	Liquidation
Insurance Guarantee Scheme	(1) Protection Function (2) Rescue Function	Protection Function	Protection Function
Emergency Funding Plan	Emergency Lending (proposed)	Emergency Liquidity Assistance	(1) Orderly Liquidation Fund (2) Emergency Lending

(Chart: Frameworks of the CMME Mechanisms in China, the UK and the US)

In China, when an insurer runs into trouble, measures/procedures the insurer may go through can generally be divided into two categories: regulatory measures and bankruptcy procedures. Regulatory measures are led by the insurance regulatory authority, ie the CBIRC, which mainly include pre-takeover regulatory measures, takeover, and revocation liquidation. By comparison, bankruptcy procedures are judicial procedures and are hosted by the relevant court, which include composition, reorganisation and bankruptcy liquidation. During the process of these

measures/procedures, the ISF may function to provide financial support to bail out the troubled insurer, or to protect policyholders by means of either maintaining continuity of policies or making compensation payments to policyholders when their policies are terminated.[903] However, due to the lack of consideration of the special features of insurers, as well as the illogicality existing in statutory or regulatory provisions, many measures/procedures in the current CMME mechanism are argued to be ill-suited to insurers. In other words, it will be unfeasible to apply these measures/procedures to troubled insurers. In practice, to date, no bankruptcy procedure of a troubled insurer has ever taken place, and takeover is the most severe measure that has once been carried out to deal with crises of insurers.

In the UK, the CMME mechanism consists of the Proactive Intervention Framework and the insolvency system. Within the Proactive Intervention Framework, there are various regulatory measures the PRA can take to deal with crises of insurers in a proportionate manner, but there is no design of regulatory takeover in this framework which allows the PRA to take control of the management and property of a troubled insurer to address its crisis. In cases where there exist grounds for commencing relevant (quasi-)insolvency procedures against a troubled insurer, eligible parties (eg the management of the insurer, creditors (including policyholders), the PRA and the FCA) may take the initiative to commence a certain (quasi-)insolvency procedure, ie company voluntary arrangement, administration, winding-up, or scheme of

[903] For a more detailed discussion, see Part 3.5 in this thesis.

arrangement. Generally speaking, in an insolvency procedure, an insolvency practitioner will be appointed to take over and administer the troubled insurer, creditors will have rights to make decisions on major issues relating to how the troubled insurer should be dealt with, subject to sanctions of the court, and the court will have the final say in deciding relevant procedural or substantive issues, or settling disputes between the insurer and interested parties.[904] During the process, the FSCS may step in to perform the protection function by means of maintaining continuity of policies or making compensation payments to policyholders when policies are terminated, but normally it will not function to bail out the troubled insurer.[905] Despite the fact that a lot of efforts have been made to adapt the general insolvency system for insurers in the current CMME mechanism, it is arguable that some arrangements inherent in the insolvency system are not suitable for insurers, or may not lead to desirable outcomes when applied to insurers. For example, it is questionable whether it is necessary to keep company voluntary arrangement in the CMME mechanism, and it is also questionable whether the design of "creditors' decision" in insolvency procedures is compatible with the special features of insurers.[906]

In the US, the CMME mechanism is centred on the insurer receivership system at

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[904] For a more detailed discussion, see Part 4.2 in this thesis.

[905] For a more detailed discussion, see Part 4.3 in this thesis.

[906] More discussions relating to these two points can be found in, for example, Section 4.2.1, Section 6.3.2 and Section 6.4.1 in this thesis.

the state level, which is complemented by relevant regulation at the federal level. At the state level, there are administrative supervision and the insurer receivership system. Administrative supervision can be regarded as a period of enhanced supervision, during which a troubled insurer should follow the directions of the state insurance commissioner to make good any deficiencies in its operation while the insurer is still under the control of its management.[907] If the troubled insurer fails to restore to normal conditions under administrative supervision, the insurance commissioner may petition the court for a seizure or a receivership procedure (ie conservation, rehabilitation or liquidation). Once a court order of a seizure or a receivership procedure is entered, the insurance commissioner will take over the troubled insurer and carry out the procedure under the supervision of the court.[908] In cases where a troubled insurer in liquidation is found insolvent, the Life and Health Insurance Guaranty Association or the Property and Casualty Insurance Guaranty Association will perform the protection function by means of maintaining continuity of policies or making compensation payments to policyholders when policies are terminated.[909] Given the fact that the state insurance commissioner may lose sight of the impacts troubled insurers can have on the financial stability of the whole country or even the whole world, the relevant regulation focused on the objective of maintaining financial stability is thus enacted at the federal level. It is likely that the

[907] For a more detailed discussion, see Section 5.2.1.1 in this thesis.

[908] For more detailed discussions, see Part 5.2 and 5.3 in this thesis.

[909] For a more detailed discussion, see Part 5.4 in this thesis.

Orderly Liquidation Fund in the Treasury will provide liquidity to insurers in rehabilitation or liquidation, or the emergency lending from the Federal Reserve System will provide liquidity to troubled but not insolvent insurers (not in receivership procedures) when there is a market-wide liquidity strain.[910]

Comparing the UK model and the US model, generally speaking, this thesis is of the opinion that the US model is preferable. Apart from the separation of state regulation and federal regulation, which constitutes a hindrance to dealing with troubled insurers that pose systemic risk, the CMME mechanism in the US is basically suitable for insurers. Since the whole mechanism in the US is specific to insurers, completely independent of the bankruptcy system for ordinary companies, all arrangements in the mechanism can be designed in a way which is compatible with the special features of insurers, without including any elements in the bankruptcy system which may not work effectively or efficiently when applied to insurers. By comparison, since the CMME mechanism in the UK is based on the general insolvency system, despite the modifications specifically made for insurers, there still exist some arrangements which are inherent in the insolvency system but are arguably not compatible with the special features of insurers. In fact, the UK regulatory authorities have also recognised that the design model adopted in the current mechanism may not be satisfactory,[911] so it is reasonable to assume that a radical reform of the CMME mechanism will take place

[910] For a more detailed discussion, see Section 5.5.2 in this thesis.

[911] See, for example, HM Treasury, 'Financial Sector Resolution: Broadening the Regime' (August 2012) 32; Bank of England, 'The Bank of England's Approach to Resolution' (October 2017) 19.

in due course in the UK.

Given the above discussions, when it comes to the reform of the CMME mechanism in China, in terms of the relationship between the CMME mechanism and the general bankruptcy system, it is argued in this thesis that the US model is a better model to learn from. In the long run, it is better that China have a CMME mechanism which is independent of, rather than based on, the general bankruptcy system. Only by building on this model, can the CMME mechanism designed/reformed in a way which does not include any arrangements that are inherent in the general bankruptcy system but are arguably not suitable for insurers, eg the design of creditors' meeting[912] and the role of bankruptcy administrators.[913] Based on this design philosophy, the following parts of this chapter will further discuss how measures/procedures can be designed or arranged to form an effective and efficient CMME mechanism in China in the future.

6.2. Commencement of Post-Takeover Procedures

In the CMME mechanism in a certain jurisdiction, unlike pre-takeover tools which are regulatory measures and will be taken by the regulatory authority, post-takeover procedures may be judicial procedures in nature, which involve the function of a court of competent jurisdiction. In this part, the analysis will be made with the focus on

[912] For a more detailed discussion of whether there should be the design of creditors' meeting in the CMME mechanism, see Section 6.3.2 in this chapter.

[913] For a more detailed discussion of whether it is desirable that bankruptcy administrators carry out relevant procedures dealing with crises of insurers, see Section 6.3.1 in this chapter.

when, as well as how, post-takeover procedures can be initiated.

6.2.1. Triggers

In each jurisdiction, the insurance business is highly regulated, and insurers are subject to a comprehensive set of statutory or regulatory requirements. Accordingly, triggers for measures/procedures in the CMME mechanism should be set to reflect the requirements insurers should comply with. When insurers fall below these requirements and thus become troubled, relevant measures/procedures in the CMME mechanism should be initiated to restore the insurers to normal conditions or to let the insurers exit the market in an orderly manner.

However, in China, the scope of grounds for commencing relevant procedures in the current CMME mechanism has been set too narrowly. Due to the fact that the current mechanism is based on the general bankruptcy system, but without much consideration of the special features of insurers, the grounds for commencing reorganisation or bankruptcy liquidation of insurers are the same as those for ordinary companies. Generally speaking, these grounds are only concerned with “insolvency”, the standard of which combines both cash-flow insolvency and balance-sheet insolvency. In other words, a reorganisation or bankruptcy liquidation can be initiated against a troubled insurer only when the insurer is unable to pay its debts as they fall due, as well as the insurer’s assets are not sufficient to pay all of its debts or the insurer is apparently unable to pay all the debts.[914] However, due to the uniqueness of

[914] Enterprise Bankruptcy Act, art 2. (China)

insurance business, seldom will a troubled insurer fall into such an insolvency status.[915] As a consequence, with the triggers focused merely on "insolvency", reorganisation or bankruptcy liquidation is in effect rendered less useful or even useless in addressing crises of insurers. This to a certain extent can be evidenced by the fact that there has never been a case relating to reorganisation or liquidation of a troubled insurer so far. Therefore, it is argued that triggers for reorganisation or liquidation of insurers should not be limited to "insolvency", and it is necessary that a reform should be carried out in this respect.

In the UK, although the CMME mechanism is also based on the general insolvency system, the scope of grounds for commencing relevant insolvency procedures of insurers (eg administration and winding up) is broader than that in China. This is reflected in several aspects. Firstly, "insolvency" in the UK has a broader meaning. A company will be deemed unable to pay its debts, ie insolvent, if the company becomes cash-flow insolvent, or balance-sheet insolvent.[916] Accordingly, an insolvency procedure can be initiated against a company based on the grounds of its cash-flow insolvency or its balance-sheet insolvency. Secondly, the grounds for commencing winding-up are diverse, not just limited to "insolvency". The court can even grant a winding-up petition when the court thinks it is just and equitable to do so.[917] Thirdly, targeted at insurers, it is specifically provided that if an insurer's permission to effect

[915] For a more detailed discussion of this issue, see Section 2.3.3.3 in this thesis.

[916] Insolvency Act 1986, s 123. (UK)

[917] Insolvency Act 1986, s 122(1). (UK)

or carry out insurance contracts has been cancelled by the PRA, the court can wind up the insurer upon the petition being presented by the PRA.[918] Therefore, unlike China, where relevant bankruptcy procedures cannot be initiated until insurers become, or are likely to become, both cash-flow insolvent and balance-sheet insolvent, in the UK, relevant insolvency procedures can be initiated in a more timely manner when there exist crises of insurers.

In the US, in line with the fact that the insurer receivership system is different from the general bankruptcy system, grounds for commencing a receivership procedure also differ significantly from those for a bankruptcy procedure. There are various grounds by virtue of which the state insurance commissioner can initiate a receivership procedure (ie conservation, rehabilitation or liquidation) against a troubled insurer. These grounds reflect the statutory or regulatory requirements insurers should comply with, and are related to various aspects of insurers' operation, including financial conditions, management situations, etc.[919] Although "insolvency" constitutes one important ground therein, the scope of these grounds is much broader than "insolvency". Based on any of the grounds, the court may grant the insurance commissioner's petition for a receivership procedure. Due to the fact that the root cause of crises, or even failures, of insurers usually lie in management problems during the operation of insurers, with the deterioration of financial conditions, or even

[918] Financial Services and Market Act 2000, s 367(3). (UK)

[919] Insurer Receivership Model Act § 207. (US) For a more detailed discussion, see Section 5.2.2 in this thesis.

insolvency, just being the negative consequence, the design of various grounds for commencing a receivership procedure makes it possible for crises of insurers to be addressed effectively at an early stage, preventing troubled insurers eventually becoming insolvent or minimising adverse impacts troubled insurers may have.

Learning from experience in the UK and the US, this thesis argues that the grounds for commencing reorganisation or liquidation of insurers in China should be reformed to be more diverse, rather than just limited to "insolvency".[920] The grounds should be set in a way which reflects the statutory or regulatory requirements insurers should comply with, so that reorganisation or liquidation can be initiated in a timely manner when insurers fall below the requirements and run into serious trouble. Otherwise, reorganisation or liquidation may not be fully utilised in dealing with crises of insurers so as to achieve desirable outcomes if they cannot be initiated until insurers become or are likely to become insolvent.

6.2.2. Entry into Post-Takeover Procedures

When insurers run into trouble and there exist triggers for post-takeover procedures, how such procedures can be initiated becomes a matter of concern. This relates to who has the standing to petition for a certain procedure, and who has the authority to determine the commencement of a procedure.

[920] This is in line with the ICP 12 established by the IAIS. See IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12.6 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

In China, the commencement of a takeover differs from that of a bankruptcy procedure. While a takeover, as a regulatory measure in nature, will commence when the CBIRC decides to do so, a bankruptcy procedure (ie composition, reorganisation or bankruptcy liquidation), as a judicial procedure in nature, will commence when the petition for the procedure filed by eligible parties is granted by the court. However, the CBIRC's attitude also has a decisive effect on the commencement of a bankruptcy procedure of an insurer. As is specifically provided, only after obtaining prior approval from the CBIRC, can the troubled insurer or its creditors petition the court for a composition, reorganisation, or bankruptcy liquidation; otherwise, only the CBIRC itself can directly petition the court for a reorganisation or bankruptcy liquidation.[921] Therefore, it can be said that in the absence of the CBIRC's intervention, there will be no bankruptcy procedure of an insurer.

Situations are quite different in the UK and US. In the UK, generally speaking, like in the case of other ordinary companies, a petition for an insolvency procedure of a troubled insurer can be filed with the court by the insurer itself, its directors or its creditors.[922] Since "creditors" therein include contingent or prospective creditors, without any doubt, policyholders of a troubled insurer, like other creditors, have the standing to petition for a relevant insolvency procedure. In addition, in line with the fact that insurers are regulated financial institutions, it is specifically provided that the

[921] Insurance Act, art 90. (China)

[922] See Insolvency Act 1986, sch B1 para 12 and s 124. (UK)

PRA or the FCA can also petition the court for an administration or a winding-up if the situation requires.[923] Therefore, an insolvency procedure of a troubled insurer in the UK will commence when the petition for the procedure filed by any eligible parties is granted by the court. In contrast to the UK legislation, which allows various eligible parties to initiate insolvency procedures, the US legislation limits the party who can initiate receivership procedures only to the state insurance commissioner. It is especially emphasised that no receivership procedure will be commenced by a person other than the insurance commissioner, and no court would have jurisdiction to deal with any receivership procedure commenced by any other person.[924] In other words, in the US, a receivership procedure will commence only when a petition is filed with the court by the insurance commissioner and the court approves the petition.[925]

Based on the comparison, in terms of the CMME mechanism in China, careful consideration should be given to the question as to whether relevant parties other than the insurance regulatory authority, ie the CBIRC, should be allowed to petition for a reorganisation or liquidation of an insurer. Regarding this question, this thesis is of the opinion that only the CBIRC should be given the standing to petition the court for a reorganisation or liquidation of a troubled insurer, which is in line with the US approach. This proposition can be justified from different perspectives:

Firstly, it is believed that the CBIRC would make informed decisions and thus take

[923] See Financial Services and Market Act 2000, ss 359 and 367. (UK)

[924] Insurer Receivership Model Act § 105A. (US)

[925] Insurer Receivership Model Act § 202A. (US)

appropriate actions in the event of crises of insurers. As the regulatory authority in the insurance market, the CBIRC is responsible for achieving the objective of protecting policyholders and the objective of maintaining financial stability. When identifying a troubled insurer, the CBIRC should intervene in a way which makes sure that these two objectives will be achieved. Therefore, the CBIRC will normally have in place a plan which contains an escalation ladder of intervention that could produce a desirable result. In this case, if a petition for a reorganisation or liquidation is filed with the court by other parties, the plan made by the CBIRC may then be disrupted. As a consequence, the entry into a reorganisation or liquidation at a time not in line with the CBIRC's plan would probably lead to less desirable outcomes.

Secondly, in fact, in the current legislation, the CBIRC's attitude has already had a decisive effect on the commencement of a bankruptcy procedure of a troubled insurer. Since it is required that prior approval from the CBIRC should be obtained if relevant parties other than the CBIRC itself would like to petition for a bankruptcy procedure, the CBIRC's favourable attitude towards a bankruptcy procedure constitutes a prerequisite for the commencement of that procedure.[926] To report the intent of initiating a bankruptcy procedure to the CBIRC and seek its approval becomes an extra formality relevant parties should go through before they file a petition to the court. This, as this thesis argues, makes the whole process complicated and burdensome.

Thirdly, it is never an easy task for creditors (including policyholders) to prove that

[926] Insurance Act, art 90. (China)

an insurer runs into trouble, and thus convince the court to commence a reorganisation or liquidation. As a consequence, few creditors (including policyholders) will bother to petition for a reorganisation or liquidation of a troubled insurer, especially when their claims against the insurer may not even meet the costs to be incurred by filing such a petition. Also, since most unsecured creditors other than policyholders have claims inferior to insurance claims in the claims hierarchy which should be respected in bankruptcy procedures, the incentives for these creditors to initiate the procedures are further reduced. In a nutshell, it is reasonable to assume that most creditors of a troubled insurer will choose to take “a free ride” rather than take proactive actions.

Given the above consideration, when it comes to the reform of the CMME mechanism in China, the initiation of a reorganisation or liquidation should be redesigned to be more streamlined and efficient. This thesis holds that it is the CBIRC that is responsible for taking appropriate actions to deal with a troubled insurer, which includes having the exclusive standing to petition the court for a reorganisation or liquidation. Relevant parties, if they are the first one to identify certain problems in an insurer, only need to report the problems to the CBIRC, but do not need to and are also not allowed to petition the court for a reorganisation or liquidation by themselves. Since this arrangement differs so much from the arrangements in the general bankruptcy system that relevant interested parties have the standing to petition for a reorganisation or liquidation, it will be easier for this arrangement to be made in a context where the CMME mechanism is independent of, rather than based on, the

general bankruptcy system.

6.3. Effects of Post-Takeover Procedures

When a post-takeover procedure commences, the control of a troubled insurer will be transferred from its existing management to certain external bodies, normally either regulatory authorities or insolvency practitioners. In this part, the effects of post-takeover procedures will be discussed from three perspectives: the role of regulatory authorities, the decision-making process and the treatment of policyholders.

6.3.1. Role of Regulatory Authorities

Insurers are under the supervision of insurance regulatory authorities throughout their lifetime. In the event of crises of insurers, the way that regulatory authorities function largely determines how the crises will be addressed. Therefore, it is important that the role of regulatory authorities should be carefully considered when the CMME mechanism is designed or reformed.

In the current CMME mechanism in China, due to the fact that takeover is a regulatory measure in nature while bankruptcy procedures are judicial procedures in nature, the role the CBIRC plays in takeover differs from that in bankruptcy procedures. In a takeover, the CBIRC will have full authority in deciding relevant issues during the process. As indicated in the case of AIGC,[927] the CBIRC will form a takeover group to take over and administer the troubled insurer, and deal with the crisis in a way as it

[927] For a more detailed discussion of the case of AIGC, see Part 3.3 in this thesis.

thinks appropriate. By comparison, in a bankruptcy procedure of an insurer, in theory, the court of competent jurisdiction will host the procedure, and a bankruptcy administrator will be appointed to take over and administer the troubled insurer. Since there is a lack of special consideration for insurers in the current bankruptcy system, it is not known how the CBIRC may function after a bankruptcy procedure commences. What also remains unclear is how takeover, which is led by the CBIRC, can be coordinated with bankruptcy procedures, which are hosted by the court.

In the CMME mechanism in the UK, there is no design of regulatory takeover, and the post-takeover procedures consist of insolvency procedures, the commencement of which generally means troubled insurers will be taken over by insolvency practitioners. Due to the fact that insurers are regulated financial institutions, special provisions with regard to how relevant regulatory authorities can participate in insolvency procedures have been made in the legislation. Generally speaking, during the process of an insolvency procedure, the PRA and the FCA are entitled to be heard at any relevant hearing of the court, to receive any materials required to be sent to creditors, to attend any meeting or decision procedure for creditors, to apply to the court for a scheme of arrangement to be sanctioned if such an arrangement is proposed between the insurer and its creditors, etc.[928] What is more, in an administration, when noticing that the administrator's action or proposed action may unfairly harm the interests of members or creditors of the troubled insurer, or that the

[928] See Financial Services and Market Act 2000, ss 362 and 371. (UK)

administrator is not performing his functions as quickly or as efficiently as is reasonably practicable, the PRA or the FCA is also entitled to apply to the court to challenge that action.[929] Under these arrangements, in an insolvency procedure of an insurer, although regulatory authorities can voice their opinions during the process and can even apply to the court to correct improper actions taken by insolvency practitioners, they have no authority, in theory, to decide how the crisis will be addressed. Thus, it is fair to say that regulatory authorities will only play an ancillary role when a troubled insurer is placed in an insolvency procedure.

In contrast to the situation in the UK, insurance regulatory authorities play a key role throughout the process of dealing with troubled insurers in the US. In the state insurer receivership system, it is the insurance commissioner who will take over and administer an insurer when the insurer is placed in a receivership procedure (ie conservation, rehabilitation or liquidation), and will have great discretion in deciding relevant issues during the process, subject to the court's approval or review. Although the court has the ultimate authority in deciding whether the insurance commissioner's proposed actions should be granted or the insurance commissioner's actions are appropriate, the court normally will not object to the proposals or decisions made by the insurance commissioner in the absence of good reasons.[930] Therefore, despite the fact that receivership procedures are judicial procedures in nature, it is still fair to say

[929] See Financial Services and Market Act 2000, s 362; Insolvency Act 1986, sch B1 para 74. (UK)

[930] See Debra J. Hall and Robert M. Hall, 'Insurance Company Insolvencies: Order out of Chaos' (1993) 12(2) Journal of Insurance Regulation 145, 168.

that these procedures are led by the insurance commissioner.

Based on the comparison, in light of the uniqueness of insurers, this thesis approves of the US approach and holds that regulatory authorities should be vested with extensive powers in dealing with crises of insurers, including the power of taking control of the management and property of troubled insurers when necessary.[931] Different from ordinary insolvency procedures where insolvency practitioners will be appointed to take over and administer insolvent companies, in relevant procedures in the CMME mechanism, such as reorganisation and liquidation, it is the regulatory authorities who should carry out these procedures. Therefore, in terms of the CMME mechanism in China, it is recommended that reorganisation or liquidation of insurers should be carried out by the CBIRC rather than bankruptcy administrators. This proposition can be justified from the following perspectives:

Firstly, to achieve the objective of protecting policyholders and the objective of maintaining financial stability in the case of crises of insurers requires the involvement of the CBIRC. As the regulatory authority in the insurance business, the CBIRC is responsible for, and is also deemed more competent than anyone else in, achieving these two objectives. Thus, there is a good chance that both of the objectives will be achieved in reorganisation or liquidation of troubled insurers if it is the CBIRC who

[931] This is in line with the ICP 12 established by the IAIS. See IAIS, ‘Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups’ (November 2019) ICP 12.7 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

carries out these procedures. By contrast, since bankruptcy administrators are private bodies, it is beyond their responsibility as well as capacity to take account of the objective of maintaining financial stability in their action. As a corollary, if it is bankruptcy administrators who carry out reorganisation or liquidation of troubled insurers, although they may still function well in protecting policyholders, they may not be able to maintain financial stability when there is a systemic crisis.[932]

Secondly, since the insurance business is highly professional, dealing with crises of insurers should depend on those who are familiar with the insurance business. However, it is unrealistic to expect that ordinary bankruptcy administrators will know the insurance business very well, let alone how to deal with crises of insurers. In addition, given the fact that the incidence of reorganisation or liquidation of insurers is normally low,[933] few bankruptcy administrators will have an opportunity to be involved in a case of a troubled insurer. As a consequence, the lack of relevant knowledge as well as experience makes it less likely for bankruptcy administrators to address crises of insurers in an effective and efficient way. By contrast, as the insurance regulatory authority, the CBIRC knows the insurance business inside out. If the CBIRC is vested with the exclusive power to carry out administration and liquidation of insurers, it is more likely that desirable outcomes will be achieved in individual cases,

[932] See, for example, Martin Čihák and Erlend Nier, 'The Need for Special Resolution Regimes for Financial Institutions – The Case of the European Union' (IMF Working Paper, September 2009) 6 <www.imf.org/external/pubs/ft/wp/2009/wp09200.pdf> accessed 25 March 2017.

[933] Note: To date, no reorganisation or liquidation of insurers has ever occurred in China.

and the CBIRC will also become more and more experienced in addressing crises of insurers as the cases it is involved in accumulate. What is more, the CBIRC's exclusive standing in carrying out administration and liquidation of insurers can to a large extent ensure that the consistent strategy will be applied in different cases, with similar situations always dealt with in a similar way, so that fairness can be promoted between cases.

Thirdly, expenses of reorganisation or liquidation which should be borne by troubled insurers will be largely reduced if it is the CBIRC who carries out the procedures. Since bankruptcy administrators are profit-oriented entities which make a profit by providing services in bankruptcy procedures, they will charge clients the market price for the services. Given the fact that reorganisation or liquidation of insurers normally lasts for years or even dozens of years, relevant service fees, if charged by bankruptcy administrators, will be a huge burden on the already exhausted insurers, largely reducing the assets that would otherwise be available for satisfying claims of policyholders and other creditors. By contrast, since it is the CBIRC's responsibility to supervise the insurance market, the CBIRC will not charge any service fees if the legislation requires/authorises it to carry out reorganisation or liquidation of insurers, but should be allowed to be reimbursed for the expenses incurred during the process. Therefore, in cases where the CBIRC carries out reorganisation or liquidation of insurers, troubled insurers will pay much less procedure expenses than in cases where bankruptcy administrators carry out the procedures, so that there will be more assets left to satisfy claims of policyholders and other creditors.

In addition, since insurers in China are normally large in size and how well they operate will usually have a great impact on society, at least at a local level, the CBIRC is always expected to intervene in dealing with crises of insurers so as to minimise the adverse impact on the social stability, which is enshrined as an ultimate policy aim by the state. From this perspective, in current China, it is also not realistic to expect that reorganisation or liquidation of troubled insurers will be just carried out by bankruptcy administrators in practice.

Taken together, this thesis argues that the CBIRC is more suitable than bankruptcy administrators in dealing with crises of insurers, and the CBIRC should be given the exclusive standing in carrying out reorganisation or liquidation of insurers. Since this arrangement is so different from relevant arrangements in the general bankruptcy system, it will be easier for this arrangement to be made in a context where the CMME mechanism is independent of, rather than based on, the general bankruptcy system.

6.3.2. Decision-Making Process

Due to the fact that both the CMME mechanisms in China and the UK are based on the insolvency/bankruptcy system for ordinary companies, creditors' decision (creditors' meeting) constitutes an important design, which requires that major issues in relevant procedures should be subject to creditors' decisions. However, since most insurance claims are contingent or prospective at a certain point of time, how to calculate policyholders' voting rights during the decision-making process becomes a challenge. In this aspect, while no special provision has been made in the current mechanism in China, there exist special provisions in the UK guiding how policyholders'

claims should be calculated in winding-up.[934] But even in the UK, there is a lack of provisions regarding how to calculate policyholders' voting rights in procedures other than winding-up (eg CVA or administration), which obviously will cause a lot of uncertainties if relevant cases occur. Also, since there are normally a vast number of creditors (including policyholders) in an insurer, to obtain favourable votes from the required majority of creditors so as to get certain issues approved may sometimes be unrealistic. For example, in reorganisation in China, a draft reorganisation plan will be approved only when it is approved by all the specified 4 creditors' groups, ie the group for secured debts, the group for debts relating to the employees' welfare, the group for unpaid taxes, and the group for ordinary debts; and within each group, the draft reorganisation plan will be approved if (1) one-half or more of creditors participating in the voting process vote in favour of it, and (2) the value of claims of those casting favourable votes is not less than two-thirds of the value of all claims in that group.[935] In the case of a troubled insurer, since there may be hundreds of thousands of or even millions of policyholders, even if an additional creditors' group is established especially for policyholders for voting purposes, it is unrealistic to expect that the value of claims of the policyholders who participate in the voting process and cast favourable votes will exceed two-thirds of the value of all insurance claims. Taken together, given the challenges the design of "creditors' decision" may bring in dealing with troubled

[934] For a more detailed discussion, see Section 4.2.3.2 in this thesis.

[935] Enterprise Bankruptcy Act, arts 82, 84 and 86. (China)

insurers, it is questionable whether this design should be retained in the CMME mechanism.

Unlike the mechanisms in China and the UK, in the insurer receivership system in the US, there is no design of creditors' decision at all. How to deal with crises of insurers in receivership procedures (ie conservation, rehabilitation and liquidation) will largely depend on the judgement of the receiver, ie the insurance commissioner. That is to say, the insurance commissioner has extensive authority in deciding issues relating to troubled insurers in receivership procedures, without the need to seek creditors' decisions, but subject to prior approval of the receivership court when it comes to some major issues.[936] However, this does not mean that the level of protection of creditors' rights has been downgraded. All interested parties are allowed to file objections with the court if they object to any actions proposed by the receiver.[937] But any objection should be based on justifiable grounds. Otherwise, if the court determines that the objection is frivolous or filed merely for delay or for other improper purposes, the court may order the objecting party to pay the receiver's reasonable costs and fees of defending the action.[938] Therefore, as the US experience shows, the mechanism dealing with troubled insurers can work well without incorporating the design of "creditors' decision" in relevant procedures.

Considering the uniqueness of insurers, this thesis approves of the US approach and

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[936] See Insurer Receivership Model Act §§ 301A, 401A and 501A. (US)

[937] Insurer Receivership Model Act § 107B. (US)

[938] Insurer Receivership Model Act § 107B(5). (US)

argues that there should be no design of creditors' decision in the CMME mechanism, and regulatory authorities should have the authority to decide relevant issues when addressing crises of insurers, subject to the court's prior approval or review.[939] This is believed to be a desirable option which can promote efficiency in dealing with troubled insurers while doing no harm to interested parties. In the absence of the design of "creditors' decision", there are still many other arrangements in the CMME mechanism which can ensure that the interests of creditors (including policyholders) will not be unfairly harmed. For example, according to the commonly accepted principle of "no creditor worse off than in liquidation", no matter how regulatory authorities deal with troubled insurers, creditors should not be put into a worse situation than if the troubled insurers are liquidated.[940] Also, since claims of policyholders have priority over most other unsecured claims in the claims hierarchy if insurers are liquidated, no losses should be allocated to policyholders unless creditors with lower-ranking claims have absorbed losses.[941] What is more, eligible policyholders who are covered by the insurance guarantee scheme will be protected

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[939] This is in line with the IAIS's ICP 12. See IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12.7.10 and 12.11.3 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

[940] See, for example, IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12.11.2 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

[941] See, for example, IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12.7.11 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

to a large extent, and thus will suffer only a small proportion of losses, if any. In addition, like the US approach, in cases where interested parties are not satisfied with regulatory authorities' actions or proposed actions, they should still be allowed to challenge the actions in front of the court.

Therefore, in the future reform of the CMME mechanism in China, it is recommended in this thesis that the design of "creditors' meeting" in reorganisation or liquidation should be removed, and the CBIRC should be authorised to decide relevant issues during the process, subject to the court's prior approval when it comes to certain major issues, such as restructuring or transferring insurers' business and distributing insurers' assets. Since the design of "creditors' meeting" constitutes an inherent feature in the general bankruptcy system, the removal of "creditors' meeting" from the CMME mechanism can only be achieved when the CMME mechanism is independent of the general bankruptcy system. In other words, the undesirability of the design of "creditors' meeting" in dealing with crises of insurers constitutes an important ground for the argument that the CMME mechanism should be independent of, rather than based on, the general bankruptcy system.

6.3.3. Treatment of Policyholders

In line with the objective of policyholder protection, special protection will be provided to policyholders in the CMME mechanism. This is reflected not only in the efforts to minimise losses policyholders may suffer in their insurance claims, but also in the efforts to ensure the timeliness of payment of insurance claims. Since it is common to the CMME mechanisms in China, the UK and the US that insurance claims have priority

over most other unsecured claims in the claims hierarchy and there are insurance guarantee schemes protecting policyholders to a certain degree, the arrangements for minimising losses of policyholders are basically the same in essence in these three jurisdictions. So this section will focus mainly on the arrangements as to when insurance claims will be paid after a post-takeover procedure commences, which is inevitably related to the arrangements as to when insurance guarantee schemes may take action to perform the function of protecting policyholders.

In China, under the current arrangements, while the payment of debts (including insurance debts) will not be affected when a troubled insurer is placed in takeover, the payment of debts (including insurance debts) will be automatically stayed when the petition for a bankruptcy procedure (ie composition, reorganisation, or bankruptcy liquidation) of a troubled insurer is granted by the court.[942] Thus, insurance claims of policyholders, like claims of other creditors, will not be satisfied by the insurer for a long period of time during the process of a bankruptcy procedure. Although it is reasonable to expect that policyholders can get timely compensation payments from the ISF, the current legislation only allows policyholders to assign their insurance claims to the ISF and receive compensation after a troubled insurer enters a revocation liquidation or bankruptcy liquidation.[943] As a consequence, in cases where a troubled insurer enters a reorganisation, policyholders can neither get non-delayed payments

[942] Enterprise Bankruptcy Act, art 16. (China)

[943] Insurance Security Fund Regulations, reg 24. (China)

of insurance claims from the insurer, nor receive compensation from the ISF. The resulting significant delay in the satisfaction of insurance claims will not only deviates from the objective of policyholder protection, but also disrupt functions "insurance" should fulfil in society. To avoid this, it is necessary to reform the current arrangements so as to ensure that insurance claims will be satisfied in a timely manner during crises of insurers.

In the UK, although payment of insurance debts, like other debts, will normally be stayed when an insurer is in administration or winding-up, eligible policyholders can receive compensation from the FSCS during the process after assigning their debts to the FSCS.[944] Therefore, the FSCS's involvement in these procedures can largely reduce impacts that crises of insurers may have on most policyholders. Also, when it comes to long-term insurers, if long-term insurance policies remain in force in winding-up, as is the norm, it may still be the case that long-term insurance claims will be paid without any disruption notwithstanding winding-up.[945] In this way, an exception to the stay effect has been made for long-term insurance claims, so that long-term insurance policyholders can be well protected from crises of insurers.

In the US, despite the normal stay effect the opening a receivership procedure (ie conservation, rehabilitation, or liquidation) will have, payments of insurance claims may remain uninfluenced. As is often the case, when insurers in conservation or

[944] PRA, 'Rulebook – SII Firms – Policyholder Protection 16.1' (3 July 2015).

[945] Insurers (Winding Up) Rules 2001, SI 2001/3635, r 23. (UK)

rehabilitation are believed to be solvent, insurance claims will be paid as usual.[946] Even if payments of insurance claims are stayed, there still exist hardship exceptions which allow policyholders facing financial hardship to receive partial payments from insurers on a timely basis.[947] Although payments of insurance claims will be stayed when insurers in liquidation are insolvent, at this stage insurance guaranty associations will intervene to make compensation payments to eligible policyholders.[948] Taken together, to avoid or mitigate disruption which may be caused by crises of insurers, special arrangements have been made to ensure that claims of policyholders will often be paid or compensated, wholly or partially, in a timely manner during receivership procedures.

Although the UK and the US have taken different approaches to dealing with insurance claims in relevant procedures in their CMME mechanisms, the common goal is to minimise adverse impacts troubled insurers may have on policyholders. The major differences in approaches adopted in these two jurisdictions lie in the stay effect of paying insurance claims in the reorganisation process (ie, respectively, administration in the UK, and conservation and rehabilitation in the US), and the timing of when

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[946] See, for example, Francine L. Semaya and William K. Broudy, 'A Primer on Insurance Receiverships' (2010) 40 The Brief 22, 29; Iain A.W. Nasatir and Christopher M. Maisel, 'Beware of Rehabilitation Plans' (2013) 22(2) The Insurance Receiver 19, 20. See also Jonathan D. Rose, 'Financial Crises at Insurance Companies: Learning from the Demise of the National Surety Company During the Great Depression' (2017) 24(3) Financial History Review 239, 250.

[947] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 32.

[948] See Life and Health Insurance Guaranty Association Model Act § 8B; Property and Casualty Insurance Guaranty Association Model Act § 8A(1)a. (US)

insurance guarantee schemes (ie, respectively, the FSCS in the UK, and insurance guaranty associations in the US) may intervene to compensate policyholders. When it comes to reforming the CMME mechanism in China, this thesis is of the view that while the existing stay effect of paying debts (including insurance debts) in reorganisation or liquidation should be retained, policyholders should be entitled to receive compensation from the ISF in both reorganisation and liquidation. This is modelled on the UK approaches rather than the US ones. It is held in this thesis that to stay paying insurance claims in reorganisation is a cautious option which will be fair to all policyholders. Otherwise, in cases where an insurer in reorganisation which was originally believed to be solvent later is found to be insolvent or turns to be insolvent, if full payments have already been made to policyholders with crystallised claims during the process of reorganisation, it will be unfair to policyholders whose claims crystallise after the finding of insolvency. Therefore, it is better that payments of all debts (including insurance debts) should be stayed when an insurer enters a reorganisation, and the ISF should function to compensate eligible policyholders in a timely manner.

Given the above discussions, it is recommended in this thesis that when an insurer enters a reorganisation or liquidation, payments of insurance claims by the insurer should be stayed automatically, but eligible policyholders can assign their rights related to insurance claims to the ISF so as to receive compensation from the ISF in advance. By assuming rights assigned by each policyholder, if later the ISF is paid a dividend by the troubled insurer with an amount more than the amount of

compensation a certain policyholder has received, then the difference should still be returned to the policyholder.

6.4. Coordination of Procedures

In a well-organised CMME mechanism, relevant elements within the mechanism should coordinate with each other. Drawing on experience in the UK and the US, revolving around how the CMME mechanism in China can be streamlined, this section will discuss, in turn, whether "composition" should be retained in the mechanism, what the borderline is between "takeover" and "reorganisation", and whether there should be both revocation liquidation and bankruptcy liquidation in the mechanism.

6.4.1. Composition

On the issue of whether troubled insurers are allowed to propose collective voluntary arrangements with its creditors, the attitude shown in the CMME mechanism in the US is in marked contrast to that in China and the UK. While it is permissible for troubled insurers to initiate such voluntary arrangements in China and the UK, this is not the case in the US.

In China, as it is provided in the Insurance Act, upon the approval of the CBIRC, a troubled insurer can petition a court of competent jurisdiction for a composition.[949] In this procedure, it is the troubled insurer itself that should come up with a draft composition proposal to be submitted to the creditors' meeting for consideration, and

[949] Insurance Act, art 90. (China)

will implement the composition proposal after it is approved by the creditors' meeting.[950] However, since it will be difficult to calculate policyholders' voting rights in the creditors' meeting[951] and it will also be unrealistic to expect that the required majority of favourable votes from creditors can be obtained so as to get the approval of a composition proposal,[952] it seems unfeasible for composition to be applied to insurers. In practice, no case relating to compositions of insurers has ever taken place.

In the UK, there exist CVA and scheme of arrangement, by virtue of which troubled insurers can reach collective voluntary arrangements with creditors. Due to similar reasons why composition in China is unsuitable for insurers, it is also arguable that CVA in the UK is not suitable for insurers.[953] Likewise, there is hardly any case relating to CVAs of insurers. Unlike CVA, scheme of arrangement is not an insolvency procedure, but a measure in company law which is specific to the UK. Through a scheme of arrangement, a company can reach a compromise or arrangement with its creditors or members, or any class of its creditors or members.[954] In the past few decades, schemes of arrangements in combination with provisional liquidations were the most frequently adopted approach to dealing with troubled insurers. However, due to the

[950] Enterprise Bankruptcy Act, arts 95 and 98. (China)

[951] For a more detailed discussion, see Section 3.4.1.3 in this thesis.

[952] A composition proposal will be approved by the creditors' meeting if (1) more than half of creditors participating in the voting process vote in favour of it, and (2) the value of claims of those casting favourable votes is not less than two-thirds of the value of all unsecured claims. See Enterprise Bankruptcy Act, art 97. (China) For a more detailed discussion, see Section 3.4.2 in this thesis.

[953] For a more detailed discussion, see Section 4.2.1 in this thesis.

[954] Companies Act 2006, s 895(1). (UK)

changes in laws as well as the regulatory authorities' attitudes in recent years, it remains to be seen how schemes of arrangements will function in the case of crises of insurers in the future.[955]

By contrast, in the CMME mechanism in the US, there is not a procedure equivalent to composition in China or company voluntary arrangement in the UK. As is provided in the IRMA, one ground on which the state insurance commissioner can petition the court to commence a receivership procedure is that an insurer has systemically attempted to compromise with creditors on the ground that it is financially unable to pay its obligations in full.[956] Therefore, it is not difficult to infer that the purpose of the legislation in the US is to avoid collective voluntary arrangements proposed by a troubled insurer when the insurer is still in the control of the existing management.

In terms of how the overall framework of the CMME mechanism in China should be designed, this thesis argues that composition should not be retained in the CMME mechanism, which draws on the US experience. This can be justified from different perspectives. Firstly, since mismanagement is often the underlying cause of crises of insurers, it is not acceptable if troubled insurers are still allowed to propose collective voluntary arrangements with creditors (including policyholders) when they are under the control of the existing management. Secondly, even if troubled insurers are eligible to make use of composition, it will be unfeasible to obtain the approval for a

[955] For a more detailed discussion, see Section 4.2.4 in this thesis.

[956] Insurer Receivership Model Act § 207R. (US)

composition proposal from a vast number of creditors (including policyholders). Thirdly, to have composition in the CMME mechanism which keeps the design of "creditors' meeting" will not be consistent with the argument in this thesis that there should not be creditors' meeting in reorganisation or liquidation.[957] Taken together, the thesis is of the view that when an insurer runs into trouble, the insurer under the control of its existing management should not be allowed to propose collective voluntary arrangements with its creditors. If the reform of the CMME mechanism can be carried out in a way based on the design philosophy that the CMME mechanism is independent of the general bankruptcy system, there is no need to take into consideration the composition procedure, a bankruptcy procedure which is unsuitable for insurers.

6.4.2. Takeover and Reorganisation

In the CMME mechanism in China, there are takeover and reorganisation, with takeover being a purely regulatory measure and reorganisation being a judicial procedure. Since it is recommended in this thesis that the CBIRC, rather than bankruptcy administrators, should carry out reorganisation,[958] it is the CBIRC who will take control of the management and property of troubled insurers in both takeover and reorganisation. Given the fact that a troubled insurer can be restructured for rescue purposes in both takeover and reorganisation, it is necessary to clarify what

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[957] For a discussion of whether there should be the design of "creditors' meeting" in reorganisation and liquidation, see Section 6.3.2 in this chapter.

[958] For a more detailed discussion, see Section 6.3.1 in this chapter.

different effects takeover and reorganisation may have and how they can coordinate with each other.

It can be said that seizure and conservation in the state receivership system in the US are the procedures analogous to takeover in China, and rehabilitation in the US is equivalent to reorganisation in China. Unlike takeover in China which is a regulatory measure, seizure and conservation in the US are judicial procedures, which will be carried out by the insurance commissioner under the general supervision of the receivership court. Both seizure and conservation can be regarded as interim procedures, with seizure being more of an expedient. Upon the insurance commissioner's petition, the court may forthwith issue a seizure order on an ex parte basis, authorising the insurance commissioner to immediately take possession and control of all or a part of a troubled insurer's property, relevant records, etc.,[959] so as to avoid diversion of funds or destruction of records.[960] A seizure will be ended if the insurance commissioner fails to commence a receivership procedure (ie conservation, rehabilitation or liquidation) after having a reasonable opportunity to do so.[961] When it comes to a receivership procedure, a troubled insurer will have the opportunity to be heard before the court makes a receivership order, and the commencement of receivership means the insurance commissioner will fully take over the troubled

[959] Insurer Receivership Model Act § 201A, B. (US)

[960] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) ii.

[961] Insurer Receivership Model Act § 201D. (US)

insurer.[962] The intention of having conservation as a receivership procedure is "to allow a limited amount of time for the insurance commissioner to determine whether rehabilitation or liquidation is preferable",[963] and the normal time limit for conservation is 180 days, with an additional 180 days upon the court approval.[964] However, since in both conservation or rehabilitation, the insurance commissioner, upon the court approval, can take any necessary or appropriate action to reform and revitalise the insurer,[965] it seems that there is no substantive distinction between conservation and rehabilitation. This, as argued in this thesis, to a certain extent reduces the significance of having both conservation and rehabilitation in the receivership system.

Due to the fact that takeover in China is a regulatory measure in nature, how takeover distinguishes from reorganisation in China is different from how seizure and conservation distinguish from rehabilitation in the US. The thesis is of the view that a main distinction between takeover and reorganisation should lie in the effects they may have on creditors. Determined by its nature as a regulatory measure, takeover will have direct effects just on a troubled insurer and its inside parties (eg shareholders, the management, and other employees), but normally will not affect the interests of creditors (including policyholders). Like the period of seizure or conservation in the US,

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[962] Insurer Receivership Model Act § 202D, E. (US)

[963] Insurer Receivership Model Act Proceedings Citations § 302. (US)

[964] Insurer Receivership Model Act § 302A, B. (US)

[965] See Insurer Receivership Model Act §§ 302C and 402A. (US)

the period of takeover in China should also be regarded as an interim period. The purpose of having takeover in the CMME mechanism is to allow the CBIRC to take full control of a troubled insurer on an immediate basis, and then take appropriate actions to address the crisis of the insurer at its own discretion, as long as the actions will not affect the interests of creditors. In cases where the CBIRC cannot restore a troubled insurer to normal operations through a takeover, the CBIRC may petition the court for a reorganisation or liquidation procedure, thereby converting the takeover into a reorganisation or liquidation. Since reorganisation is a judicial procedure, the restructuring effects reorganisation may have are stronger than takeover. This is mainly reflected in the fact that actions taken in reorganisation may directly affect the interests of creditors. For example, there will be a stay on payment of claims when a reorganisation commences; debts (including insurance debts) owed by a troubled insurer will be written down if the CBIRC proposes to do that and the court approves it; and insurance policies carried on by a troubled insurer will be transferred to other insurers if the CBIRC proposes to do that and the court approves it. Therefore, with different effects on creditors, takeover and reorganisation can complement each other in dealing with crises of insurers and together contribute to a well-structured CMME mechanism.

6.4.3. Revocation Liquidation and Bankruptcy Liquidation

In the current CMME mechanism in China, there exist two types of liquidation, ie revocation liquidation and bankruptcy liquidation. Although there has never been any case relating to either type of liquidation, it is normally held that revocation liquidation

is a regulatory measure dealing with solvent troubled insurers and bankruptcy liquidation is a judicial procedure dealing with insolvent insurers.[966] In other words, when there is a need to liquidate a troubled insurer, whether the insurer is insolvent will determine which type of liquidation should be adopted. While a revocation liquidation will be carried out by the CBIRC, a bankruptcy liquidation will be carried out by bankruptcy administrators under the supervision of the court. However, due to the uniqueness of the insurance business, to accurately predict whether an insurer is insolvent may sometimes be found unfeasible, and a troubled insurer which was originally regarded as solvent may still turn out to be or become insolvent.[967] Therefore, it is doubtful whether it is advisable to have both revocation liquidation and bankruptcy liquidation, which are respectively targeted at troubled but solvent insurers and insolvent insurers.

In the CMME mechanisms in the UK and the US, liquidation (or winding-up) is a judicial procedure, and grounds for commencing liquidation are diverse, not just limited to “insolvency”. In the UK, it is likely that an insurer will be placed into a compulsory winding up when the insurer’s permission to carry on insurance business is cancelled by the PRA or when the Secretary of State thinks the continuing operation

[966] See, for example, Xiang Long, 'The Role of Insurance Regulatory Authorities in the Compulsory Market Exit System for Insurers' (2010) 12 Insurance Studies 51, 55; Ting Zhang, 'A Study on China's Risk Disposal and Market Exit System for Troubled Insurance Companies' in Jingshan Chen and Ting Zhang (eds), *Legal Comments on Crisis Management System for Financial Institutions in East Asia*, vol 1 (Law Press · China 2015).

[967] For a more detailed discussion, see Section 2.3.3.3 in this thesis.

of the insurer would harm the public interest.[968] In the US, according to the IRMA, there are 22 grounds for commencing a receivership procedure, and the existence of any ground can warrant a liquidation of an insurer.[969] Therefore, generally speaking, in both the UK and the US, whether an insurer is insolvent does not influence how liquidation (or compulsory winding-up) will be carried out.

Drawing on the experience in the UK and the US, this thesis is of the opinion that instead of having both revocation liquidation and bankruptcy liquidation, there should be only one liquidation procedure, which is a judicial procedure, in the CMME mechanism in China. This is also in line with the view in this thesis that triggers for a certain measure/procedure in the CMME mechanism should reflect statutory or regulatory requirements an insurer should comply with, but not limited to "insolvency".[970] There is no need to have two types of liquidation according to whether insurers are insolvent. In the reformed liquidation procedure, as discussed earlier in this chapter, it is recommended that the CBIRC, rather than bankruptcy administrators, should carry out liquidation of insurers under the supervision of the court.[971]

6.5. Insurance Guarantee Schemes and Emergency Funding

[968] See Financial Services and Markets Act 2000, s 367(3); and Insolvency Act 1986, s 124A. (UK)

[969] For a more detailed discussion, see Section 5.2.2 in this thesis.

[970] For a more detailed discussion, see Section 6.2.1 in this chapter.

[971] For a more detailed discussion, see Section 6.3.1 in this chapter.

Plans

Insurance guarantee schemes, as a safety net in the insurance market, have a significant role to play in the event of crises of insurers. There are two main functions insurance guarantee schemes may perform: the function of protecting policyholders (the protection function) and the function of rescuing troubled insurers (the rescue function). While all insurance guarantee schemes in different jurisdictions can serve the protection function, only some of them can serve the rescue function.[972] Apart from insurance guarantee schemes, given concerns about systemic risk, some jurisdictions have set up emergency funding plans as a last resort, so that emergency funding can be used to deal with troubled insurers for the purposes of maintaining financial stability. In a certain jurisdiction, how an insurance guarantee scheme or emergency funding plan may function deeply influence the way crises of insurers will be addressed. Therefore, it is important to make sure that functions of insurance guarantee schemes or emergency funding plans are designed in a way which can produce desirable effects.

[972] For more information, see, for example, OECD, 'Policyholder Protection Schemes: Selected Considerations' (2013) <www.oecd-ilibrary.org/finance-and-investment/policyholder-protection-schemes_5k46l8sz94g0-en> accessed 31 October 2018; IAIS, 'Issues Paper on Policyholder Protection Schemes' (October 2013) <https://iaisweb.org/page/supervisory-material/issues-papers/file/34282/life-insurance-securitisation-october-2003#> accessed 31 October 2018; EIOPA, 'Consultation Paper on Proposals for Solvency II 2020 Review: Harmonisation of National Insurance Guarantee Schemes' (9 July 2019) <www.eiopa.europa.eu/sites/default/files/press/news/eiopa-bos-19-259_consultation_paper_on_harmonisation_of_igss.pdf> accessed 9 July 2019.

In China, the ISF serves the purpose of protecting policyholders as well as the purpose of maintaining financial stability, and there is a plan to specifically provide that the People's Bank of China, as the lender of last resort, can provide emergency lending to troubled systemically important financial institutions (including insurers) for the purposes of maintaining financial stability.[973] When dealing with troubled insurers, the ISF can perform both the protection function and the rescue function. Under the current mechanism, the protection function means that when an insurer is placed into a revocation liquidation or bankruptcy liquidation and its assets are insufficient to pay insurance claims, the ISF can compensate policyholders or other insurers which have assumed policies transferred from the troubled insurer; and the rescue function means that when an insurer falls into a major crisis, which may seriously jeopardise the public interest or financial stability, the ISF can provide financial assistance directly to the troubled insurer, ie bail out the insurer.[974] However, in the current legislation, a lot of illogicality or ambiguities can be identified in the provisions relating to the protection function, and there is a lack of provisions about the rescue function.[975] To date, only the rescue function has been performed by the ISF in practice, and the existing experience shows that the ISF will inject capital into troubled insurers or

[973] The People's Bank of China, China Banking and Insurance Regulatory Commission and China Securities Regulatory Commission, 'The Guidance on Improving the Regulatory System for Systemically Important Financial Institutions' (November 2018) <www.gov.cn/xinwen/2018-11/27/content_5343833.htm> accessed 27 November 2018.

[974] See Insurance Security Fund Regulations, regs 3 and 16. (China)

[975] For a more detailed discussion, see Part 3.5 in this thesis.

troubled insurance holding companies for rescue purposes.[976] Since there are no clear provisions about in what circumstances the ISF can perform the rescue function, the ISF's over-reliance on the rescue function in practice leaves an impression on the insurance market that the ISF will always come to the rescue when an insurer runs into trouble, and thereby all creditors, and sometimes even shareholders, of the troubled insurer will be fully protected. As a consequence, the existence of the ISF's rescue function has actually provided an implicit guarantee to all market participants. There is little doubt that this will cause moral hazard problems and go against the interests of the whole market in the long run. Thus, it is necessary that restrictions should be imposed on the ISF's rescue function. Also, due to the fact that while the performance of the rescue function will have the effect of fully protecting all creditors of a troubled insurer, the performance of the protection function will only ensure that insurance claims of eligible policyholders are protected to a certain level, how to coordinate the protection function and the rescue function in the CMME mechanism needs to be carefully considered. What is more, since both the rescue function the ISF can perform and the planned emergency lending function the People's Bank of China can perform will have the actual effect of bailing out troubled insurers, how to coordinate these two functions also merits careful consideration.

In the UK, there exists the FSCS which mainly serves the purpose of protecting policyholders in the CMME mechanism, and no other emergency funding plans have

[976] For a more detailed discussion, see Part 3.5 in this thesis.

been established specifically for dealing with crises of insurers. The functions the FSCS can perform include both the protection function and the rescue function. While the protection function will be fulfilled through the way of compensating eligible policyholders or securing the continuity of insurance policies, the rescue function will be fulfilled through the way of providing financial assistance to troubled insurers.[977] Unlike the ISF in China which still serves the purpose of maintaining financial stability, there is no mention in the UK legislation that the FSCS should take financial stability into account when dealing with crises of insurers. So even when the FSCS considers performing the rescue function in a certain case, the motivation would mainly lie in the pursuance of policyholder protection.[978] In line with this stance, it is required that if financial assistance is provided to a troubled insurer, the cost of doing so should not exceed the cost of paying compensation to policyholders, unless the additional cost would otherwise be justified by the benefits, and the effect of doing so should not materially benefit persons other than policyholders.[979] In fact, it is rare that the FSCS performs the rescue function by providing financial assistance directly to a troubled insurer. Also, there are arrangements which help coordinate the protection function and the rescue function. For example, with regard to the general insurance policies under which 90% of the claims would be covered by the FSCS if an insurer was in

[977] For a more detailed discussion, see Part 4.3 in this thesis.

[978] PRA, 'Rulebook – SII Firms – Policyholder Protection 5.1' (3 July 2015). (UK)

[979] See Financial Services and Markets Act 2000, s 217(4); Explanatory Notes to the Financial Services and Markets Act 2000, para 434; PRA, 'Rulebook – SII Firms – Policyholder Protection 5.1' (3 July 2015). (UK)

default, the FSCS only guarantees that policyholders with these general insurance policies will receive at least 90% of benefits under the policies when the rescue function is performed.[980] In other words, claims or benefits under insurance policies may be written down by a certain degree, with policyholders suffering some losses, when the FSCS provides financial assistance to a troubled insurer. Thus, the existence of the FSCS's rescue function never means that policyholders, other creditors or shareholders of troubled insurers will be fully protected.

In the US, insurance guaranty associations are established at the state level, which only serve the purpose of protecting policyholders, and there are still emergency funding plans at the federal level, which serve the purpose of maintaining financial stability. In each state, both the Property and Casualty Insurance Guaranty Association and the Life and Health Insurance Guaranty Association can perform the protection function, albeit normally in a different way, with the Property and Casualty Insurance Guaranty Association mainly paying compensation to policyholders in liquidation and the Life and Health Insurance Guaranty Association mainly securing continuity of insurance policies in liquidation.[981] Although the Life and Health Insurance Guaranty Association can also perform the rescue function, by means of providing financial assistance to a troubled insurer in conservation or rehabilitation, normally it is unwilling to do so to avoid an actual bail-out of the troubled insurer.[982] In cases where

[980] PRA, 'Rulebook – SII Firms – Policyholder Protection 6.2' (1 October 2015). (UK)

[981] For a more detailed discussion, see Part 5.4 in this thesis.

[982] NAIC, 'Receiver's Handbook for Insurance Company Insolvencies' (2018) 321.

crises of insurers pose a threat to financial stability, there is still a likelihood that the Orderly Liquidation Fund established in the Treasury will provide liquidity to insurers in rehabilitation or liquidation, or emergency lending from the Federal Reserve System will provide liquidity to troubled but not insolvent insurers.[983] That is to say, to avoid or alleviate systemic crises, bail-outs of troubled insurers may be carried out at the federal level.

From the above discussions, while the FSCS in the UK and insurance guaranty associations in the US mainly or only serve the purpose of protecting policyholders, the ISF in China serves both the purpose of protecting policyholders and the purpose of maintaining financial stability. This constitutes the underlying reason why the FSCS in the UK and insurance guaranty associations in the US are more likely to perform the protection function and less likely to perform the rescue function, while the ISF in China tends to rely more on the rescue function. It has to be admitted that since the number of insurers in China's market is comparatively small and each insurer may be of great importance to society,[984] to rescue troubled insurers can often be regarded as an expedient way in addressing crises of insurers. This is especially the case in an environment where the need of maintaining social stability is highly emphasised by

[983] Relevant discussions can be found in Section 5.5.2.2 and Section 5.5.2.3 in this thesis.

[984] While China has the second largest insurance market in terms of premiums written, there are only around 170 insurers operating in the market. See Swiss Re Institute, 'World Insurance: The Great Pivot East Continues' (4 July 2019) 9 <www.swissre.com/dam/jcr:b8010432-3697-4a97-ad8b-6cb6c0aece33/sigma3_2019_en.pdf> accessed 1 June 2020; 'Members' (*Insurance Association of China*) <www.iachina.cn/col/col19/index.html> accessed 1 June 2020.

the government. Nevertheless, it is still argued in this thesis that the ISF's performing the rescue function should be the exception rather than the norm.

Drawing on experience from the UK and the US, the thesis is of the view that only when a troubled insurer poses a threat to financial stability, or when the cost of performing the rescue function is predicted to be less than the cost of performing the protection function, should the ISF perform the rescue function by providing financial assistance directly to the troubled insurer. To alleviate the moral hazard that may be produced, the rescue function should not have the effect of fully protecting policyholders, other creditors or shareholders of a troubled insurer. It is recommended that when the rescue function is performed, rights of policyholders, other creditors or shareholders should be written down in a proper manner. In order to coordinate the rescue function and the protection function, insurance claims or future insurance benefits should be written down by a degree imposing losses on policyholders which is corresponding to the losses policyholders would suffer should the protection function be performed; and in order to keep in line with the claims hierarchy which should be followed in liquidation, rights of other creditors or shareholders should be written down by a degree imposing more losses on them than those on policyholders.[985]

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[985] This is in line with the IAIS's ICP 12. See IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 12.10 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

Following the principle that the property insurance security fund can only be used to deal with crises of property insurers and the life insurance security fund can only be used to deal with crises of life insurers,[986] by virtue of a corresponding source of fund, the ISF can only provide financial assistance to property insurers or life insurers when performing the rescue function. It seems this principle will be inevitably violated if the ISF provides financial assistance directly to a troubled insurance holding company, just as in the case of China United Insurance Group Company and the case of AIGC.[987] Thus, it is necessary that the ISF should not misuse the rescue function to bail out insurance holding companies in the future. Since there is a plan to provide for the emergency lending function of the People's Bank of China for the purposes of maintaining financial stability,[988] dealing with troubled insurance holding companies may depend on this source of emergency lending when there are concerns about systemic crises. Nevertheless, to avoid causing moral hazard problems in the market, there should also be strict restrictions to ensure that the emergency lending function will only be performed in exceptional circumstances.

6.6. Recommendations on the Overall Framework of the CMME

[986] Insurance Security Fund Regulations, reg 18. (China)

[987] For a more detailed discussion, see Part 3.5 in this thesis.

[988] The People's Bank of China, China Banking and Insurance Regulatory Commission and China Securities Regulatory Commission, 'The Guidance on Improving the Regulatory System for Systemically Important Financial Institutions' (November 2018) <www.gov.cn/xinwen/2018-11/27/content_5343833.htm> accessed 27 November 2018.

Mechanism in China

Based on the discussions in the previous parts of this chapter, it is not difficult to find that a complete overhaul of China's CMME mechanism is needed. This thesis is of the opinion that the CMME mechanism in China should become independent of, instead of based on, the general bankruptcy system, and measures/procedures contained in the mechanism should be tailored for insurers.

This thesis proposes that, in the streamlined CMME mechanism in China, there should be pre-takeover measures, takeover, reorganisation and liquidation. Grounds for initiating these measures/procedures should be set to reflect statutory or regulatory requirements insurers should comply with. When an insurer falls below statutory or regulatory requirements and there is a need for the CBIRC to intervene, the CBIRC can initiate appropriate measures/procedures at its discretion. While the CBIRC will have full authority in carrying out pre-takeover measures or a takeover, the CBIRC should petition the court to commence a reorganisation or liquidation and carry out the procedure under the supervision of the court. The general ideas as to how these measures/procedures can be designed or arranged will be put forward, respectively, as follows:

(1) Pre-takeover measures

When pre-takeover measures are taken by the CBIRC against a troubled insurer, the insurer will still be administered by its own management, but subject to the CBIRC's restrictions, directions, or sanctions. In line with the ICP 10 established by the IAIS,

pre-takeover measures the CBIRC can take basically include: (a) imposing restrictions on some of the insurer's activities, such as prohibiting the insurer from issuing new policies or new types of product, requiring the insurer to alter its business practices, and restricting the transfer of assets; (b) making directions to reinforce the insurer's financial position, such as requiring an increase in capital, and restricting or suspending dividend or other payments to shareholders; (c) making other appropriate directions, such as requiring the reinforcement of governance arrangements, internal controls or the risk management system; and (d) imposing administrative sanctions on the insurer or individuals responsible for the insurer's breach of laws.[989] In fact, most of these measures have already existed in the current legislation. Additionally, if the situation requires, the CBIRC can also initiate a rectification, a special measure in China with more intense effects. Once the insurer is placed in a rectification, it will operate under the day-to-day monitoring of a rectification group designated by the CBIRC until such time as the grounds for initiating the rectification have been removed.

(2) Takeover

Takeover is a regulatory measure by virtue of which the CBIRC can take control of the management and property of a troubled insurer to deal with a crisis. It should be regarded as an interim measure, which will last for no more than 2 years.[990] When a

[989] See IAIS, 'Insurance Core Principles and Common Framework for the Supervision of Internationally Active Insurance Groups' (November 2019) ICP 10 <www.iaisweb.org/page/supervisory-material/insurance-core-principles-and-comframe> accessed 15 November 2019.

[990] Insurance Act, art 146. (China)

takeover is initiated, the functioning of the insurer's shareholders' assembly, board of directors and board of supervisors will be suspended and the CBIRC will have full authority in administering the insurer. During the process, the CBIRC may either take appropriate measures to restore the insurer to normal conditions consistent with statutory or regulatory requirements and then return the insurer to its original management, or decide to initiate a reorganisation or liquidation against the insurer based on overall consideration of the situation in which the insurer is involved. In line with its nature as a regulatory measure, normally, the takeover will have direct effects just on the insurer itself and its inside parties (eg shareholders, the management, and other employees), but will not affect the interests of creditors (including policyholders).

(3) Reorganisation

When regulatory measures are not sufficient to address a crisis of an insurer, but it is still possible that the insurer could be rescued as a going concern or it is still necessary that the insurer should be maintained as a going concern out of consideration for financial stability, the CBIRC can petition the court for a reorganisation. During the period of reorganisation, under the supervision of the court, the CBIRC can administer the insurer and take any necessary actions to revitalise the insurer. When an action proposed by the CBIRC would affect creditors' interests, such as writing down debts of creditors (including policyholders) and transferring insurance policies to other insurers, the CBIRC should obtain prior approval from the court before implementing such an action. While there is no need to involve creditors (including policyholders) in the decision-making process during reorganisation, safeguards are provided to creditors

to ensure that their interests will not be unduly harmed. For example, actions taken by the CBIRC should be in line with the principle of "no creditor worse off than in liquidation", and interested parties objecting to the CBIRC's actions or proposed actions will have the standing to challenge these actions in the court.

Payment of insurance claims of policyholders, like claims of other creditors, will be automatically stayed once a troubled insurer enters a reorganisation. To avoid causing significant disruption to the function of insurance, the ISF will step in to perform the protection function. It means that the ISF may either pay compensation to policyholders after policyholders assign rights related to insurance claims to the ISF, or pay compensation to other insurers which have assumed insurance policies transferred from the troubled insurer. However, if the troubled insurer poses a threat to financial stability, or if the cost of performing the rescue function is predicted to be less than the cost of performing the protection function, the ISF can also perform the rescue function by providing financial assistance directly to the troubled insurer. In cases where the ISF alone cannot address concerns about systemic crises, the People's Bank of China may still function to provide emergency lending for the purposes of maintaining financial stability.

(4) Liquidation

When the CBIRC holds that a troubled insurer should cease to exist as a legal entity, the CBIRC can petition the court for a liquidation. At this stage, treatment of life insurance policies will be different from that of property insurance policies. When a property insurer enters a liquidation, property insurance policies will cease to have

effects after a specified buffer period, eg 30 days. This buffer period allows some time for policyholders to seek substitute insurance coverage from other insurers, which avoids interrupting the insurance coverage all of a sudden. Then each property insurance policyholder will automatically be entitled to a claim with the amount equal to the insurer's unearned premium in the liquidation. By comparison, when a life insurer enters a liquidation, under normal circumstances, life insurance policies will continue in force, and the CBIRC will seek to transfer all life insurance policies to other insurers. But if it eventually turns out that the transfer is not feasible, life insurance policies may also be terminated and policyholders will only be entitled to dividends in the liquidation.

The ISF will perform the protection function during liquidation. Like in reorganisation, payment of all claims, including insurance claims, will be automatically stayed once a troubled insurer enters a liquidation. By assigning rights related to the insurance claim to the ISF, an eligible policyholder can get compensation from the ISF in advance, saving his/her trouble to participate in the lengthy liquidation process. If the ISF eventually receives an amount in liquidation which is more than the amount it paid to the policyholder, the ISF should return the difference to the policyholder. Additionally, when life insurance policies are transferred to other insurers, the transferee insurers may also get compensation from the ISF to facilitate the transfer.

Based on the comparative study of the CMME mechanisms in China, the UK and the US, this thesis has proposed a brand-new CMME mechanism for China by providing a comprehensive set of recommendations on the overall framework of the CMME

mechanism. The proposed mechanism constitutes a possible option that can be considered when the relevant reform is carried out in China. Since this thesis recommends such a radical reform, it may not be feasible to immediately adopt all the recommendations therein in practice, or it may not be realistic to expect that all the recommended measures/procedures can work very well if they are immediately adopted in a reform. How the CMME mechanism functions will be inevitably influenced by the social, economic or legal environment. There are still some perceivable difficulties/obstacles that need to be overcome so as to ensure that the proposed CMME mechanism can function properly. For example, the CBIRC and the relevant courts should gain professionalism in as well as familiarity with dealing with troubled insurers so that they can act in an effective and efficient way when crises of insurers occur. And the relationship between the CBIRC and the courts should keep at arm's length, so that the courts, instead of being a rubber stamp, can substantively review or supervise the CBIRC's actions in judicial procedures and make sure the interests of relevant parties will not be unfairly affected. Due to the fact that the insurance market in China is still at an early stage of development and the country is still in a transition period which has shifted from a planned economy to a market-based economy, there is still a long way to go to before there can be a highly favourable environment in which a well-designed CMME mechanism can function in a way as expected.

6.7. Chapter Summary

With the aim of coming up with recommendations on how the CMME mechanism in China can be reformed to be more compatible with the special features of insurers, a systemic comparison of the CMME mechanisms in China, the UK and the US is made from the following perspectives:

(1) Frameworks of the CMME Mechanisms

The CMME Mechanisms in the UK and the US represent two typical alternative models, with the UK one largely based on the general insolvency system and the US one completely independent of the general bankruptcy system. Given the fact that some arrangements inherent in the insolvency system are arguably not compatible with the special features of insurers (eg the design of “creditors’ decision”), to have a CMME mechanism which is independent of the insolvency system could easily avoid such arrangements. In this sense, this thesis is of the view that the US model is preferable to the UK model in general. Therefore, it is recommended that when the CMME mechanism in China is reformed, the US model should be followed, so that the mechanism will become independent of, instead of based on, the general bankruptcy system.

(2) Commencement of Post-takeover Procedures

Due to the fact that the current CMME mechanism in China is based on the general bankruptcy system, but there is a lack of modifications for insurers, the grounds for commencing reorganisation and bankruptcy liquidation of insurers are the same as those for ordinary companies, only concerned with “insolvency”. This in effect makes reorganisation or bankruptcy liquidation less useful or even useless in addressing

crises of insurers. By comparison, the equivalent grounds in the UK and the US are much broader. Especially in the US, since these grounds are targeted only at insurers, they are related to various aspects of insurers' operation. Drawing on this experience, it is recommended that grounds for commencing reorganisation and liquidation in the CMME mechanism in China should not be limited only to "insolvency", but should be reformed to reflect the statutory or regulatory requirements insurers should comply with.

Upon a finding of relevant grounds for reorganisation or liquidation, while a troubled insurer itself (or its directors), its creditors and regulatory authorities are entitled to petition the court to commence a reorganisation or liquidation in China and the UK, only regulatory authorities have the standing to do so in the US. Learning from the US experience, it is recommended that in the reformed CMME mechanism in China, only the regulatory authority (ie the CBIRC) should be allowed to petition the court for a reorganisation or liquidation. In this way, the CBIRC may take the most appropriate actions to deal with crises of insurers according to its judgement, without being disturbed by other parties.

(3) Effects of Post-takeover Procedures

In post-takeover procedures, the control of a troubled insurer will be transferred from its existing management to certain external bodies, normally either regulatory authorities or insolvency practitioners. While in China and the UK, it is insolvency practitioners that will carry out reorganisation and liquidation, in the US, it is regulatory authorities that will carry out these procedures. In light of the uniqueness

of insurers, in the reformed CMME mechanism in China, it is argued that the US experience should be learnt from, and the regulatory authority (ie the CBIRC), instead of insolvency practitioners, should carry out reorganisation and liquidation.

In line with the fact that both the current CMME mechanisms in China and the UK are based on the insolvency system for ordinary companies, creditors' decision (creditors' meeting) constitutes an important design. This means that major issues in reorganisation or liquidation of insurers should be subject to creditors' decisions. By contrast, in the CMME mechanism in the US, there is no design of creditors' decision at all, and how to deal with crises of insurers will largely depend on the judgement of regulatory authorities, subject to the court's prior approval or after-the-fact review. Considering the challenges in seeking creditors' decisions in dealing with troubled insurers and learning from the US experience, the thesis recommends that the design of "creditors' meeting" in reorganisation and liquidation should be removed from the CMME mechanism in China, and the CBIRC should have great discretion in deciding relevant issues during the process, subject to the court's prior approval when it comes to certain major issues.

For the purposes of protecting policyholders, arrangements should be made to ensure that insurance claims will be paid without any unnecessary delay in the event of crises of insurers. However, under the current CMME mechanism in China, if a troubled insurer is in reorganisation, policyholders can neither get non-delayed payments from the insurer due to the stay effect, nor receive compensation from the ISF, which will result in a significant delay in payment of insurance claims. By

comparison, in the UK, although payment of insurance claims, like any other claim, will normally be stayed in administration, the FSCS can function to compensate eligible policyholders; and in the US, as an exception to the normal stay effects, insurance claims will often be paid as usual when an insurer in conservation or rehabilitation is believed to be solvent. Based on the comparison, when it comes to reforming the CMME mechanism in China, it is recommended to learn from the UK approaches. To be specific, in order to make sure that all policyholders will be treated fairly, payment of claims (including insurance claims) should be stayed when a reorganisation commences. But to ensure timely payment of insurance claims, the ISF should function to provide compensation to eligible policyholders.

(4) Coordination of Procedures

While in the current CMME mechanisms in China and the UK, a troubled insurer is allowed to propose a collective voluntary arrangement with its creditors when it is still in the control of the existing management, in the CMME mechanism in the US, a troubled insurer's attempt to systemically compromise with its creditors may result in the regulatory authority's initiating a receivership procedure. This thesis approves of the US approach and recommends that composition should not be retained in the CMME mechanism in China. This is also in line with the recommendation that there should be no design of creditors' meeting in the CMME mechanism in China.

Since both takeover and reorganisation in the CMME mechanism in China can be utilised to restructure insurers, it is necessary to clarify how to coordinate them in dealing with crises of insurers. Although seizure and conservation in the US are

analogous to takeover in China, and rehabilitation in the US is equivalent to reorganisation in China, little can be learnt from the US when it comes to ways to make takeover and reorganisation complement each other. In the opinion of this thesis, a main distinction between takeover and reorganisation should lie in the effects they may have on creditors. As a regulatory measure, takeover allows the CBIRC to immediately take control of a troubled insurer, and then take appropriate actions to address the crisis of the insurer, as long as the actions will not affect the interests of creditors. In cases where the CBIRC cannot restore a troubled insurer to normal operations through a takeover, the CBIRC may petition the court for a reorganisation, so that further restructuring measures can be taken to rescue the insurer and keep it as a going concern.

While there is only one type of liquidation in the CMME mechanisms in the UK and the US, there are revocation liquidation and bankruptcy liquidation in the current CMME mechanism in China. It is normally held that revocation liquidation is a regulatory measure dealing with solvent troubled insurers and bankruptcy liquidation is a judicial procedure dealing with insolvent insurers. Drawing on the experience in the UK and the US, it is argued in this thesis there should be only one liquidation procedure in the CMME mechanism in China. This is also consistent with the recommendation that grounds for commencing liquidation should be diverse, not limited to “insolvency”. In the reformed liquidation, as discussed earlier, it is the CBIRC that should carry out the procedure under the supervision of the court.

(5) Insurance Guarantee Schemes and Emergency Funding Plans

Unlike the insurance guarantee schemes in the UK and the US which mainly perform the function of protecting policyholders when dealing with crises of insurers, the insurance guarantee scheme (ie the ISF) in China tends to rely more on the function of rescuing insurers. To avoid causing moral hazard problems, the ISF's performing the rescue function should be restricted. It is recommended that only when a troubled insurer poses a threat to financial stability, or when the cost of performing the rescue function is predicted to be less than the cost of performing the protection function, may the ISF perform the rescue function. In addition, following the principle that, within the ISF, the fund for property insurers should be separated from the fund for life insurers, the ISF should not misuse the rescue function to provide financial assistance directly to a troubled insurance holding company. In cases where troubled insurance holding companies pose systemic risk, the People's Bank of China may function to provide emergency lending for the purposes of maintaining financial stability.

Based on the above findings, this thesis proposes a brand-new CMME mechanism for China. In the proposed mechanism, there are pre-takeover measures, takeover, reorganisation and liquidation. When an insurer falls below statutory or regulatory requirements, the CBIRC can initiate appropriate measures/procedures at its discretion to address the crisis. While the CBIRC will have full authority in carrying out pre-takeover measures or a takeover, the CBIRC should petition the court to commence a reorganisation or liquidation and carry out the procedure under the supervision of the court. During the process, the ISF can perform the protection

function or the rescue function, and if the crisis of the insurer poses a threat to financial stability, it is still possible that emergency lending might be provided by the People’s Bank of China for rescue purposes.

The proposed mechanism in this thesis constitutes a possible option that can be considered when the relevant reform is carried out in China. But it has to be admitted that there is still a long way to go before there can actually be a well-functioning CMME mechanism.

Chapter 7 Conclusion

The CMME mechanism in China is still at an early stage of development. The current CMME mechanism is based on the bankruptcy system for ordinary companies and there is a lack of special consideration for insurers. As a corollary, it is unrealistic to expect that many of the measures/procedures in the current mechanism can be well applied to troubled insurers. In fact, in practice, there has not been any case involving a bankruptcy procedure of an insurer. In order to change the status quo, it is necessary that a radical reform of the CMME mechanism in China should be carried out.

With the aim of coming up with recommendations for the future reform of the CMME mechanism in China, this thesis conducts a comparative legal study of the CMME mechanisms in China, the UK and the US. In order to find out how the CMME mechanism in China can be reformed to be more compatible with the special features of insurers, the thesis, in turn, discusses the uniqueness of the CMME mechanism, examines the CMME mechanism in China to point out the major problems in it, examines the CMME mechanisms in the UK and the US to show what experience or lessons can be learnt, and puts forward recommendations on how to reform the CMME mechanism in China based on the comparison. There now follows a summary of the main findings or arguments in this thesis:

(1) Uniqueness of the CMME Mechanism

As a mechanism dealing with crises of insurers, the CMME mechanism should be designed in a way compatible with the special features of insurance and insurers.

Differences between the CMME mechanism and the insolvency system for ordinary companies can/may be found in many aspects, which include objectives of the mechanism/system, the existence of regulatory intervention, triggers for relevant procedures, the involvement of insurance guarantee schemes, the design of “creditors’ decision” and the necessity of continuing certain business. It is these differences that largely contribute to the uniqueness of the CMME mechanism.

(2) The CMME Mechanism in China

The current CMME mechanism in China is based on the general bankruptcy system. The major components of the CMME mechanism include the regulatory intervention system (including takeover, revocation liquidation, etc.), the bankruptcy system (consisting of composition, reorganisation, and bankruptcy liquidation) and the ISF. However, due to the lack of consideration of the special features of insurers, a lot of problems can be identified in the current mechanism, which either make it unfeasible for some measures/procedures therein to be carried out against troubled insurers, or make it uncertain how some measures/procedures therein should be carried out against troubled insurers. Therefore, in order to reform the CMME mechanism to make it more compatible with the special features of insurers, some significant questions need to be answered. For example, what role can the regulatory authorities play during the process of addressing crises of insurers? Is it appropriate to set “insolvency” as the only ground for commencing a bankruptcy procedure of an insurer? Are bankruptcy administrators suitable for carrying out bankruptcy procedures of insurers? How will policyholders be treated in a bankruptcy procedure? How will creditors’

meetings be held in a bankruptcy procedure? Is composition as a bankruptcy procedure suitable for dealing with troubled insurers? How can takeover and reorganisation be coordinated? Is it necessary to have both revocation liquidation and bankruptcy liquidation in the CMME mechanism? How can the Insurance Security Fund's protection function be coordinated with its rescue function? Only with clear answers to these questions, can crises of insurers be addressed in an effective and efficient way under the CMME mechanism.

(3) The CMME Mechanism in the UK

In the UK, the CMME mechanism is largely based on the general insolvency system. The major components of the CMME mechanism include the Proactive Intervention Framework, the insolvency system (consisting of CVA, administration, and winding-up), schemes of arrangement, and the FSCS. Considering the special features insurers have, a number of modifications have been made to the general insolvency system to facilitate the application of insolvency procedures to insurers. However, it is argued that there are still some arrangements which are inherent in the insolvency system but are arguably not suitable for insurers in this CMME mechanism. For example, it is insolvency practitioners who will carry out insolvency procedures of insurers and major issues during the process will be subject to creditors' decisions, although to seek creditors' decisions constitutes a real challenge in the case of insurers. Also, company voluntary arrangement, as an insolvency procedure, is applicable to insurers, although it is arguably unfeasible to carry it out and there has hardly been a case in practice. What is more, since there is a lack of arrangements designed for the objective of

maintaining financial stability, it is doubtful whether crises of insurers can be addressed in an orderly manner if troubled insurers pose systemic risk.

(4) The CMME Mechanism in the US

In the US, the CMME mechanism is completely independent of the general bankruptcy system. The major components of the CMME mechanism include the state receivership system (consisting of pre-receivership tools, conservation, rehabilitation and liquidation), the insurance guaranty associations, and the relevant regulation at the federal level. Under this mechanism, when an insurer runs into trouble, the state insurance commissioner can petition the court to put the insurer into a receivership procedure. No systemic compromise should be sought by an insurer with its creditors when the insurer is under the control of its management. Once a court order of a receivership procedure is entered, the state insurance commissioner will be appointed as receiver and will carry out the receivership under the supervision of the court. The receiver has broad discretion in dealing with the troubled insurer and can decide all relevant issues without seeking creditors' decisions, but subject to the court approval or review. Insurance guaranty associations will mainly perform the function of protecting policyholders in receivership. In cases where troubled insurers pose systemic risk, the Orderly Liquidation Fund or the Federal Reserve System may still provide financial assistance to help address crises of insurers. Taken together, since the whole CMME mechanism is specifically designed to deal with crises of insurers, arrangements in the mechanism are generally compatible with the special features of insurers.

(5) Recommendations on the CMME Mechanism in China Based on the Comparison

With the aim of coming up with recommendations on how the CMME mechanism in China can be reformed to be more compatible with the special features of insurers, comparisons of several major aspects are particularly made between China, the UK and the US. To sum up, in terms of these selected aspects, the recommendations for the future reform of the CMME mechanism in China are as follows:

(a) As to the framework of the CMME mechanism, it is better for China to follow the US model rather than the UK model. That is to say, China should have a CMME mechanism which is independent of, instead of being based on, the general bankruptcy system.

(b) As to the grounds for commencing a reorganisation or liquidation, they should be set to reflect the statutory or regulatory requirements insurers should comply with. Learning from experience in the UK and the US, this thesis argues that the grounds in China should be more diverse, not just limited to “insolvency”.

(c) As to how a reorganisation or liquidation can be initiated, it is argued that only the CBIRC should be given the standing to petition the court for a reorganisation or liquidation of a troubled insurer in China, which is in line with the US approach.

(d) As to how regulatory authorities may function in the event of crises of insurers, this thesis approves of the US approach and holds that regulatory authorities should be vested with extensive powers, including the power of taking over troubled insurers. Therefore, it is the CBIRC, rather than bankruptcy administrators, who should carry out reorganisation or liquidation.

(e) As to the decision-making process during a reorganisation or liquidation, the thesis argues that the design of "creditors' meeting" should be removed and the CBIRC should be authorised to decide all relevant issues, subject to the court's prior approval or review. This is in line with the US approach.

(f) As to treatment of policyholders in a reorganisation or liquidation, the thesis is of the view that while the existing stay effect of paying debts (including insurance debts) should be retained, policyholders should be entitled to receive compensation from the ISF. This is modelled on the UK approaches rather than the US ones.

(g) As to whether troubled insurers are allowed to propose collective voluntary arrangements with its creditors, the thesis approves of the US approach and thus argues that composition should not be retained in the CMME mechanism in China.

(h) As to the relationship between takeover and reorganisation, this thesis is of the view that a main distinction between them lies in the effects they can have on creditors. Unlike reorganisation which is a judicial procedure in nature, takeover is a regulatory measure. As a consequence, the interests of creditors should not be affected in takeover.

(i) As to how to coordinate revocation liquidation and bankruptcy liquidation, drawing on the experience in the UK and the US, this thesis is of the opinion that these two types of liquidation should be combined into a "liquidation" procedure, which is a judicial procedure in nature in the CMME mechanism in China.

(j) As to how the ISF may function in the event of crises of insurers, although the ISF can perform both the protection function and the rescue function, its performing

the rescue function should be restricted. Unlike the People's Bank of China, which can provide emergency lending to troubled insurance holding companies when there are concerns about systemic crises, the ISF should not provide financial assistance directly to insurance holding companies.

Based on all discussions, this thesis proposes a brand-new CMME mechanism for China. Broadly following the model of the CMME mechanism in the US, the proposed CMME mechanism in China is independent of the general bankruptcy system. In the proposed mechanism, there are pre-takeover measures, takeover, reorganisation and liquidation. When an insurer falls below statutory or regulatory requirements, the CBIRC can initiate appropriate measures/procedures at its discretion to address the crisis. While the CBIRC will have full authority in carrying out pre-takeover measures or a takeover, the CBIRC should petition the court to commence a reorganisation or liquidation and then carry out the procedure under the supervision of the court. In reorganisation or liquidation, the CBIRC can decide all relevant issues, subject to the court's approval or review, without seeking decisions from creditors of the insurer. During the process, the ISF can perform the protection function or the rescue function, and if the crisis of the insurer poses a threat to financial stability, it is still possible that emergency lending might be provided by the People's Bank of China for rescue purposes.

As the first comprehensive comparative legal study of the CMME mechanisms in China, the UK and the US, this thesis also for the first time comes up with a comprehensive set of recommendations on the overall framework of a brand-new

CMME mechanism for China. However, it has to be admitted that it may not be feasible to immediately adopt all these recommendations in practice, or it may not be realistic to expect that all the recommended measures/procedures can work very well if they are immediately adopted in a reform. Considering the fact that the insurance market is still at an early stage of development and China is still in a transition period which has shifted from a planned economy to a market-based economy, it is fair to say that there is still a long way to go before there can actually be a well-functioning CMME mechanism in China.

Hopefully, this thesis will be a springboard which can elicit more discussions in this area, and thus can help contribute to a better CMME mechanism in China in the future.

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