

An EU recovery & resolution regime for insurance

Note for discussion: 5 March 2015 EGBPI

This note is intended to facilitate a discussion on a possible proposal for an EU recovery and resolution regime for insurance. The principal issues for consideration are outlined briefly below along with questions to be discussed. Participants will be asked to share their views in the meeting of the EGBPI on 5 March.

Answers are requested to be sent ahead of the meeting to FISMA-D4@ec.europa.eu, particularly for question 2.

1. What would a possible recovery & resolution regime seek to address?

The default course of action for failed insurers **in the absence of a resolution regime is to go into normal winding-up proceedings**. This can lead to a disorderly failure, with possible risks to financial stability and social costs. If States intervene this can lead to costs to the public purse.

1.1. Possible **risks to financial stability** associated with the winding-up of an insurer can include:

- a. **Policyholder runs and fire sales:** fears of an imminent failure can lead to a policyholder run in the form of mass surrenders, in particular where the insurer has bank-like products, which require assets to be sold at fire sale prices to fund the pay-outs and can in turn depress markets. This could, for example, cause instability in the sovereign bond market in which insurers are key investors.
- b. **Contagion:** the failure of a large (re)insurer can transmit financial distress to other insurers via reinsurance ties and impose direct losses on to investors more generally. (E.g. there are over 70 EEA headed conglomerates and, more generally, banks are substantial investors in the debt capital issued by insurers.)
- c. **Default on derivatives:** the winding-up of an insurer will represent an event of default under the terms of most derivative contracts. This makes it possible for the counterparties in these contracts to close out, potentially destroying value and imposing greater losses on policy holders. (E.g. during the crisis the US Treasury and the New York Fed provided over \$180 billion in support to AIG to prevent them being closed out on their substantial portfolio of derivative contracts.)

1.2. **Social risks**, arising principally from disruption to the continuity of the insurance cover, can include:

- a. **Critical payments to policyholders:** payments from insurance products may be critical when individuals rely on them as a primary source of current or future income, whether to meet general living expenses or to mitigate individual costs, such as healthcare costs.
- b. **Disruption to businesses which are legally required to get professional insurance:** certain types of insurance are required in order to conduct specific economic activities. When an insurer enters winding-up proceedings, cover and payments are suspended so that insured businesses may come to a standstill until replacement insurance can be arranged. There may be a lack of substitutability in certain specialised insurance markets (e.g. medical, legal, construction, aviation etc.).

1.3. Possible **costs to the public purse**

The above-listed adverse consequences for financial stability and the social costs of disorderly failures can lead to political pressure on States to bail-out insurers in difficulty rather than letting them enter winding-

up proceedings¹. In the crisis European insurers received public support qualifying as state aid under EU law which totalled more than 6.5 billion euros².

Question 1: Do you agree with this analysis? What other significant risks should an insurance recovery and resolution regime seek to address, in particular building on the experience of member states that have already adopted a recovery and resolution regime and/or a special administration regime?

2. The need for action at European level

The G20 has agreed to take steps to end public bailouts of financial institutions which are "too-big-to-fail". To this end, the FSB and international standard-setters have developed enhanced prudential and supervisory requirements and recovery and resolution arrangements, which jurisdictions are expected to apply for entities identified as Globally Systemically Important Financial Institutions (G-SIFIs). The main tools for resolution of insurers are set out in the **Key Attributes** adopted by the FSB in October 2014³.

Nine global systemically important insurers (G-SIIs) were identified by the FSB in July 2013, five of which are headquartered in the EU (IT, DE, FR, UK). No agreement has yet been found on the designation of systemic reinsurers. Recovery and resolution plans for G-SIIs are expected to be in place by the end of 2015, together with the legal framework and tools to implement them.

The FSB's Key Attributes, covering both insurers and reinsurers, also set out legal framework conditions for cross-border cooperation. These aim to **improve cross-border cooperation and coordination** amongst the various authorities competent over different insurance undertakings in the same cross-border group, to avoid disagreements at the point of crisis as well as economic costs stemming from indecision.

In November 2013, EIOPA conducted a survey to obtain a better knowledge of crisis prevention, management and resolution approaches and practices that already exist amongst the different national supervisory authorities (NSAs) for the insurance sector. The results showed significant differences between resolution powers and tools available to national authorities⁴. In October 2014, EIOPA further adopted an Opinion on sound principles for Crisis prevention, Management and Resolution Preparedness of NCAs, the objective of which is to foster common understanding and practices amongst national authorities in order to enhance cooperation between supervisors in the prevention and management of crises⁵.

Moreover, the absence of an EU recovery and resolution framework may also limit policyholders' trust and freedom of choice. Policyholders can face unequal protection depending on whether they contract with a local or a foreign insurer due to differences in resolution powers (and insurance guarantee schemes) between

¹ Note also the recent FSB consultation on the identification of critical functions and shared services of systemic insurers, which covers these risks and points to some possible other channels (e.g. repos and securities lending) where disruption in the operations of insurers can have similar effects. http://www.financialstabilityboard.org/wp-content/uploads/c_141016.pdf

² Source: Commission State aid scoreboards

³ http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

⁴ Survey on Crisis Prevention, Management and Resolution. Preparedness of NCAs, November 2013 https://eiopa.europa.eu/Publications/Reports/Report_on_Crisis_Prevention_Management_and_Resolution_Preparedness_of_NSAs.pdf

⁵ https://eiopa.europa.eu/Publications/Opinions/EIOPA_Opinion_on_Sound_Principles_Crisis_Prevention_Management_and_Reso.pdf

Member States. Policyholders may become more willing to contract with foreign insurers if they know that all Member States have common resolution tools that ensure an equal treatment of policyholders in case of crisis.

Question 2: Supplementary to the information provided to EIOPA for their survey carried out in 2013, please provide up-to-date details set out in the Annex.

Question 3: Does your Member State foresee changes to national legislation following the FSB recommendations or the EIOPA opinion?

3. Scope and tools of a possible EU recovery and resolution framework

3.1. Scope

The scope of an EU resolution proposal could be (i) limited to the systemic (re)insurers that have been designated by the FSB only, (ii) include all cross-border insurers or (iii) include all insurers. The degree to which the three options address the main risks discussed above are presented in summary form in the table below.

It is worth noting that there are no past cases of “systemic” (in the FSB sense) EU insurers failing. The recent EIOPA insurance stress tests provided further evidence that the insurers most at risk of failure belong to the non-systemic category⁶.

	OPTION 1	OPTION 2	OPTION 3
Scope	Systemic (re)insurers (currently 5 groups)	Cross-border (re)insurers (including systemic (re)insurers)	All (re)insurers subject to Solvency II
Address financial stability risks	Achieved	Achieved	Achieved
Address social costs	Not achieved	Partially achieved	Achieved
Address vulnerabilities revealed by EIOPA stress tests	Not achieved (EIOPA stress tests showed that EU systemic insurers are not specifically vulnerable)	Partially achieved	Achieved (EIOPA stress tests identified that the most vulnerable insurers are small and medium-sized ones, which would be captured in this scope)
Cross-border cooperation in crises for groups established in at least two MS	Not achieved beyond the 5 EU systemic insurers	Achieved	Achieved

⁶ <https://eiopa.europa.eu/Publications/Surveys/Stress%20Test%20Report%202014.pdf>

Harmonise protection of policyholders of local vs. foreign insurers	Not achieved beyond the 5 EU systemic insurers	Partially achieved	Achieved
Prevention of bail-outs	Partially achieved (public bail-outs still possible in many cases ⁷ (i.e. outside the systemic entities))	Partially achieved (public bail-outs still possible in some cases (i.e. outside the cross borders (re)insurers))	Achieved (public bail-outs could be avoided, as the proposal would provide an alternative solution in all cases)

Question 4: If action is needed at EU level, should the scope of a proposal be limited to the systemic entities which are designated by the FSB? If yes, should it include reinsurers (designation pending)? If not, what is the most appropriate scope, recognising the potential costs? If it is limited to cross-border (re)insurers (option 2), which cross-border business should it actually include: through subsidiaries, through branches, through free provision of services?

3.2. Core tools

In addition to the recovery and resolution plans that the (re)insurance entities and their authorities have to prepare, the FSB guidance emphasises the following tools: transfer of portfolios of insurance contracts, creation of a bridge institution, suspending policyholders' rights to withdraw from their contracts, and restructuring of any liabilities (including guarantees to policyholders and beneficiaries). This set of supervisory and resolution tools could constitute the **core of a possible proposal**.

Additional capital and minimum loss-absorbing capacity requirements (akin to the so-called TLAC or MREL rules in banking⁸) do not appear to be necessary in the context of insurer resolution. It also does not appear to be necessary or appropriate for any of the authority actions associated with resolution to be automatic (i.e. based on quantitative triggers). As set out in the FSB guidance and following the framework of the EU Bank Recovery and Resolution Directive, it seems more appropriate for the tools to be **flexible and to allow for discretion** on the part of the relevant authority (whether it be the supervisor or the resolution authority), with appropriate safeguards to ensure that any interference in an insurer's operations is justifiable and proportionate. A proposal on resolution could thus not imply automatic intervention by public authorities during the failure of an insurer, but provide a flexible set of supervisory and resolution tools which can be deployed for timely, co-ordinated intervention to meet the objective of avoiding the risks associated with a disorderly failure. The tools and their likely costs would depend on the scope of the proposal, as set out in the table below:

	OPTION 1	OPTION 2	OPTION 3
Scope	Systemic (re)insurers (currently 5 groups)	Cross-border (re)insurers (including systemic	All (re)insurers subject to Solvency II

⁷ That is, there would be no EU law implementing the G20-endorsed FSB Key Attributes that public bailouts of financial institutions should no longer occur. State aid rules on their compatibility with the internal market would however continue to apply.

⁸ "Total loss-absorbing capacity" (FSB term); "Minimum requirement for own funds and eligible liabilities" (BRRD term)

		(re)insurers)	
<p>RECOVERY PLANS (drafted by (re)insurers) and</p> <p>RESOLUTION PLANS (drafted by authorities)</p>	<p>Low cost, since systemic (re)insurers and their authorities are already preparing plans, following FSB recommendations.</p>	<p>Admin burden for non-systemic groups. Costs can be limited by relying as much as possible on existing, forward-looking reporting on risks required under Solvency II (e.g. ORSA). The net cost would be further reduced as the plans will improve governance.</p>	<p>Same as option 2, especially if non cross-border (re)insurers were to be exempted from new planning requirements</p>
<p>MAIN TOOLS and POWERS for authorities</p>	<p>Tools and powers do not depend on the scope of the proposal. In any case, all 28 Member States need to be equipped with common recovery and resolution tools and powers (as G-SIIs can have subsidiaries in all Member States). These powers could include for example:</p> <ul style="list-style-type: none"> - replace managers, appoint a temporary administrator, -close to certain new business, -impose a moratorium on surrender rights, close-out rights, or on other payments -restructure liabilities, by writing-down certain creditors (e.g. investors in hybrid capital instruments) or altering insurance contracts (e.g. haircutting unsustainable guarantees) -transfer/separate assets and/or liabilities to a healthy insurer or a bridge institution <p>Administrative costs of setting up a resolution authority in Member States where they do not currently exist would be largely offset by the reduced likelihood of disorderly failures. Furthermore, all Member States, as required under the BRRD, should already have a Resolution Authority for banks; Member States may decide that these authorities also become the resolution authority for insurers.</p>		
<p>CROSS-BORDER COOPERATION and COORDINATION</p>	<p>Tools for cooperation do not depend on the scope of the proposal. This would entail a harmonised legal framework for cooperation in all 28 Member States, addressing in particular the rights of home or host authorities in the event of failure and subsequent cooperation between authorities (crisis management groups).</p>		

Question 5: Are these tools appropriate to address the issues raised in section 1?

Question 6: Should additional tools be considered for inclusion in a possible proposal? Do you share the view that additional capital and minimum loss-absorbing capacity requirements are not necessary in the context of insurance?

Question 7: Do you agree that a framework for cross-border cooperation should be included in a possible proposal?

4. An insurance guarantee scheme (IGS)

It is understood that today, the following Member States have one or several domestic IGSs in place beyond motor insurance (source: Commission White Paper 2010): BG, DE, DK, ES, FR, IE, LV, MT, PL, RO, UK. There is no specific IGS EU legislation and the existing IGS models vary extensively across Member States (not the same types of insurance policies covered, different levels or types of protection, ex ante or ex post funding). The establishment of resolution funds or IGSs have been included in the FSB guidelines to help fund resolution with industry-resources.

A flanking measure of the recovery and resolution regime could be a requirement for Member States to set up an IGS. This would avoid cases of domestic policyholders of foreign insurers based in Member States that do not have an IGS not being compensated, promoting an equal treatment of policyholders and a level playing-field. It is noted however that the limited number of insurers in smaller Member States can, however, make the creation of an IGS difficult (if one insurer is in trouble, the IGS would have to rely on too limited a number of contributors). It is also worth noting the interaction with the scope: an IGS requirement across Member States may only be viable and purposeful if all insurers are included.

Such a scheme could cover all policies or vary coverage depending on the type of policy, for instance distinguishing between life and non-life insurance. The failure of a life insurer can lead to considerable financial hardship for policyholders, especially those saving for retirement. Apart from any lost savings, it may also be difficult to find similar coverage again due to intermittent changes in age and health. For non-life policyholders the losses could be limited to paid premiums, but could also be larger if they have outstanding claims at the time of failure. The failure of a non-life insurer can have tough social consequences too, for example on beneficiaries of annuities stemming from liability insurance (e.g. victims of motor accidents). There might be good arguments for limiting IGS protection to certain specific types of non-life insurance policy (e.g. compulsory insurance only); however, for reasons of practicability and fairness, it might be difficult to split IGS coverage into too many sub-regimes.

Also, IGS can intervene at different points in a crisis: either in the context of final winding-up proceedings, or earlier, in combination with the use of resolution powers. For example, an IGS can act to secure continuity of insurance policies by taking them over directly (through a portfolio transfer). This is particularly relevant for life insurance policies, which may be difficult to replace under the same terms. Alternatively if a portfolio of contracts is being transferred to another insurer, with haircuts being imposed on guarantees to make them more sustainable for the receiving insurer, the IGS can intervene to compensate for such haircuts.

Scope	OPTION 1 (systemic (re)insurers)	OPTION 2 (cross-border (re)insurers)	OPTION 3 all (re)insurers subject to Solvency II
INSURANCE GUARANTEE SCHEMES (at national level)	Not economically sustainable because some MS host very few subsidiaries of systemic groups (lack of diversification in the IGS)	Easier than under option 1, but still difficult as some MS host very few foreign insurers (lack of diversification in the IGS)	Feasible , although a few small MS with small insurance markets may still face a lack of diversification of risks in their IGS. No ex ante cost provided ex-ante funding would not be required; Costs would only materialise for healthy (re)insurers if the IGS is activated.

Question 8: Should a possible proposal include a requirement for Member States to set up an IGS? If so, which types of products should it cover and how should it assist in the event of a failure?

5. Link with the Solvency II Directive

The Solvency II Directive contains a title on the reorganisation and winding up of (re)insurance undertakings, but does not address recovery⁹ and resolution. In addition, Article 141 provides that the supervisory authorities shall have the power to take all measures necessary to safeguard the interests of policyholders in the case of insurance contracts, or the obligations arising out of reinsurance contracts.

An initiative on recovery and resolution would actually specify a list of such measures, and would set out triggers, however flexible, for the two phases (recovery and resolution).

Question 9: How do you see the interplay between the recovery and resolution measures considered in a potential initiative and the existing provisions of the Solvency II Directive?

⁹ Article 138(2) of Solvency II requires *ex post* recovery plans in case of breach of the SCR, but they are different from *ex ante* recovery plans as envisaged by the FSB.

ANNEX – Information requested from Member States.

Replies can be based on those provided to the EIOPA Survey on Crisis prevention, management, and resolution preparedness carried out in 2013. However, more precise information is desirable to inform the preparation of a possible legislative proposal.

I. Preparation

	Please select: Yes/ No/ Restr. (Restr = available but subject to restrictions)	If Restr, then please specify here:
Is a recovery plan ¹⁰ required from:		
- G-SIIs?		
-other insurance groups?		
Is an authority required to draft resolution plans for:		
-G-SIIs?		
-other insurance groups?		

II. Triggers

Are there automatic/discretionary indicators (both quantitative and qualitative) to trigger the use of recovery and resolution powers ?

III. Powers available to national authorities

Are the following powers available?	Please select: Yes/ No/ Restr. (Restr = available but subject to restrictions)	If Restr, then please specify here:
Remove and replace senior management		
Seek for a Court's appointment of an Administrator		
Appoint an Administrator/ Conservator or Special Manager		
Close an undertaking to new business		
- in certain lines of business?		
- as a whole?		
Alter contractual guarantees provided to policyholders and beneficiaries:		
-on claims already incurred (e.g. annuities in payment)?		
-on future claims not yet incurred?		
Temporarily stay the exercise of early-termination rights in insurance contracts		
Force a portfolio transfer (please explain how valuation is performed and how the recipient undertaking is chosen, e.g. through tender or auction)		
Force recapitalisation of an undertaking through issuance of share capital		
Call supplementary contributions from Members		
Impose a moratorium on payments:		
-to insurance creditors?		
-to other creditors and shareholders? (e.g. commissions to intermediaries, coupons, dividends)		
Decide the opening of winding-up proceedings		
Seek for a Court's decision to open winding-up proceedings		

¹⁰ The focus of this question is on *ex ante* recovery plans, different from the *ex post* recovery plans required under Article 138(2) of Solvency II in case of breach of the SCR

IV. Resolution authority

Which authority exercises resolution powers?

IV. Cooperation between national authorities

Are there formal crisis management groups or equivalent arrangements to deal with crises of:

- G-SIIs headquartered in your jurisdiction?
- other cross-border groups headquartered in your jurisdiction?

VI. Insurance guarantee scheme

If an insurance guarantee scheme has been set up, does it intervene only in case of winding-up of an undertaking, or could it intervene earlier in combination with the use of resolution powers (e.g. compensate in whole or in part a haircut on guarantees imposed by the resolution authority, or a haircut resulting from a transfer of portfolio to another undertaking)? Is its mandate defined geographically, e.g. in relation to policies contracted solely with insurers whose head office is situated in that Member State or can/must coverage also apply to branches of insurers whose head office is situated in other Member States? Which products are covered and what is the level of coverage?