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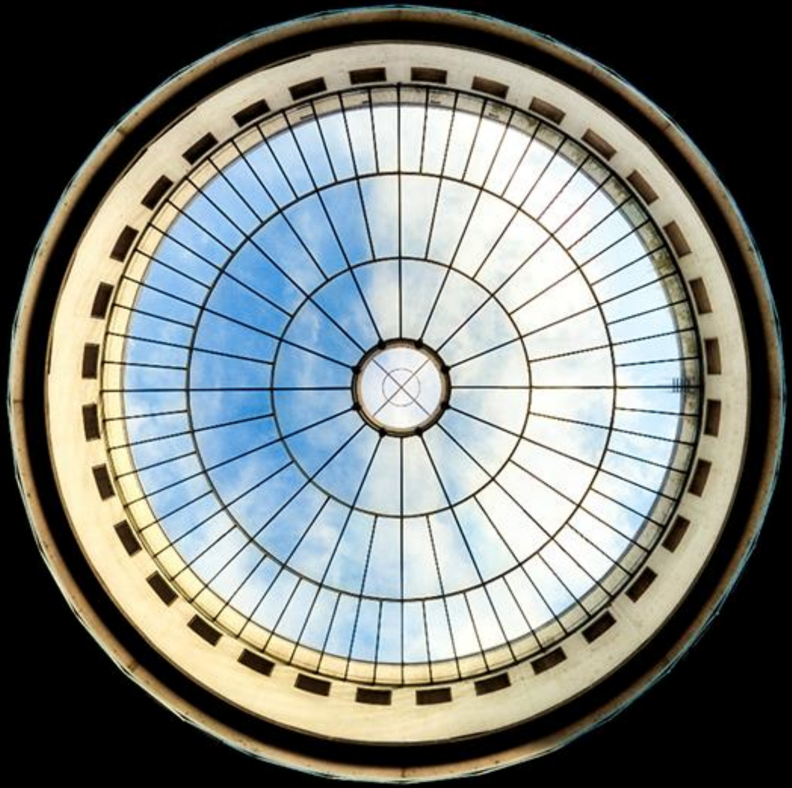

Recovery and resolution

The importance of case-by-case supervisory judgement within a framework

Andrew Bulley | 25 October 2018

Centre for Regulatory Strategy, EMEA

Providing a forward-looking view of the most important regulatory developments affecting financial services firms

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- Dedicated team of 20 professionals develops insights, blogs, publications and presentations
- Workshops with client teams to advise on the aggregate impact of relevant forthcoming regulatory developments
- Maintain active cross-EU dialogue with the ECB and the ESAs

CENTRE *for* REGULATORY STRATEGY EMEA

The Centre is led by **David Strachan**, who joined Deloitte from the FSA where he was Director of Financial Stability, and **Andrew Bulley**, who joined Deloitte from the PRA where he was Director of Life Insurance Supervision

SCR & MCR breach

The current regime – Solvency II Directive Articles 54, 138, 139, 141 and 144

An insurance or reinsurance firm that no longer complies with the **SCR** (or is at risk of non-compliance within 3 months) must submit a realistic recovery plan within **2 months**, and then has a maximum of **6 months** to restore its compliance with the SCR, extendable by a further **3 months**.

Supervisor may restrict or prohibit free disposal of assets in **exceptional circumstances**.

An insurance or reinsurance firm that no longer complies with the **MCR** (or is at risk of non-compliance within 3 months) must submit a realistic finance scheme within **1 month**, then has a maximum of **3 months** to restore its compliance with the MCR.

Supervisor may restrict or prohibit free disposal of assets.

Where the solvency position of the undertaking continues to deteriorate, supervisory authorities shall have the power to take **all measures necessary** to safeguard the interests of policy holders in the case of insurance contracts, or the obligations arising out of reinsurance contracts.

Run-off? | Liquidation? | Recovery? | Resolution?

When the MCR is breached, and the insurer or reinsurer is not able to submit a realistic short-term finance scheme within a month, or when there is significant non-compliance with the SCR and no realistic recovery plan is submitted to supervisors within two months, (re)insurers need to **disclose appropriate information** on the nature and effects of these developments.

Where compliance has not been restored within 3 months (MCR) or 6 months (SCR), further disclosure is required, including any **further remedial measures** planned.

The supervisor shall **withdraw authorisation** if an insurer does not comply with the MCR, and if the supervisor considers the insurer's finance scheme to be "manifestly inadequate", or if it fails to comply with an approved scheme within 3 months.

Recovery and resolution frameworks
The potential disadvantages of insolvency

Insurers have a duty to provide continuity of cover and payments, and supervisors have a responsibility to safeguard the interests of policyholders. If supervisors rely on insolvency law for events of failure, would financial stability and policyholder protection be jeopardised?

Disadvantages of insolvency

- **"Critical" policyholder payments or cover** could still be **disrupted** in practice

Insolvency could lead to…

- **Key service provider withdrawals**, such as custodian banks/outsourced providers)
- **Increased capital burn** through **additional insolvency and legal challenge costs**, especially regarding competing policyholder claims, and **derivative contract voiding** and replacement cost of mass close-out of derivatives

Key conclusions

- Supervisors will need to understand in depth the probability and scale of these risks
- Resolution powers would provide optionality to avoid insolvency consequences for policyholders case by case

Resolution versus run-off

The PRA's position

The PRA expects firms in breach of SCR to *"act in a way that* ***avoids significant systemic disruption****, while* ***protecting vital economic functions*** *and which ensures that* ***policyholders are appropriately protected****."*

The PRA will usually allow a firm in breach of the MCR with no realistic prospects of recovery to *"to* ***continue activities necessary to carry out existing contracts*** *in a manner, and for so long as, the PRA considers necessary in order to afford an appropriate degree of protection to policyholders".* The firm will, however, not be allowed to write new business.

The PRA will require a firm with no realistic prospect of prompt restoration of compliance with the MCR to bring its business to a close in as rapid and orderly manner as is consistent with the generality of policyholders' best interests.

PRA SS7/15: Solvency II: supervision of firms in difficulty or run-off

The PRA will be particularly concerned to ensure that:

- policyholders can maintain their insurance cover or obtain alternative insurance cover on reasonable terms where this is critical to them or their business;
- payments to them, which are essential for their living necessities, continue without disruption; and
- where this becomes necessary, the method for distributing assets amongst creditors (and shareholders) is fair to both those whose claims have arisen and those who may have claims in the future, given the increased risk that the firm will not have sufficient assets to pay all creditors in full.

PRA SS7/15: Solvency II: supervision of firms in difficulty or run-off

Resolution versus run-off

Case study: Equitable Life

Supervisors will always seek to avoid a position where there is a risk of imminent failure of an insurer. Due to the usual "slow burn" characteristic of an insurer failure, better outcomes may be achieved by initiating a solvent run-off before reaching a point where the choice is between resolution, insolvency, or bailout.

Nearly 20 years after Equitable Life entered run-off, it has agreed to transfer its business to Reliance Life, and offered a £6,900 per policyholder payout to those who still have with-profit policies with it. The Equitable Members Action Group (EMAG) has stated that policyholders who left Equitable still remain £2.5 billion out of pocket.

Equitable Life's proposal include:

- increasing the 35% capital distribution to a level expected to be between 60% and 70%;
- closing the with-profits fund, ending guaranteed investment returns;
- converting with-profits policies to unit-linked; and
- transferring all policies to Reliance Life.

A vote by Equitable's remaining policyholders is expected in 2019

"Resolution of a life insurer, or dealing with one that has severe weakness can take a long time and involve multiple phases; problems can linger for a long time"

Equitable Life U.K.: a Decade of Regulations and Restructuring, Geneva Association, 2016

Source: http://www.equitable.co.uk/good-news-for-with-profits-policyholders/, https://www.emag.org.uk/ and https://www.theguardian.com/money/2018/jun/15/equitable-life-to-shut-down-with-surprise-18bn-policyholder-windfall

Signs of failures

From the Sharma report to EIOPA's failures and near failures report

15 years later, the underlying causes of failure have not changed much

2002

*"Although a well-managed firm can still fail, **poor management** makes a firm vulnerable and we believe that in practice it is the **primary root cause** of most problems in insurance firms"*

- Sharma Report, 2002

2018

One of the two **most general causes** of failure or near miss reported in the EIOPA database is the risk that *"**management or staff lack the necessary skills**, experience or professional qualities"*

- Failures and near misses in insurance, EIOPA. 2018

Underlying causes - internal	Underlying or trigger causes – external
Management risk	Economic cycle / condition risk
Internal governance and control risk	Market competition risk
Controller/group risk	Social, technological, demographic, political, legal, tax etc. risks
	Catastrophe / extreme event risk

Top 5 primary causes of failures and near misses for EU insurers		
	Life	**Non-life**
1	Management and staff competence risk	Technical provisions - evaluation risk
2	Investment / Asset-liability management risk	Internal Governance & control risk
3	Market risk	Management & staff competence risk
4	Technical provisions - evaluation risk	Underwriting risk
5	Economic cycle / condition risk	Accounting risk

Banks and Insurers

Different balance sheets

Insurers and banks have different balance sheet and liability profiles, and serve different roles in the financial system and broader economy. This means that the options for dealing with a distressed insurer versus a distressed bank can be radically different.

Insurers often have long-term, illiquid liabilities that can be matched with suitable assets

Mismatch risk and capital issues can often be dealt with over a long period of time

Insurers have traditionally been seen as insulated from the risk of "runs", with the exception of surrender risk for some contracts

Insurers generally do not provide services and infrastructure critical to the financial system…

…however, insurance services may be critical to the policyholders who depend on them

Early intervention and early resolution

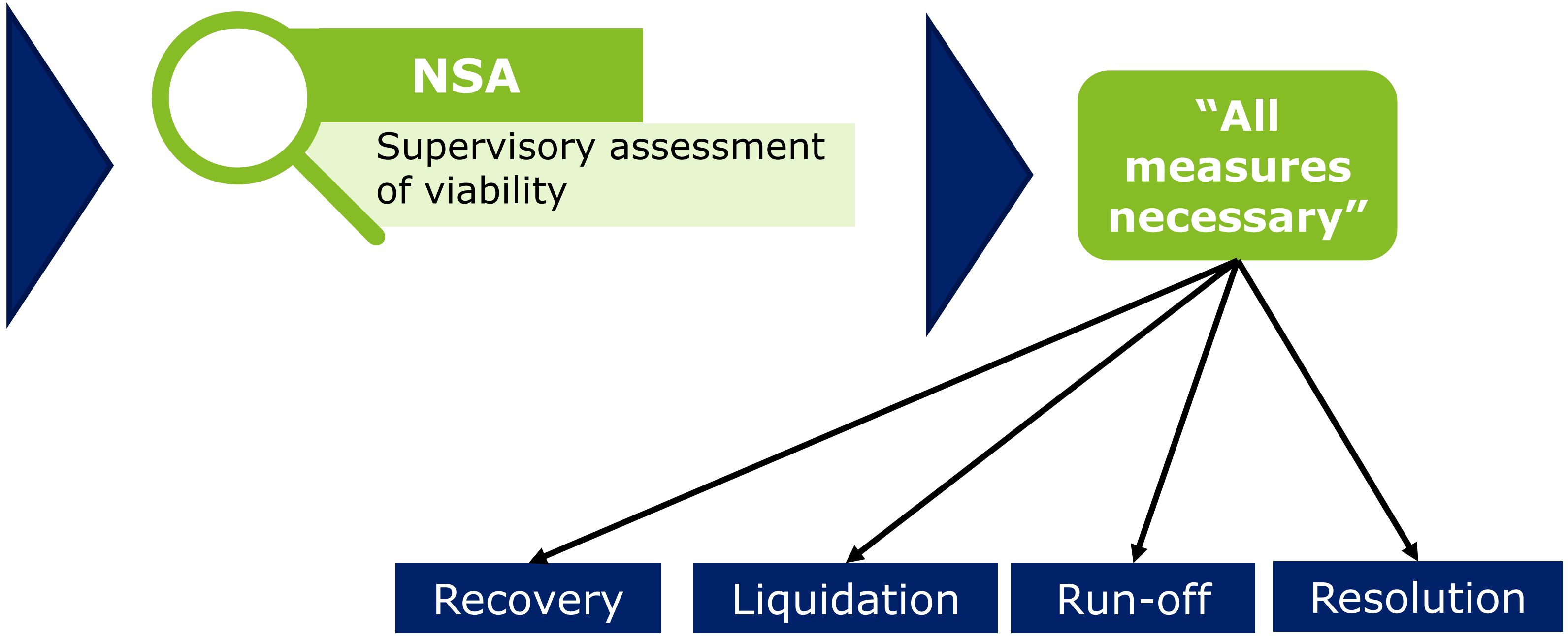
Supervisory decision-making and judgment

Determining the viability or non-viability of an insurance undertaking **will always include supervisory judgment**. Strict rules leaving no room for judgement may lead to sub-optimal outcomes due to the specificity of each insurer’s distress situation. Each insurer’s specific reason for failure means supervisory authorities need some operational flexibility.

Early signals of failures – Top 5 (EIOPA)
Deteriorating capital strength - low solvency margin relative to the firm’s risks
Evidence of poor management
High expenses and low profitability
Failure to implement regulatory or supervisory requirements or advices
Declining profitability for underwriting income

Source: Failures and near misses in insurance, EIOPA, 2018

Other warning signs of failure
Lack of challenge in governance processes
Outlier exposures
Poor internal governance of capital
‘Revolving door syndrome’
Running tight and/or variable capital surpluses
Outlier assumptions or creative accounting
‘Window dressing’



Calling time

When do you "pull the plug" on an insurer?

Evaluating the viability of an insurance company will always require judgment by supervisors, in particular in the absence of a well-designed resolution regime. Supervisors should always be attentive to the risk that waiting for an unlikely recovery, or for a candidate to buy the failing or likely to fail business, could mean leaving policyholders worse-off in the end.

EIOPA's opinion on Conditions for entry into resolution
The insurer is **no longer viable or likely to be no longer viable** and has not reasonable prospect of becoming so: • The insurer is in breach or likely to be **in breach of the MCR** and there is no reasonable prospect of compliance being restored • The insurer is in breach or likely to **be in breach of other prudential requirements** (e.g. requirements on assets backing technical provisions), there is no reasonable prospect of compliance being restored and such non-compliance will likely lead to balance sheet or cash flow insolvency • There is a strong likelihood that **policyholders and/or creditors will not receive payments as they fall due**
Possible **recovery measures have been exhausted** – either tried and failed or ruled out as implausible to return the insurer to viability – or cannot be implemented in a timely manner
A resolution action is necessary in the **public interest**

A number of factors can ultimately help supervisors evaluate whether an insurer should be wound-up, resolved, or enter into run-off. For example:

- When supervisors no longer have faith in management
- When liabilities can no longer effectively be capped or quantified
- When a shrinking balance sheet means that creditors/policyholders who are 'getting out' have an unfair advantage compared to those who remain

However, these are very difficult supervisory judgments, and reality may turn out differently.

Pulling it All Together

- Insurance failures are complex with a high risk of unforeseen consequences; judgement case by case is crucial
- Run off has generally served policyholders well without endangering systemic stability. But in the absence of resolution powers it can be “faute de mieux”
- Key “just and equitable” problem of departing policyholders vs those remaining
- Fatal, if perfectly understandable temptation of leaving a failing firm too long in the search – or hope – of a solution whilst capital continues to burn away
- Judgement therefore needs to be exercised within a disciplined, rigorous framework
- Judgement needs to focus, case by case, and inter alia on whether the liabilities can be realistically valued; business model sustainability; prospects for internal capital generation to trade out of difficulty on an acceptable timescale
- But above all **management and governance quality** is a necessary, if not sufficient condition: an issue, ultimately, of trust
- Resolution powers: a powerful discipline on firms and a potential game-changer for supervisors in terms of options