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IRSG Opinion on Potential Harmonisation of Recovery and Resolution Frameworks for Insurers

0. Key points

a. Objectives and scope

- The proposals should distinguish between those which achieve the objectives by reducing the likelihood of entry into resolution/liquidation and those which maximise outcomes once in resolution/liquidation.
- Preventative proposals which achieve objectives by reducing the likelihood of entry into resolution/liquidation should be assessed relative to what Solvency 2 provides.
- Proposals which achieve objectives by maximising outcomes once a firm is in resolution/liquidation should be viewed in the context of a resolution framework.
- A resolution framework should take stock of lessons learnt from the crisis. The first one has been that supervisory coordination is absolutely critical when it comes to resolving a company in trouble and that the perspective cannot be national only in those cases.
- Action to be taken at European level, should be focusing on applying the existing maximum harmonization requirement to Solvency II.
- It is not appropriate for member states to have flexibility in deciding which insurers are subject to the framework as this undermines the effectiveness of implementing a harmonised framework.

b. Preventative Frameworks

- Solvency 2 provides for significant enhancement of the supervisory coordination and cooperation framework within Europe.
- Pre-emptive recovery planning, which is foremost a preventative framework, requires conditions under which the actual pre-emptive recovery plans will be implemented. These conditions, which are linked to when the supervisor intervenes, are provided by Solvency 2

recovery planning requirements which aim to restore policyholder protection to the target level.

- Early intervention, which is primarily a preventative framework, needs to be linked to what is already in Solvency 2 in respect of supervisory intervention and the general supervisory framework. Rather than developing new frameworks, correct and harmonised application of Solvency should be the priority given that Solvency II was designed to allow early intervention and already:
    - Gives supervisors powers to: intervene if the high target SCR is breached, take increasing action through the ladder of intervention, and fully take control of the company, at the MCR level, when there is still significant solvency capital remaining.
    - Also requires companies to take a forward looking view and cover all risks, including liquidity.
    - Also has very extensive monitoring through the reporting requirements
- The SCR should therefore remain across Europe as the only intervention point – as there does not appear to be convincing evidence indicating that this will be insufficient.
- The mechanisms regulated currently under Solvency II are conservative enough to protect policyholders where there is non-compliance with the Solvency Capital Requirement (SCR) or even when there is a risk that would lead to such non-compliance. Solvency II already includes certain requirements in terms of recovery (recovery plan in case of non-compliance with the SCR and supervisory powers in deteriorating financial conditions…). Therefore, the purpose of supplementing the current supervisory framework should have very strong arguments and reasons.
- The case studies provided appear to relate to Solvency I and so could significantly overstate gaps as they do not recognise the very significant increase in prudential supervision delivered by the Solvency 2 framework.
- One should bear in mind that Solvency II came into force only few months ago so it seems reasonable to have more experience on the operation of this new EU prudential framework before proposing new requirements.
- Implementation of the building blocks in section 4 (particularly regarding early intervention and recovery and resolution planning) has the potential to lead to an effective increase in capital requirements for insurers. Any such requirements would need to be implemented in a fully harmonised manner, otherwise they would contradict the maximum harmonisation Solvency 2 directive.
- From a policyholder protection point of view, where there is little risk of policyholder protection falling below the target level for a given firm, pre-emptive recovery planning does not help in achieving the policyholder protection objective. If the requirement is not targeted it could be counterproductive. Requiring recovery plans when an insurer's SCR has not been breached would increase insurers' compliance burden. It would also add another layer of solvency requirements and thus introduce legal uncertainty in relation to the prudential framework for insurers.
- The scope of any requirements to have a recovery plan before breach of the SCR should be limited through proportionality to firms for which it would provide tangible benefits and should in such cases, be seen as part of their regular ORSA rather than an additional process. Correct application of proportionality will in practice mean very few insurers will actually be required to develop such plans. Any such requirements should not be used on a firm by firm basis as an intervention point by supervisors before the SCR is breached. In principle,

simplified obligations for recovery or resolution planning frameworks should not be needed. Rather the scope of the framework should be appropriately defined. In particular, it does not seem reasonable that all insurers, reinsurers and groups are subject to recovery planning as soon as they are subject to Solvency 2 (as is stated in paragraphs 154 and 155 of the discussion paper).

c. Resolution Frameworks

- Otherwise resolution should be only used as a last resort because normal sale/run-off/portfolio transfer options will be suitable for almost every case in practice and have proven to work well in the past. Resolution should not be applied before the insurer has passed the point of non-viability.
- Where firms are required to deliver full pre-emptive recovery plans as additional processes, which are not their ORSAs as discussed above, these should also be used by supervisors to develop resolution plans, in order to maximise the benefit of the such recovery plans in terms of prevention and optimisation of resolution outcomes.
- However, anticipating regulatory intervention is hardly justifiable in terms of proportionality and would undermine a cornerstone of Solvency II crisis management. It could also be noted that early intervention could negatively impact the reputation/value of an insurer.
- Regulatory intervention to remove ex-ante perceived barriers to resolution could impose significant costs on insurers or impact efficient ongoing operation and should be targeted at insurers most of risk of entry into resolution, or which pose a threat to the financial stability and real economy objectives. The proposed recovery and resolution building blocks have been heavily influenced by the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions. We do not believe that it is appropriate to take this framework, which was developed primarily from a macro-prudential banking perspective, and apply it in a micro-prudential insurance supervisory framework.
- While we agree that resolution authorities could have a broad range of powers at their disposal to ensure insurers can be resolved in an effective and orderly manner, in practice portfolio run-off and transfer are likely to be the most effective powers in the event of insurance company failure. Having regard to the fact that insurance liabilities are primarily policyholder technical provisions, bailing in bondholders would have limited impact on the resolution of insurers. This is a further key difference between insurance and banking.
- For cross border firms, co-operation and co-ordination between supervisors will be essential in facilitating insurance company resolution in order to implement a resolution strategy which maximises policyholder protection across the insurance firm or group

New Powers

- The only new power that appear useful would be for “stay and suspension powers” to be extended to all NCAs. This would avoid any residual concerns over the risk of individual company mass lapses or across-the-market mass lapse events. Such powers exist already in some markets and, although very rarely needed, preserve value, have proved effective in the few cases used and can prevent the need to use more drastic measures. However, in the case of an individual company, supervisors should not be able to intervene before the SCR is breached without the company’s agreement. In the case of mass lapses across a market the need for such action would require clear and documented justification from the supervisor concerned.

1. General comments

a. Objectives

The requirement for regulatory recovery planning needs to be viewed in the context of the objectives of the framework. Primary objectives of resolution (and by implication recovery) are described in paragraph 214 as protection of policyholders, financial stability, continuity of critical functions and protection of public funds. For most insurance firms which are not systemic and do not offer critical functions, policyholder protection will be the key objective.

In general there are two avenues through which prudential measures in the context of recovery and resolution can increase policyholder protection

- Measures which reduce the probability of a firm failing and entering into liquidation / resolution
- Measures which increase the likelihood that, once a firm fails and enters into liquidation/resolution, claims will be made in full or maximise the level of claims made from a policyholder protection perspective.

A similar differentiation can be made for other objectives although the focus of the second avenue may be different from a financial stability or real economy perspective.

The first avenue is preventative insurance prudential supervision and should in principle be already covered in the Solvency 2 framework. If elements are identified which require changes to the prudential supervision framework, these should be captured in changes to Solvency 2 rather than through a separate framework.

The second avenue is insurance resolution and it would be appropriate for this to fall under a separate resolution framework.

The pre-emptive recovery planning, early intervention and supervisory co-ordination and co-operation building blocks fall under the first avenue. Developing and implementing this preventative framework appropriately should form the bedrock upon which the resolution framework can be build.

Resolution, resolution planning, resolvability assessments, early intervention and supervisory co-ordination and co-operation fall under the second avenue.

b. Preventive Supervision

Supervisory Cooperation and Coordination

A key observation of the financial crisis was the lack of supervisory coordination and cooperation. The Solvency 2 framework provides for significant enhancement in this area which could be further expanded upon within the Discussion Paper.

Regulatory intervention, pre-emptive recovery planning and the link with Solvency 2

Regarding preventative supervision the relationship between pre-emptive recovery planning and early intervention needs to be considered. In this context it is worth discussing the conditions for implementation of the pre-emptive recovery plan.

Paragraph 163 of the Discussion Paper which discusses recovery planning states that "from a crisis management perspective, it is important to be prepared for [breach of the SCR] scenarios in a pre-emptive manner." This indicates that the pre-emptive regulatory recovery plan is triggered in the situation where an insurer breaches its SCR.

Paragraph 164 states that the recovery plan sets out options and measures an insurer would adopt to "restore its financial strength and viability following a (significant) deterioration of its solvency position." This indicates that the pre-emptive recovery plan would also cover scenarios where the firm suffers a major stress but potentially still covers its SCR, or in other words that a major deterioration in financial strength would be a trigger for implementation of the pre-emptive regulatory recovery plan. There is no further description within the discussion paper of the triggers for implementation of the pre-emptive regulatory recovery plan or the powers of the regulator in the case where the pre-emptive regulatory recovery plan has been triggered.

Appendix I Annex 4 of the FSB Key Attributes provides detail on this when it states in paragraph 1.5 "the recovery plan serves as a guide to the recovery of a distressed firm. In the recovery phase, the firm has not yet met the conditions for resolution or entered the resolution regime." This indicates that the recovery plan is triggered when the firm is close to but not yet reached resolution. Paragraph 1.6 goes on to state that "The authorities should have the requisite powers to require the implementation of recovery measures".

The above comments are consistent with the interpretation of the trigger for a pre-emptive regulatory recovery plan implementation being the point at which the firm is one level above resolution and the regulator or supervisor has the power to implement elements of the plan. This would be a breach of the SCR under Solvency 2.[1]

The SCR is set at a high level, significantly above the amount needed to pay liabilities. The SCR is (and was intended to be) an early intervention point and there does not appear to be evidence to indicate any earlier supervisory intervention powers are needed. Company management may of course design their own steps based on their desired internal targets and buffers where they plan action before the SCR is breached. These may also be described in their ORSA or other internal policy documents. However, they remain entirely management and not supervisory decisions and therefore not part of any regulatory requirements.

It is important to note that if the trigger for implementation of a regulatory recovery plan were to imply that the supervisor intervenes to some degree at this point (for example it influences the choice or implementation of the recovery options) then the recovery plan would cease to be for management purposes. If the recovery plan was no longer for management purposes then this could result in an intervention point which is higher than the Solvency 2 trigger for regulatory intervention

[1] We note here and as set out in section 2.3 of the paper NSAs have significant powers to intervene before breach of the SCR.

and this could imply a new a change to the role of the SCR in the Solvency 2 framework. This in turn would suggest a general increase in capital requirements above the Solvency 2 SCR.[2] On the other hand if such a trigger is not harmonised, or harmonised at a minimum level, then the principle of maximum harmonisation under the Solvency II Directive would seem to be undermined.

Early intervention and the link with Solvency 2

Paragraph 189 states that early intervention could be regarded as further developing or supplementing existing powers in Solvency 2 and that "the aim is to supplement Solvency 2 and not interfere with the actual supervisory framework." Any measures or frameworks which provide for early intervention can be expected to be an integral element in the supervisory framework and should be viewed in the context of the objectives of that framework. Furthermore it is not clear how supplementing Solvency 2 in this way would not interfere with the actual supervisory framework given the central role that Solvency 2 now plays in insurance supervision.

Paragraph 190 states that early intervention objectives are similar to the supervisory objectives in Solvency 2. The link with the objectives of the FSB Key Attributes (which acts a source for much of the material in the discussion paper) regarding systemic and real economy is not made, in line with the proposal that early intervention proposals are made with the specific intention of developing Solvency 2.

In this context it is not clear why the proposals on early intervention fall within the remit of this Discussion Paper on recovery and resolution, particularly given that the proposal is for a minimum harmonising recovery and resolution framework whereas Solvency 2 is a maximum harmonising directive. The link with Article 242 of the Solvency 2 Directive should be made here as appropriate.[3]

Paragraph 191 refers to the supervisory ladder of intervention in Solvency 2 and states that intervention by NSAs may be needed before the breach of regulatory capital requirements in order to avoid the escalation of financial problems. The existing ladder of intervention in Solvency 2 as described in recital 60 of the Solvency 2 Directive has been designed specifically to address this issue from a solvency perspective. Furthermore the SCR and risk margin underlying the technical provisions are designed to provide a high level of policyholder protection. If the proposal is to provide for early intervention based on solvency over and above what is already in existence in Solvency 2, the reasons for doing this in terms of the perceived limitations of Solvency 2, should be made clear.

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[2] Recital 60 of the Solvency II directive states "The supervisory regime should provide for a risk-sensitive requirement, which is based on a prospective calculation to ensure accurate and timely intervention by supervisory authorities (the Solvency Capital Requirement), and a minimum level of security below which the amount of financial resources should not fall (the Minimum Capital Requirement). Both capital requirements should be harmonised throughout the Community in order to achieve a uniform level of protection for policy holders. For the good functioning of this Directive, there should be an adequate ladder of intervention between the Solvency Capital Requirement and the Minimum Capital Requirement."

[3] Article 242 states that By ►M5 31 December 2018 ◄ the Commission shall make an assessment of the benefit of enhancing group supervision and capital management within a group of insurance or reinsurance undertakings including a reference to COM(2008)0119 and the report of the Committee on Economic and Monetary Affairs of the European Parliament on this proposal of 16 October 2008 (A6-0413/2008). That assessment shall include possible measures to enhance a sound cross- border management of insurance groups notably of risks and asset management. In its assessment, the Commission shall, inter alia, take into account new developments and progress concerning:(a) a harmonised framework on early intervention

Regarding Paragraph 192, a clear distinction should be made between supervisory powers which are available for and after breach of the SCR in any harmonised framework.

Early intervention conditions

Paragraph 194 states that early intervention conditions should allow for a sufficient degree of supervisory judgement and discretion and hard quantitative criteria should be avoided. In this respect there is already a hard quantitative criterion for supervisory intervention at the SCR level in Solvency 2 which shows that such criteria cannot necessarily be avoided as they provide clarity to firms and supervisors. Where clear criteria are not provided there needs to be a robust supervisory framework in place which ensures consistent treatment across firms and over time. Such a framework should provide for clear communication to the firm regarding early intervention including, among other things, the potential for entry into early intervention and the reasons for such. This underlines that early intervention cannot be separated from the supervisory framework.

Paragraph 195 states that early intervention should be triggered before the Solvency 2 supervision ladder becomes effective. Please refer to comments above in respect of paragraphs 189 to 191 here. Paragraph 195 goes on to state that early intervention would "cover the point where the financial situation of an insurer starts to deteriorate and is expected to deteriorate further if no action is taken". This indicates that the supervisor would become involved if an insurer suffers a deteriorating in financial condition which is ongoing, irrespective of the health or otherwise of the insurer. This is not targeted or even practical. It also suggests that management would not take the necessary steps to arrest the deterioration without the need for supervisory intervention.

Paragraph 196 lists example of conditions which could be taken into account. Solvency coverage as provided by Solvency 2 is by far the most accurate determinant of an insurer's financial condition and in particular its ability to meet claims to policyholders. Supervisors and the markets will also be provided with regular and up to date financial solvency information Solvency 2 reporting requirements. Other company specific items, such as share price information and credit spreads are likely to be poor substitutes as either accurate or up to date indicators of policyholder protection. Changes in financial indicators are unlikely to provide much practical insight into the firm specific financial condition unless mapped to solvency. Similarly if changes in non-financial indicators such as an increases life expectancy occurred such changes would be incorporated into firm calculations and processes including solvency coverage calculations as and when they emerge (refer to Article 272 of the Solvency 2 delegated acts on the actuarial function responsibilities).

There seems to be a contradiction in paragraph 197. Introducing new early intervention conditions will by definition create a new intervention level i.e. the early intervention level

Case Study

Paragraph 162 states that the case study in box 3 illustrates that the NSA in question would have been better able to deal with the crisis situation in a more efficient manner if pre-emptive recovery and resolution plans were in place.

The background to the case study states that “the main cause for the problems was the challenging market conditions; the combination of low interest rates, declining sales in the life insurance market and high competition and low margins in the non-life market”. These comments suggest that the business model of the firm may have been under threat for a significant period. In this case entry into financial difficulty was not sudden or unpredictable and that a targeted pre-emptive recovery and resolution framework would have achieved the necessary objectives without creating undue costs for policyholders, supervisors and firms.

The example in box 3 concerns a case study which took place during the old Solvency I regime. Therefore many of the issues which were identified as impediments to orderly recovery and resolution may be eliminated or significantly ameliorated under Solvency 2. This should be considered in the analysis. In particular the Solvency 2 SCR and MCR provide a clear ladder of regulatory intervention. Furthermore there will not be a major change in the valuation of insurance liabilities on going from a going concern to a gone concern assumption, driven by use of different market parameters for the valuation of insurance liabilities, under Solvency 2 and the recognition of deferred tax assets in base and stress can be expected to be subject to significant analysis in the Solvency 2 framework. Regarding the other impediments to orderly recovery and resolution identified (lack of transferability, intra group connectedness and early termination rights) these issues that should be identified by the firm as part good risk management framework under Solvency 2, although they are unlikely to have been assessed in the context of recovery and resolution in this framework. For example, the analysis which revealed that bankruptcy of the holding company might have been triggered if the life insurer was put into run-off is something that should have been identified in the group ORSA. The case study should consider how Solvency 2 provisions enhance supervisory cooperation and how this may have helped to address issues which were identified.

The case study would have benefited from further explanation of how pre-emptive recovery and resolution planning would have directly improved policyholder protection in this case. In particular why did the absence of a pre-emptive recovery and resolution plan increase the risk of a disorderly resolution – was there not sufficient time once the supervisor stepped in to carry out the analysis required and identify the best options and if so what was driving the time pressures? What impediments to recovery and resolution would have been removed early and what would have been the consequences of their removal?

Recovery Planning

In a Solvency 2 context, the pre-emptive recovery plan helps to prepare for a situation where the firm can no longer meets its SCR following a (severe) stress scenario (see above discussion on conditions for implementation of the pre-emptive recovery plans). Having a pre-emptive recovery

plan in place means that if the firm suffers a severe stress, it will be better prepared to restore policyholder protection to the target level. In this sense a pre-emptive recovery plan can provide a degree of insurance in event of solvency falling below the target level.

In practice the level of enhanced policyholder protection (or insurance) provided by a pre-emptive recovery plan will become more important as the firm gets closer to the trigger point. For example, policyholders of a firm which has a 110% coverage of its SCR and an ORSA which shows a deteriorating solvency coverage trend in the central scenario would see their protection increase significantly more from a pre-emptive recovery plan than those of a healthier firm.

This suggests that the recovery planning framework should be targeted at firms which meet some or all of the following criteria; they are vulnerable to not meeting their SCR in stress scenarios (from the ORSA for example) or are vulnerable to sudden and unpredictable shock events which could lead to a significant breach in SCR coverage before recovery options could be implemented.

On the other hand, policyholders of healthy firms are unlikely to need the insurance provided by recovery plans to maintain the target level of SCR coverage post shock. To the extent that pre-emptive recovery plans give firms the confidence to hold less capital, on the basis that an effective recovery plan provides a layer of insurance in the event of deteriorating solvency, such recovery planning could be counter-productive. In fact it may be more effective to require pre-emptive recovery plans in the event of a firm having insufficient funds to cover SCR in a severe stress scenario, as this would act as an incentive for firms to carefully monitor capital and exposures around those levels.

Regulatory recovery plans for healthy firms, could be significantly out of date given the change in circumstance which would be necessary before implementation. This is a likely outcome where the firm is implementing preventative measures in the pre recovery state to avoid entry into regulatory recovery. This could be overcome by regularly updating the recovery plan as regulatory recovery nears, but this only serves to highlight that the pre-emptive regulatory recovery plan could be expected to go out of date as the financial position deteriorates. The recovery options a firm takes are likely to be specifically contingent on the circumstances which lead to the recovery. It is difficult to anticipate in advance the circumstances which would lead to a firm entering regulatory recovery and the economic and market environment when this occurs for a healthy firm which shows no breach in SCR in severe stress scenarios for example. The recovery plan could detract from direct preventative risk management and supervision and requirements would be likely to increase costs for supervisors and firms which will be directly passed on to policyholders in mutual companies and are likely to be indirectly passed on in shareholder companies. In light of the above comments there is a strong case for targeting the requirement for regulatory recovery plans at less financially healthy firms.

Pre-emptive recovery planning can be of value for certain companies but any initiative must be based on proportionality and considered part of their ORSA reporting and not used as a backdoor tool for intervention before SCR is breached.

2. Maximising Resolution Outcomes

a. Resolution Planning

Comments above regarding pre-emptive recovery planning are generally also relevant to pre-emptive resolution plans.

Where firms are required to deliver full pre-emptive recovery plans as additional processes, which are not their ORSAs as discussed above, these should also be used by supervisors to develop resolution plans, in order to maximise the benefit of the such recovery plans in terms of prevention and optimisation of resolution outcomes.

Generally regarding recovery and resolution planning and resolvability it is not necessary to have a framework which allows for simplified obligations for certain insurers. It is more important to get the scope of the requirements right in the first place.

b. Resolvability Assessments

Paragraph 187 states that "in case resolution authorities identify significant impediments to the resolvability of an insurer, they should be able to require the removal of these impediments." Again this needs to be viewed in the context of the objectives of prudential frameworks and in particular how removal of impediments to resolvability improves policyholder protection, either directly or indirectly. Where regulatory intervention to remove ex-ante perceived barriers to resolution imposes significant costs on an insurer or has an impact on its efficient ongoing operation, the case needs to be made as to how this improves policyholder protection. Indeed such intervention could make an insurer less flexible in how it responds to a stress situation and therefore potentially reduce policyholder protection. In any case it would only seem appropriate to make such changes when there is an increased risk of a firm entering into a resolution phase, for example when it is already in regulatory recovery.

The FSB duly notes the importance of not restricting ongoing insurance operations in this regard where it states in its guidance on resolution planning for systemically important insurers that "Authorities may therefore need to require firms to make appropriate and proportionate changes to legal and business structures where necessary to address such obstacles and improve their resolvability (KA 10.5). The decision to impose any such requirement should take due account of the effect on the soundness and stability of ongoing business."

Furthermore it is important to note here that the proposed recovery and resolution building blocks have been heavily influenced by the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions. We do not believe that it is appropriate to take this framework, which was developed primarily from a macro-prudential banking perspective, and apply it in a micro-prudential insurance supervisory framework.