

5 December 2012

## **EC Consultation on a possible recovery and resolution framework for financial institutions other than banks**

### **EIOPA Response**

1. EIOPA is responding to the COM consultation on a possible recovery and resolution framework for financial institutions other than banks under the provisions of Article 34 of Regulation No 1094/2010 of 24 November 2010.

#### ***General Observations***

2. EIOPA welcomes the opportunity to contribute to the development of EU policy on recovery and resolution in the area of insurance. As such, this response does not address the other elements of the financial sector addressed in the Commission's consultation. In addition to responding to the specific questions posed in the consultation, EIOPA would like to provide input on some more general issues on recovery and resolution. These issues are likely to come up in the development of a comprehensive and meaningful policy for recovery and resolution.
3. The development of recovery and resolution frameworks has its roots in the current, primarily banking-led crisis. As a result, recovery and resolution frameworks for banking have been developed first and reflect the specific systemic significance and financial interconnectedness of the banking sector. In addition the particular or special nature of banks has also shaped international thinking on resolution and recovery policy.
4. Examination of the (re)insurance sector from a financial stability perspective has revealed (re)insurers to have a more stable business model; to be relatively less interconnected; and, in some cases, to be more substitutable than banks. There are, however, activities undertaken by insurers that have systemic impact and these have been the focus of IAIS work to identify systemically important insurers<sup>1</sup>. The systemic significance of the insurance sector is considered to be less than that of the banking sector, but it has systemic significance nonetheless.
5. Nevertheless, the broader economic significance of the insurance sector must be acknowledged, since insurance serves a number of key economic functions.

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<sup>1</sup> A small number of business lines can be identified as falling within the Shadow Banking concept in terms of supporting leverage or extended intermediation chains. Non-traditional/Non insurance business lines are also used to identify G-SII.

It is a facilitative business in so far as insurance facilitates other economic activities, for example trade credit insurance, public and employers' liability and transport insurance underpin broader economic activity. Life insurance allows policyholders to smooth their incomes and is a key savings channel through which funds are invested in capital and debt instruments, as well as other assets.

### *Objective of Recovery and Resolution*

6. The Solvency II Directive (2009/138/EC) very clearly sets out policyholder protection as its main overarching goal. This is outlined in Recital 16, 'The main objective of insurance and reinsurance regulation and supervision is the adequate protection of policyholders and beneficiaries. The term beneficiary is intended to cover any natural or legal person who is entitled to a right under an insurance contract. Financial stability and fair and stable markets are other objectives of insurance and reinsurance regulation and supervision which should also be taken into account but should not undermine the main objective', and further substantiated by articles 27 and 28 of the Solvency II Directive.
7. This is also in line with the IAIS Insurance Core Principles (ICPs) which promote the protection of policyholders as the objective of prudential supervision of insurers. It is also worth highlighting that the EU framework for bank recovery and resolution proposed by COM in June 2012 also hinges around a similar set of objectives for banks: Resolution would have to: 1) safeguard the continuity of essential banking operations, 2) protect depositors, client assets and public funds, 3) minimise risks to financial stability, and 4) avoid the unnecessary destruction of value.
8. By contrast the COM consultation focuses primarily on the financial stability rationale for the development of a recovery and resolution framework. Section 4.2.1 (a) of the COM consultation document focuses on "possible recovery and resolution arrangements for systemically relevant insurers, in anticipation of but without prejudice to how exactly these may ultimately be designed". This is consistent with the approach taken in the measures proposed by the IAIS to deal with Globally – Systemically Important Insurers.
9. EIOPA is of the view that this is possibly an overly narrow view of the context within which recovery and resolution policy for insurers should be considered. The singular focus on systemic significance as the motivating factor for developing recovery and resolution reflects the rationale for the application of recovery and resolution techniques to the banking sector. It does not fully reflect the nature of the insurance sector's broader economic significance and the importance of policyholder protection.
10. There is a clear distinction between recovery and resolution for (a) financial stability, and (b) policyholder protection. In the context of financial stability, the objective is to reduce negative externalities on the financial system of a failure. In the context of policyholder protection, the objective is to mitigate the impact on the stakeholders of the individual undertaking, primarily the policyholders. Recovery and resolution arrangements designed for the

purpose of financial stability, may not necessarily be optimal for the purpose of policyholder protection. EIOPA is of the view that any policy proposals should address these objectives and what powers and tools should be available to deal with each one.

11. The consultation paper provides a comprehensive summary of current thinking on the systemic significance. It does not, however, address fully the broader economic implications of an insurance failure. It is quite feasible that an insurer judged not to be systemically important could have a wider impact on some parts of the economy and, particularly, on the affected policyholders if it failed. This would be compounded if a number of insurers in a given market were to fail simultaneously. EIOPA is of the view that the protection of policyholders should also be considered as part of the resolution framework, together with financial stability. Further work is required, however to determine the hierarchy of objectives and when each one would be addressed.
12. There may be situations where, without necessarily posing a risk to financial stability,<sup>2</sup> the failure of an insurer could be better dealt with using recovery tools rather than more traditional resolution methods in order to protect policyholders. For example, the objective of protecting policyholders could be under particular threat if a life insurer was to fail and recovery tools were not available. It has to be stressed that insurance undertakings are providers of retirement annuities, health care funding, obligatory motor insurance (MTPL) and other important products, and consequently their continuation is desirable regardless of whether its failure would have systemic or financial stability consequences.
13. This opens an issue in relation to terminology and what is meant by resolution and recovery in insurance, which needs to be further explored. In banking terms, resolution has come to be understood as intervention before balance sheet insolvency in order to continue critical functions, warehouse profitable activities and prepare unprofitable activities for liquidation. In this context, EIOPA's view is that the definition used in the consultation for the term "resolution" should be fine-tuned.<sup>3</sup> As commonly understood today, resolution in relation to insurance involves the use of existing tools such as run-off (solvent and insolvent), portfolio transfer, and schemes of arrangement etc. to achieve either an orderly wind-down of an insurer and/or transfer of sustainable business to another insurer. Recovery by comparison focuses on the continuation of firms in terms of continuity of cover and vital insurance services.

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<sup>2</sup> EIOPA defines financial stability in the following terms: "Financial stability, in the field of insurance and pension funds, can be seen as the absence of major disruptions in the financial markets, which could negatively impact insurance undertakings or pension funds. Such disruptions could, for example, result in fire sales or malfunctioning markets for hedging instruments. In addition, market participants could be less resilient to external shocks, and this could also affect the proper supply of insurance products or long-term savings products at adequate, risk-sensitive prices" (EIOPA's "Second half-year Financial Stability Report 2012").

<sup>3</sup> According to the text of the Consultation (footnote p. 5), "resolution" refers to actions undertaken by authorities if the problems cannot be overcome with recovery or other measures, and failure to act would jeopardise financial stability.

14. EIOPA is of the view that the objectives underlying the development of a European recovery and resolution framework should adequately reflect the objectives of insurance supervision that will be put in place by Solvency II. A key question to be addressed is when to use resolution tools and when to use recovery tools and whether policyholder or financial stability concerns should hold sway. EIOPA is of the view that in certain circumstances the protection of policyholders and mitigation of broader economic impacts should be considered as part of the resolution context at least as much as the objective of financial stability. This is an area that would benefit from further examination in developing a recovery and resolution framework.

### *Resolution Authority*

15. EIOPA is of the view that successful recovery and resolution requires that an authority or authorities be given a clear resolution role. Resolution and supervision differ in terms of timing of their interventions and tasks assigned and should therefore be clearly distinguished. Nevertheless, successful resolution is dependent on the knowledge of supervisors, as they are the ones who know the undertaking's structure and its financial conditions. A framework must provide for a smooth transition between the supervision and recovery stages based on close cooperation and information sharing.

16. The consultation does not address the designation of a resolution authority in each jurisdiction. This is an area that would have to be addressed in developing a recovery and resolution framework. Related areas that would have to be addressed include the objectives, mandate, composition, role and funding of such an authority. Dealing with these issues would address one of the shortcomings of existing arrangements.

17. EIOPA considers that Member States should be given enough flexibility in the designation of a resolution authority. In any case, clear allocation of resolution powers would allow clear boundaries and mandates to be established relative to supervisory authorities and other resolution authorities. An absence of this leads to boundary problems in terms of the transition from recovery to resolution, which could generate inaction bias. EIOPA is of the view that if there are multiple authorities responsible for resolving entities of the same group within a single jurisdiction, then legislation should provide for one to be named as the lead authority to coordinate resolution action.

18. Of particular importance is provision for information sharing and close cooperation between supervisors and resolution authorities. This facilitates a smooth transition from recovery, which is a supervisory responsibility, to resolution, which is the responsibility of the resolution authority. In practical terms the resolution authority must be well prepared to take responsibility for the insurer in question and to be able to act quickly. This requires that it be informed at an early stage of firms in difficulty and that it have access to detailed information to refine the resolution plan for activation.

### *Institutional Model*

19. EIOPA believes that in addition to the designation of a resolution authority, an institutional model for resolution should also ideally be defined. This has

two main facets: first, whether resolution is a court or administrative process and second, what the precise form of the resolution authority would be. There is a range of options regarding the latter from specialist liquidators appointed by the court at the behest of the supervisory through to a guarantee scheme having resolution/liquidation powers.

20. It is recognised that existing insolvency procedures may be too cumbersome and slow moving to achieve financial stability and/or policyholder protection objectives. Consequently, the resolution regimes being developed in banking typically include a provision for the resolution authority to act very early, when a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming viable. It could act before balance sheet insolvency to resolve an entity and so preserve critical activities.
21. Early resolution action embodies a crucial trade-off, where private ownership interests are set against a wider social welfare objective. In the absence of some compensating mechanism, and even with it, early resolution action could be construed to represent appropriation of assets. The earlier the resolution action the more likely injured parties (e.g. shareholders) would seek to challenge the action judicially.
22. The traditional tools that have been available for insurance resolution have been tested in some jurisdictions. In those cases, supervisory authorities, the courts and industry have experience of their use and understand the strengths and shortcomings of each national framework. Tools, such as portfolio transfer and run-off, are designed primarily to deal with “slow-burn”, individual failures rather than multiple failures. They have not been extensively tested in dealing with complex cross-border groups. Equally, they are not necessarily designed to deal with a sudden deterioration in the viability of larger firms. Such tools are likely to be inappropriate to deal with the sudden failure of a large complex insurer. This raises the question of whether new tools are required to deal with more complex and/or systemic events.
23. EIOPA is of the view that greater harmonisation of powers across the EU, along with improved cross-border recognition of resolution actions taken in different countries would enhance the resolution environment in the EU. There is a wide range of institutional models across the EU and greater harmonisation of these models in terms of objectives, powers and available tools would be a positive development. The extent of harmonisation that is achievable, however, needs further analysis.
24. EIOPA is of the view that the resolution of cross border groups needs further attention, since these are the entities more likely to be affected by the proposed framework. Furthermore, the framework should not undermine the ability of national authorities responsible for supervision and resolution of undertakings belonging to the group to act in an effective manner.

### *Funding*

25. The consultation does not mention the issue of funding. In principle, a resolution regime is intended to remove or minimise the need to use

taxpayers' funds. There are, however, a range of ways in which resolution may be funded including resort to the Insurance Guarantee Scheme (IGS), disposal of assets, limitation of creditor rights, etc. It may also be the case that interim funding may be required in order to carry out some elements of the resolution process.

26. EIOPA is of the view that the issue of funding cannot be ignored, but that flexibility should be given to Member States with regard to the different funding options.

### *Relationship with Supervision and Trigger Points*

27. The relationship between supervision and resolution, especially the transition from recovery to resolution if recovery fails is an important issue. As highlighted in EIOPA's crisis prevention and management framework there is a continuum of increasingly serious actions that can be taken. Supervision can go as far as recovery, as set out in 2009/138/EC, but if that fails then resolution is triggered. There should not be a cliff effect here, as the resolution authority should have been alerted to the situation, should be prepared and should be able to act at short notice to carry out a resolution.
28. In assessing, existing insurance insolvency tools one strand of analysis has focused on the cost of insurance insolvency. Some researchers relate higher costs of insurance insolvency, in terms of calls on the insurance guarantee fund/policyholder write downs, to supervisory forbearance.<sup>4</sup>
29. If a supervisor delays in taking action in relation to a failing insurer and forbears this may increase the cost of insolvency since the position of the insurer would have deteriorated. Another line of investigation relates to the actual insolvency process and its length. In some jurisdictions, the process does not seem efficient and various agents servicing the process exhaust a significant part of the estate. This is a function of institutional design and the allocation of appropriate incentives.
30. EIOPA believes that there should be a focus on mechanisms to improve the efficiency of the resolution process by de-incentivising, unnecessary forbearance and ensuring that the institutional structures do not allow the estate to be unduly exhausted.
31. The enhanced supervisory process embodied in Solvency II, will make it difficult for supervisors to forbear unduly as they must take a risk based approach that reflects the challenges facing firms. In addition, it provides a clear framework for intensifying supervisory action as the position of an insurer deteriorates. This presents the question of how any modification to the resolution regime would interact with Solvency II. These issues underline the importance of implementing Solvency II sooner rather than later. In this regard, EIOPA is of the opinion that the recovery and resolution framework

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<sup>4</sup> "Insurance Company Failures: Why Do They Cost So Much?", Grace, M.F et al., Georgia State University Working Paper No. 03-1, October 2003

should be made compatible with Solvency II but without making it conditional on the start of the new prudential regime.

32. A key question in insurance resolution is when to act, rather than how to act. Insurers that in the long run are expected to become insolvent can continue to write new business for some time before insolvency in balance sheet terms materialises. This exposes more policyholders to the ailing firm and makes the situation worse. Faced with a situation where insolvency is not immediate, management at such an insurer may have an incentive to “gamble for redemption” and adopt high risk strategies to return the firm to financial health.
33. The question for supervisors of when to act is a challenging one and is constrained by national legislation and legal precedent. Supervisors will typically seek to avoid a situation where they face legal challenge for being pre-emptive in their actions. This being particularly likely where resolution powers are strongest and premature use could generate claims of expropriation of private property. On the other hand, supervisors will seek not to delay their actions unduly, especially where there are strong accountability arrangements where they must account for their actions.
34. The most straightforward situation is where resolution powers are triggered once a set of financial thresholds is breached however there are a number of drawbacks. Supervisors, typically value having some discretion to manage the situation of an ailing entity in order to give space for a private sector solution without jumping straight to resolution. Consequently, a fine balance will be required in framing trigger conditions for a resolution regime that balances clear thresholds for action and supervisory discretion.
35. In most jurisdictions the existing resolution tools often require the firm to be at or close to insolvency, meaning that the firm will already be in a very poor condition. An alternative approach is to specify the trigger conditions in terms of breach of the threshold conditions for authorisation. This is a much broader set of conditions that spans control and governance conditions, in addition to financial conditions.
36. EIOPA is of the view that giving supervisors discretion to provide breathing space to find a preferably private sector solution for an ailing firm can generate better outcomes. In crisis situations this may be useful to avoid procyclical actions that would arise as a result of immediate enforcement of supervisory requirement. Excessive forbearance, however, can be very harmful in that a firm may be allowed to continue trading even though it has not meaningful means of recovery. This would worsen the situation of the firm and expose more policyholders to its difficulties. A counterbalance to excessive forbearance is the incentive to act created by a robust accountability mechanism.
37. Consequently, EIOPA believes that the triggering of resolution powers must balance the need to act early to maintain significant activities and to preserve financial stability with the need to protect private property rights. Overly early action may face claims of appropriation unless the resolution

framework explicitly protects creditors to ensure that they would be no worse off than in a liquidation scenario.

38. EIOPA believes that the best approach to trigger conditions is a more nuanced one that could include reference to a wider set of conditions such as breach of threshold authorisation requirements.

### *No Creditor Worse Off than in Liquidation*

39. A typical feature of the resolution regimes developed for banking has been the inclusion of a No Creditor Worse Off than in liquidation clause (NCWO). This safeguard is typically included as a counterbalance to the pre balance sheet insolvency triggering of resolution and the risk of appropriation of private property.
40. This safeguard, taken together with the public interest in preserving financial stability, forms the basis for the early triggering of resolution actions prior to balance sheet insolvency.
41. In an insurance context, the concept of NCWO may be a little clouded by the range of possible outcomes for various creditors under the different actions that could be taken for resolution or recovery purposes. Nonetheless, the Insurance Winding-Up Directive<sup>5</sup> provides for Member states to make a choice about the preferential position of policyholders over (i) technical provisions or (ii) the entire asset base of the insurance company being wound up. In short, regardless of the winding up and reorganisation actions being taken, insurance policyholders have a preferential position.
42. Policyholders could be allocated to a number of types dependent on the line of business involved and national norms:
- (a) general insurance policyholders and life insurance policyholders (in the few instances where composite insurers remain authorised);
  - (b) unit-linked policyholders, non-profit policyholders, and with-profit policyholders;
  - (c) with-profit policyholders within one sub-fund compared to another sub-fund;
  - (d) direct insurance policyholders and reinsurance cedants; and
  - (e) Annuitants (and others with crystallised claims) and potential claimants.
43. It is understood that depending on the legal system in question the rights of some of these policyholders may differ according to whether the insurer is a going concern, in run off or in an insolvent winding up. For example, on a going concern basis funds and sub-funds typically operate on a strict ring-fenced basis with transfers of profits from the funds strictly controlled. On insolvency, however, the assets of each fund/sub-fund could be pooled and future insurance benefits could be valued on a different basis.

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<sup>5</sup> Directive 2001/17/EC, of 19 March 2001, on the reorganisation and winding-up of insurance undertakings

44. There is a risk that where a resolution authority wants to preserve certain functions (compulsory insurance, payments to distressed annuitants) but not to others then where shareholder funds and senior creditor funds are insufficient some policyholders may be disadvantaged in favour of others. In all cases, the application of NCWO could be very complicated and might not provide adequate protection to all policyholders.

***Specific Questions Posed in the Consultation***

***1. Are the resolution tools applicable to traditional insurance considered above adequate? Should their articulation and application be further specified and harmonised at EU-level?***

45. EIOPA would identify the following resolution tools that are applicable to traditional insurance:<sup>6</sup>

- (a) Run-off, either solvent or insolvent and compulsory or voluntary;
- (b) Portfolio transfer, which is available even to firms in run-off;
- (c) For non-life mutual and mutual-type associations with variable contributions, the calling for supplementary contributions from their members;
- (d) Recourse to the Insurance Guarantee Scheme to secure continuity of insurance policies by transfer to solvent insurer or compensation of beneficiaries/policyholders. In some jurisdictions the IGS may actually act as a bridge insurer;
- (e) Restructuring of liabilities, either through a court proceeding (Scheme of Arrangement) or by supervisory approval to ensure that losses are fairly distributed among policyholders/creditors;
- (f) Appointment of an Administrator/Conservator or Special Manager; and
- (g) Compulsory winding-up by order of the court and/or the supervisor

46. There is long experience in dealing with failed insurance companies, which utilises tools such as the appointment of an Administrator/Conservator, portfolio transfers, run-off and, in some countries, resort to the insurance guarantee scheme. The use of these techniques reflects the fact that the insurance business model does not generally require rapid liquidation of assets to meet short-term liabilities.

47. In some jurisdictions these tools have been regularly used and have proven adequate in dealing with individual, "slow-burn" failures of smaller firms. However, there has been no experience in Europe of resolving a large, complex insurance group with extensive cross border operations. There is a strong possibility that the current tools would prove inappropriate to deal with a sudden failure of a large complex insurer or even to deal with the failure of several smaller insurers in a single jurisdiction.

48. The current arrangements may have adverse effects for policyholders in some jurisdictions for the following reasons:

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<sup>6</sup> It is, however, important to stress that Member States have different tools available and, therefore, not all tools considered can be used in all Member States.

- (a) Run-off may not provide adequate protection for long-term policyholders, because of the risk that the capital buffer is eroded before all long-term policyholders have received their payouts;
- (b) Some methods of compressing liabilities and / or providing compensation to policyholders, such as Schemes of Arrangement in the UK, are court-driven processes and so are conducted in the private, rather than the public interest;
- (c) Entry into run-off of a firm of significant size could have adverse impact on the provision of funding to the European financial system and / or the provision of critical economic functions to the real economy;
- (d) Administration or liquidation may only be used when it is assessed that the insurer is or is likely to become unable to pay its debts<sup>7</sup> – in other words at a stage when it may be too late in practice to effect a transfer of business from the administration to a performing third party; and
- (e) If the administrator has an objective to continue to administer the insurer's long term contracts with a view to securing a transfer, this may have equal status with the administrator's other objectives, which may create challenges where a solution that delivered continuity for those with long term contracts might deliver a worse outcome for other creditors. In a court based system the administrator could seek the guidance of the court on discharging his duties but a decision would still have to be made;

49. Where the administrator has a duty to co-operate with the national compensation scheme, there may not be clarity over who should seek a buyer for the insurer's long-term business nor on what terms they may do so (for example whether they might depart from the creditor hierarchy or the requirement to treat creditors within a certain class on a *pari passu* basis), but this would depend on the extent to which the relative roles are clear in legislation.

50. In addition, putting a firm into administration or liquidation may have financial stability implications for the following reasons:

- (a) There is likely no requirement on the administrator to consider potential risks to the financial system, and so an administrator may take action in pursuit of maximising creditor value which is not consistent with maintaining financial stability (e.g. the administrator may cease to make liquidity available to bank counterparts); and
- (b) The liquidation of a major European insurer could clearly have an adverse impact. Such impacts might include driving down asset prices via forced sales, failing to protect critical functions, or eroding market confidence. Moreover, in the absence of specific legal provisions to deal with netting and close-out of contracts, insolvency would constitute an

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<sup>7</sup> In the case of Administration the trigger conditions may vary and could extend to conditions such as the firm not being operated in a manner consistent with policyholder interest.

event of default that could trigger disorderly close out of an insurer's positions.

51. A common theme is that the existing tools are typically designed to deal with creditor interests and are not concerned with broader objectives. In general, they do not, for example, include preservation of critical functions or financial stability as primary objectives.
52. EIOPA is of the view that the existing toolkit for insurance resolution was designed for use on "slow burn", individual insurance failures. It was not designed to deal with multiple, simultaneous failures or the sudden failure of a large complex insurer or group. Some jurisdictions have used the existing toolkit and have experience of its strengths and weaknesses. As some elements of the current toolkit were designed to protect creditors, they do not always provide optimal outcomes for policyholders. As such, EIOPA welcomes the current initiative to consider expansion and development of the resolution toolkit to address broader objectives.
53. EIOPA believes that it is vital to be very clear about the objectives of resolution, with due consideration being given to the use of recovery tools. Any new framework should be flexible enough to deal with both the resolution and recovery objectives,
54. On the question of greater specification and harmonisation of the articulation and application of the existing resolution tools, EIOPA recognises the benefits that would bring, especially for cross-border operating groups and their policyholders. In an ideal world, a more harmonised set of tools with consistent design, implementation and enforcement features would bring considerable certainty to firms and policyholders. Such a development would also support greater recognition of resolution actions across borders. Developments in this direction would greatly improve the cross-border coordination of resolution and reorganisation actions, which would be a positive step in bridging the gaps in the existing framework.
55. EIOPA is recognised in law as the coordinating body for crisis management in the EU insurance sector. At present, it faces a task of facilitating coordination or coordinating against a landscape of heterogeneous resolution frameworks across Member States. EIOPA is of the clear view that measures taken to improve harmonisation will support coordination and strengthen the EU resolution framework.
56. EIOPA also recognises the challenges to achieving such a harmonised approach. The resolution frameworks existing in Member States today are very different. They reflect differences in legal frameworks and significant institutional differences. EIOPA is of the view, however, that this should not be an obstacle to exploration of just how much harmonisation can be achieved, while also leaving room for Member States to further develop their national resolution regimes.

***2. Do you think that a further framework of measures and powers for authorities, additional to those already applicable to insurers, to resolve systemically relevant insurance companies is needed at EU level?***

57. The full range of tools and powers set out in the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions are not available in all jurisdictions. EIOPA is of the view that completion of the resolution "toolkit" is an initiative that should be addressed in any new policy framework. As outlined in the response to Question 1, this would entail greater harmonisation across the EU. It should however be borne in mind that –as stressed in the response to Question 7– detailed work is required to fully examine how some of the powers could be used or adapted for use in an insurance context.

58. In terms of the additional instruments that ought to be considered these are dealt with in the response to Questions 8, 9 and 10.

***3. In your view, which scenarios/events might lead to the need to resolve a systemically relevant insurance company? Even before that, which types of scenarios systemic insurers and authorities need to be prepared for which may imply the need for recovery actions if not yet resolution?***

59. The Sharma Report<sup>8</sup> provided a definitive study of the causes of insurance company failure, the findings of which have been echoed by other researchers<sup>9</sup>. This work suggests that focusing on specific scenarios or events identifies only the proximate causes of insurance company failure. The mechanism of failure involves the interaction of the trigger event and a range of factors that determine the "fragility" of a firm at a given point in time. Consequently, susceptibility to the effects of given scenarios will vary across firms and over time. In this sense, EIOPA believes that there is limited value in speculating in this consultation on the scenarios/events that might cause a systemically relevant insurance company to require resolution. The focus should be instead on mitigating the impact of a failure.

60. As to the question of preparation for particular scenarios, EIOPA is of the view that the specific scenarios are less important than the possible effects on individual firms. The real value in planning for any hypothesised event for an individual firm is to understand what would cause an element of the firm to "fail", along with the possible actions that the firm could take to avoid or mitigate such an outcome. The challenge for supervisory authorities is that this work can only really be carried out on a firm by firm basis, with the result that supervisory authorities must develop plans for dealing with each systemically significant firm.

61. In terms of trying to improve resolution and the resolvability of firms, EIOPA emphasises the importance of mitigating the impact of a failure rather than the probability. The starting point is the failed firm and how the impact of that failure can be best managed and mitigated is the most important issue. Nevertheless, measures taken to improve resolvability may have the beneficial side-effect of mitigating the latent fragility of an insurer. This may

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<sup>8</sup> Report on Prudential Supervision of Insurance Undertakings, Conference of the Insurance Supervisory Services of the European Union, December 2002.

<sup>9</sup> "Why Insurers Go Bust", G. Platin and J-C. Rochet, Princeton University Press, 2007

be achieved through structural changes or changes in management focus/culture.

62. In practical terms, whatever plan is conceived is highly unlikely to provide a blueprint for dealing with any future crisis. EIOPA is of the clear view, however, that understanding what actions a firm can take or how businesses can be reorganised is vital to being able to make more informed decisions in a crisis. This is consistent with the governance and risk management principles underlying Solvency II, for example the ORSA. The scenarios are less important than understanding what makes insurers potentially “fragile”, what actions insurers could potentially take and what is potentially feasible in terms of reorganisation. As outlined in the responses to Question 5, the aims should be to be well prepared to react to varying circumstances.

### **Objectives**

#### **4. Do you agree with the above objectives for resolution of systemic insurance companies? What other objectives could be relevant?**

63. EIOPA agrees with the objectives for resolution set out in the consultation paper. These are consistent with the objectives set out in the FSB Key Attributes for Effective Resolution Regimes for Financial Institutions and are appropriate objectives in terms of the preservation of the stability of the financial system.
64. EIOPA would also like to emphasise the importance of policyholder protection and limiting the economic impact of the failure of an insurer(s). As outlined in the General Observations section above, EIOPA notes that the financial stability argument for resolving insurers is not as persuasive as for resolution of banks. Rather, the failure of an insurer may have a broader direct economic impact that could be better mitigated by the stabilisation of an insurer. Stabilisation, however, might use some of the same measures and powers that could be utilised for resolution.
65. EIOPA suggests that in framing any future legislation a broader view be taken in specifying objectives to allow more flexible use of measures and powers. This would allow both financial stability and policyholders’ protection objectives to be addressed. This balanced approach needs to be further explored in light of the new resolution framework.

### **Recovery and Resolution Plans**

#### **5. Do you think that recovery plans should be developed by systemic insurers and resolution plans by resolution authorities? Do you think that resolution authorities should have the power to request changes in the operation of insurers in order to ensure resolvability?**

66. Large and complex insurance undertakings, especially insurance groups, feature many of the same characteristics as large, complex banks and financial conglomerates. For example, complicated webs of intra-group transactions, operational interconnections through “centres of excellence” and extensive use of shared services. Such complexities could conceivably have an adverse impact on recovery and resolution for either financial stability or policyholder purposes. On this basis, EIOPA has no doubt that the

development of recovery and resolution planning requirements for insurance is necessary.

67. Echoing the points made in paragraphs 57 to 60, there is a clear rationale for systemic insurers to develop recovery plans. While such plans may not provide a blueprint for dealing with a given scenario, they provide a discipline for the management of insurers to consider what actions they could and would take. Such plans highlight the logistical, legal and practical challenges that would need to be addressed and how they might be addressed. A fundamental question to be asked is whether the use of recovery and resolution planning should be extended to a limited number of other firms in a proportionate manner. EIOPA considers that supervisors should be able to ask for recovery plans where necessary. Restricting the framework to systemically relevant insurers, limits the tools that supervisors have at their disposal and may raise level playing field concerns.
68. EIOPA would expect such plans to be detailed and realistic, and that they would not assume access to any support from public funds. However, the requirement to prepare a recovery plan could be applied proportionately at solo level, reflecting the importance of having plans for significant subsidiaries as part of integrated group plans. In addition, EIOPA would expect that institutions would be required to submit plans to supervisors for assessment as to whether they are comprehensive and likely to restore the viability of the institution. This is consistent with the expectations on governance and control underlying Solvency II, especially the requirement to submit recovery plans and the ORSA.
69. As a counterpoint to the recovery plans developed by firms, EIOPA supports the idea that resolution plans should be developed by resolution authorities. As outlined earlier, EIOPA does not believe that a resolution plan can provide a simple manual for dealing with a resolution. Rather, the development of such plans should highlight what can be done to resolve a firm and how it could be done.
70. A crucial element in the successful development of both recovery and resolution plans is close contact and collaboration between insurers, supervisory authorities and resolution authorities. For example, while firms should design their own recovery plans, supervisors should review these to ensure they are credible and take into account a wide and plausible range of scenarios. Equally, in drawing up resolution plans, the authorities will require significant input from firms depending on the nature and level of detail in the plans.
71. As for the second question, EIOPA believes that giving resolution authorities the power to request changes in the operation of insurers before the resolution phase requires careful analysis and design. This is necessary to avoid potential coordination problems between the resolution authority and the supervisory authority, even where they are part of the same institution.

### ***Resolution Triggers***

***6. Do you agree that resolution should be triggered when a systemic insurer has reached a point of distress such that there are no realistic***

***prospects of recovery over an appropriate timeframe, when all other intervention measures have been exhausted, and when winding up the institution under normal insolvency proceedings would risk causing financial instability?***

72. The trigger point for resolution and the specific nature of the triggers are discussed in paragraphs 25 to 36. However, it is worth noting that the process “supervision → recovery → resolution → insolvency” should be clearly specified. In particular, it is very important to achieve a smooth transition between supervision, recovery and resolution.
73. As outlined in responses to earlier questions, there is a rationale for using some measures and powers to achieve a stabilisation objective. This would suggest adding the objective of preserving policyholder interests and limiting broader economic effects.
74. EIOPA also believes that the concept of distress needs to be more clearly defined. One relatively nuanced way to do this would be to have reference to continued adherence to the conditions for authorisation.

***7. Should these conditions be refined? For example, what would be suitable indicators that could be used for triggering resolution of systemic insurers?***

75. See responses in paragraphs 70 and 71.
76. In addition, there may be a need to graduate the triggers to reflect the severity of the measures/powers that they would trigger. For example, the triggers enabling the powers to appoint a Special Manager or Administrator could reasonably be less onerous and further from the point on balance sheet insolvency than the triggers for asset separation or forced sales/transfers. EIOPA would support the development of more graduated and granular qualitative trigger mechanisms.

***Resolution Powers***

***8. Do you agree that resolution authorities of insurers could have the above powers? Should they have further powers to successfully carry out resolution in relation to systemic insurers? Which ones?***

77. This is one of the most important questions in the consultation, since it gets to the heart of the development of a resolution framework. The proposed list encompasses the powers commonly seen in banking resolution frameworks. In principle, EIOPA could endorse the list but believes that considerable, detailed work is required to fully examine how some of the powers could be used or adapted for use in an insurance context. For example, the imposition of a moratorium on payments could have very adverse effects on policyholders. Some initial analysis in relation to each proposed measure is included in the table in Annex 1 to this paper.

***9. Should they be further adapted or specified to the specificities of insurance resolution?***

78. See response to Question 8.

## **Resolution Tools**

### **10. Would the tools mentioned above be appropriate for the resolution of systemic insurers? What other tools should be considered and why?**

79. Asset separation has been included in banking resolution frameworks and has actually been used. In the context described in the paper, EIOPA can see the merits of being able to separate non-insurance related assets/activities in order to affect resolution of an insurance group. Non-insurance activity by a solo insurance undertaking should be very limited given the conditions for authorisation, so it is not clear how relevant such powers would be in that context. Moreover, to the extent that insurance is a liability led business with a clear "matching" requirement between assets and liabilities it is not clear how such a power would be used.
80. Bridge Insurers are a feature of the resolution framework in some EU jurisdictions and have been used with some success. EIOPA would support measures to broaden the availability of this tool, especially in the context of dealing with multiple failures.
81. EIOPA would also support the extension of the toolkit to include wide availability of the Administrator or Special Manager options. If triggered at a suitably early stage, these options would allow very early remedial action to be taken where the incumbent management have been unable or unwilling to do what is required for recovery.
82. On Bail-In, the development of a bail-in tool for banking provides a resolution tool clearly designed to minimise the cost to the State of a resolution action. The success of the tool is dependent on the availability of liabilities that can be bailed-in and the identification of the optimal amount/proportion of liabilities to be bailed-in.
83. EIOPA believes that in principle, the same logic can be applied to the use of such a tool for insurance, especially in relation to systemically important insurance undertakings for whom such an instrument could be particularly worthwhile. It is important in the context of bail-in, however, to restate the preferred status of policyholders who should not be included in the scope of any bail-in framework.
84. As in the banking case, the level at which bail-in is imposed in a corporate structure is important. For example, in the case of insurance groups or financial conglomerates, wholesale debt is typically raised at holding company level rather than operating company level. If there is a shortfall between expected policyholder claims and the firm's asset value, bailing in holding company creditors and down-streaming the proceeds to recapitalise the insurance subsidiaries would help ensure policyholders within the subsidiaries were protected. It would also:
- (a) avoid any need to make difficult judgements on which creditors should be protected from the bail-in at operating company level;
  - (b) remove the risk of competing insolvency proceedings being initiated across different jurisdictions; and
  - (c) avoid the need to find potential purchasers for the insurance business.

85. At the same time, a bail-in at group level is not neutral for individual subsidiaries and could lead to an unfair treatment of minority shareholders of the subsidiary under certain circumstances. Consequently, the level at which bail-in takes place is important and needs to be carefully considered.
86. Development of a bail-in tool for insurance would also need to take account of the capital structure of the insurance sector and the extent to which liabilities that could be bailed-in are used in the funding of insurance undertakings. As demonstrated, for example, in the most recent QIS the insurance sector is primarily equity funded with unrestricted Tier 1 funds accounting for >80% of own funds, so that the effective use of this option may be less significant than for banking.

### ***Group and Cross-Border Resolution***

#### ***11. Do you think that, within the EU, resolution colleges should be set up and involved in resolution issues of cross border insurance groups?***

87. EIOPA considers that the proposal to put in place resolution colleges for cross-border groups as means of ensuring a coordinated approach deserves further consideration. As a matter of simple logic, any measures that can be taken to improve coordination are to be welcomed. There are a number of issues that would need to be addressed in making provision for such mechanisms.
88. First, there is the question of membership of resolution colleges. EIOPA is of the view that such colleges could have membership extending –when needed– to other parties, such as central banks and ministries of finance. This, however, raises practical and operational issues that need to be dealt with and relate to professional confidentiality requirements in particular. Experience from the banking sector suggests that for successful operation of such groups all members must have, and adhere to, the same strict professional confidentiality requirements. This is the only way in which insurers could be expected to share the highly confidential information that must be considered in resolution.
89. Second, the relationship between resolution colleges and supervisory colleges needs to be addressed. EIOPA considers it important to have a smooth transition between recovery and resolution, which would require very close cooperation between resolution and supervisory colleges. This would argue for supervisory colleges to act as resolution colleges or the latter to be a part of or add-on to the former. As such, they could maintain a level of activity in non-crisis times consistent with planning for resolution. This would allow them to be efficiently activated more fully in the case of a crisis.
90. Third, successful coordination depends on a degree of consistency of objectives and incentives for those being coordinated. EIOPA recognises the primary national character of supervision and resolution today. In order to be successful, resolution colleges and their members should have clearly set down mandates and responsibilities that support coordination.
91. Even if all such measures were addressed, EIOPA is aware of the potential challenges that would arise from the legal and institutional differences that prevail across the EU.

**12. How could the decision-making process be organized to make sure that swift decisions can be taken? Should this be aligned with the procedures already set out in Title III of Directive 2009/138/EC?**

92. The procedures set out in Title III of Directive 2009/138/EC certainly form a reasonable basis on which to organise the decision-making process. EIOPA views this as having the benefit of using an existing set of agreed procedures that has the benefit of avoiding duplication and fostering familiarity.
93. Nevertheless, unless the powers, objectives and incentives of those taking part in the coordinated process are broadly compatible then the outcome will not be as optimal as it might be. In this regard a balance has to be drawn between national authorities having appropriate flexibility in the area of resolution of undertakings authorised in their jurisdiction, taking account of the impact of resolution on the local market, and ensuring effective coordination.

**13. Alternatively, do you think that responsibility for resolving systemic insurers should be centralised at EU-level?**

94. One of EIOPA's primary responsibilities is to facilitate coordination of, or to coordinate, supervisory actions in response to adverse developments or an emergency situation. EIOPA, with its members, has put in place mechanisms to carry out these responsibilities and it continues to refine this framework.
95. Despite increased cross border activity in the sector, especially resinsurance, over time, insurance does not have the same interconnection on a cross-border basis as banking. There is more of a national flavour to insurance supervision and, by extension, resolution. In addition, insurance resolution has typically been privately funded, through industry levies for example, and so faces fewer challenges in terms of implications for national treasuries and use of taxpayers' funds.
96. A fundamental challenge to coordination at present is the different legal and institutional structure for resolution prevailing across the EU. EIOPA is of the view that centralisation is not really a feasible solution given the different insolvency regimes, different bodies appointed as resolution authorities and different insurance guarantee schemes that are in place. Rather, EIOPA would welcome measures to strengthen the existing framework for coordination, such as harmonisation of the objectives of resolution authorities, clarification of policyholder preference and harmonisation of the tools and powers available to resolution authorities. EIOPA stands ready to contribute fully to work in this area.

**14. Do you think that a recognition regime should be defined to enable mutual enforceability of resolution measures?**

97. This is an important question which would benefit from further analysis. In general, EIOPA agrees that a recognition regime would undoubtedly facilitate mutual enforceability. It could be described as a necessary condition for mutual enforceability but it is not a sufficient condition, since a range of other alignment measures would also need to be taken in the EU to make such mutual recognition feasible.

98. The other alignment measures that would need to be taken would address:
- (a) greater harmonisation of resolution authorities' objectives;
  - (b) greater harmonisation of the tools and powers available to resolution authorities;
  - (c) greater harmonisation of trigger points for the use of various tools and powers; and
  - (d) consideration of the interest of each affected party in the recognition regime.

***15. Do you think that to this end bilateral cooperation agreements could also be signed with third countries?***

99. Greater coordination of resolution activities both within the EU and with non-EU authorities is a pre-requisite for an effective resolution regime. As outlined in the discussion on bail-in, intervention could occur at various levels in a group structure and the optimal intervention point could be a company outside the EU. EIOPA is of the clear view that coordination and cooperation with non-EU supervisory and resolution authorities would be a prerequisite for a meaningful resolution framework.
100. Bilateral cooperation agreements would be one element of such a framework, but EIOPA believes that more wide reaching alignment of objectives, toolkits and powers would be necessary for really achieve a joined up framework.

## Annex 1 – Initial Assessment of Possible Resolution Powers

| <b>Proposed Power</b>   | <b>Applicability to Insurance</b>  | <b>Issues for further assessment</b>   |
|---|--|--|
| Remove and replace senior management.   | Applicable - This is an essential part of the resolution toolkit. It must, however, be structured in such a way as to reflect employment laws and not generate unnecessary legal action  | None   |
| Appoint an Administrator.   | Applicable – This power allows a degree of flexibility in terms of keeping a firm running while restoring its viability or making a decision on sale options.  | <p>Key questions in relation to the appointment of an Administrator cover:</p> <ul style="list-style-type: none"> <li>• What is the precise mandate of the Administrator, as this differs currently across jurisdictions.</li> <li>• What are the Administrator’s powers regarding the sale of the firm? What rights do existing shareholders have?</li> <li>• Who appoints? The supervisory/resolution authority or the Court?</li> <li>• How is the Administrator remunerated</li> </ul> |
| Operate and resolve the entity including taking commercial decisions to restructure or wind down the entity’s operations.   | Applicable – Resolution requires that the resolution authority take control of the entity and have a free hand to take the actions necessary for resolution.   | How exactly control of the entity is achieved needs to be developed. Is this a Court decision or a matter of administrative law? What rights of appeal would be available to the owners of the entity?   |
| Restructuring of liabilities, either through a court proceeding (Scheme of Arrangement) or by supervisory approval to ensure that losses are fairly distributed among policyholders/creditors | <p>Applicable - The following liability restructuration techniques can be considered:</p> <ul style="list-style-type: none"> <li>- Direct insurance liabilities can be compressed by early termination of guarantees, conversion of annuities</li> </ul> | This tool may raise substantial issues in Member States without the power to amend the existing contracts before the winding-up.   |

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|   | <p>into lump sum payments, early payment of individual claim reserves fairly reduced.</p> <p>- Reinsurance liabilities can be restructured through commutation of reinsurance treaties.</p>   |   |
| Transfer or sell specified assets or liabilities to a third party entity.         | Applicable – Separation of certain elements of the business is again a core element of the resolution toolkit.  | There is already a tool available to achieve this in most jurisdictions. Portfolio Transfers are commonly used and the governing legislation often includes provisions to ensure policyholder interests are protected. The interaction between the proposed power and the Portfolio Transfer tool needs to be further examined. This would address, at the very least, the right to initiate a transfer, the precise mechanism and how stakeholder interests are addressed. |
| Establish a temporary bridge institution to take over certain critical functions. | Applicable – Critical functions are not as significant in an insurance context relative to banking. Nevertheless, there may be a desire to continue certain business lines and a bridge insurer is one way of achieving this. There is at least one EU Member State that uses a bridge insurer type of structure as the core of its insurance guarantee scheme. | As with all bridge vehicle the following questions will need to be addressed in detail: <ul style="list-style-type: none"> <li>• Who would own the entity?</li> <li>• How would it be capitalised and funded?</li> <li>• How would it be staffed?</li> <li>• What would its mandate be in terms of the restructuring of the business?</li> <li>• How would the assumed business be treated on the books of the</li> </ul>   |

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|  |   | <p>bridge entity? Pooling or segregation? This is an important question as it affects policyholder rights.</p> <ul style="list-style-type: none"> <li>• As a specifically insurance focused question, how would policyholder interests be addressed? This is critical given that insurance involves risk pooling and pooling of assets, so that beneficial treatment for one group of policyholders may damage the interest of another.</li> </ul> |
| Separate non-performing assets into a distinct vehicle.  | <p>Unclear – This is very much a banking power, designed to “clean the balance sheet” of an ailing bank, thereby allowing it to focus on business rather than having to deal with asset recovery, provisioning and recapitalisation issues.</p> <p>Insurance is very much a liability led business, with a significant degree of matching between assets and liabilities. It is not clear how such separation would be done in a practical sense and what it would achieve.</p> | Further analysis required to examine exactly how this tool could be used.  |
| Recapitalise an entity by amending or converting the terms of specified parts of the entity in order to allow for the continuity of essential functions. | Further analysis needed – The adjustment of insurance liabilities has been used regularly in insurance resolution. The option is not available in all jurisdictions but where it is, such action can only be taken in an insolvency context.  | <p>The following areas would merit further investigation:</p> <ul style="list-style-type: none"> <li>• How to balance policyholder interests, since an action may disadvantage some policyholders relative to others.</li> <li>• When such measures could be</li> </ul>  |

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|  |   | taken and whether it requires insolvency or could be used in a more pre-emptive manner.   |
| Supplementary contributions from Members, in case of Non-life mutual and mutual-type associations with variable contributions. | Applicable - Non-life mutual and mutual-type associations with variable contributions can call for supplementary contributions from their members.  |   |
| Override rights of shareholders of the firm in resolution.   | Applicable – If the resolution authority takes control of the firm then shareholder rights are overridden. This is the cost of being able to take action in the broader public interest to resolve a firm.  | The question that arises in this context is exactly what shareholder right are overridden? Do they retain any rights in relation to a sale of the business, putting it into run-off etc.?                                   |
| Temporarily stay the exercise of early termination rights.   | Applicable – Insurers, like other financial institutions, enter into a wide range of contracts both commercial and financial with other entities. These contracts may involve essential services supplied to the insurer (e.g. IT services, data provision) or financial contracts (e.g. derivatives) entered into with other financial institutions. As with all other resolution situation, disorderly termination of contracts in the event of a resolution action may undermine that purpose of the action. | Examination of the specificities of contracts entered into by insurers is needed to fully understand how such powers would be properly constituted.   |
| Impose a moratorium on payment flows.  | Applicable – Certainly being able to control payment flows out of an insurer in a resolution scenario is a key power. The application of a moratorium in relation to policyholder/beneficiary payments needs to be carefully  | Further exploration of the appropriate limitation of a moratorium is required. This examination should also take account of the potential for the insurance guarantee scheme to make payments and then be subrogated in the |

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|  | considered. In some instances the payments are of a critical/essential nature (e.g. health insurance).  | resolution process.   |
| Effect the closure and orderly wind-down of the company. | Unclear – the question here is whether the resolution authority is responsible for actual liquidation of the company or the run-off of the company. | Further assessment of the appropriate institutional structure is required here in terms of whether the resolution authority itself would perform these tasks or whether they would be outsourced. |