Industry at odds with regulators over new framework for insurance recovery and resolution

There is an emergent divergence of opinion between trade body Insurance Europe and regulators. Will calls for further regulation create more substantial fissures?

Insurance Europe, a trade body comprised of insurance associations representing approximately 95% of European premium insurance income, recently issued a press release reaffirming its stance on EU proposals for harmonising recovery and resolution frameworks for insurers. Insurance Europe argues that proposals for substantially changing recovery and resolution rules for insurers are unnecessary. Rather, it asserts, current safeguards provided under Solvency II (a European framework governing capital adequacy and risk reduction for insurers) are sufficient. In particular:

- Insurers are required to hold a high level of capital in the form of the Solvency and Capital Requirement (**"SCR"**), which is calculated at the level of a 1 in 200 year loss event;
- If an insurer does fall below its SCR, regulators can intervene, and ultimately assume full control of an insurer before it becomes insolvent; and
- Solvency II already includes rules governing the winding-up of an insurer.

Insurance Europe argues that overhauling current rules is unnecessary because:

- The risk profiles of banks and insurers are different – the former have a greater exposure to sudden unforeseen failures (e.g., a "run" on the bank) whereas insurers' liabilities build up gradually over a longer timeframe;
- The interlinkage of banks means that the sudden failure of one bank can create a domino effect across the entire financial system. Insurance Europe argues that insurance liabilities are independent of each other, and that systematic risk is much lower should an insurer fail;
- Insurers are by virtue of their business models less exposed to fluctuations in business cycles compared to banks. This renders insurers more resilient, and makes their failures rarer; and
- There is a higher degree of substitutability with insurance products than in banking.

However, Insurance Europe does see merit in expressly providing that regulators should not intervene while an insurer is still meeting its SCR, and in giving regulators the power to use "stay and suspension" powers to prevent mass lapses.

EIOPA's proposals for wider harmonisation

Insurance Europe's announcement was borne out of a discussion paper from the European Insurance and Occupational Pensions Authority (**"EIOPA"**), in which it considered harmonising national recovery and resolution frameworks for insurers in the EU. EIOPA suggested "minimised harmonisation" whereby EU member states would be enabled to implement new regulatory measures to their respective insurance markets. Specifically, EIOPA has suggested four "building blocks" for minimum harmonisation:

1) **Preparation and planning**, whereby insurers and national authorities make preparations during normal business climate for future times of financial stress;
2) **Early intervention** whereby national authorities are granted extended Solvency II powers;
3) **Resolution**, i.e., broad powers to resolve insurers, including the ability to impose a stay and suspension to prevent policyholders and other creditors exercising their contractual rights against the insurer for a period of time; and
4) **Cooperation and coordination**, which includes exchange of information and joint efforts between national and foreign authorities.

An insurance landscape in line with BDDR?

Insurance Europe's reaffirmation of its position can be viewed as expressing concerns that the EU is seeking to extend requirements established in the Bank Recovery and Resolution Directive (**"BRRD"**) to insurers. The BRRD was introduced in the wake of the financial crisis to enable national authorities to take manage the failure of banks, and ensure that the systematic stability of financial markets can be preserved as much as possible. Resolution requires authorities to ensure that banks' critical functions can continue and protect client assets.

The Financial Stability Board (**"FSB"**), a Basel-based body which is tasked with making recommendations regarding preserving global financial stability, maintains a list of global systematically important insurers (**"G-SIIs"**) which are subject to certain resolution planning standards resulting from the FSB's "Key Attributes" consultation in 2013 (and subsequently updated). EIPOA's harmonisation efforts could extend these requirements into a BRRD-style regime for all major European insurers.

EIOPA's discussion paper builds on a survey among national supervisory authorities carried out in early 2016. It is now considering whether to publish an opinion on further efforts to achieve harmonisation.

Our comment

Imposing a full recovery and resolution regime on insurers would not be popular in the insurance industry. Its participants are well aware of the huge amount of work banks have had to do in order to comply with the BRRD. Moreover, many of the points made by Insurance Europe make sense: Solvency II is indeed a strong capital framework, and should make the insolvency of an insurer a very unlikely event.

Nevertheless, EIOPA's discussion paper gives examples of member states having to bail out insurers (admittedly, all in 2008, prior to Solvency II being introduced), and of member states introducing their own legislation to provide resolution powers (the examples given are France, The Netherlands and Romania, and in each case the legislation has been introduced after Solvency II). This evidence shows that some member states are sufficiently concerned about the possibility that an insurer will become insolvent that they think resolution powers should be made available just in case.

It is worth considering that scenario more carefully. At a time when it is at its weakest, the insurer could find itself subject to numerous further stresses: policyholders surrendering products where they are allowed to do so; cedants and reinsurers threatening to exercise termination rights if payments are not made; banks accelerating loan repayments and removing overdraft facilities; constant demands for market and media updates. In the absence of a clear recovery and resolution plan, and clear resolution powers, neither the insurer nor its regulator would be well-placed to do anything quickly about these stresses, or even to make a certain statement to concerned policyholders and other creditors – other than to seek the protections of formal insolvency, which must be a last possible resort.

Faced with that scenario, the insurer and its regulator and its policyholders are likely to be glad if the regulator had some resolution powers to enable it to deal quickly and decisively with the scenario, while allowing the insurer to avoid formal insolvency.

The question is therefore not whether the powers would be useful in that scenario, but whether it is worth putting all EU insurers to considerable extra effort by introducing a harmonised recovery and resolution regime when that scenario is so unlikely. Nothing is to prevent member states introducing their own rules if they wish to do so. Some have already done so, and EIOPA itself acknowledges that this may be better than a harmonised regime because then the rules can more accurately complement the existing law of the member state concerned.

We tend to favour this view. Nevertheless, inconsistency across member states has the potential to create competitive imbalances, which the EU abhors. Consequently the status of future efforts to introduce an EU-wide harmonisation regime for insurer resolution (whether through attempts for minimum harmonisation or more far-reaching steps) is one to watch for later in 2017.