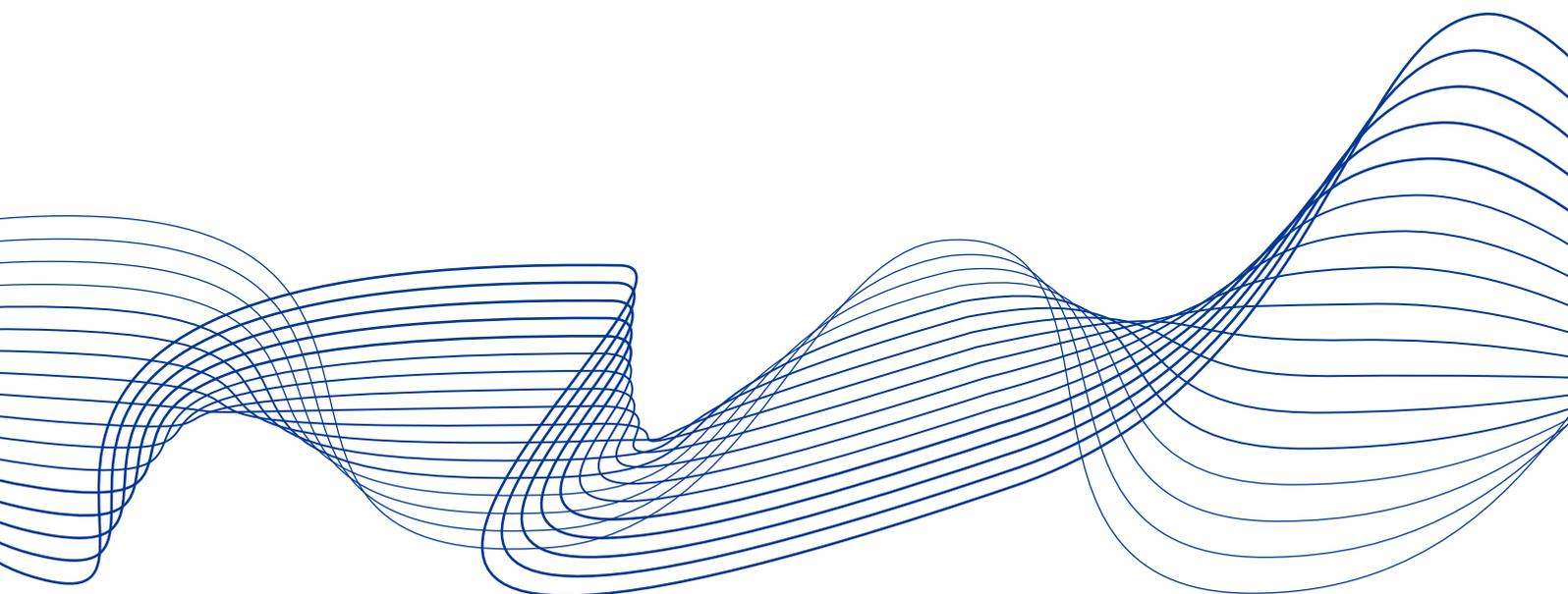


# Recovery and resolution for the EU insurance sector: a macroprudential perspective

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Report by the ATC Expert Group on Insurance



**ESRB**  
European Systemic Risk Board  
European System of Financial Supervision

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## Executive Summary

1. **This report focuses on a recovery and resolution (RR) framework for insurers<sup>1</sup> from a macroprudential perspective.** Covering primary insurers and reinsurers, the report (i) discusses the need for comprehensive RR policies to complement supervisory and macroprudential policies; (ii) identifies and describes a number of potential RR tools; (iii) highlights funding aspects of the resolution process; and (iv) considers cross-sectoral and cross-border implications and contagion channels that arise when resolution tools are applied.
2. **The disorderly failure of an insurer or a group of insurers may pose financial stability risks.** Recent studies have shown that the contribution of the insurance sector, especially that of the life insurance segment, to systemic risk has increased. This is, in particular, due to a substantial common exposure to aggregate risk, caused partly by the ever more explicit sensitivity of insurers' balance sheets to interest rate volatility, and to its growing interconnectedness with the rest of the system through financial markets, e.g. due to their active role in the capital and, to some extent, derivatives markets. As a result, rather than absorbing adverse shocks, the EU insurance sector may transmit and/or amplify shocks to other parts of the financial system once negatively affected. Moreover, there are also strong linkages between insurers. For example, the failure of a reinsurer will directly affect other insurers. More generally, certain types of insurers, in particular non-life insurers offering compulsory and sometimes niche insurance, provide essential services that are necessary for the functioning of the real economy. The disorderly failure of an important insurer of this type at short notice might lead to a temporary shortfall in supply and an inability to address the needs of the real economy, leading to a stalling in goods supply.
3. **The regular insolvency procedure might be unable to manage a failure in the EU insurance sector in an orderly fashion.** A broad set of tools, in addition to those related to insolvency proceedings, may enable authorities to be better prepared to deal with situations involving the distress and default of insurers. The regular insolvency procedure may not always be consistent with policyholder protection and financial stability objectives. In contrast to other resolution tools, it may not consider the continuity of critical functions or the preservation of any other important functions.<sup>2</sup> As such, in the event of the failure of a large insurer or the simultaneous failure of multiple insurers, it may not be possible to prevent contagion spreading to other parts of the financial system. Moreover, following the regular insolvency procedure, the settlement of policyholders' claims could be delayed by several years, possibly undermining the wider public's trust in the EU insurance sector as whole.
4. **Financial stability and policyholder protection objectives are equally relevant to an RR framework in the insurance sector.** The possibility of the simultaneous disorderly failure of several life insurers cannot be disregarded at this juncture. A prolonged low interest rate (LIR)

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<sup>1</sup> Unless otherwise specified, this report uses the term "insurer" to collectively refer to insurers that directly insure businesses and households (primary insurers) and insurers that provide insurance to other insurers (reinsurers). The terms "primary insurer" and "reinsurer" are used when the text only applies to one type of insurer. Specific references are made to differences in the business models of reinsurers and primary insurers, since reinsurers insure primary insurers (and other reinsurers), but not private households.

<sup>2</sup> The report advocates further discussion of critical functions in the insurance sector. For details, see Box 2.



environment could lead to solvency problems throughout the life insurance sector, in particular for life insurers that offered products with guaranteed returns at a time when interest rates were higher.<sup>3</sup> In the very unlikely scenario that the LIR environment were combined with an event of suddenly falling asset prices (a so-called double-hit scenario), there could be a risk of life insurers in several countries coming under stress simultaneously. Even if no failing insurer were systemically important on its own, the disorderly simultaneous failure of several insurers could, collectively, pose a risk to financial stability. Against this background, this report argues that financial stability aspects should be considered as part of insurance RR frameworks, together with policyholder protection objectives.

5. **An effective RR framework needs to take a sectoral view, while allowing for the principle of proportionality.** The international effort has so far focused on global systemically important insurers – nine global systemically important insurers (G-SIIs) have been designated by the FSB, with five of these domiciled in the European Union (EU). G-SIIs are subject to an enhanced RR framework, used primarily as a tool to address the “too-big-to-fail” issue. There are, however, multiple challenges, such as the LIR affecting the sector as a whole. Moreover, in addition to considering the financial stability implications related to a disorderly failure of a single insurer, systemic risks arising from common exposures should also be taken into account. In the LIR environment some institutions may prove unable to successfully adjust their business models to new challenges and, if all other regulatory measures fail, their orderly exit should be assured. This suggests that regulatory attention should focus on the overall sector, including smaller and less diversified insurers which might threaten financial stability if they failed simultaneously in a disorderly manner. Nevertheless, the benefits of a RR framework with a broad scope need to be weighed against the additional costs, allowing national authorities to follow the principle of proportionality.
6. **An effective RR framework also requires arrangements to fund resolution without having to resort to public funds.** In some EU Member States the existing national frameworks might have difficulty to avoid the event of the disorderly failure of a large insurer or the simultaneous disorderly failure of several insurers without having to resort to public funds. An undesirable alternative to the use of public funds would be a policyholder-funded bail-in, with policyholders losing a significant part of their investments, which could have widespread negative implications for sovereigns and financial markets. Moreover, if the insurance guarantee schemes (IGSs) are not properly equipped to compensate policyholders for their losses, public trust might also suffer.
7. **Differences between national legislations increase the complexity of ensuring that the failure of an insurer active in several EU Member States can be managed in an orderly manner.** The recent crisis has illustrated the consequences of a lack of effective crisis management for financial institutions that are active across borders. Following the saying “international in life and national in death”, the authorities in individual jurisdictions have the power which could be applied only at the level of local entity rather than at the level of cross-border group. As in the banking sector, large and internationally active groups play an important role in the insurance sector in the EU, while reinsurers from the EU play a leading

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<sup>3</sup> As shown by the EIOPA 2016 insurance stress tests, both explicit and implicit guarantees are of relevance. For the distinction of contractual guarantees, please consult the IAIS report on Systemic Risk from Insurance Product Features (IAIS 2016b).



role in the global market. At the same time, however, national insolvency procedures, insurance RR frameworks and national IGSs continue to differ widely across the EU. Although this allows national authorities to account for national specificities, a patchwork of national rules cannot fully take account of the cross-border implications of a complex failure. This could result in legal uncertainty, unequal treatment of domestic and foreign policyholders, potential spillover effects into host countries and competitive distortions of national actions. The cross-sectoral implications of the failure scenario, particularly in the case of a financial conglomerate active across borders, would increase the complexity even further. This indicates that the harmonisation of the EU RR framework for insurers across the EU would be a step in the right direction.

8. **While a comprehensive RR framework for the banking sector is operational at EU level, an EU-wide policy strategy addressing risks related to the insurance sector is lacking.**

Whereas the Solvency II Directive is a major step forward in the enhancement of the Single Market, no EU legislation has been proposed, in respect of an RR framework for insurers or IGSs. Filling this regulatory gap will require a broad range of stakeholders in Europe to work together, including EU and national legislators, EIOPA, macroprudential authorities and microprudential regulators. The possibility of an LIR environment continuing for a protracted period of time underlines the fact that the work to develop, strengthen and harmonise an effective RR framework for insurers at EU level should be reinvigorated and include consideration of the related funding aspects.

9. **The report considers a number of RR tools for the EU insurance sector.** The tools considered in this report vary in terms of their costs and benefits, implications for the different stakeholders and applicability in the EU insurance sector. They are grouped as shown below, reflecting how, and at what stage of an insurer's distress or failure, they may be used.

- *RR planning.* The Solvency II framework includes provisions that require insurers that breach their Solvency Capital Ratio (SCR) to prepare recovery plans ("ex post recovery plans"). However, this report stresses that pre-emptive RR plans can increase awareness (e.g. in terms of recovery capacity, resolvability and obstacles to the resolution of an insurer) and might thus support more decisive action by both insurers and supervisors if the solvency position of an insurer deteriorates. This indicates that more attention should be devoted to the RR planning phase during "good" or normal times and that supervisors' powers should be aligned with this principle.
- *Recovery measures and early intervention tools.* Financial stability and consumer protection are best served if the failure of an insurer can be avoided by applying recovery measures (designed and implemented by insurers) and early intervention tools (available to home authorities). Some early intervention tools are already available in individual EU Member States. However, they typically only allow supervisory authorities to intervene once solvency requirements have been breached. This might prevent supervisory authorities from intervening in a timely manner. The expansion and harmonisation of early intervention tools would help supervisors in individual EU Member States to limit disruption to the wider financial market and would limit the unnecessary destruction of value.



- *Commonly used resolution tools.* Liquidation (as part of regular insolvency proceedings) and run-off,<sup>4</sup> which is an insurance-specific resolution tool, are the most frequently used and broadly available tools across the EU. They come, however, with a number of deficiencies. Liquidation does not ensure the continuity of critical functions or the preservation of other functions, it sometimes has priorities that differ from policyholder protection and financial stability, and it is a time-consuming process. Despite these shortcomings, liquidation remains a valid resolution tool – e.g. in conjunction with other resolution tools discussed in this report. A run-off can ensure continuity of cover for existing policyholders. It also does not require the fire sale of assets, thereby reducing the destruction of value for policyholders. However, it may result in a partial settlement of claims if not used in conjunction with other resolution tools discussed in this report. Given the benefits to financial stability of the continuity of critical functions, the use of run-off should be available across the EU and should include solutions to address any funding shortfalls that might occur.
  - *Resolution tools that allow the transfer or separation of all or part of the portfolio.* Portfolio transfer, separation of assets and liabilities, and the use of bridge institutions are considered in this report. With the exception of portfolio transfers, these tools are not currently widely available in the EU for the resolution of an insurer. They increase the resolution authority's flexibility in identifying and separating viable business and/or vital economic functions and liquidating the remainder under ordinary liquidation proceedings.
  - *Tools affecting contractual rights.* The bail-in tool and the power to impose restrictions on the termination of contracts are also considered in this report. These tools interfere with contractual rights and have therefore been used rarely in the EU. The rationale for imposing restrictions on the termination of contracts is to give the resolution authorities the time to deal with a distressed insurer. The bail-in tool involves the restructuring, limiting or writing down of liabilities and, at the same time, allocates losses to shareholders and creditors, including policyholders, in a transparent manner. In contrast to the ordinary insolvency procedure, it ensures the continuity of the critical functions and viable parts of the insurer. The introduction of the bail-in tool is under consideration in the Netherlands, and a few EU Member States allow policyholders to restructure liabilities for the purpose of portfolio transfer. Further consideration could be given to the option of granting the authorities in charge of resolution the powers to restructure, limit or write down liabilities, including both insurance and non-insurance liabilities. The report recognises that, due to the particular structure of insurers' balance sheets, the bail-in tool is probably less effective in the insurance sector than in the banking sector, when applied to capital or debt. Still, the change to insurance liabilities should be a measure of last resort and with adequate safeguards and a reliable source of funding in place to ensure protection of policyholders. This could include the power to modify the terms of existing contracts, for example, for life and saving contracts by reducing guaranteed rates of return or by reducing benefits by a specified percentage.
10. **The report highlights the relevance of insurance industry-funded arrangements for an effective resolution process.** Any failure and the related resolution process, including the normal insolvency procedure, is associated with significant costs. Against this background, the

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<sup>4</sup> In the context of resolution, a run-off as a voluntary decision of the company is not viewed as a resolution tool.



expansion and/or creation of funding arrangements should be assessed as part of any discussion on RR tools. Dedicated resolution funds (RFs) or insurance guarantee schemes (IGSs) are two possible sources of funding for resolution, and the costs of these are directly borne by the industry. At this juncture, Romania is the only country in the EU with an operational RF, whereas IGSs operate in the majority of EU Member States, albeit often with limited scope for specific insurance policies. Moreover, the possible use of IGSs beyond compensating policyholders is mostly restricted to the use of a limited number of resolution tools (mostly portfolio transfer) and focused on a single objective of policyholder protection. Taken together, the current funding arrangements appear incomplete and, in the event that a default of an insurer or several insurers were to pose risks to financial stability, the need to resort to public funds would be very likely. The report argues that both IGSs and RFs can play an important and complementary role in the resolution process<sup>5</sup> and that their use could be further explored at EU level. Notwithstanding the role IGSs could play in resolution funding, the question of adequate policyholder protection across the EU also warrants further attention (ESRB 2017).

11. **Any resolution action should pay attention to the significant cross-sectoral spillover effects of the resolution tools applied.** For example, the application of a stay on termination rights could impact counterparties through open derivative positions. The report recognises that the application of the bail-in tool increases interconnectedness across sectors and, therefore, the consistency of resolution regimes across sectors should be further evaluated and improved. This would guarantee the effectiveness of the tools and minimise the costs and cross-sectoral spillovers of resolution actions, particularly in the case of financial conglomerates.
12. **The interaction between resolution and macroprudential authorities poses some practical challenges.** This report argues that ongoing interaction between the resolution authority and other stakeholders, in particular the supervisory and macroprudential authorities, is desirable, and this interaction should be decided prior to any crisis. However, the process of assigning responsibilities during a failure could be hampered by the fact that a resolution authority for insurers has not been designated in most EU Member States.
13. **Against this background, this report advocates the development of a harmonised effective RR framework for insurers across the EU.** This includes the following:
  - Existing RR frameworks should be evaluated and, if appropriate, enhanced and harmonised at EU level. Furthermore, efforts should be made to ensure their consistent implementation.
  - The existing RR toolkit should be expanded and the multiple use of RR tools should be allowed. A majority of ESRB member institutions take the view that this should include giving resolution authorities the power to modify the terms of existing contracts as a measure of last resort and subject to adequate safeguards.
  - The RR framework should cover the whole insurance sector, while allowing for proportionality.

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<sup>5</sup> The existence of IGSs can provide compensation for policyholders where losses are too burdensome and the existence of a resolutions funds (RFs) for cases when compensation is needed in line with the no creditor worse off (NCWO) principle.



- The financial stability objectives of the RR framework should be recognised, with a majority of ESRB member institutions taking the view that it should be put on an equal footing with the objective of policyholder protection. In addition, the interactions of the resolution authority with the macroprudential authorities should also be clarified.
- Lastly, work on RR frameworks should go hand-in-hand with a discussion of how resolution should be funded.



## Section 1

### Introduction

14. **The global financial crisis revealed, amongst other fault lines, the shortcomings from a financial stability perspective of a government bailout and normal insolvency procedure.** Although a government bailout mitigates contagion both within a sector and in terms of its spread to other financial sectors, the associated increase in sovereign debt creates substantial cost to current and/or future taxpayers. It also increases the risk of moral hazard. The crisis also showed that a normal insolvency procedure can lead to spillovers such as concerns about the liquidity and solvency positions of other market participants with similar business models or asset holdings. These self-perpetuating dynamics then become an important driver of market developments, leading to a systemic crisis and a generalised loss of confidence in the financial system.
15. **Recovery and resolution frameworks have been developed to address these shortcomings.** Since the crisis, new legislation has been put in place – at both global and EU level – with the aim of making financial institutions more robust and reducing their risk of failure. Moreover, new recovery and resolution (RR) tools are being developed to enable authorities to intervene more effectively prior to a failure and, when institutions do fail, to resolve them in an orderly manner that does not require taxpayer support and that minimises the impact on financial stability. While the EU-wide RR framework for the banking sector is operational and some EU Member States are in the process of strengthening their national RR frameworks for insurers, no EU legislative proposal has been put forward for an RR framework in the insurance sector.
16. **This report aims to contribute, from a macroprudential perspective, to the ongoing debate in the EU on the RR framework for insurers.** Building on previous ESRB positions,<sup>6</sup> and the recent ESRB Secretariat staff response to the EIOPA Discussion Paper (ESRB 2017), the report (i) discusses the need for comprehensive RR framework to complement supervisory and macroprudential policies; (ii) identifies and describes a number of potential RR tools; (iii) highlights funding aspects of the resolution process; and (iv) considers cross-sectoral and cross-border implications and contagion channels.

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<sup>6</sup> See ESRB (2015), ESRB (2016a) and ESRB (2016b).



## Section 2

# Systemic risks and the case for an effective recovery and resolution framework for insurers

### 2.1 Introduction

17. **This section describes systemic risks in the insurance sector and makes the case, from a macroprudential perspective, for an EU recovery and resolution framework for insurers.** The first subsection reviews the relevance of insurance from a macroprudential perspective, thereby laying the foundations for the discussion in the remainder of the report. It highlights the possible occurrence of spillover effects in other (financial) sectors and other countries when an insurer is in distress or fails. The second subsection analyses the impact of a low interest rate (LIR) environment, while the final subsection sets out arguments for and against strengthening existing frameworks in EU Member States and supports the development of an EU-wide, harmonised RR framework.

### 2.2 Systemic risks in the insurance sector

18. **A well-functioning insurance sector contributes to economic growth and financial stability.** Insurers play an important role in the economy as providers of protection against idiosyncratic, financial and economic risks. With liabilities standing at one-third of EU households' wealth, consumers depend on the insurance sector for their future income. Moreover, with assets worth two-thirds of EU GDP, the EU insurance sector is a significant part of the financial sector and one of the largest institutional investors (ESRB 2015). In particular, insurers are an important source of long-term funding, and their long-term investment strategy can – in principle – enable them to act as shock absorbers in financial markets (IMF 2016).
19. **However, the sector may also pose systemic risks.** The ESRB previously identified four main transmission channels of systemic risk: (i) insurers amplifying shocks due to their involvement in so-called non-traditional and non-insurance activities (NTNI); (ii) insurers acting procyclically in terms of investment and pricing; (iii) the collective failure of life insurers under a scenario of prolonged low risk-free rates and suddenly falling asset prices (i.e. “the double hit”); and (iv) a lack of substitutes in certain classes of insurance vital to economic activity (ESRB 2015).
20. **The contribution of the insurance sector to systemic risk has increased since the financial crisis.** Although the systemic risk associated with a default by individual insurers has changed little, the contribution of the insurance sector as a whole to systemic risk has increased in recent years (IMF 2016a). This increase is associated with higher commonalities in exposures to aggregate risk within the insurance sector and with the rest of the financial sector, as well as greater exposure to market risks through asset and liability (duration) mismatches, induced by increased sensitivity of certain types of insurers to interest rates. The changing nature of insurance activities, both in terms of investments and product offerings (e.g. a switch to unit-linked/defined contribution models for life insurance or the increased use of early cancellation clauses), has resulted in greater commonality across the financial



system. It thus follows that insurers may be more likely to perform poorly when other parts of the financial system are also facing difficulties.

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## Box 1

### Systemic risks of reinsurers

**Reinsurers traditionally transfer risk within the insurance sector.** They are important to the global insurance industry in that they provide a mechanism by which the risks of a cedent (local primary insurers or other reinsurers that cede certain risks to a reinsurer) can be pooled. As a result, the cedent is protected from extreme events and “tail losses” on its own exposures as specific underwriting (or targeted market) risks are transferred to a reinsurer. This system not only allows insurers to limit potential losses from an individual policy contract (or from a portfolio of policies), but also to increase underwriting capacity and achieve a targeted risk profile (e.g. by reducing risk concentration). By spreading insurance risks globally, reinsurance diversifies losses stemming from local insurance markets, while providing capital relief and balance sheet protection. While the reinsurance industry is small in comparison with the primary insurance industry, it still plays an important role in the non-life sector.

**Reinsurance may also be a source of concern for financial stability.** Although the ways in which reinsurers and primary insurers may pose systemic risks are similar, there may be features specific to reinsurance which need to be monitored from a financial stability perspective (ESRB 2015). The ESRB previously identified the following systemic risks posed by reinsurance: (i) intra-industry interconnectedness with both primary insurers and other reinsurers (known as ‘reinsurance and retrocession spirals’),<sup>7</sup> increasing the risk of contagion within the insurance sector; (ii) the risk arising from high market concentration of reinsurers, both globally and in the EU, and the related substitutability issue, which may lead to a risk of market friction in the event of a reinsurer failing; (iii) interconnectedness with the rest of the financial system and possible procyclical investment behaviour and (iv) captive reinsurance (ESRB 2015).

**Not much is known about the systemic risk posed by the failure of a reinsurer, although there are indications that it might have increased.** Little is known about the pattern and degree of damage caused by the failure of a reinsurer as there have been few such events in the past. Indeed, major risk events in recent years have demonstrated the well-designed risk-absorbing capacity of the global reinsurance market, with little spillover effects. However, several metrics indicate that the likelihood of a failure might have increased, and the spillover effects for the whole insurance sector might be more severe than those observed in the past. First, the reinsurance business has become more concentrated, with the top five reinsurers accounting for more than half of the reinsurance capacity worldwide.<sup>8</sup> This process has led, to better diversified portfolios across risks and regions, including additional benefits of economics of scale, although it might also increase the risk that reinsurers have become too-big-to-fail. Second, the ratings of reinsurers’

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<sup>7</sup> Insurance market spirals, both reinsurance spirals and retrocession spirals, arise from the interplay of practices employed by the insurance industry to disperse risk and spread it across other insurers. Reinsurance spirals refer to links between primary insurers and reinsurers whereas, whereas retrocession spirals refer to links between reinsurers themselves.

<sup>8</sup> The top five reinsurers accounted for 53% of the market in 2015, up from 51% in 2010 (A.M.Best 2010 and A.M.Best 2015). From a longer-term perspective, the top five reinsurers in 2009 accounted for roughly the same amount of the market as the top ten reinsurers in 1998 (roughly 52%). In 1991, the top ten reinsurers accounted for 35% of the market (Cummins and Weiss 2014).



financial strength have deteriorated in recent years and, although they are still characterised by a high degree of robustness, their outlook is negative (A.M.Best 2016). Furthermore, a change in business practices, such as the increased use of a special termination clause (e.g. with respect to rating triggers in reinsurance contracts) might exacerbate the problem of reinsurance and retrocession spirals.<sup>9</sup>

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### 2.2.1 Spillovers to other sectors

21. **Insurers can transmit shock across financial markets.** Within Europe and North America respectively, there could be large spillovers a between different sectors, including insurers. In Asia, non-life insurers and reinsurers seem to be highly interconnected with other sectors in the region. In terms of spillovers across the regions, Europe and North America appear to be the most interconnected, with insurers (in particular life insurers) from Europe having a high potential to transmit spillovers to the American financial market (IMF 2016a).<sup>10</sup> A separate analysis for Europe indicated that, before the global financial crisis, insurers were recipients of spillovers from other sectors although, more recently, they seem to have become a source of spillovers (IMF 2016a).
22. **Insurers may pose systemic risks arising from their funding and investment activities.** Collectively, insurers are among the largest investors in financial assets in the EU. They can contribute to systemic risks through various channels, which include taking up more risks, increasing commonality in asset composition within the financial sector, leading to increased exposure to common shocks (“tsunami risk”), or increasing procyclicality in their investment behaviour. For instance, analysis by the Bank of England concludes that the systemic risk associated with activities of the UK insurance sector that propagate or amplify shocks to financial counterparties or markets may be the greatest source of systemic risk from insurers for the UK (French et al 2015).
23. **Disruption to systemically important financial counterparties can occur if these institutions no longer have access to funding from EU insurers.** Insurers hold large amounts of debt securities and shares issued by banks and other financial institutions in the EU. From the perspective of banks’ balance sheets, these accounted for 4% of total bank funding in the euro area in 2014 (ESRB 2015), while, on average, around 13% of debt issues by euro area banks is held by insurers domiciled in the euro area and Sweden.<sup>11</sup> This figure is even higher in some EU Member States, e.g. 28% in Belgium, Greece and Slovakia and 37% in France. The ECB has emphasised that contagion risks from ownership links to banks and other financial institutions are among the most significant risks (ECB 2008). Insurers also

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<sup>9</sup> Insurance market spirals, whether reinsurance spirals or retrocession spirals, arise from the interplay of practices employed by the insurance industry to disperse risk and spread it across other insurers. While reinsurance spirals may impact primary insurers, retrocession spirals may trigger failures of multiple reinsurers at the same time, which would also have a further impact on a wide range of primary insurers.

<sup>10</sup> According to the IMF, spillovers are defined as the impact of changes in asset price movements (or their volatility) in one region/sector on asset prices in other regions/sectors, and are measured as each region’s/sector’s contribution to the total residual variance of the equity returns of all other regions/sectors.

<sup>11</sup> From the perspective of the insurers, 18% of the total financial assets of EU insurers in 2014 were investments in bank bonds (ESRB 2015).



place deposits with banks which can easily be withdrawn<sup>12</sup> and may lend cash to banks and other financial institutions through repo transactions. Taken together, if the funding activities of EU insurers were to cease abruptly on large scale, this could pose a systemic risk to other parts of the financial system.

24. **Insurers' growing participation in capital markets and their increased "non-core" activities seem to be the main reasons for their growing links with the rest of the financial sector.** According to the IMF, as a result of increased exposure to man-made catastrophes (such as terrorist attacks) and through the concentration of insurance risks in danger zones, insurers have been turning more frequently to capital markets and alternative risk transfer (ART) mechanisms to mitigate the impact of catastrophes on their balance sheets.<sup>13</sup> This has increased their links with the rest of the financial sector, including the banks, which act as counterparties to ARTs, albeit that the amount of these transactions is low. Insurers are interconnected with other financial market participants through credit default swaps and securities lending, which caused major spillovers during the financial crisis.<sup>14</sup> They are also interconnected through derivatives trades, in particular interest rate swaps (Abad et al 2016). Moreover, insurers participate in capital markets to diversify risk via credit-linked securities (Baluch et al 2011). It also seems likely that these links may be attributed to the "non-core" or "banking-like" activities of insurers, such as the provision of financial guarantees, asset lending, issuing credit default swaps, investing in complex structured securities, and an excessive reliance on short-term sources of financing (Cummins and Weiss 2014).
25. **Procyclical investment behaviour by insurers could make them more likely to transmit shocks, albeit that evidence to date has been mixed.** Procyclical investment behaviour by insurers as a group may exacerbate the tendency for financial markets to experience "booms" and "busts". The capital position of other financial and non-financial institutions could then deteriorate by a fall in the market prices of financial assets held, which could lead to second-round effects resulting from fire sales and liquidity spirals (Brunnermeier and Pedersen 2009). Evidence of insurers in the EU demonstrating procyclical investment behaviour has so far been mixed (Bank of England and Procyclicality Working Group 2014; Bijlsma and Vermeulen 2015, Timmer 2016).
26. **Some insurers are directly interconnected with other parts of the financial sector since they are part of financial conglomerates.** There were 83 financial conglomerates in Europe in 2016, up from 75 in 2009 (Joint Committee of European Supervisory Authorities 2016). Insurer-led conglomerates are the second most common type of conglomerate after bank-led conglomerates (Chart 1) – an insurance entity often forms part of a bank-led conglomerate, since those conglomerates traditionally follow a bancassurance model. They are also present in conglomerates led by asset managers or pension funds, which have gained prominence over the last decade. In general, insurer-led conglomerates tend to be smaller than bank-led conglomerates (European Commission 2010c) and some of these only operate locally. At the same time, the 30 largest financial conglomerates, most of which have an insurance entity,

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<sup>12</sup> This was, for example, the case in Greece in 2014 (ESRB 2015).

<sup>13</sup> The data on ART is for the US insurance sector only. There is a lack of EU data on this.

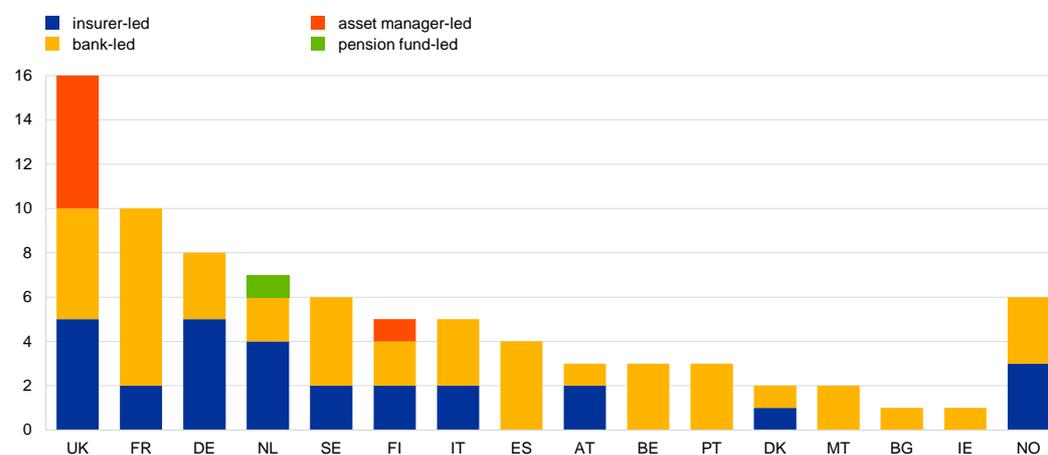
<sup>14</sup> See, for example, Cummins and Weis (2014); Dungey et al (2014) and Pierce (2014).



belong to the biggest financial groups in Europe: ten of the 13 EU G-SIBs and three out of five EU G-SIIs are also financial conglomerates.<sup>15</sup>

Chart 1

**Number of financial conglomerates by type and domicile (2016)**



Source: JC of ESAs (2016) and ESRB based on national data.

Note: Data for the UK also include four conglomerates with the head of group outside the EU/EEA.

27. **A financial conglomerate may pose high risks of contagion spreading from one part of the conglomerate to the others.** Conglomerates have certain benefits, e.g. in terms of risk diversification and the reinforcement of commercial capacity. This comes, however, with additional costs in terms of interdependencies and, therefore, higher risks of contagion between group entities. The intensity of the interconnections within a conglomerate depends on what strategy the conglomerate employs to combine activities in different sectors. There could be financial (e.g. intra-group transactions), operational (e.g. shared services) and commercial links<sup>16</sup> and, moreover, there could also be reputational risks. For instance, the failure of the insurance part of a financial conglomerate could lead to the significant degradation of the financial position of other parts through the reputational channel. Contagion could also spread in the other direction, e.g. the financial position of the insurance part could deteriorate if another part were no longer able to reimburse a loan granted by the insurer or if a breakdown of the banking agent network had materially affected the distribution model of the insurance part. As parts of financial conglomerates, the distress or failure of the insurance part could have a direct impact on other parts, and vice versa.
28. **The degree of interconnectedness is one of the key elements in the global assessment of systemic importance of insurers.** The global financial crisis highlighted the consequences of the close interconnectedness of the financial sector. This resulted in the FSB placing high importance on the degree of interconnectedness in its G-SIFI framework.

<sup>15</sup> G-SIBs refer to global systemically important banks and G-SIIs to global systemically important insurers. Both G-SIBs and G-SIIs are designated annually by the Financial Stability Board.

<sup>16</sup> Financial interconnectedness is related to intragroup transactions, operational interconnectedness to shared supporting systems and services (e.g. IT), and commercial interconnectedness arises when a common distribution channel is used by different parts of a conglomerate.



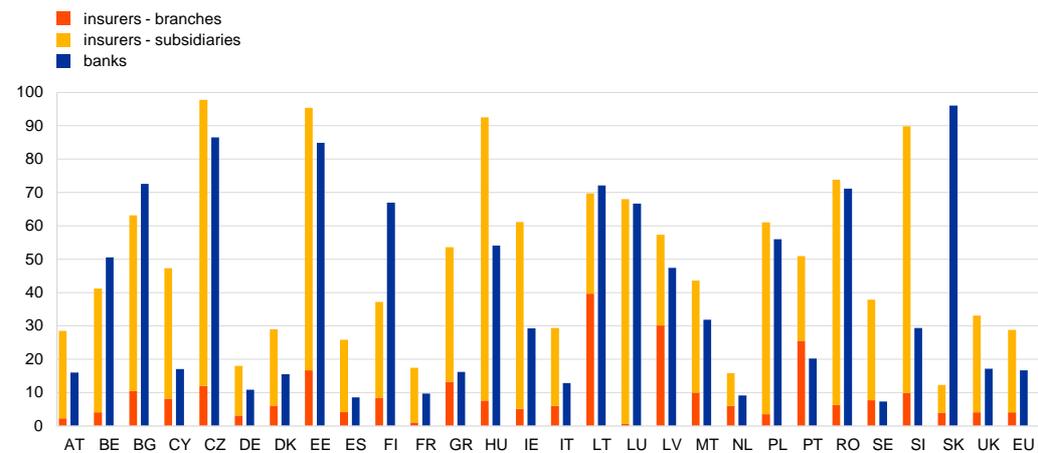
The IAIS approach weighted the interconnectedness category for insurers with almost 50% (IAIS 2016c). The indicator covers both direct exposures via the counterparty exposure channel and indirect exposures of insurers to the macroeconomy via the macroeconomic exposure channel.

## 2.2.2 Cross-border spillovers

29. **Cross-border activity of primary insurers in the EU is high.** Considering both subsidiaries and branches, the cross-border activity is more prominent in the EU primary insurance sector than in the EU banking sector (Chart 2). For their EU cross-border business, EU insurers operate mostly via separate legal entities in the form of subsidiaries. On average, only 3.5% of gross premiums is written by foreign EU branches. Branches are, however, significant in some EU Member States and their connections still form a dense and diversified network within the EU insurance sector. As Chart 3 shows, in some cases the direction of exposures of branches goes from small EU Member States (in terms of the size of the economy and the financial sector) to large EU Member States. This means that even if the exposure is small for the country in which the branch is located it could be large for the country in which the insurer is domiciled. This argument also applies to exposures via subsidiaries.

Chart 2

### Cross-border activity in the banking and insurance sectors within the EU (2012, %)



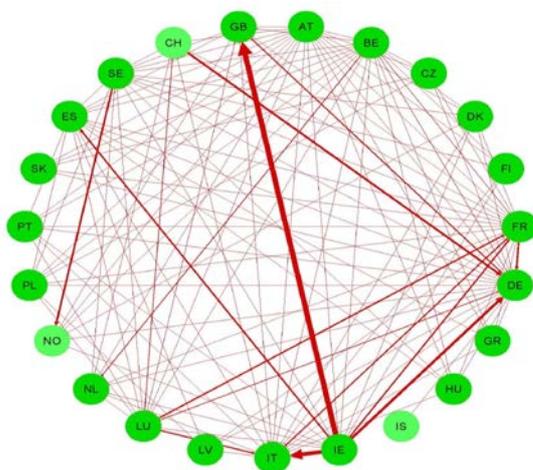
Source: EIOPA (2016), based on Schoenmaker and Sass (2014).

Note: Data refer to 2012. Cross-border activity in the insurance sector is measured as the percentage of gross written premiums written by subsidiaries and branches controlled by foreign enterprises located in the EU. For the banking sector, cross-border activity is measured as the total amount of foreign lending (assets) as a percentage of total lending (assets). The chart illustrates the cross-border activity in the EU coming from other EU Member States only. The EU uses a simple average across all EU Member States.



Chart 3

**Network of exposures in terms of insurance branches (2014)**



Source: OECD Insurance Statistics 2015. ECB Exchange Rate Statistics used for currency conversion.  
Note: Data refer to 2014, and to business written abroad by EU/EEA insurers through branches and agencies. The thickness of the lines is relative to the size of the business. Non-EU EEA countries (CH, IS, NO) are shown in light green.

30. **The reinsurance sector is traditionally an international business, with EU-based reinsurers playing an important role.** The international nature of the reinsurance business serves to diversify exposures to risk in the insurance sector. In particular, the EU-domiciled reinsurers account for more than 45% of gross premiums written worldwide (A.M. Best 2014).<sup>17</sup> Moreover, in terms of the relative transfer of risks between geographic regions, aggregated gross reinsurance premiums assumed and ceded by regions show that European reinsurers are – in contrast to any other region – “net insurance risk takers” (IAIS 2017).<sup>18</sup>
31. **The failure of an insurer could have cross-border spillover effects.** Given the high degree of cross-border activity in the EU insurance sector, the failure of a cross-border insurance entity in one country could impact financial stability in other countries. Similarly to financial conglomerates, the effects relate primarily to financial (e.g. intra-group transactions), operational (e.g. shared services), commercial and reputational links. They will differ depending on the nature and intensity of interconnectedness within an insurance group, and on whether cross-border insurers operate in host countries through subsidiaries or through branches. Analogously, the failure of a reinsurer with a large international portfolio could have repercussions in several countries due to the nature of their business associated with retrocession and reinsurance spirals, as well as a high level of concentration in the reinsurance market.

<sup>17</sup> This figure increases to more than 60% if Swiss reinsurers are also included.

<sup>18</sup> This is a persistent finding over time. See also previous reports (e.g. IAIS 2012).

## 2.3 Systemic risks associated with a low interest rate environment

32. **The LIR environment increases the likelihood of insurers' failures, particularly in the life sector.** The current LIR environment highlights how the systemic importance of insurers may change over time. Globally, the outlook for many insurance companies continued to deteriorate in 2016 as expectations of an extended period of low interest rates rose (IMF 2016) and, even though Europe has shown some economic recovery, interest rates are likely to remain low for some time. The LIR environment is not a risk in itself, although it is a trigger for vulnerabilities, in particular in respect of life insurance.<sup>19</sup> Therefore, if the LIR environment extends into the future, it is likely to weaken the resilience of the insurance sector across the EU. Despite the varying exposure of national insurance sectors to this risk, the impact on the insurance sector would be noticeable in all EU Member States.
33. **The 2016 EIOPA stress test showed that in a prolonged LIR environment a significant number of EU insurers would lose a substantial part of their assets over liabilities.**<sup>20</sup> In a situation of secular stagnation with yields remaining low for a long period of time, insurers would experience a highly negative impact on their excess of assets over liabilities and own funds.<sup>21</sup> In particular, insurers with long-term life policies involving interest rate guarantees could face difficulties keeping their financial promises. If rates stayed low for long, a situation could arise where policies would continue to pay out a return that is higher than incoming returns on assets. In such an environment, relatively high interest rate guarantees on liabilities with a longer payout period would weigh on the profitability and solvency of these companies over time, which could eventually lead to failures. The evidence shows that the insurance sector is reacting to the LIR environment by shifting towards policies with lower or no guarantees for new contracts (ESRB 2016b).
34. **The likelihood of a "double-hit" scenario has also increased.** If the LIR environment were combined with a sudden increase in risk premia there would be a risk that life insurers in several countries could simultaneously come under stress. The 2016 EIOPA stress test shows that European insurers are highly sensitive to this scenario, which would negatively impact on their excess of assets over liabilities and own funds.<sup>22</sup> However, the impact would not be equally spread among the different insurers or national markets. Even though the failure of an individual insurance company may not be systemically important, if it failed at the same time as other insurers it might contribute significantly to systemic risk. Against this background, the common vulnerability to a "double hit" from low interest rates and declining asset prices is

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<sup>19</sup> Non-life insurers are experiencing less pressure due to their shorter investment horizons and the possibility of repricing existing contracts.

<sup>20</sup> The exercise involved 236 insurance undertakings at solo level, from 30 European countries (EIOPA 2016c).

<sup>21</sup> According to the 2016 EIOPA stress test results, at an aggregated level, the "low-for-long" scenario resulted in a fall in the excess of assets over liabilities of about EUR 100 billion, with insurers representing 16% of the sample losing more than a third of their excess of assets over liabilities. If long-term guarantees (LTG) and transitional measures were not included, 25% of the sample lost more than a third of their excess of assets over liabilities in the low-for-long scenario. No impact on groups was considered.

<sup>22</sup> According to the 2016 EIOPA stress test results, the so-called "double-hit" scenario (reflecting a sudden increase in risk premia in conjunction with the low yield environment) had a negative aggregated impact on the undertakings' balance sheets of close to EUR 160 billion (-28.9% of the total excess of assets over liabilities) with more than 40% of the sample losing more than a third of their excess of assets over liabilities. If LTG and transitional measures were not included, almost 75% of the sample would lose more than a third of their excess of assets over liabilities. It should be noted that the "double hit" scenario reflects a very extreme and rare combination of events.



viewed as one of the most prominent systemic risks, possibly leading to cascading failures in the sector (ESRB 2016a).

35. **The changing nature of the insurance business exposes insurers to new types of risks and increases their interconnection with the rest of the financial sector.** For example, the ESRB has identified that, as a result of structural changes in investments and product offerings by life insurers, liquidity risks in the life insurance sector could become more prominent than in the past. This is due to (i) the risk of selective redemptions by policyholders when insurers invest in less liquid and long-term assets (e.g. infrastructure and real estate), (ii) the transfer of investment risk to policyholders, including the broader provision of unit-linked/defined contribution models, which are more easily surrendered at short notice, and (iii) a move into bank-like savings products without adequate expertise and risk management (ESRB 2016b). Moreover, with greater integration into financial markets, life insurers are more exposed to risks stemming from other sectors, in particular through (i) higher lending to banks and (ii) an increase in the impact of risk factors shared with the investment fund sector due to greater product similarity following the shift to unit-linked products (ESRB 2016b).
36. **A protracted LIR environment could also induce some insurers to increase investments in risky and/or less liquid assets with a higher return, thus exposing them to a higher probability of distress (search-for-yield behaviour).** The move towards less liquid and higher-risk assets such as stocks, infrastructure and real estate could occur, in particular, in life insurance and long-tail non-life (casualty) insurance, although risk-oriented capital requirements in Solvency II could mitigate this development. Although no shift of portfolios towards riskier categories of assets has been generally observed throughout the insurance sector, firm-level case studies suggest that smaller life insurers, in particular those with weaker capital positions and those with higher shares of guaranteed liabilities, tend to take on more risk (IMF 2016). This riskier behaviour could be also relevant for reinsurers, given the high level of competition they face as other investors offer an alternative to traditional reinsurance and drive down prices.

## 2.4 A recovery and resolution framework for insurers from a macroprudential perspective

37. **In this context it is worth revisiting the need to strengthen the RR toolkit at national level and to examine the case for a harmonised RR framework in the EU.** New challenges and developments in the insurance sector mean that the existing legal and institutional frameworks should be revisited across the EU in order to assess their sufficiency to address systemic risks in the insurance sector in an effective manner, without creating unnecessary distortions to other financial sectors or countries. An effective RR framework should provide authorities with a set of early intervention tools in order to deal with, in a timely manner, distressed insurers under a “going-concern” approach, and a set of resolution tools to deal effectively with a failing insurer under a “gone concern” approach.
38. **An effective resolution toolkit could mitigate the financial stability implications of a failure in the insurance sector, in comparison with normal insolvency procedure.** As the experience of the recent crisis has shown, the insolvency procedure has several shortcomings. First, it may not provide continuity of critical functions (see Box 2 on critical functions). This could mean that the key economic transactions facilitated by insurance might not be possible without policyholders incurring significant additional costs. Second, it might not be able to prevent possible contagion to other parts of the financial system. This is especially



so for large insurers (e.g. the failure of AIG), but is also the case for the simultaneous failures of small insurers. Another disadvantage of liquidation is the time required, which could result in delays of several years in the settlement of outstanding claims, possibly undermining society's trust in the insurance sector as a whole and the financial system in general.

39. **If they are equipped with a broad set of tools in the recovery phase, authorities might be better able to avoid a failure.** Insurance risks are typically “slow-burning”, including longevity risks as well as risks associated with the LIR environment. This means that they lead to failure only after a number of years if not properly addressed under the “going-concern” approach. This period of time allows supervisory action to be taken, within the limits of legal and institutional frameworks. It follows that expanding the toolkit for early intervention periods provides authorities with more options to avoid an insurer needing to be wound down, which would benefit policyholders as well as financial stability.
40. **It follows that the objectives of the resolution of insurers are both financial stability and policyholder protection, and that they are interlinked.** According to the FSB, the objectives of resolution are (without ranking): (i) to avoid severe systemic disruption; (ii) to avoid exposing taxpayers to losses; (iii) to protect vital economic functions;<sup>23</sup> and (iv) to protect policyholders (FSB 2014a). These objectives are interlinked and overlap. If vital economic functions are impaired because of a failing insurer, systemic disruptions may arise and the government might step in to bail out the failing insurer, exposing taxpayers to losses.<sup>24</sup> In the event of a capital shortfall at a life insurer, there could be an impact on consumer confidence in the financial sector as well as political pressure to bail out this insurer rather than let it enter liquidation, given the nature of its liabilities (ESRB 2015).
41. **Moreover, an effective RR framework requires taking a sectoral view, albeit subject to the principle of proportionality.** The challenges the insurance industry is facing indicate that the RR framework needs to look beyond the individual firms that could pose a systemic risk on their own. Instead, a broad perspective, where all insurers (including smaller insurers) are subject to the RR framework, is warranted.<sup>25</sup> The potential solvency problems of individual firms may lead to cascading effects that could become systemic. Although the RR framework should, in principle, cover the whole sector, its implementation should follow the principle of proportionality. For example, the benefits related to the application of certain pre-emptive measures, such as RR plans, should be considered against the additional costs of their implementation, in particular with respect to small insurers and/or insurers with less diversified product offerings and with strong capital positions. Furthermore, national authorities should have the flexibility to apply the RR tools that best suit local conditions and should also have the power to exempt some insurers from certain aspects of the RR framework, e.g. RR plans, without preventing authorities from applying all the powers at their disposal should the need arise. The principle of proportionality as explained above applies across the whole report.
42. **Strengthening existing RR frameworks for insurers across the EU could limit systemic risks following distress or failure.** Strengthening the current RR framework at national level could help mitigate financial stability concerns in the ways below.

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<sup>23</sup> The terms “vital economic functions” and “critical functions” are used interchangeably by the FSB (e.g. FSB 2014a).

<sup>24</sup> The EU state aid rules must be complied with before a state bailout is approved by the European Commission.

<sup>25</sup> As indicated by the IMF, firm-level case studies suggest that the behaviour of smaller and weaker insurers warrants the attention of supervisors (IMF 2016a), since they tend to take on relatively more risk.



- Critical functions could be identified in RR planning and could be better protected in resolution.
- Strengthening frameworks could encourage better preparation for crises and the early implementation of preventive actions. For example, measures such as RR planning and resolvability assessments could reveal potential contagion channels.
- A strengthened set of early intervention tools may help to avoid an insurer's failure, allowing national competent authorities to address a potential issue with the right tool, which would benefit policyholders as well as financial stability. Moreover, an enhanced set of resolution tools could help to avoid a liquidation in which it might not be possible to preserve critical functions, and which could also lead to a potential destruction of value.
- The exchange of confidential information in times of crisis and the requirements of coordination between the relevant authorities within the country during the resolution process would be defined and governed by a strengthened legal framework.

43. **Increased harmonisation in Europe could limit systemic risks of cross-border contagion.** Strengthening national frameworks might not be sufficient, given that insurance is an international business, with large cross-border insurers operating in several EU Member States. At the same time, the fact that a failing insurer would typically not need to be resolved as quickly as a failing bank, offers some room for national discretion. While it is recognised that the harmonised framework could provide a certain flexibility to address the national specificities of local insurance sectors, some degree of harmonisation across the EU may help to mitigate systemic risks and create a level playing field in the ways described below.

- A harmonised EU-wide RR framework would enable better evaluation of the implications for other jurisdictions of any national measure taken. This would mean that the protection of critical functions in one country would not adversely affect the critical functions in another country.
- Harmonised RR plans would make it easier for authorities to compare measures planned for distressed insurers across the EU and enable them to better analyse and mitigate any spillovers to other sectors or across borders.
- A common set of rules is particularly relevant in the event of the distress of a large international insurer conducting significant business in several EU Member States or in the event of the simultaneous distress of several unrelated insurers in several EU Member States.
- A strengthened legal framework applicable EU-wide would increase coordination and cooperation mechanisms, including information sharing, across borders. Enhanced cross-border coordination could prevent cross-border spillovers. Although coordination arrangements for supervisory colleges, including emergency planning, are currently in place,<sup>26</sup> appointed administrators or liquidators at national level or national resolution

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<sup>26</sup> See Annex 1.E of EIOPA Guidelines on the operational functioning of colleges (EIOPA 2014b).



authorities for insurers are not required to coordinate their resolution planning and actions across jurisdictions.<sup>27</sup>

- Investors and customers would be treated more similarly in all countries, which could contribute to a higher level of financial integration. This could increase trust in the insurance sector and in the EU internal market.
44. **This report recognises that a few ESRB members might hold a different view on some aspects of RR frameworks for insurers.** It is broadly recognised that RR frameworks for insurers need to be strengthened across the ESRB membership. Moreover, several authorities initiated or are considering measures to strengthen their national frameworks, either due to recent experience or to the fact that low systemic risk of insurers in the past does not guarantee the absence of systemic risk in the future (IAIS 2015). However, a few ESRB member institutions take the view that it might not be cost effective to introduce an ambitious RR framework for insurers. This reflects sparse evidence to date that traditional lines of business of insurance have generated or amplified systemic risk within the financial system or in the real economy and, that existing national frameworks have functioned properly so far. Moreover, they are of the view that national frameworks could be reinforced without the introduction of a comprehensive single EU-wide RR framework. Furthermore, since most failures of EU insurers have not impaired the EU financial system to any great extent, and given concerns over potential conflict between policyholder protection and financial stability, some authorities prefer to place higher importance on the policyholder protection objective than the financial stability objective in the RR framework for insurers, while recognising the importance of both (ESRB 2017).

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## Box 2

### Critical functions in the insurance sector

**The concept of critical functions has been developed by the FSB as part of its RR framework.** Critical functions are “essential and systemically important functions” (FSB 2013) or “vital economic functions” (FSB 2014a), for which continuity should be maintained in the resolution process while avoiding unnecessary destruction of value.<sup>28</sup> Where such functions have been identified resolution tools other than regular liquidation proceedings should be considered. The reason for this is that safeguarding critical functions is not an objective of the regular liquidation proceedings; the liquidation process could, instead, lead to the destruction of their value. Moreover, a regular liquidation process could also include the possible disruption of payments to policyholders or other financial institutions (FSB 2016).

**The FSB considers criticality in the context of the impact of a failure on the financial system and the possible substitutability of the failed insurer.** According to the FSB, the provision of

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<sup>27</sup> Title IV of the Solvency II Directive (“Reorganisation and winding-up of insurance undertakings”) provides regulation in this area in the EU. The regulation largely refers to the right of the competent authorities of the home EU Member State to take action in line with national legislation, while keeping the supervisory authorities of other EU Member States informed of the decisions. It should be noted, however, that cross-border cooperation in the form of crisis management groups and cooperation agreements are foreseen, and partially implemented, in the EU as a result of global standards for G-SIIs; although these would not necessarily apply to a population broader than the five EU GSIs.

<sup>28</sup> Critical functions, systemically important functions, essential functions and vital economic functions are used interchangeably.



insurance includes three key functions carried out by insurers which may be viewed as critical: (i) writing new business; (ii) providing insurance cover for existing business; and (iii) making payments to policyholders (FSB 2016b). Insurers also provide important non-insurance functions to third parties, such as asset management. The criticality of all functions provided by insurers varies across insurance products, insurers and jurisdictions. The FSB defines a function of an insurer as critical if it satisfies all of the following conditions: (i) it is provided by an insurer to third parties not affiliated to the firm; (ii) the sudden failure to provide that function would probably have a material impact on the financial system and/or the real economy as it would give rise to systemic disruption or undermine general confidence in the provision of insurance; and (iii) it cannot be substituted within a reasonable period of time and at a reasonable cost (FSB 2016b).

**The identification of critical functions is dependent on time and context.** The impact of an insurance failure could vary, depending on the conditions in the financial system and the economy at the time of the failure. It is, therefore, difficult to identify all critical functions prior to a resolution. For example, during the distress of an insurer it might not be possible to find a substitute insurer within a reasonable period of time and at a reasonable cost. As a result of this, certain types of insurance might become critical if a lack of substitutability of an insurer within a reasonable period of time is likely to have a significant impact on the financial system and/or the real economy. Similarly, if a reinsurer fails, primary insurers could face a situation where – for a considerable period of time – they are not able to buy reinsurance for certain risks at a reasonable cost and, as a result, they might stop underwriting these risks. The lack of substitutability might therefore justify resolution measures aimed at recapitalising the insurer so it can continue to be able to write new business, or resolution measures aimed at providing continuity in order to facilitate substitutability over time. Furthermore, the FSB also recognises that the identification of critical functions involves making a broader political and economic judgement, e.g. it might be necessary to preserve the continuity of functions that are material to the real economy, e.g. in the event of disruption of cover or payments to a significant number of policyholders, in particular in the life business (FSB 2016b).

**It may be appropriate to consider critical functions from a broader perspective.** Some elements of the previous definition have not proved very helpful in identifying critical functions in the insurance sector. It should be noted, especially in the current environment of low yields, that the failure of an insurer does not occur suddenly, but gradually. Slow-burning distress can materially impact the financial system and the real economy, undermining confidence. This type of failure should therefore be taken into account in the RR framework. Furthermore, there may be other important functions which may be worth examining in the context of insurance resolution, including pension fund management and asset management. Lastly, it might be of interest to safeguard the viable parts of an insurer.

**Furthermore, the industry-wide definition of critical functions might prove more relevant in the LIR environment.** The FSB focuses on criticality stemming from the failure of a single entity. As pointed out by the IMF, such an approach covers “domino” systemic effects, where the failure of a single entity has systemic consequences for the broader economy (IMF 2016). Another contribution to systemic risk is, however, through common exposures across firms that may endanger financial intermediation in the system as a whole in the event of an adverse shock, referred to as “tsunami” systemic effects. In the LIR environment, which raises the possibility of an extreme severe double-hit scenario, no individual failing insurer might have a significant impact on financial stability on its own, but if several insurers were to fail simultaneously they might collectively produce a material systemic effect.

**For the purpose of this report, a broader perspective is taken in respect of criticality, and the report advocates further discussion of critical functions in the insurance sector.** Within the



spirit of the FSB statement that criticality is not a binary concept and that there is a spectrum of criticality (FSB 2013), the report goes beyond a narrow interpretation of the FSB definition of critical functions in the insurance sector. A critical function, in the context of this report, is understood as any function of an insurer or a group of insurers, which (if not provided) might have a significant impact on the financial system or the real economy. On the back of these considerations, it is recognised that the definition and the scope of critical functions merit further discussion, both at European and global level, i.e. when a harmonised EU-wide RR framework is being developed, in order to adequately cover all critical functions worth preserving, from both an individual-firm and an industry perspective.

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## Section 3

# International and European initiatives on recovery and resolution for insurers

### 3.1 Introduction

45. **This section provides an overview of recent initiatives in both a global and a European context.** It describes the work of the IAIS and the FSB, with a special focus on the approach to G-SIIs. It shows how some of the ideas developed for G-SIIs are being integrated into the IAIS Insurance Core Principles (ICPs) for all insurers. Moreover, the section describes the initiatives at European level, in particular by the COM and EIOPA. It would appear that, in the absence of a harmonised approach, several national initiatives aimed at reinforcing national RR frameworks are increasingly under consideration.

### 3.2 Global initiatives

46. **At a global level, the IAIS and the FSB are the main driving forces establishing the principles of recovery and resolution (RR) in the insurance sector.** The IAIS is the global standard-setter for the insurers. In addition, it participates in a global initiative, under the purview of the FSB and the G20, to identify global systemically important insurers (G-SIIs), whose failure or distress, it has been recognised, would have financial stability implications due to their size, market importance or global interconnectedness. The IAIS developed the initial assessment methodology as well as policy measures to be applied to G-SIIs. The designation of G-SIIs, however, is the responsibility of the FSB.
47. **The RR standards envisaged by the IAIS are currently structured in three layers.** They differ according to the importance of insurers in terms of their size, the intensity of their cross-border activities and their systemic importance (Table 1). The additional layers dealing with complex undertakings were developed following the 2008 financial crisis. The near collapse of a few large financial conglomerates (including cross-border insurers) during the global financial crisis led the IAIS to publish a proposal for the resolution of cross-border entities and groups in 2011, which is currently being discussed as part of ComFrame,<sup>29</sup> the framework for internationally active insurance groups (IAIG). Moreover, the G-SII package was released in 2013 and provides a broader list of policy measures for RR, although these are applicable to designated G-SIIs only.
48. **The work to harmonise the approaches to the G-SII standards is ongoing.** Both the relevant IAIS Insurance Core Principle for RR, namely ICP 10<sup>30</sup> (for recovery) and ICP 12<sup>31</sup> (for resolution) are currently under revision. Moreover, work is ongoing to integrate ComFrame for IAIG into ICPs, including the M3E3 element (for both recovery and resolution).<sup>32</sup> As such,

<sup>29</sup> The Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). It is also expected that the ComFrame will later be integrated into the ICPs.

<sup>30</sup> ICP 10 on preventive and corrective measures.

<sup>31</sup> ICP 12 on winding-up and exiting from the market. This was originally referred to as ICP 16 and was first published in 2006.

<sup>32</sup> In August 2016, IAIS released a draft Module 3 Element 3 (so called "M3E3") part of ComFrame, which deals with RR.



the M3E3 will no longer exist as a standalone standard for IAIG, although the considerations with regard to IAIG will be kept. The current ICP 12 requires the national authorities to have the liquidation option available only for failing insurers. Moreover, this standard applies primarily to individual insurers and does not address an insurer's failure from a cross-border or group perspective. The revised ICP 12 standard is expected to be approved by the end of 2017 and should include new aspects of the RR framework, thereby making it more consistent with the approach for G-SIIs.

Table 1  
International standards on RR

	Individual Insurer (group)	IAIG	G-SII
ICPs	ICP 10 (for recovery) and ICP 12 (for resolution, both ICPs are under review)		
ComFrame		M3E3 (under review)	
G-SII package			G-SII measures

Source: ESRB.

49. **Financial stability considerations have caused a broadening of RR standards.** In general, the protection of policyholders is viewed as a priority in winding-up. In ICP 12 (as it currently stands), the winding-up procedure is understood as a tool that minimises disruption to the timely provision of benefits to policyholders. Since the crisis, however, focus has shifted more towards financial stability considerations, in the recognition that the distress or failure of some insurers might cause a dislocation in the global financial system, with adverse economic consequences across a range of countries.<sup>33</sup>
50. **Winding-up and run-off is still appropriate for traditional business lines with limited cross-border implications, but changes in market structure call for new policy tools to be considered.** According to ICP 12, all jurisdictions should introduce necessary procedures into their legislation for the exit of an insurer from the market, giving the supervisory authority the power to close an insurer. However, experience of the recent crisis has led the IAIS to note that the tools available to insurance supervisors to resolve insurers with cross-border business activity have not kept pace with the evolution of the groups themselves in terms of their complexity and their geographical and cross-sectoral interconnectedness (IAIS 2011b). For this reason, the future ICP 12 will be more consistent with the approach taken in respect of G-SIIs. The standard will stipulate that a series of tools – such as run-off, portfolio transfer, writing down or restructuring liabilities including insurance liabilities – should be available to the resolution authority, provided their use respects the no-creditor-worse-off (NCWO) principle.
51. **With so little global guidance, several issues might arise in dealing with a cross-border resolution.** The IAIS notes that there is currently no international insolvency framework for insurers (IAIS 2011b). Moreover, relations in the resolution process between viable and non-viable entities, as well as relations between insurance and non-insurance entities, including cross-sector regulated entities and non-regulated entities (such as holding companies), raise

<sup>33</sup> In line with the FSB definition of G-SIIs.



further issues for dealing with a resolution in a group-wide context. As a reaction, the future ICP 12 will also comprise standards on (international) cooperation in resolution.

52. **The work on G-SIIs builds upon the FSB Key Attributes (KAs) of effective resolution regimes.** First published in October 2011, the KAs were updated in 2014 with additional guidance, including insurance sector-specific guidance (Annex II). The KAs set out the core elements of an effective national resolution regime for systemically important financial institutions (SIFIs) that does not rely on taxpayers' funds. In June 2016, the FSB provided further guidance on developing resolution strategies for systemically important insurers, specifically in respect of determining a preferred resolution strategy based on an analysis of insurers' business models, the criticality of insurers' functions and policyholder protection arrangements, as well as elements for making the resolution strategy feasible and credible. These include, among other things, the capacity to absorb losses in resolution (FSB 2016, § 3.6).
53. **The policy measures for G-SIIs include enhanced supervision, effective resolution and higher loss absorption capacity.** The IAIS is working towards applying these measures to G-SIIs, reflecting the greater risk that these institutions pose to the global financial system. The measures are designed to reduce moral hazard and the negative externalities that would stem from the potential disorderly failure of a G-SII. In particular, they aim at reducing the probability and impact of a failure of G-SIIs, incentivising G-SIIs to become less systemically important, and giving non-G-SIIs strong disincentives to become G-SIIs. Effective resolution of G-SIIs includes: the establishment of crisis management groups (CMGs); the preparation of RR plans, including a liquidity risk management plan and a systemic risk management plan; the carrying out of resolvability assessments; and the adoption of institution-specific cross-border cooperation agreements. Greater loss absorption capacity is intended to internalise some of the costs to the financial system and the overall economy, make G-SIIs more resilient to low-probability but high-severity events, and act as a disincentive to carrying out activities that pose a threat to the financial system.
54. **Five insurers headquartered in four EU Member States have been identified as global systemically important insurers (G-SIIs).** G-SIIs are designated on an annual basis by the FSB, which has identified nine insurers as G-SIIs since 2013, of which five are headquartered in the EU (Table 2). Jurisdictions with G-SIIs are expected to apply the agreed policy measures (outlined in the previous paragraph) to their respective G-SIIs.

Table 2  
List of European G-SIIs

Aegon N.V. (NL, as of 2015)	Allianz SE (DE)
Aviva plc (UK)	Axa S.A. (FR)
Prudential plc. (UK)	

Source: FSB.

Note: Another European insurer – Assicurazioni Generali S.p.A. (IT) – was designated as a G-SII in 2013 and 2014.

55. **The IAIS updated its methodology for the identification of G-SIIs in mid-2016.** While the assessment methodology used to identify G-SIIs also applies to reinsurers, all global reinsurers have so far been below the threshold designated by the IAIS. The IAIS released an updated G-SII assessment methodology in mid-2016, which will be used by the FSB to identify insurers as G-SIIs as of 2017, using end-2016 data (IAIS 2016c). The new



methodology aims at better capturing the heterogeneity across the industry by the structured use of both quantitative and qualitative elements, including the use of absolute reference values for the reinsurance-related indicator, in order to effectively measure the global systemic importance of reinsurance activities and related risks. Furthermore, a reinsurance supplement assessment has been introduced to provide an in-depth analysis of insurers with significant third-party reinsurance activities. Moreover, as is the case in the banking sector, domestic SIIIs could be established in individual jurisdictions under domestic regulatory arrangements, and may follow different definitions and timelines, although this approach has not yet been adopted in the EU.

56. **Insurance guarantee schemes (IGSs), also known as policyholder protection schemes, provide a minimum level of compensation to policyholders and the IAIS has recognised that they can also contribute to an orderly resolution.** The IAIS published a paper in 2013 summarising the main guidance and core principles relating to this issue (IAIS 2013). It recognised that IGSs could contribute to the objectives of resolution by facilitating the continuing provision of insurance, providing financial support to an entity intending to purchase an insolvent insurer (or to which insurance policies would be transferred), or by working as a bridge institution. As such, IGSs contribute to maintaining public confidence and stability in the insurance sector and in the financial system in general.

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### Box 3

#### Insurance RR in light of other sectoral RR initiatives

**The KAs have been used as the main reference for RR frameworks covering financial institutions of all types whose failure could be systemic.** They were first published in 2011 and updated in 2014 to accommodate sector-specific considerations. Annex 2 provides an example dealing with the insurance sector. The sector-specific guidance recognises that not all KAs are equally relevant and might need to be adapted for effective implementation in a particular sector. The sector-specific guidance therefore sets out how KAs should be understood in a sector-specific context.

**Global standards for RR are being implemented at different speeds.** The banking sector is a frontrunner, with the policy framework being implemented in most FSB member states, in particular in G-SIBs' home jurisdictions. The first G-SIIIs were identified in 2014, and the policy framework was slowly implemented throughout FSB member states. Recently, the focus of the work has shifted towards developing RR standards for central counterparties (CCPs).

**Furthermore, the EU approach to RR for insurers differs from that taken in other sectors.** The KAs were developed for G-SIFIs, yet the EU has expanded the RR framework to all credit institutions in the EU, including third-country subsidiaries. The EU RR framework for the banking industry has been fully operational since 2015, and includes a single resolution authority. Similarly, the EU recognises all EU CCPs as being systemically important and, as such, the European Commission's proposal regarding the RR of CCPs, which was published at the end of 2016, has been expanded to all CCPs domiciled in the EU. In both cases the EU has been seen as a first mover, releasing its first proposals for RR frameworks while the global standards were still being developed. In contrast to the banking sector and financial market infrastructures, no legislative initiative at EU level has so far been undertaken in respect of RR standards for insurers.

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### 3.3 EU initiatives

57. **The European Commission (COM) and EIOPA are the main driving forces in respect of the insurance sectors at EU level.** Crisis prevention and crisis management are two of EIOPA's key responsibilities.
58. **The COM initiated a discussion on insurance RR, but no concrete proposals have been followed up yet.** In 2012, the COM launched a consultation on the possible framework for the RR of non-bank financial institutions, including primary insurers and reinsurers (European Commission 2012). The aim of this consultation was to gather the views of stakeholders as to the possibility of developing an RR framework in Europe. In 2013, the Expert Group on Banking, Payments and Insurance (EGBPI) was set up as a consultative body whose role was to help the COM prepare draft delegated acts in the area of banking, payments and insurance.<sup>34</sup> An exchange of views on insurance RR took place at the EGBPI meeting in March 2015. At that time there seemed to be no consensus among EU Member States on the need for an EU-level regulatory initiative on this matter (European Commission 2015 and EGBPI 2015). Furthermore, in 2016, Jonathan Hill, then Commissioner for Financial Stability, Financial Services and the Capital Markets Union, stated that new EU regulation on that matter was not considered to be a priority at that time.<sup>35</sup>
59. **In November 2014 EIOPA adopted a set of Sound Principles to help National Competent Authorities (NCAs) in developing their crisis prevention, management and resolution frameworks (EIOPA 2014a).** The stated overarching goal of EIOPA's initiative was to support the stability of the EU financial system and the protection of policyholders. The principles are consistent with the FSB's KAs and represent a repository of sound principles in the field of crisis prevention, management and resolution with regard to insurance, arguing, for example, that RR plans should be drafted, at least for systemically important insurers, in a pre-emptive and proportionate way.
60. **The analyses, conducted by both the COM and EIOPA, have noted a remarkably high degree of heterogeneity among EU Member States regarding their RR frameworks and IGSs, which could inhibit cross-border cooperation in the event of a failure.** The series of surveys were conducted with the aim of reaching a better understanding of the situation in EU Member States. In 2010, the COM published a White Paper on IGSs, accompanied by an impact assessment. This was followed by an EIOPA report on cross-border cooperation mechanisms between IGSs in the EU, published in 2011 (EIOPA 2011). With regard to crisis management, EIOPA conducted its first survey on crisis prevention, management and the resolution preparedness of NSAs in 2013 (EIOPA 2013) and, more recently, it published a discussion paper on potential harmonisation of recovery and resolution frameworks for insurers (EIOPA 2016b), followed by an EIOPA opinion on the same subject (EIOPA 2017), which both included a comprehensive overview of national RR frameworks for insurers.
61. **The ESRB and EIOPA have pointed out that EU improvements plus harmonisation of the RR and IGS frameworks for the insurance sector could help, also in light of the risk of a prolonged LIR environment.** The ESRB stated in early 2016 that IGSs and RR

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<sup>34</sup> The **EGBPI** is a consultative entity composed of experts appointed by EU Member States in order to provide advice and expertise to the Commission and its services in the preparation of draft delegated acts in the area of banking, payments and insurance

<sup>35</sup> **European Commission – SPEECH/16/274, Extract from speech by Commissioner Jonathan Hill**



arrangements at national level may not be sufficient to handle episodes of widespread financial stress involving the simultaneous failures of life insurers in several countries (ESRB 2015). In its strategy paper on macroprudential policy beyond banking, the ESRB stressed that a proposal for an RR framework for insurers should be a priority from a macroprudential perspective (ESRB 2016a). Recently, against the background of the protracted LIR environment, the ESRB has established that further improvements and harmonisation of RR frameworks for insurers could help facilitate an orderly exit from the market for insurers who are unable to adapt their business models (ESRB 2016b). Furthermore, EIOPA's discussion paper provides, *inter alia*, a rationale for harmonisation and puts forward preliminary ideas for the building blocks of a minimum harmonised RR framework for insurers in the EU (EIOPA 2016b), which were further elaborated in EIOPA's opinion (EIOPA 2017).

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#### Box 4

#### RR framework and financial conglomerates

**In the EU, a Directive governing the supervision of financial conglomerates supplements the relevant sectoral legislation.** A typical large conglomerate has over 400 licences over several jurisdictions and several sectors, while the biggest conglomerates may have over 900 legal entities or licences (European Commission 2010c). It had already been recognised by 1999 that large and complex groups, which combine licences in various sectors of the financial system, need additional supervision so they can effectively monitor, ring fence, limit and influence activities which may spread risks between the entities of a financial conglomerate (European Commission 2010c). The objective of this supplementary supervision was to control for the risk of double gearing (i.e. multiple use of capital) and risks which are not sector specific, such as the risk of contagion, management complexity, concentration and conflicts of interest which arise when licences for different financial services are combined in a single conglomerate. The Financial Conglomerates Directive (FICOD)<sup>36</sup> was the EU's response to this need, supplementing sectoral legislation.

**The recent crisis has shown the difficulty of resolving a troubled conglomerate.** The near failure and bailout of the American International Group (AIG), a US-based insurance-led conglomerate, is the most prominent example. The near failures of the ING Group, the Aegon Group and SNS Reaal, all financial conglomerates based in the Netherlands, are also worth mentioning. All three provided bancassurance, ING being a bank-led, Aegon an insurance-led and SNS Reaal a symmetric financial conglomerate (IAIS 2011a). In 2004 AIG was the largest insurer in the world (IAIS 2011a), but it came under extreme pressure during the financial crisis due to its involvement in non-traditional non-insurance (NTNI) activities, primarily through a non-insurance subsidiary specialising in over-the-counter derivatives trades. Simultaneously, AIG's life insurance subsidiaries also experienced significant liquidity and capital stress as a result of the massive losses it incurred in the securities lending program and from intra-group investments. With regard to the Dutch financial conglomerates, bank entities faced acute liquidity problems due to the overall loss of confidence in financial markets, while insurance entities suffered large losses on their investment portfolios. Moreover, there were also signs of reputational effects impacting the groups.

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<sup>36</sup> Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurers and investment firms in a financial conglomerate (FICOD).



Both the US and the NL governments concluded that the potential failure of their respective conglomerates would create systemic risks and decided to bail out the groups instead.<sup>37</sup>

**No regulation specifically addresses the resolution of financial conglomerates as a whole in the EU.** Instead, sectoral legislation is applied if a financial conglomerate fails. The BRRD applies fully to bank-led conglomerates, and in those cases the group-level resolution authority would be a banking resolution authority.<sup>38</sup> This authority, together with the resolution authorities of subsidiaries within the scope of the BRRD, would have the power to draft the group resolution plan. The group recovery plan should, *inter alia*, include a detailed description of all financial, operational and commercial interconnections within the conglomerate and should suggest options to ensure the continuity of shared services, e.g. between the bank entity and the insurer entity. Moreover, it would need to take into account the specificities of the different types of business lines covered. So far, only the banking RR regulation has been harmonised across the EU, while national RR regulations apply to the insurance entities of a financial conglomerate. For internationally active insurance-led conglomerates, the creation of a harmonised RR framework for insurers in the EU would have the advantage of enhancing the consistency of resolution regimes across sectors and jurisdictions.

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### 3.4 Current status and recent initiatives at national level

62. **There are significant differences across the EU.** Based on information provided by 30 NSAs, EIOPA's results reveal that there are major differences in respect of the RR measures available across EU Member States (EIOPA 2016b and EIOPA 2017). Besides taking stock of the available powers and tools, it also captured different stages of crisis management and it included questions on cross-border cooperation and coordination and IGSs. The main results are summarised in this section.
63. **In general, the authorities make limited use of pre-emptive RR plans as there are constraints on the early intervention powers available to national authorities.** The use of recovery and resolution planning and resolvability assessments is currently essentially limited to designated G-SIIs – their expansion to IAIGs is at an early stage. Some early intervention powers are common throughout the EU, such as the power to require insurers to make additional provisioning and the power to require the removal of members of the management body, directors or managers (EIOPA 2016b and EIOPA 2017). Other, more intrusive powers, such as the power to require the sale of subsidiaries and the power to require the transfer of financing operations to the parent company, are much less common. Furthermore, in many cases the exercise of the powers is subject to a variety of conditions or prerequisites (e.g. a breach of the Solvency Capital Requirement (SCR)), which may inhibit supervisors' ability to intervene at a sufficiently early stage to prevent the disruption of an insurer.

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<sup>37</sup> It should be noted that the insurer subsidiaries of bank-led conglomerates were among the beneficiaries of the bailout, receiving around 30% of state support in the case of AIG and ING and 60% in the case of SNS Reaal (IAIS 2011a). It is a positive outcome that all insurers repaid their state loans, however the indirect costs related to this exercise have not yet been calculated (e.g. in terms of the costs of personnel or the costs of the winding-down of some parts of these companies, which is still ongoing).

<sup>38</sup> Articles 12.1 and 3 of the BRRD.



Chart 4

**Resolution tools in the insurance sector**



Source: EIOPA (2017)

**64. Significant differences were also identified in the resolution approaches in the different EU Member States.** These differences refer to the issues below.

- *Resolution authorities.* Only two EU Member States have a designated resolution authority for insurers. The relevant NSA and/or a relevant ministry are usually in charge of the winding-down of insurers.
- *Objectives of the resolution.* In most EU Member States the national framework does not set out specific objectives for resolution, but specifies instead more general objectives for the NSA to pursue. In most countries the main objective is the protection of policyholders, followed by maintaining financial stability.
- *Entry into resolution.* In most EU Member States there are no specific conditions for entry into resolution. In general, the approach is based on the conditions for winding-up/liquidation and/or those related to a breach of the Solvency II requirements (EIOPA 2016b and EIOPA 2017).
- *Resolution powers.* Traditional tools, such as the withdrawal of authorisation, putting the company into run-off or transferring the portfolio, are widely available. However, other resolution powers (such as the transfer of reinsurance contracts, measures affecting policyholders' rights in relation to insurance contracts or the restructuring of (re)insurance liabilities), are not common in the EU (see Chart 4).



- *Safeguards*. The resolution of insurers is subject to the no-creditor-worse-off (NCWO)<sup>39</sup> principle in ten EU Member States, and that four EU Member States' national authorities also make reference to the ability to depart from the pari passu principle in order to maximise value for all creditors, including policyholders, as a whole (EIOPA 2016b and EIOPA 2017).
65. **There is also significant heterogeneity across the EU in respect of resolution funding and insurance guarantee schemes (IGSs).** Only Romania has set up a resolution fund. Moreover, while bank depositors are covered by up to €100,000 in the event of the failure of a bank, according to the EU Directive on deposit guarantee schemes<sup>40</sup>, European policyholders do not have a similar harmonised level of protection. According to the COM's White Paper on IGSs, only 12 EU-EEA countries operate one (or more) general IGSs, leaving around 26% of all life insurance policies and 56% of all non-life insurance policies unprotected (European Commission 2010a). More recently, EIOPA showed that this number has increased, although many of these have very limited coverage (EIOPA 2016b and EIOPA 2017). The IGSs also differ in scope, operational procedures, funding arrangements and main functions. In addition to the compensation of policyholders for losses in the event of liquidation, some could also fund the transfer of an insurer's portfolio to a bridge institution or other insurer (thus staying closer to the functions of a resolution fund). For further analysis, please refer to Section 5.
66. **The resilience of IGS frameworks in the EU has not been tested for the failure of large insurers.** The ESRB notes that current schemes in the EU are appropriate in the event of the failure of small insurers partly due to the long-term nature of insurers' winding-up proceedings given their long-term liabilities (ESRB 2015). However, the resilience of current IGSs has not been tested by the failure of a large insurer, or by the simultaneous failure of several large insurers.
67. **There are generally no specific cross-border coordination and cooperation arrangements for crisis situations.** Apart from the designated G-SIIs, there are often no (formal) crisis management groups or other equivalent arrangements in place, and the existing supervisory college structures act as a partial substitute. In addition, in a crisis a distinction is made between domestic and cross-border business. For example, the way existing IGSs are designed means that domestic insurance business activity is better protected than cross-border business activity via branches. The impact assessment accompanying the Commission White Paper found that while a third of domestic activity is not protected, the proportion rises to just under half for cross-border activity (European Commission 2010b).
68. **Some NSAs reported gaps and shortcomings in their existing frameworks.** Almost half of the NSAs reported shortcomings in the existing legal framework, including resolution powers and early intervention powers (EIOPA 2016b and EIOPA 2017). A few NSAs reported that they plan to reinforce their national RR frameworks. The initiatives are at different stages – some EU Member States, such as the Netherlands and France, have already formulated a specific proposal for reforming the national framework, and Romania has already

<sup>39</sup> From the FSB Key Attributes: "Creditors should have the right to compensation where they do not receive at least what they would have received in the liquidation of the firm under the applicable insolvency regime".

<sup>40</sup> Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes.



introduced a RR framework for insurers. These three examples of national initiatives are shown in Box 5.

69. **So far there has been little or no consensus or political support for harmonising the frameworks in the EU.** The Commission's White Paper recognised that most of the problems stemming from the existence of different national legal frameworks could be resolved by the establishment of a single EU-wide IGS framework covering all life and non-life policies written and purchased within the EU. It also acknowledged that harmonising the RR framework throughout the EU would not only increase the availability of RR tools, but would also provide a common basis for dealing with any cross-border failure. So far, however, this idea has not received the necessary political support (EGBPI 2015).

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#### Box 5

### **A comparison between RR frameworks in Romania, the Netherlands and France**

**The Romanian RR framework for insurers is the first national framework of its kind in Europe, while France and the Netherlands are in the process of strengthening their respective RR frameworks.** The Romanian RR framework was set up in 2015 through an amendment of the prevailing national law concerning insurance and the insurance guarantee fund. The framework is fully operational and developed to secondary legislation. In France, the national resolution authority for insurers has been designated,<sup>41</sup> and the RR legislative framework for insurers is expected to be adopted in 2017. In addition the Netherlands is finalising a legislative proposal which seeks to improve the resolution framework for insurers, as well as the rules governing insolvency and winding-up proceedings.

**These three countries decided that, in the event of the failure of an insurer, the existing tools and procedures would not be sufficient.** In Romania, the need for an RR framework was triggered by the difficulties faced by two large insurers in 2014 and 2015, while both the Netherlands and France experienced near-to-failure cases of financial conglomerates during the global financial crisis.<sup>42</sup> Their experience showed that in a situation of widespread financial stress the scope for recovery is limited, the court-led winding-up procedures are not always efficient, and the transfer of portfolios is problematic so, as a result, government intervention is required. Moreover, policyholders are affected by the cessation of payouts during resolution, as is particularly the case in long winding-up proceedings. Large insurers pose additional problems, as they cannot be easily absorbed by other insurers and their portfolios cannot be readily transferred. Reinforcing RR planning therefore seemed appropriate for these entities. Added to the economic background of a low interest rate, low yield environment, and coupled with decreasing premium income from new individual life insurance business, the two authorities decided to reinforce their RR frameworks for insurers.

**The protection of policyholders and maintaining financial stability are the objectives of the respective RR frameworks in all three countries, although there are differences in the design of the frameworks, the resolution tools and funding arrangements.** All three frameworks envisage strengthening the RR planning and resolution process, although the Romanian framework

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<sup>41</sup> Autorité de contrôle prudentiel et de résolution (ACPR) has been designated as the national resolution authority for insurers, following its designation as the resolution authority for banks.

<sup>42</sup> E.g. ING Group, AEGON Group and SNS Reaal in the case of the Netherlands and Dexia in the case of France.



also includes changes to early intervention powers and the Dutch proposal foresees improved insolvency and winding-up proceedings. In terms of resolution tools, sale of activity, portfolio transfer and a bridge institution are common to all three frameworks. In Romania, the resolution authority also has an asset separation tool at its disposal, while the Dutch proposal foresees the possibility of a bail-in without portfolio transfer, as well as the option to amend policyholder rights in all scenarios. The French proposal seeks to expand administrative policy measures and determine the conditions of remuneration of managers. It does not include any measures amending policyholder rights beyond those already included in current national legislation, i.e. the possibility of reducing life technical provisions when transferring a portfolio. In terms of resolution funding, the Romanian regime relies on the combination of an IGS and a resolution fund (RF), which is collected ex ante by the industry. The proposed Dutch framework would use an RF financed ex post, which would serve the more limited purpose of setting up a bridge institution and compensating policyholders if they are deemed to be worse off than they would have been under insolvency. The French regime does not plan to introduce an RF, although it has left the existing IGS untouched. Table 3 below summarises the comparison.

Table 3  
**Comparison of Romanian (existing), Dutch and French (both proposed) RR frameworks**

	Romania	The Netherlands	France
<b>Structure</b>	<ul style="list-style-type: none"> <li>RR planning</li> <li>Early intervention</li> <li>Resolution</li> </ul>	<ul style="list-style-type: none"> <li>RR planning</li> <li>Resolution</li> <li>Improved insolvency and winding-up proceedings</li> </ul>	<ul style="list-style-type: none"> <li>RR planning</li> <li>Resolution</li> </ul>
<b>Resolution tools</b>	<ul style="list-style-type: none"> <li>Sale of activity and portfolio</li> <li>Bridge institution</li> <li>Transfer to asset management vehicles (asset separation tool)</li> </ul>	<ul style="list-style-type: none"> <li>Sale of activity and portfolio</li> <li>Bridge institution</li> <li>Bail-in without portfolio transfer</li> <li>Amendment of policyholder rights</li> </ul>	<ul style="list-style-type: none"> <li>Sale of activity and portfolio<sup>43</sup></li> <li>Bridge institution</li> <li>Administrative policy measures</li> <li>Determination of the conditions of remuneration of the managers</li> </ul>
<b>Funding</b>	<ul style="list-style-type: none"> <li>Resolution fund (ex ante until threshold)</li> <li>IGS</li> </ul>	<ul style="list-style-type: none"> <li>Resolution fund (ex post)</li> </ul>	<ul style="list-style-type: none"> <li>IGS</li> </ul>

Source: ESRB.

**It is difficult to address the problem of cross-border resolution in the absence of a European regime.** A resolution measure available in one of the three EU Member States cannot be applied to a group subsidiary in another EU Member State if it is not available in the host authority. The possibility of group resolution is therefore limited to national regimes, although the French RR regime includes some measures in this respect. Moreover, none of the three frameworks extends its powers to the incoming branches of insurers from other jurisdictions, and frameworks do not specifically address the protection of policyholders outside their jurisdictions who hold contracts with domestic insurers.<sup>44</sup> All in all, this could still lead to disorderly failures and could also have financial stability implications.

<sup>43</sup> The current French Law (Code des Assurances - Article L423-2) already allows the ACPR to amend policyholders' rights in the case of a transfer of portfolios before the withdrawal of the insurer's license.

<sup>44</sup> All national frameworks should reflect the principle of Article 160 of the Solvency II Directive of equal treatment of contracts underwritten under the freedom to provide services or through branches and with no discrimination against foreign insured persons and beneficiaries.



## Section 4

# Recovery and resolution powers and tools

### 4.1 Introduction

70. **This section provides an overview of the possible recovery and resolution (RR) tools available to the insurance sector.** Recovery, early intervention and resolution tools are covered by this section, which also discusses the different plans that could be developed to increase awareness of the RR measures that may be adopted once a situation has deteriorated. It is worth noting that most of these tools and pre-emptive plans were developed during work on global systemically important institutions (G-SIIs), including internationally active insurance entities. Unlike in the banking sector, there is no harmonised framework to prevent and manage failures of insurers in the EU, and different tools are currently available at national level. This section discusses the advantages, implications and challenges of different tools and plans in respect of the insurance sector.
71. **The specificities of the insurance sector need to be clearly reflected by the design of an RR framework.** First, the probability of a run on an insurer is lower than it is of a run on a bank. Resolving an insurer is therefore less time-critical than resolving a credit institution.<sup>45</sup> Second, there is generally a high level of substitutability in the insurance sector, although the situation could be different if several insurers were to face difficulties simultaneously (see also the discussion of critical functions in Box 2). Third, the protection of policyholders is a recognised objective of the RR framework for insurers, although this does not exclude the possibility that policyholders might absorb some losses (FSB 2014a). An effective insurance guarantee scheme could address this issue.
72. **In the RR cycle, identifying triggering events is important.** Insurers (for recovery) and competent authorities (for early intervention and resolution) should be required to apply the respective recovery, early intervention and resolution tools based on a triggering event. For example, resolution tools could only be applied if an insurer is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so.<sup>46</sup> The issue of triggers for entering recovery, early intervention or resolution is not harmonised at this time. This leads to different approaches across the EU, which may create uncertainty, particularly in respect of cross-border insurers (EIOPA 2016b and EIOPA 2017). Harmonising the RR framework with the ladder of intervention under Solvency II is therefore important.

### 4.2 Recovery and resolution planning

73. **The timely application of recovery, early intervention and resolution measures requires planning and the existence of appropriate legal powers.** Even though time may be less critical for the insurance sector than it is for the banking sector, it is still essential to address

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<sup>45</sup> The terms for banks and credit institutions are used interchangeably throughout this report.

<sup>46</sup> Based on EIOPA's Discussion Paper, this trigger point usually refers to a significant breach of the Solvency II requirements as a trigger to initiate the resolution of an insurer (EIOPA 2016b).



potentially severe financial problems at an early stage in order to be able to reduce the likelihood of failure.

74. **Recovery and resolution plans provide a guide if the financial position of an insurer deteriorates.** A recovery plan sets up a range of viable options the insurer could take if financial stress occurs, although the insurer would not yet meet the conditions for resolution. If the insurer implements these recovery measures there should be a reasonable probability of recovery.<sup>47</sup> The resolution plan recommends the effective use of resolution tools by the resolution authority in order to resolve the failing insurer, while protecting policyholders and preventing severe disruption to the financial system and the real economy. The recovery plan is drawn up by the insurer and assessed by the supervisor, whereas the resolution plan is drafted by the resolution authority.
75. **Ideally, both recovery and resolution plans should be drafted ex ante.** The RR plans could be pre-emptive (ex ante) or ex post. Pre-emptive RR plans have been introduced in global standards for G-SIIs and it is likely that this requirement will be extended to IAIGs in 2020. Moreover, pre-emptive RR plans are also seen as having sound principles by EIOPA (EIOPA 2014a). Pre-emptive RR plans are currently required in only a small minority of EU Member States – mostly those where G-SIIs are located. Ex post recovery plans are required under Solvency II when an insurer no longer complies with the Solvency Capital Requirement (SCR). In contrast to global standards, which are of a “soft” law nature, Solvency II rules are binding across the whole of the EU.
76. **A requirement to develop and maintain a credible pre-emptive recovery plan would raise awareness of possible adverse scenarios before they actually occur.** A plan of this type would complement the Own Risk and Solvency Assessment (ORSA) prepared under Solvency II. While the ORSA also takes a forward-looking perspective and considers the future capital needs of an insurer in light of its business strategy and risk profile, it does not necessarily identify detailed possible adverse scenarios and available recovery options, including governance arrangements and appropriate recovery indicators that act as triggers.<sup>48</sup> During the pre-emptive recovery planning process, insurers are able to gauge their recovery capacity in terms of their ability to withstand a range of adverse scenarios of an idiosyncratic or a systemic nature. Developing and maintaining credible and consistent recovery plans would force insurers not only to analyse possible adverse scenarios in detail, but also to ascertain what kind of recovery measures are available.
77. **It would also raise supervisors’ awareness of potential herding behaviour in respect of common recovery strategies which could cause systemic risks.** The supervisory authority would review the plans as part of the supervisory process that assesses their credibility. By reviewing plans across the sector, supervisors would become aware of insurers being herded into strategies that might be optimal when considered in isolation, but could become a systemic risk if pursued by many insurers at the same time. For example, multiple insurers triggering their recovery options by divesting the same assets simultaneously could have a much greater impact than if this action were undertaken by just one insurer. Cooperation with macroprudential authorities might be relevant to addressing such findings.

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<sup>47</sup> FSB Key Attributes, I-Annex 4 – Essential Elements of Recovery and Resolution Plans.

<sup>48</sup> FSB Key Attributes, 11 – Recovery and resolution planning.



78. **Similarly, pre-emptive resolution plans could be used as effective tools by authorities in charge of resolution.** These plans are tailored to insurers and take all their specificities into account, including their complexity, interconnectedness, level of substitutability and size. They also address any potential impediments to an effective and timely resolution, and identify responsibilities across authorities. From a macroprudential perspective, resolution planning assists the early identification of the likely impact of an applied resolution tool on the wider market, including its impact on the stakeholders who will bear the costs of resolution. It also raises awareness of possible implications for the real economy and the wider insurance sector.
79. **This measure should be applied in accordance with the principle of proportionality.** Supervisory authorities should be given flexibility in respect of the scope, content and level of detail of the pre-emptive plans, in accordance with the principle of proportionality. This would avoid excessive burdens, e.g. in terms of the costs of implementation, on both insurers and supervisors.

#### 4.3 Recovery measures and early intervention tools

80. **Recovery measures and early intervention tools are intended to be implemented when institutions face financial stress, to avoid having to resort to resolution.** The rationale for this is that both financial stability and consumer protection are normally best served if the situation can be restored without resorting to resolution.<sup>49</sup>
81. **Recovery measures would be implemented by the insurer in line with the agreed recovery plan.** Examples of recovery measures include, for instance, the sale of subsidiaries to reduce the risk profile, the cancellation of dividends, and a capital increase (e.g. rights issue).
82. **On the other hand, early intervention measures would be taken by the supervisory authority responsible.** In light of this, the supervisory authority should have the appropriate legal powers to intervene prior to putting an individual insurer into resolution. Examples of early intervention measures include: (i) requiring changes to the business strategy, or the legal or operational structure; (ii) requiring the removal of members of the senior management and management body; (iii) requiring the company to create additional provisioning or reserves, and (iv) appointing a temporary administrator.<sup>50</sup>
83. **Many early intervention measures for the insurance sector are already available in EU Member States, although in practice this availability is subject to restrictions.** As a general rule, under the Solvency II framework supervisors are required to take all measures necessary to safeguard the interests of policyholders if the financial situation continues to deteriorate following non-compliance with the SCR.<sup>51</sup> EIOPA shows that, although early intervention powers are widely available across the EU, even before a breach of the SCR has

<sup>49</sup> Applicable in cases where resolution is considered necessary in respect of the public interest, otherwise normal insolvency procedures are applicable.

<sup>50</sup> For the banking sector, the BRRD explicitly requires eight early intervention measures that supervisory authorities at least, should have at their disposal (BRRD, Article 27).

<sup>51</sup> Solvency II directive, Article 141.



occurred, their availability is subject to restrictions (EIOPA 2016b and EIOPA 2017). Granting supervisors further explicit powers would enable them to intervene early.

84. **The LIR environment emphasises the need for the effective use of pre-emptive measures.** A prolonged LIR environment may reduce some insurers' solvency ratios until eventually they no longer have enough capital to pay claims in full. A significant proportion of the industry might be affected by such a capital shortfall. However, this is a "slow burn" issue, giving authorities an opportunity to undertake significant RR planning as well as to apply early intervention tools. These tools will be more effective if they can be used before the SCR has been breached, especially when a capital shortfall in the future might be forecast in view of the current trend of the insurer's solvency position.<sup>52</sup> The tools will be key to proactively minimising the capital shortfall, and reducing the likelihood of conditions deteriorating to the extent that it becomes necessary to use resolution tools.

#### 4.4 Resolution tools

85. **A resolution authority should have an effective resolution toolkit at its disposal, providing it with the flexibility to apply the least disruptive measure under any given circumstances.** Moreover, the use of resolution tools is not generally mutually exclusive and a combination of several tools might produce the best result. It should be noted, however, that no measure is without side effects, e.g. in terms of the time needed to implement it or in terms of the impact it would have on consumer confidence. When deciding which resolution tool to use, the resolution authority should consider the relevant circumstances, i.e. the ability of different groups to bear losses and the resulting contagion risk.
86. **The existing resolution toolkit is fairly limited across the EU.** Since the crisis, additional resolution tools for insurers have been developed. Many of these were inspired by the resolution tools in the banking sector, although some new insurance-specific tools have also been developed. As Table 4 shows, they have been proposed as part of the G-SIIs framework, although the IAIS is currently amending the ICP 12 standard, which recommends making resolution tools available in their respective jurisdictions. Most of the new tools are not currently available in the majority of EU Member States (EIOPA 2016b and EIOPA 2017).
87. **Moreover, resolution tools can be applied at different levels within an insurance group.** The FSB stipulates that resolution tools can be applied at the holding or parent company level of a group, at the level of a sub-holding, and/or at the level of subsidiary entities. Resolution strategies for insurance groups may be based on entry into resolution at the level of individual operating entities or at the level of a non-operating holding company, or a combination of both, depending on the characteristics of the group (FSB 2016). The choice of points of entry should be guided by the group structure of the insurer and the way that its activities are organised within that structure. The availability and coverage levels of IGSs may also be a relevant consideration.

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<sup>52</sup> For example, the solvency position of an insurer, which is subject to transitional measures activated under Solvency II, might not improve given the LIR environment. As a result, the insurer could breach its SCR in the future, once the transitional measures would have been phased out over time.



Table 4  
Resolution tools

Resolution Tools	Sector	
	Bank	Insurance
Liquidation		
Withdrawal of permission to write new business / Run-off		
Bridge institution		KAs
Asset separation		KAs
Bail-in / Restructuring of liabilities		KAs
Portfolio transfer		KAs
Temporary stay on early termination rights		KAs
Moratorium / Suspension of surrenders and pay outs		KAs

Source: ESRB.

Note: The blue background colour refers to tools which are broadly available in the EU Member States, 'KAs' refers to tools introduced by the FSB KAs (Annex 2). Only tools discussed in this section are covered in this table.

#### 4.4.1 Commonly used resolution tools

##### 4.4.1.1 Liquidation

88. **Liquidation constitutes the main part of ordinary insolvency proceedings.** It involves a withdrawal of authorisation from the insurer. The insurer is declared insolvent by a court or ministry of its competent jurisdiction and is then placed under legal supervision and controlled by an appointed liquidator. The liquidator controls the gathering of the insurer's assets and determines its liabilities. During the liquidation process, all policies are cancelled and premiums are returned to policyholders. All claims against the insurer are identified, quantified, and adjudicated. Also, applicable insurance guarantee funds are triggered, and all assets are generally liquidated. The insurer's assets and securities are ranked and distributed in the manner set forth by law as being the most effective way to discharge the debts that are owed to various creditors, and policyholders may rank equally with certain creditors.<sup>53</sup> To this end, the liquidator develops a plan to distribute the insurer's assets according to established law and submits this plan to the relevant court and/or competent authority for approval. Finally, the insurer's assets are equitably distributed to its creditors and the proceedings are closed.
89. **In contrast to other resolution tools, liquidation might not guarantee continuity of critical functions and is quite a lengthy process.** As the experience of the global financial crisis suggests, a bankruptcy filing by a financial institution can have a negative systemic impact on the financial system. Moreover, the process can take several years and is also associated with delays in the settlement of outstanding claims, possibly undermining the trust of the wider public in the EU insurance sector as a whole.
90. **Nevertheless, liquidation remains an applicable tool within an effective resolution toolkit.** It remains appropriate to use liquidation for insurers with no critical functions. It could

<sup>53</sup> Article 275 of the Solvency II Directive in general affords policyholders a certain priority.



also be applied together with another resolution tool. In a case of this type, where the resolution authority is applying another resolution tool partially (e.g. the sale of business or asset separation), the remaining (non-critical) part of the institution could be wound up under ordinary insolvency proceedings.

#### 4.4.1.2 Run-off

91. **Run-off has long been a distinct resolution tool in the insurance sector.** Its use across the EU is longstanding and widespread. The current level of non-life insurance liabilities for insurers in run-off is approximately €247 billion (PwC 2016), and the insurance business model lends itself to the use of run-off as a resolution tool. First, there are usually penalties involved when an insurance contract is cancelled. In contrast, depositors incur almost no costs when withdrawing funds from a bank. Second, insurance is basically driven by the liability side of the balance sheet. As a result, it does not have the maturity transformation role of a bank.<sup>54</sup>
92. **Run-off contributes to the stability of the sector, particularly if it is combined with other resolution tools.** Run-off in the context of resolution is triggered by the decision of the competent authority to withdraw an insurer's licence to write new business in the case of financial distress or non-compliance with Solvency II.<sup>55</sup> The rationale of its use is that insurers may not be able to afford to continue to expand and to write new business, but they can afford to honour contractual obligations related to the existing stock of policies, while avoiding much of the cost and disruption involved in the normal liquidation procedure. Moreover, preventing new business from being written reduces an insurer's capital requirements and the expenses associated with new business (European Commission 2012). However, a run-off in the context of resolution usually means that the insurer is only able to partially honour its contractual obligations and that a number of claims might not be paid in full. It is, therefore, an insolvent run-off. An accompanying resolution tool (such as a bail-in or the restructuring of liabilities) or some other injection of capital<sup>56</sup> may be used to allow the insurer to enter solvent rather than insolvent run-off. Otherwise, a resolution tool other than run-off might be more appropriate. It should, however, be noted that a solvent run-off may become an insolvent run-off over time, e.g. if changes to the value of the insurer's assets and liabilities lead to a quicker-than-expected run down of its capital buffer (FSB 2011).
93. **A run-off can be compatible with continuity in cover for existing policyholders.** To the extent that policyholders can purchase insurance from other providers on renewal, run-off is compatible with continuity of cover for existing policyholders. The lack of a substitute on the renewal of the cover provided by the EU insurer in run-off could give rise to systemic disruption or undermine confidence in the EU insurance sector. In such a case, resolution tools other than run-off might be more appropriate.

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<sup>54</sup> Inspired by the insurance sector, some regulators have asked banks to prepare plans for solvent wind-down, which would be similar to run-off but would largely focus on a bank's trading book, rather than on the institution as a whole. See, for example, Bank of England (2015)).

<sup>55</sup> A run-off could also happen on a voluntary basis by an insurer's decision to stop the sale of new policies, if, for example, the insurer changes its business model. This is also referred to as a 'solvent' run-off and the insurer is able to make payments in full without altering arrangements with policyholders and other creditors. Voluntary run-off is, however, not considered within the scope of this section, as it cannot be viewed as a resolution tool.

<sup>56</sup> For example, an IGS may have the power to inject capital into an insurer instead of paying claims if the insurer fails.



94. **The success of a run-off also requires policyholders to believe that their claims will be honoured.** If this is not the case policyholders might begin to cancel their contracts. Given the increased use of a special termination clause in the insurance sector, in particular for reinsurance contracts, insurers seem to be more vulnerable to early policy cancellations than in the past (Paulson et al 2014). Cancellation is more likely for highly insurable, low-risk individuals, although this also applies to institutional investors. So, an insurer might be left with a portfolio of higher-risk contracts with less insurable policyholders or economically unattractive contracts, e.g. life policies with high guaranteed returns. There may not be adequate capital for this type of portfolio shift. As a result, policyholders with claims that arise earlier might be better off than policyholders with claims that arise later. In addition, the maturity profile of the insurer's asset portfolio may not provide sufficient liquidity to meet demand in the event of a spate of cancellations. This scenario may be averted by ring fencing the assets that correspond to certain insurance liabilities (European Commission 2012).

#### 4.4.2 Resolution powers and tools that allow the business to be transferred or separated

##### 4.4.2.1 Portfolio transfer<sup>57</sup>

95. **Portfolio transfer involves the transfer of policyholder obligations, along with corresponding assets, from a distressed insurer to one or more third parties.** A third party may be another insurer(s) or a bridge institution if a willing buyer (or buyers) cannot be found. Portfolio transfer has been used in both the banking and the insurance sectors, although the processes are not identical. In contrast to the banking sector, where assets (loan books) are transferred in exchange for other assets, portfolio transfer in the insurance sector consists of transferring liabilities (the portfolio of insurance contracts) and corresponding assets, which are received to cover the liabilities the third party has taken over.
96. **Portfolio transfer ensures continuity of cover and payments while the distressed insurer is wound down without disruption to the transferred policyholders.** It allows claims to be paid as they fall due and reduces disruption and possible value destruction. The key advantage of portfolio transfer is that continuity of coverage can be maintained for certain parts of a distressed insurer's business with limited use of policyholder protection or other guarantee schemes. The portfolio transfer is expected to provide continuity of cover, as policyholders should be able to purchase insurance from the insurer who has taken over the portfolio.
97. **An effective portfolio transfer in resolution might require the availability of other resolution tools.** This is particularly true when there is a capital shortfall. For example, an assets and liabilities separation tool could be used in conjunction with a portfolio transfer, since a potential buyer would only be willing to take on a viable part of the distressed insurer's portfolio. Some countries allow the policyholders' liabilities to be restructured in order to make a transfer possible or, alternatively, the IGS could be used to facilitate a portfolio transfer. The IGS could be involved with the justification that a portfolio transfer might be the most cost-

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<sup>57</sup> This tool is referred to as a sale of business tool in a banking context.



effective way to protect the rights of the current policyholders. Powers to transfer related reinsurance without having to obtain the reinsurer's consent may also be required since the continuity of reinsurance is often critical to ensuring that the new insurer remains sufficiently capitalised and that policyholders are adequately protected. Furthermore, if some of the distressed insurer's liabilities have been left behind additional resolution tools may be required, e.g. run-off or liquidation. If only the remnant of the distressed insurer is liquidated, it should be ensured that compensation is no worse than the amount that would have been received if the insurer had been liquidated as a whole (FSB 2016b).

98. **One significant challenge to enacting portfolio transfer is finding a willing buyer in a suitable timeframe.** Evaluating the policyholder liabilities and assets involved in a transfer takes time and a bridge institution might need to be set up to run the insurance business temporarily (FSB 2011). Moreover, operational difficulties could slow down the process – for instance, IT systems used to service insurance products may be difficult to transfer (EIOPA 2016b and EIOPA 2017). Portfolio transfer might be a less viable option in times of systemic disruption. The problem of finding a willing and appropriate buyer for parts of a distressed insurer's business is exacerbated when other insurers are also subject to similar vulnerabilities.

#### 4.4.2.2 Bridge insurer

99. **A bridge insurer takes the failed insurer over for a limited period of time, thereby protecting the continuity of critical functions, including the fulfilment of existing obligations to policyholders.** The bridge insurer is entrusted with continuing the operations of the insolvent insurer (or some of these, i.e. critical functions and viable operations) until the portfolio has been transferred to a private purchaser (see Figure 1 for the process). This transaction provides sufficient time for prospective purchasers to carry out the appropriate due diligence on the failed insurer (FSB 2016a). It could also be particularly beneficial for managing crisis situations, where willing buyers are less likely to be found at short notice. It allows the resolution authority to react promptly<sup>58</sup> by maintaining the value of the insurer (or its viable part), acting as a stopgap until the portfolio can be sold to a third party. For policyholders, this means that the continuity of their cover and payments (in whole or in part) is ensured. As such, this tool helps to preserve stability and trust in the insurance sector.
100. **If a bridge insurer is created by the resolution authority, it should have an insurance authorisation, comply with regulatory requirements and operate in a conservative manner.** Moreover, it may be recapitalised by a resolution fund or an IGS or, where applicable, by a forced debt to equity conversion. A bridge institution may operate for a limited period of time and may be subsequently liquidated. This tool was created with a single insurer in mind, although it could also be possible to create a bridge insurer that could pool the viable business of different insurers (i.e. those which had failed simultaneously). The bridge insurer would be controlled and (partially) owned by a public authority, which would then operate the transferred business of a failing insurer. The resolution authority would therefore have a number of powers including (i) deciding on the management and corporate governance of the

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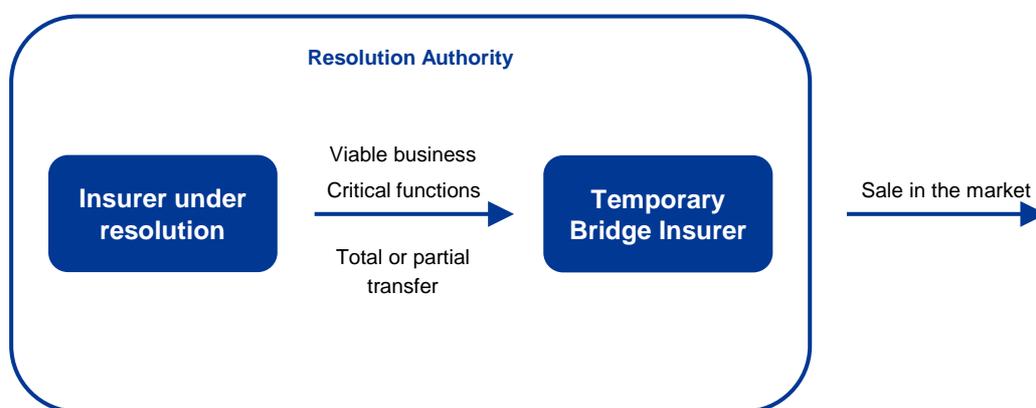
<sup>58</sup> It should be noted that a prompt reaction is only possible if the bridge insurer is founded a priori or if the insurance RR framework stipulates special conditions for the licencing of such an institution.



bridge insurer; (ii) setting the terms and conditions under which the bridge insurer must operate as a going concern; and (iii) arranging the sale or winding-down of the bridge insurer, or the sale of some or all of its assets and liabilities, to a third party. In addition, the bridge insurer could permit options to be exercised under existing insurance contracts, such as the surrender or withdrawal of contract cash value and the payment of further premiums provided for under the existing contracts. The continuation of reinsurance coverage could also be considered.

101. **The tool has not been actively used in the EU in the past.** A bridge insurer is under consideration in the global resolution regime for G-SIIs. However, in contrast to the banking sector, the tool has not been used frequently across the EU in the insurance sector in the past. Its use is stipulated in the Romanian RR framework and its introduction is also planned in France and the Netherlands.

Figure 1  
Bridge insurer



Source: ESRB.

102. **Creating a bridge insurer also poses some challenges.** First, running a bridge institution is a labour-intensive process which includes, for example, identifying the relevant business which needs to be preserved. Second, funding for the bridge insurer needs to be clarified, particularly in relation to a possible recapitalisation by a resolution fund or an IGS. Moreover, finding a private purchaser could prove challenging. If the sale to a private owner cannot be executed at an acceptable price, the cost of operating the bridge insurer may exceed the cost of liquidation. Challenges may also arise if the resolution of the failed insurer triggers the cancellation of services provided by the insurance group, in which case additional powers may be needed imposing temporary stays on the termination of contracts (FSB 2016b).



#### 4.4.2.3 Assets and liabilities separation<sup>59</sup>

103. **This tool enables authorities to relieve the balance sheet of an insurer under resolution from certain risks, while maintaining the continuity of critical functions.** The resolution authority would establish a liabilities and assets separation scheme, which would allow the liabilities and related assets and rights of an insurer under resolution (or those of a bridge insurer) to be transferred – at market value – to a separate vehicle. This separate vehicle would operate as a legal entity, with the resolution authority exercising its influence via its appointment of the manager of this separate vehicle.
104. **The separate vehicle should maximise the value of the policies.** It would either make legal arrangements to terminate the policies in return for compensation from the sale of the assets, or run them off over a longer time period. This is different from a special vehicle in the banking sector, which aims at maximising the value of the instruments through their sale or by winding these activities down in an orderly manner.
105. **The emphasis of this tool in the insurance sector is on the separation of liabilities, together with the assets held for these policies.** In the banking sector, the relief to banks' balance sheets stems from separating depreciated assets and related risks from viable asset classes. The main purpose in the insurance sector would be to allow the authorities to separate the policies (liabilities) of an insurer under resolution (or those of a bridge insurer) which might cause distress, from viable policies (liabilities). The tool would involve the identification of these liabilities, together with the assets held for these policies, and their transfer to a separate vehicle. It might, however, be difficult in practice to identify precisely which assets in the insurer's asset portfolio are held for a subset of policies. This identification is performed for larger classes of policies, but not for a subset of policies, with the exception of separate account assets and liabilities (such as unit-linked contracts).
106. **The use of the tool should be subject to safeguards in order to prevent any undue competitive advantage accruing to the failing insurer.** The tool may therefore only be used in conjunction with other tools in the resolution framework.<sup>60</sup> It may only be used if conditions in the particular market are such that the liquidation of the liabilities and related assets of the failing insurer under normal insolvency proceedings could have an adverse effect on one or more financial markets, or where the transfer is necessary to ensure the proper functioning of the insurer under resolution (or the bridge institution), or to maximise liquidation proceeds.
107. **The assets and liabilities separation tool is less likely to be used in the insurance sector.** Although it is included in the global standard for G-SIIs, it has not been implemented in relevant national legislation for insurers in the EU. Its use is not very likely given the long-term perspective taken by insurers' balance sheets. One major advantage of insurance is that insurers' assets do not need to be liquidated until claims or benefits under the policies have to be paid. The application of the assets and liabilities separation tool involves the disposal of assets and liabilities at market value. Losses could be realised if sufficient time is not allowed for the assets to return to their long-term economic value, leading to a destruction of value for policyholders.

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<sup>59</sup> The FSB refers to this instrument as an asset separation tool. Given the strong link between assets and liabilities in the insurance sector, the tool is referred as an "assets and liabilities separation tool" throughout this report.

<sup>60</sup> This is the condition for its use in the banking sector (see Article 42(5) of the 2014/59/EU).



## 4.4.3 Resolution tools affecting contractual rights

### 4.4.3.1 Imposing restrictions on the termination of contracts

108. **The power to impose temporary restrictions on the termination of insurance contracts gives the resolution authority more time to deal with a distressed insurer in an orderly fashion.** The resolution authority would have the power to temporarily suspend the termination rights of any party to a qualifying contract, including reinsurers, in order to protect the insurers' risk mitigation programme and thus reduce the risk of unnecessary destruction of value. The suspension would be on the condition that contractual obligations would continue to be met. This would avoid any deterioration in the financial position and any subsequent market instability resulting from the counterparties closing out their transactions at the same time. The exercise of this power, its scope of application, and the duration of the stay should be appropriate for the type of insurance product. Different treatment would be envisaged for life and non-life primary insurers and reinsurers.
109. **The power to impose restrictions might be less relevant for insurers.** The FSB has envisaged the use of this power by G-SIIs. However, it is presumed that this power might be less relevant for insurers than for banks, e.g. policyholders may be less likely to cancel their insurance contracts.
110. **The tool comes with some costs.** First, the application of this tool could face enforceability issues in some EU Member States. Moreover, the restriction could undermine confidence in the sector and should therefore be subject to adequate safeguards. Second, the enforceability of the suspension or restriction is not certain, especially where third-party law governs the contract; however, this issue has been increasingly addressed by changes to the contracts, in particular in respect of derivatives contracts.<sup>61</sup>

### 4.4.3.2 Bail-in / liabilities restructuring tool

111. **A bail-in tool would enable losses to be quickly assigned to shareholders and creditors.** This tool should however be available only as a last resort in the case of policyholders bail-in. A bail-in involves the use of techniques that restructure liabilities. This could be done by limiting or writing down liabilities held by providers of debt and other creditors, or by converting those liabilities into shares or other instruments of ownership. The tool would allocate losses to shareholders and creditors in a manner consistent with the statutory creditor hierarchy and legal framework. Where an insurer is failing and the bail-in tool is used, shareholders and other unsecured creditors should be fully written down before losses are imposed on policyholders. The bail-in tool would help ensure that losses are absorbed and the insurer is recapitalised.
112. **A bail-in tool would also ensure continuity of critical functions and it could address some of the systemic risks the insurance sector may pose.** Bail-in mimics the results of insolvency, but it can do this on a going-concern basis, without unnecessary value destruction

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<sup>61</sup> The International Swaps and Derivatives Association, in conjunction with the FSB, has devised a "Stay Protocol" which aims to achieve the cross-border recognition of suspensions and overrides, by incorporating this recognition into the relevant financial contract between the parties opting in to the protocol.



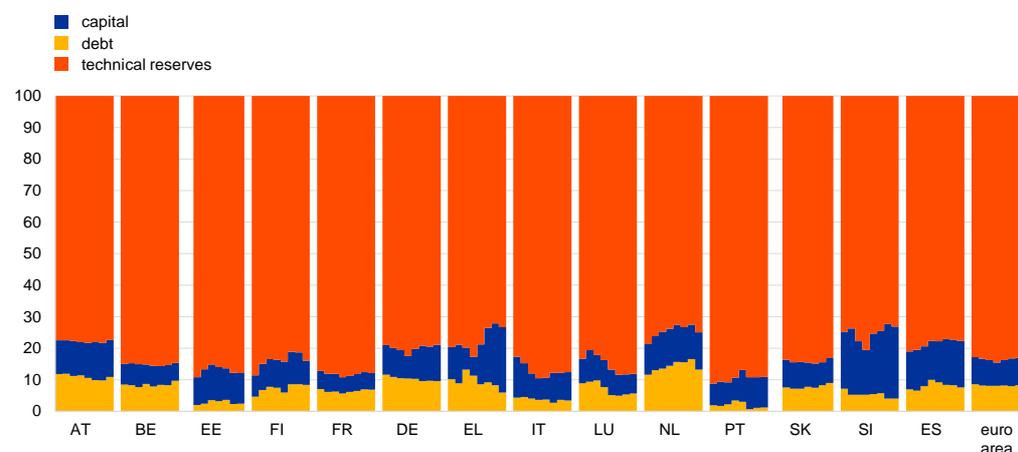
or interrupting the provision of critical functions. Losses can be assigned quickly without a long sale process, and certainty can be restored. As such, a bail-in could address the systemic risks posed by insurers, by internalising losses and limiting these to the creditors of the failing insurer, and by helping to ensure the continuity of critical functions.

113. **The success of bail-in in resolution depends on the availability of liabilities that can be bailed in and the identification of the optimal proportion of liabilities to be bailed in.** The design of bail-in requirements for insurers might be challenging due to the particular structure of their liabilities. If the bail-in tool is intended to “recapitalise” the insurer, the non-policyholder related liabilities will be converted into equity. As Chart 5 shows, insurers make less use of debt financing than other financial institutions and a large part of their liabilities consist of technical reserves. However, the share of debt financing is not negligible, especially with regard to systemically important insurers. The conversion of policyholder liabilities into equity might be more problematic, although given insurers’ liabilities structures it might be inevitable in the event of a substantial shortfall.
114. **A write-down of policyholder liabilities could accompany a portfolio transfer, ensuring that the buyer can afford to take on the insurance liabilities.** The resolution authority could be given the power to restructure, limit or write down liabilities, by reducing or terminating future benefits and guarantees, reducing the value of contracts upon surrender, and terminating or restructuring options for policyholders. It could also suspend the rights of policyholders by temporarily restricting or suspending their right to withdraw from insurance contracts. Policyholders could be compensated by the IGS (assuming one exists and that it covers that particular policy) if their rights have been affected by the resolution. An IGS allows EU Member States to identify, in advance, the policyholders and products that should receive protection, and to decide on the appropriate level of such protection. Moreover, if the process resulted in a situation where policyholders were worse off than they would have been under liquidation, the RR framework should foresee compensation in line with the NCWO principle.
115. **The tool could produce undesired side effects.** Its potential impact, as well as its various dimensions, should therefore be carefully assessed. First, it impacts protected contractual rights. As a result, bondholders might be reluctant to invest in insurers if there is a risk that the liability could be written down. Second, a write-down of insurance liabilities (or even the mere possibility of this occurring) could create a lack of confidence in the insurance sector. Moreover, if a bail-in were applied in a situation of widespread distress among insurers or in financial markets, the market could suffer from the impact this would have on investors if liabilities were written down in multiple institutions. On the other hand, the alternatives to a bail-in might also be undesirable. For example, a bailout would be undesirable from a public finance perspective and, furthermore, insolvency could also lead to a loss of confidence in the insurance sector and, as a consequence, in the broader financial sector.
116. **The tool could be applied, to some extent, in some EU Member States along with a portfolio transfer tool.** The FSB has established bail-in as a resolution tool for G-SIIs, suggesting that this power should be available to all resolution authorities in jurisdictions which are home to these insurers. In the EU, the tool has been proposed as part of the RR framework in the Netherlands, while a few EU Member States allow the restructuring of policyholders’ liabilities prior to use of the portfolio transfer tool. A breach of policyholders’ contractual rights has not, however, been contemplated as a possible solution in most EU countries and, in the absence of the consent of all policyholders, the write-down of insurance liabilities may only be executed in the context of a winding-up. Moreover, the conversion of liabilities into equity is also not envisaged in national legislation across the EU.



Chart 5

**Structure of liabilities of the insurance sector (2008-2015, %)**



Source: ECB - SDW

Note: Data refer to the period 2008-2015. Moreover, the data are not fully comparable across countries.

117. **This report recognises that EU Member States have differing views on the use of the bail-in tool.** The benefits of the conversion into equity of bondholders is generally recognised across the ESRB membership. Still, a few ESRB member institutions view this option as a last resort only, e.g. when the stability of the financial system is at stake or if creditors would face larger losses in a regular insolvency procedure. With regard to the allocation of losses to policyholders, the majority of ESRB member institutions view this as a last resort option, while a few ESRB member institutions are of the view that policyholders should not be affected by a bail-in decision at all, arguing that this might undermine the trust of the general public in the insurance sector and could therefore lead to a systemic disturbance, with mass surrenders and cancellations of policies.

#### 4.5 Cross-sectoral implications of resolution measures

118. **The application of resolution tools may also produce some cross-sectoral spillover effects.** Although an RR framework should result in less contagion and fewer spillovers to other sectors of the financial system than a normal insolvency procedure, spillover effects from some resolution tools cannot be entirely avoided. Building on experience from the banking RR framework, this section discusses the possible cross-sectoral impact of selected resolution tools on the insurance sector.

##### 4.5.1 Stay on termination rights tool

119. **This tool provides the resolution authority with more time for the resolution process.** The resolution authority could apply a stay on termination rights and other powers to terminate contracts included in the contractual clauses, giving the authority more time to resolve the failing insurer. This could be useful in cases where insurers are suffering temporary runs on their business, although runs have only been experienced exceptionally in the past (e.g. in Hong Kong and Singapore, see IAIS 2011a as well as in the UK, see Kelliher et al. 2005). Surrender penalties dampen incentives for policyholders to cash in their policies prematurely;



however, the increased use of special clauses (e.g. to terminate a contract if the insurer's rating deteriorates) might increase the likelihood of such exceptional events in the future.

120. **If applied to derivatives contracts, the tool exposes the counterparty to credit risk.**

Stays may also be applied to the termination of access to financial market infrastructures or other services (FSB 2016), and the tool could stop the spread of losses in derivatives markets. At the same time, counterparties that are not able to terminate a derivative contract would be forced to keep existing positions open with a potentially failing institution, and would therefore no longer be protected from counterparty credit risk. In the case of a resolution authority applying the stay on termination rights tool in the event of the failure of an insurer, banks might be particularly affected due to their links with derivatives trades.

#### 4.5.2 Bail-in tool

121. **The application of the bail-in tool has a direct impact on other financial market participants.**

This can be seen in the use of the bail-in tool in the banking sector, involving the bail-in of bank bonds where losses materialise for the holders of those bonds.<sup>62</sup> The loss allocation mechanism implies spillover effects for other financial market participants, which increase in line with the size of the exposure. Moreover, the introduction of the bail-in tool in the banking sector has been accompanied by the creation of TLAC/MREL requirements.<sup>63</sup> These ensure that there are sufficient liabilities available in each bank that may be expected to be bailed in, both to absorb losses and to provide the capital needed to facilitate a transfer or recapitalise the company. At the same time, the TLAC/MREL requirements might have increased interconnectedness with other sectors, including the insurance sector.

122. **There are large differences across countries and sectors for bank “bail-inable” debt holdings.**

Over the last two years, although banks have reduced their exposures, non-bank sectors have continuously increased their stake (ECB 2016). However, the sectoral exposures of non-bank sectors are relatively minor when compared with the amount of total assets held by each sector. For example, the combined exposures of the insurers and pension funds to bail-inable bank debt are 2.3% of total assets (see Chart 6). The increase in bail-inable debt holdings seems to be in line with the general trend of increased risk-taking by insurance corporations and pension funds (ICPFs) observed in their portfolio shifts towards lower-rated debt securities (ECB 2016). However, the aggregated number by sector may hide significant differences between the individual ICPFs (ECB 2016). Moreover, there are also differences across countries, e.g. ICPF holdings of bail-inable bank debt have a high proportion of debt issued by French banks (see Chart 6).

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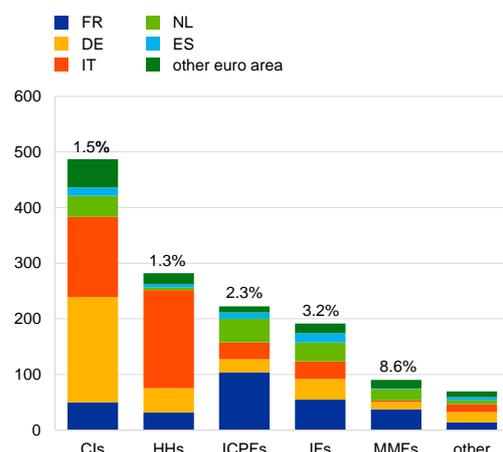
<sup>62</sup> However, the losses could not be larger than they would have been if the institution had entered insolvency instead (no-creditor-worse-off safeguard).

<sup>63</sup> TLAC refers to the FSB's Total Loss Absorption Capacity applicable to G-SIBs, and MREL stands for Minimum Requirements for own funds and Eligible Liabilities, a standard applicable to all EU-domiciled banks.



**Chart 6**  
**Holdings of bail-inable bank debt securities by euro area holding sector and by country of issuance**

(Q1 2016; EUR billions; Bail-inable bank debt as a percentage of total assets of the holding sector)



Sources: ECB sectoral SHS and ECB calculations.  
 Notes: insurers are captured in ICPFs (Insurance Companies and Pension Funds), and other institutions are: Credit Institutions (CI), Households (HH), Investment Funds (IF) and Money Market Funds (MMF).  
 The breakdowns in the chart show issuance by domicile of issuing bank and holdings by euro area (EA) sectors. Percentages at the top of columns show debt holdings relative to total assets (for financial sectors) and relative to financial assets (for households)

123. **Additional regulatory standards may be needed to adequately address risks and the consequences of holding bail-inable debt.** In the banking sector, a global standard aimed at reducing the risk of contagion from the use of the bail-in tool will be applicable from 2019 for most G-SIBs<sup>64</sup> (BIS 2016). Above certain thresholds credit institutions will be required to deduct holdings of TLAC instruments from their own regulatory capital, which will discourage them from investing largely in bail-inable debt. Furthermore, the European Commission has proposed that a similar approach be followed for EU banks (European Commission 2016). Sectoral regulation, other than that applicable to the banking sector, does not require special treatment for bail-inable debt and standards are unavailable for holdings of bail-inable debt. For the insurance sector, it may be expected that insurers' holdings of the bail-inable debt of banks, or that of other insurers, will increase in the future. This is due to proposed changes in the banking regulation related to the introduction of the TLAC/MREL requirements (IMF 2016a) and a possible shift in holdings of bail-inable bank debt to non-bank entities (including insurers) after the introduction of standards covering holdings of bail-inable debt

in the banking sector, and in light of the possible introduction of the bail-in tool for insurers in the EU (e.g. the proposed RR framework for insurers envisaged in the Netherlands). This suggests that a revision of Solvency II could provide an opportunity to include rules on bail-inable debt for insurers too.

124. **Moreover, the application of the bail-in tool should be preceded by an analysis of directly impacted investors.** An analysis of the holdings of bail-inable debt at aggregated level in the banking sector indicates that there could be possible interdependencies and spillover effects. The resolution authority, possibly in cooperation with the macroprudential authority, could therefore benefit from assessing the financial stability or contagion impact of a bail-in on other supervised entities, sectors or regions.
125. **The IAIS has decided against the establishment of a TLAC/MREL requirement for G-SIBs at this juncture (IAIS 2016a).** The use of the bail-in tool in the insurance sector would seem to be more challenging, given the particular structure of insurers' balance sheets. The IAIS has decided not to set a minimum level of bail-inable debt. Such a requirement for insurers would not only increase their linkages within the rest of the financial system, but would also imply changes to the business models and funding structures of insurers. If it were introduced, insurers would be expected to hold more bail-inable debt – typically long-term unsecured subordinated debt (IAIS 2011).

<sup>64</sup> The term G-SIBs refers to global systemically important banks.



## Section 5

### Resolution funding

#### 5.1 Introduction

126. **There are significant operational costs associated with the failure of an insurer.** One key operational cost is the cost of providing for and maintaining practical arrangements that guarantee continuity of cover and payments to existing policyholders. These costs are realised at different times and by different agents depending on the type liability and related funding arrangements. Resolution requires significant time and human resources. This cost would, to a large extent, be proportional to the size and complexity of the insolvent insurer. For example, the resolution of a cross-border insurer would require coordination between different authorities across jurisdictions.
127. **The use of specific instruments leads to further costs, including compensation of policyholders.** For example, there is likely to be a large one-off administration cost when a transfer of a portfolio of insurance contracts is required. The scale of this cost varies according to the nature of the insolvent insurer and the way the transfer is facilitated: a transfer to an existing insurer will probably have a lower cost than a transfer to a newly-created bridge institution. Moreover, managing bigger portfolios may be also expected to lead to economies of scale. When a measure other than insolvency procedure is applied, the resolution process aims at honouring the no-creditor-worse-off principle (NCWO): authorities may need to compensate policyholders and other creditors if they find themselves in a worse situation under resolution than they would have done under the ordinary insolvency of an insurer.
128. **The market values of both the assets and the liabilities of an insurer could fall if it enters resolution.** In the case of liabilities, differences could arise between the valuation of liabilities in a “going-concern” situation (under Solvency II) and the valuation in a “gone concern” situation. Furthermore, and particularly in a system-wide crisis, the disruption caused by a market-relevant insurer’s failure could cause the market value of some of its assets to fall. It is therefore plausible that asset depreciation could be minimised by prudent market signalling and the effective management of the resolution process, e.g. by avoiding the forced sale of any assets unless the alternative would be even more costly. The FSB highlighted this point in its Key Attributes (KAs), stating that resolution authorities should avoid unnecessary destruction of value and should seek to minimise the overall costs of resolution and the losses to creditors (FSB 2014a).

#### 5.2 Funding sources other than public funds

129. **One of the purposes of a resolution framework is to avoid a bailout of troubled institutions.** In the absence of a government bailout, the resolution costs associated with the failure of an insurer could be borne by three groups: (i) the insurance industry, through the use of pre-defined funding arrangements; (ii) policyholders through a write-down of insurers’ liabilities; and (iii) other creditors, through a debt write-down. Which group should bear the costs should relate to how able it is to bear the costs, as well as the incentives created by passing on the costs, and will be affected by the creditor hierarchy. Since the write-down of policyholders’ liabilities and the write-down of debt have been covered in Section 4, the remainder of this section focusses on financing from the industry.



130. **Industry-financed resolution requires reliable funding sources.** An effective RR framework should be accompanied by secure, continuous and stable funding sources, otherwise the funding arrangements cannot be relied upon by creditors, market participants and policyholders and, as a consequence, resolution may not work as a mechanism ensuring financial stability without the need to resort to public funds. Besides the funding costs of resolution tools, these funding arrangements should also cover the immediate liquidity needs of a failed insurer and the administrative costs of operating the funding arrangement.
131. **A resolution funds (RF) and insurance guarantee schemes (IGS) are examples of industry funded financing sources.** As for the banking union,<sup>65</sup> the RF and the IGS may be understood as two distinct but complementary pillars with different objectives. The primary function of an RF is to finance all the various resolution actions undertaken for an insolvent insurer, including, for example, the run-off, the sale of business, and transfer to a bridge institution. It could also be used to compensate policyholders, although this would be limited to ensure the NCWO safeguards. In contrast, IGSs have a primary function to settle claims for policyholders, thus providing for policyholder protection in the event of an insurer's failure by covering claims not related to NCWO safeguards. Since IGSs in some EU Member States have been given limited powers to finance resolution actions too, this report also considers IGSs.

### 5.2.1 Resolution funded by a resolution fund

132. **Even though an RF is envisaged in global standards for G-SIIs, it is rarely used in the EU.** According to the KAs, jurisdictions should have an industry-financed RF<sup>66</sup> or a funding mechanism in place, for the costs of providing temporary financing to facilitate the resolution of an insurer (FSB 2014a). However, only Romania has an RF for insurance, while its introduction is under consideration in the Netherlands (see Box 6), while some EU countries have IGSs with certain powers that can be used to fund selected resolution tools.

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#### Box 6

#### Examples of national resolution funds for insurers in the EU

**Experience of RFs for insurers in the EU is limited to two EU Member States.** This is despite the fact that establishing an RF is a requirement of KAs in respect of G-SIIs, which are domiciled in four EU Member States. A RF is fully operational in Romania, which is not the home jurisdiction of any G-SIIs, while a proposal has been made to establish an RF in the Netherlands.<sup>67</sup>

**The two frameworks differ significantly in terms of scope, with the RF in Romania used to finance a broad range of objectives.** It was established as a specialised structure and is managed by the Romanian IGS. The RF is able to: (i) cover the needs related to the

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<sup>65</sup> Within the banking union, a resolution fund has been created to provide funding to the resolution process where and if needed subject to conditionality, whereas deposit guarantee schemes provide funding for deposit insurance.

<sup>66</sup> This function could be provided by an IGS, which would be entrusted with assisting the use of resolution tools, e.g. a bridge insurer.

<sup>67</sup> Moreover, the RF in Romania is supplemented by an IGS, which covers all life and non-life products. In the Netherlands, the existing IGS is strictly limited to motor vehicle insurance.



implementation of resolution tools; (ii) ensure the continuity of the critical functions of the insurer under resolution; (iii) recover any reasonable expenses incurred in relation to the use of the resolution tools or the exercising of the resolution powers; (iv) guarantee the assets or the liabilities of the insurer under resolution; (v) finance a bridge institution or asset management vehicle, or grant a loan to these or to the insurer under resolution; (vi) transfer the assets and the insurance portfolio of the insurer under resolution; or (vii) pay compensation to shareholders or creditors. The resources may not, however, be used directly to absorb the losses of the insurer. The RF supports the resolution objectives, including the protection of public funds, by minimising reliance on public financial support and avoiding any significant adverse effects on the financial stability of the Romanian insurance market.

**In contrast, the RF proposed in the Netherlands will have limited coverage.** This will be a small RF restricted to financing the operational costs of resolution, such as the establishment of a bridge insurer. It should not be used for the recapitalisation of insurers or the absorption of losses, or to guarantee risks. The proposal envisages that no-creditor-worse-off safeguard breach compensation will be applied.

**There are also significant differences in respect of funding arrangements.** The Romanian RF is pre-funded, based on gross premiums, while the RF in the Netherlands is expected to be financed ex post by contributions from the insurance industry. In Romania contributions are received from all authorised insurers and are calculated separately for non-life and life insurance, through the application of a percentage share in relation to the gross premiums earned,<sup>68</sup> while no risk weights are applied. If there is a deficit in the RF to cover the obligations resulting from the implementation of resolution tools, the percentage share of the contributions may be increased up to a certain limit.

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## 5.2.2 Resolution funded by an insurance guarantee scheme

133. **Insurance guarantee schemes (IGSs) have been set up to provide protection to policyholders.** As Solvency II, like any other framework, cannot create a zero-failure environment for insurers, IGSs have a wider positive market impact by preserving consumer confidence and minimising market disruption if an insurer fails (Oxera 2007). IGSs provide last-resort protection to consumers when insurers are unable to fulfil their contractual commitments. As such, they protect policyholders against the risk that their claim will not be met if their insurer becomes insolvent (European Commission 2010a). However, the existence of an IGS may also be associated with possible adverse effects on the behaviour of market participants (e.g. moral hazard) although the alternatives, such as ex post government interventions, could have even greater drawbacks.
134. **The role of IGSs could be expanded to fund the use of resolution powers.** IGSs have been created with the objective of providing last-resort protection to policyholders, although some IGSs in the EU could take action that facilitates the use of selected resolution powers, i.e. portfolio transfer. This is done under certain conditions, which vary across EU Member States. The objective of any such action would typically be to protect policyholders rather than

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<sup>68</sup> It is 0.25% of gross premiums for life insurance and 0.4% of gross premiums for non-life insurance, up to a cap of RON 50 million (currently about EUR 11 million).



to safeguard financial stability. For instance, in the UK one of the criteria for IGS involvement in portfolio transfer is that a transfer must be beneficial to policyholders (EIOPA 2012a). It is therefore envisaged that the use of IGSs to fund resolution powers would be limited to the failure of primary insurers only and that IGSs would not generally fund a reinsurer resolution.<sup>69</sup>

135. **It follows that the use of funding arrangements could be further strengthened with the aim of increasing the credibility of the overall RR framework.** Their compatibility with the KAs could be further explored, such as allowing the funding arrangements to cover costs of any resolution tool for both policyholder and financial stability objectives.

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## Box 7

### Analysis of existing IGSs in the EU

**The importance of ensuring the continuity of payments is well established within the EU, albeit only with regard to certain insurance policies.** Most EU Member States have an IGS in place, although in many cases with very limited coverage of insurance policies.<sup>70</sup> Still, compared with 2010,<sup>71</sup> there has been an observable increase in the number of IGSs in the EU.

**Existing IGSs could mostly provide relief to policyholders for selective policies in the event of a primary insurer's failure, although the picture across the EU is somewhat fragmented.**

There are different degrees of policyholder protection across different insurance policies within individual EU Member States. Sector-wide policyholder protection is provided only in a few EU Member States, while the coverage of IGSs in a greater number of countries is limited to specific insurance products – mostly compulsory non-life insurance, such as motor vehicle insurance. The existence of IGSs for motor third-party liabilities insurance may be associated with the EU directive requiring each EU Member State to set up a fund providing policyholder protection for this purpose.<sup>72</sup> No similar EU-wide requirement exists for other insurance policies. Looking across the EU, there are big differences in the level and scope of coverage of IGSs. Moreover, the picture is further fragmented in terms of the different loss consequences for consumers, depending on their country of residence. For example, some IGSs provide coverage for branches operating in their jurisdictions while others do not.<sup>73</sup>

**Data demonstrate a general preference towards ex ante rather than ex post funding of the IGS.** There are also cases where a hybrid approach is followed i.e. funding through a mix of ex ante and ex post arrangements. This is particularly the case for countries where the IGS plays an important role in respect of policyholder protections, when measured by breadth of coverage.

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<sup>69</sup> This is due to the nature of the parties in the reinsurance contract and the absence of any direct impact on policyholders.

<sup>70</sup> For the purpose of this report, any funding arrangement that provides a policyholder relief in case of an insurer's failure (beyond the NCWO principle) has been identified as an IGS.

<sup>71</sup> A comparison is made with data from the COM White Paper (European Commission 2010).

<sup>72</sup> Directive 2009/103/EC of the European Parliament and of the Council of 16 September 2009 relating to insurance against civil liability in respect of the use of motor vehicles, and the enforcement of the obligation to insure against such a liability.

<sup>73</sup> For example, the IGS in the UK has very broad coverage, including UK policyholders from non-UK insurers (if established in the UK via a branch or subsidiary) as well as EU policyholders of UK insurers. The IGS in the ES, instead, applies the home-state principle only, covering claims from insurers established in ES including EU policyholders of ES insurers.



Table 5

## Estimated funds available under IGS

Member State	Available funds 2010 (€m)	Available funds 2015 (€m)	Market size by total assets (€m)	Sector	Type of funding	Coverage
AT	8	9	NA	Non-life	Ex-post	motor third-party liabilities insurance
BE	33	802	309,992	Life	Ex-ante	life insurance with a guaranteed interest rate
	0	0	12,678	Non-life	Ex-post	motor third-party liabilities insurance and worker's compensation insurance
BG	121	119	740	Life	Ex-post	all life insurance products
	269	286	1,137	Non-life	Ex-post	all non-life insurance products
CY	20	20	580	Non-life	Ex-ante	motor third-party liabilities insurance
CZ	NA*	54	NA	Non-life	Hybrid	motor third-party liabilities insurance
DE	1,407	1,739	978,237	Life	Hybrid	all life insurance products
	1	1	176,318	Non-life	Ex-post	property and casualty products (including health)
DK	40	58	17,729	Non-life	Ex-ante	all life and non-life insurance products
EE	0,0073	0	1,042	Life	Hybrid	mandatory funded pension (pillar 2)
	1	1	638	Non-life	Ex-ante	motor third-party liabilities insurance
EL	NA	NA	NA	Life	Ex-ante	all life and health insurance products
	NA	NA	NA	Non-life	Ex-ante	motor third-party liabilities insurance
ES	1,331	1,867	308,031	Life + non-life	Ex-ante	all life and non-life insurance products
FI	25	29	14,831	Non-life	Ex-post	motor third-party liabilities insurance and patient and worker's compensation insurance
FR	346 (630)	428 (785)	1,591,366	Life	Hybrid	all life and health insurance products
	250	250	1,344,129	Non-life	Hybrid	compulsory non-life insurance
HR	29	21	2,222	Non-life	Ex-ante	traffic, motor boat and aircraft third-party liabilities insurance
HU	5	10	1,790	Non-life	Hybrid	motor third-party liabilities insurance
IE	31	-862	35,105	Non-life	Ex-post	a broad coverage of non-life products
IT	486	580	358,201	Non-life	Ex-ante	motor third-party liabilities insurance and hunting accidents
LU	0,07	0	12,185,125	Non-life	Hybrid	motor third-party liabilities insurance
LT	13	21	409	Non-life	Ex-ante	motor third-party liabilities insurance
LV	2	5	173	Life	Ex-ante	all life insurance products (except health)
	5	13	471	Non-life	Ex-ante	a broad coverage of non-life insurance policies
MT	1	3	3,574	Life	Ex-ante	all life and health insurance products
	1	2.6	311	Non-life	Ex-ante	a broad coverage of non-life insurance products
NL	55	60	74,188	non-life	Ex-ante	motor third-party liabilities insurance
PL	39	28	43,033	life + non-life	Ex-post	all life insurance products and compulsory non-life insurance policies
PT	587	844	3,779	Non-Life	Ex-ante	motor third-party liabilities insurance and worker's compensation insurance
RO	130	227	7,242	Life + Non-life	Ex-ante	a broad coverage of life and non-life insurance policies
SI	9	7	2,432	Non-Life	Ex-ante	motor third-party liabilities insurance
SK	28	24	6,437	Non-life	Hybrid	motor third-party liabilities insurance
UK	(1,766)	(939)	1,571,100	Life	Ex-post	a broad coverage of life and health insurance policies
	(316)	(816)	129,700	Non-life	Ex-post	a broad coverage of non-life insurance policies
NO	2 (290)	2 (335)	17,424	non-life	Hybrid	a broad coverage of non-life insurance policies

Source: ESRB, based on national sources.

Note: In order to improve readability, most figures were rounded to zero decimal places. Figures in brackets represent the amounts that could be levied, not actual funds which were available on balance sheets of IGSs at end-dates. Figures with a minus sign represent a deficit. NA refers to data which is not available and NA\* is used when IGS did not exist in that specific period.



**Some IGSs have additional powers to apply resolution tools.** However, a single resolution tool is envisaged in the national legislation for IGSs, which limits flexibility in the use of the most appropriate tool in any given circumstances. For example, in Greece the main objective of the IGS in the life insurance sector is to facilitate the portfolio transfer of a failed insurer (or a part of it). If a transfer is not successful, the IGS will compensate policyholders within certain limits. In Spain, in comparison, a special winding-down procedure has been established which allows an orderly and faster process characterised by better policyholder protection and compensation, although no predetermined level of protection is guaranteed.<sup>74</sup> Similarly, a specific insolvency regime has been envisaged in Austria.<sup>75</sup>

**The use of IGSs for resolution funding purposes cannot be viewed as a credible option at this juncture.** Table 5 provides data on the estimated funds available under national IGSs.

Although the data has some limitations it is still possible to draw a number of conclusions. First, there are considerable variations in available funds, largely related to the difference in coverage provided by national IGSs and the size of respective markets. Given this limited coverage of IGSs in many EU Member States, the IGSs might have neither the legal power nor the capacity to provide sector-wide relief to policyholders. Second, notwithstanding the fact that the financing of portfolio transfer by IGSs is not allowed in all EU Member States, the practical application of this resolution tool might be further hampered by the limited coverage of IGSs in many countries. It might not be sufficient to apply the resolution tool to the limited portfolio of a failing insurer, while the use of IGSs for a broader portfolio might not be possible given a low level of available funds and the limited coverage of the IGSs. Lastly, the use of IGSs for resolution funding purposes, if included in the legislation, is limited to the objective of policyholder protection. As such, it is thought that their use might be constrained in respect of financial stability objectives and that these funds could only be used for failing primary insurers (and not for a failing reinsurer).

### 5.3 Ex post and ex ante industry financing

136. **The ultimate aim of a funding arrangement is to ensure that sufficient funds are in place to meet the contractual obligations vis-à-vis policyholders in the case of an IGS and to contribute towards resolution costs in the case of an RF.** Both IGSs and RFs incur direct and indirect costs. Direct costs include administration costs and, in the event of a failure, the costs of policyholder coverage (for the IGSs) and the costs of resolution (for the RF). Indirect costs, on the other hand, could be from negative market impacts (e.g. moral hazard or possible adverse effects on market structure and competition). The indirect costs should be weighed against the expected benefits, e.g. in the case of an IGS in terms of consumer protection and market confidence (Oxera 2007). Moreover, operational costs increase following a failure. In the absence of failure administration costs are minimal (especially for ex post funded frameworks), and the guarantee costs (IGSs) and resolution costs (RF) are non-existent. However, administrative costs would increase in the event of a

<sup>74</sup> In the past, the protection reached up to 100% on average.

<sup>75</sup> In AT, insurance companies have to establish a premium reserve fund ("Deckungsstock") for life and health business. This fund shall be administered separately from other assets and constitutes a special fund ("Sondermasse") in case of bankruptcy. Insurance claims shall have priority over the remaining claims in bankruptcy. "Deckungsstock" assets may only be subject to execution for the benefit of insurance claims.



failure, although they would still be small compared with the actual cost of providing the guarantee or of financing a resolution.<sup>76</sup> It is also worth highlighting that different resolution tools are associated with different cash flows.

137. **The fees levied on the industry may be passed on to policyholders.** Depending on the level of competition in the insurance market, the costs of any industry-financed funding arrangement could be passed on to policyholders through higher premiums. The EU market seems to be, in general, competitive, which potentially limits the possibility of passing the additional costs of the new measures on to policyholders. For example, EIOPA states that intense competition has driven the industry to considerably lower premium rates, particularly for non-life insurance sector items such as motor insurance (EIOPA 2015). Coupled with the current low growth environment, the pass-through to policyholders would probably be small.
138. **Funding can take different forms.** The IGSs and RFs could be financed: (i) on an ex ante basis, through regular contributions from insurers, before any insurer failure takes place; (ii) on an ex post basis, through recoupment mechanisms, after a failure takes place; or (iii) through a combination of the two, with a hybrid fund model holding a pre-fund, also with the ability to post-fund. In a hybrid model, when an ex ante fund has reached a target level, the annual contributions can be reduced or even eliminated. An example of this type of scheme is the “Protektor” IGS for life insurers in Germany which is mainly funded ex ante, but also has an ex post element. Furthermore, contributions could be calculated using different sensitivities to risk weighting. The fees could be based on (i) contributions or levies calculated in proportion to premium income, (ii) the significance and risk profile of an insurer, (iii) the size of liabilities, or (iv) a fixed charge per contract.
139. **Ex ante funding comes with several advantages, but also has some drawbacks.** In terms of liquidity, it provides cash resources within a short period of time to meet liquidity needs in the initial phase of a failure. In terms of credibility, it demonstrates that an IGS or an RF has the resources required to protect policyholders and/or to contribute towards funding the resolution process, particularly when no government guarantee is provided. Moreover, ex ante funding may be considered to be fairer to the industry, since all companies bear the cost of failure, including the failing company. In terms of procyclicality, raising ex ante funds in profitable times means creating a financial buffer for times of stress or failure of an insurer. Little or no additional burden is thus placed on the surviving insurers, reducing the probability of a further failure. As such, the cost can be absorbed and allocated more easily. Moreover, if combined with risk-weighted or risk-sensitive contributions, insurers taking a greater risk and thus exposed to a higher probability of failure can be charged ex ante through a higher contribution, therefore contributing further to a fairer distribution of costs and incentivising the insurer to adopt a modest risk profile. Ex ante funds could also be a source of income, particularly in respect of possible investment income on raised funds, which could be used to cover operational costs. On the other hand, ex ante RFs or IGS are associated with possible higher administrative and operational costs for their management, e.g. in terms of collecting contributions or managing investments. This drawback could be (at least partially) offset by yields on investments.

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<sup>76</sup> In the past, guarantee costs in the EU were not high (generally, a fraction of 1% of gross premiums), but in the event of a large failure, or multiple failures, the short-term costs of providing a guarantee are likely to be far higher than those experienced previously.



140. **There are certain arguments favouring ex post funding, although this form of funding is also associated with financial stability risks.** First, it might guarantee a more efficient allocation of capital. As regular contributions are not needed, insurers could use those funds more efficiently in their operations to generate income and to meet liquidity and solvency ratios. Second, ex post funding is associated with lower operational and administrative costs in 'good times', and as such IGSs or RFs do not incur any investment management or administrative costs. Third, it could be also argued that the cost of a post-fund may be lower for the industry as only the actual amount required would be collected. The disadvantages are associated with timing issues, namely an inability to raise sufficient funds, and the fact that any levies on surviving entities could lead to possible contagion due to the additional burden in times of market stress.
141. **A balance could be struck between funding ex ante and ex post.** A hybrid model could be used to keep the level of the ex ante fund adequate to meet all immediate liquidity needs and keep the ex post fund mechanism available for less likely but plausible failures.

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## Box 8

### Potential impact of a large primary insurer insolvency

**This analysis discusses the potential impact of capital shortfalls related to the failure of the largest primary insurer in individual EU Member States.** The analysis is based on the assumption that alternatives to the winding-down of a large insurer would be explored, given the impact such a failure would have on financial stability in an EU Member State. Authorities would consider different funding sources that could be needed to apply resolution tools and to provide policyholder compensation. The example chosen does not prejudice any large primary insurer insolvency and serves only as an illustration. Although the impact of other possible scenarios is not discussed (such as a scenario in which multiple insurers fail simultaneously), the findings with regard to possible funding sources could also be applicable to other scenarios.

**An example has been chosen examining a 5% and a 10% shortfall in the assets of the largest primary insurer.** The table below examines a situation where an IGS or RF has been called upon to fund the failure of the largest primary insurer in each Member State, using an example where a 5% or 10% shortfall in the assets of the largest insurer needs to be covered. For each EU Member State the size of the insurance market, the size of the largest insurer, the number of market participants, and (where data are available) the amount of surplus capital in the market is shown. In order to increase comparability across the EU, the whole primary insurance sector is considered as a whole.



Table 6

### Significance of the largest primary insurer assets in respect of national insurance market own funds

Member State	Largest insurer (by total assets)			Market			Capital shortfall over Excess capital	
	Total assets (€m)	5% capital shortfall	10% capital shortfall	Size by total assets (€m)	Excess capital (€m)	No of participants	5% CS as % of EC	10% CS as % of EC
AT	15,130	756	1,513	116,309	9,771	38	8	15
BE	76,627	3,831	7,663	322,670	14,878	69	26	52
CY	550	28	55	2,577	333	25	8	17
CZ	3,579	179	358	18,635	2,276	53	8	16
DE	188,142	9,407	18,814	1,154,555	131,270	298	7	14
DK	58,708	2,935	5,871	385,677	31,590	38	9	19
EE	513	26	51	1,680	220	18	12	23
EL	3,418	171	342	15,609	777	40	22	44
ES	64,632	3,232	6,463	308,031	25,109	185	13	26
FI	6,645	332	665	39,116	8,385	49	4	8
FR	887,070	44,354	88,707	2,935,495	106,203	32	42	84
HR	1,102	55	110	4,959	873	24	6	13
HU	1,266	63	127	7,876	332	29	17	33
IE	38,810	1,941	3,881	247,353	9,369	147	21	41
IT	107,323	5,366	10,732	1,177,304	115,915	124	5	9
LT	256	13	26	1,174	274	10	5	9
LU	28,926	1,446	2,893	172,811	8,054	73	18	36
LV	140	7	14	644	45	8	16	31
MT	1,744	87	174	3,885	397	8	22	44
NL	96,330	4,817	9,633	496,205	25,783	146	19	37
PL	10,122	506	1,012	43,033	8,360	60	6	12
PT	14,021	701	1,402	53,319	1,185	46	59	118
RO	707	35	71	3,621	299	32	12	24
SE	80,681	4,034	8,068	444,641	115,942	150	3	7
SI	2,708	135	271	6,629	579	15	23	47
SK	2,272	114	227	6,533	573	16	20	40
UK	344,999	17,250	34,500	1,700,800	55,225	286	31	62
NO	56,463	2,823	5,646	151,754	10,508	71	15	31

Source: ESRB based on national data.

Note: data as at end-2015, but RO used Solvency II data for 1 January 2016. Excess capital (Market own funds) expressed in terms of SII eligible own funds whenever possible. For DK, pension funds are also covered and only non-life insurers with non-life assets worth more than EUR 500m are covered. In EE, five branches are also covered.

**The impact on IGSs of the failure of a large primary insurer could be significant, although the overall effect is difficult to assess.** IGSs provide policyholder relief and, in some specific cases, they could be allowed to finance some resolution tools (such as a portfolio transfer).

Comparing the amount of funds available in the IGSs (see Box 7) to the amount of capital shortfall could provide an estimate of the funds available in the IGS to cover the shortfall. There are obvious limitations to this data – for example a shortfall of 5% (10%) in the capital of the largest primary insurer would not translate into the same amount of IGS payouts, since not all policies are necessarily covered by the IGSs and compensation payments could be capped. Moreover, the IGS funding could be sufficient if long-term claims are paid only when they fall due. Also, a large capital shortfall on protected policies could deplete available funds across the insurance sector and it could



take several years to fully refund the IGSs (see the example of IE with a deficit for its IGS in 2015 in Box 7). Further work would be useful to better understand the potential impact on individual IGSs of a significant primary insurance failure.

**Moreover, given the absence of an RF in the majority of EU Member States, the authorities would be left with no sources for funding the resolution process, even if there were resolution tools in place.** This means that a failed insurer would need to absorb the costs, which could further exacerbate losses incurred by policyholders. At this juncture, where there are no resolution tools other than liquidation (which might lead to severe contagion effects) and no related sources of funding available to national authorities, a bailout by the state would seem to be the most likely option where there are financial stability concerns caused, for example, by the failure of a large insurer.<sup>77</sup> This analysis stresses that an effective RR framework should also take funding arrangements into consideration.

**Time provides an opportunity for authorities to strengthen funding arrangements.** As the analysis shows, some EU Member States would have difficulty affording the failure of their largest insurer, without the allocation of losses to policyholders or a bailout. However, the specificity of the insurance sector is that time might be a less pressing issue. For example, in the case of the impact of the LIR, this would be a “slow burn” issue. Time therefore provides an opportunity for the authorities to create new funded schemes or strengthen existing schemes, both IGSs and RFs, and to build up their target levels ahead of an insurer’s failure.

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<sup>77</sup> It is worth noting that EU state aid rules must be complied with before a state bailout is approved by the European Commission.



## Section 6

### Role of the macroprudential authority

142. **Macroprudential policies and recovery and resolution (RR) policies can complement and reinforce each other, and there is the potential for each of them to support the other's objectives.** A macroprudential authority can propose or take measures itself to address sources of systemic risk in the insurance sector, thus reducing the likelihood of failures. An effective RR framework could reduce the likelihood of failures of individual entities and could reduce any impact on financial stability, e.g. in terms of systemic contagion, in the event of a failure. Moreover, the resolution framework could strengthen market discipline and reduce incentives to take excessive risks, thus mitigating the need for intervention by the macroprudential authority. In contrast, in the absence of an effective RR framework and in the presence of financial stability concerns, this situation might require more forceful macroprudential action. Robust resolution frameworks improve the ability of the authorities to deal credibly with individual weak insurers, thereby helping to guarantee a more efficiently structured system-wide regime.
143. **Furthermore, crisis management requires close coordination among all authorities, both ex ante as well as during the crisis.** The 2008 financial crisis demonstrated severe weaknesses in the financial system's safety net. While the deficiencies were evident almost worldwide, the most severe problems were encountered in Europe, largely due to the weak coordination, consultation and development of coherent strategies to deal with the crisis (COM 2010a and COM 2010b). Financial instability is made worse by uncertainty, and crisis management and resolution are complex processes, requiring the involvement of different types of expertise. It is therefore important to identify and agree upfront on the relevant organisations involved in the process, including their roles and responsibilities, as well as to set out a framework for the decision-making process for all parties involved in a crisis situation. A clear division of responsibilities and actions to be taken is also important for transparency and accountability, and to ultimately improve the understanding of policy actions by the financial sector and the public at large.
144. **Ongoing interaction is desirable between all the authorities involved.** The supervisory, macroprudential and resolution authorities play different roles in respect of their tasks, functions and powers. It is therefore crucial that they cooperate closely and exchange information for the resolution process to be efficient. Where an individual insurer's distress is linked to wider market turmoil or macroeconomic issues, or the insurer itself is systemically important, the macroprudential authority may be helpful in advising on the consequences of various measures taken by the supervisory or resolution authority.
145. **Cross-border and cross-sectoral perspectives and coordination are also crucial.** The recognition of losses in a predictable and transparent manner, and their allocation across insurers in the context of cross-border resolution, inherently requires coordination and agreement among national authorities. Delaying this agreement could ultimately result in resolution being disruptive when it is attempted or resolution not being attempted at all for fear of a backlash. National initiatives, which aim at improving resolution frameworks for insurers in individual jurisdictions, are likely to fall short of what is required to guarantee the consistent application of rules and the viability of resolution regimes in different countries, including the maintenance of the integrated operations of parent institutions with subsidiaries in different countries and the ex ante coordination of loss allocation between these countries. If a planned measure by a resolution authority could also have spillover effects, the macroprudential authority should be involved, in order to guarantee an adequate degree of coordination and



limit possible negative spillover effects. Moreover, the macroprudential authority is also well equipped to give an opinion on the cross-sectoral effects of measures taken by the resolution authority.

146. **Currently, considering financial stability does not always feature as one of the objectives of national RR frameworks for insurers across the EU.** Section 2 explained that the insurance sector can pose systemic risks. Moreover, according to the IAIS, a benign record showing little systemic risk from insurers in the past does not guarantee the absence of systemic risk potential in the future, as empirical assessments of the systemic importance of insurers can change over time (IAIS 2015). The current LIR environment is a good example of how this evaluation can change. However, the resolution frameworks currently applicable in several EU Member States do not generally recognise financial stability objectives in the resolution process. It follows that no formal involvement of the macroprudential authority in the RR process is envisaged. Harmonising the RR objectives across the EU with the FSB approach, by recognising policyholder protection and financial stability as objectives in the national RR frameworks, would also help to clarify the role of the macroprudential authority in the RR process.
147. **The macroprudential authority should be involved in the RR process in case there are financial stability implications.** Close coordination between the resolution authority and the macroprudential authority should be ensured so that their respective actions can be coordinated and reinforced. The resolution authority should be mandated to liaise with the national macroprudential authority, informing it in advance of any significant actions it plans to propose, in case there are any financial stability implications. Although the resolution authorities are mandated to take the lead in coordinating the overall policy response, the macroprudential authority could support the process by providing advice, based on its assessment of the evolution of the level and sources of systemic risk. It may also use available instruments to contain the amplification of risks and spillovers.
148. **The involvement of the macroprudential authority is foreseen by the current supervisory regime.** Solvency II foresees the possible consultation of the ESRB in “exceptional adverse situations”. Solvency II grants national authorities the power to allow extended recovery periods for insurers that breach their capital requirements when this is related to a wider exceptional adverse situation in the markets declared by EIOPA.<sup>78</sup> This is aimed at reducing the possible procyclical effects of a breach of SCR, such as distressed sales of assets on financial markets. Normally insurers have six months (extendable to a maximum of nine months) to return to financial soundness in accordance with a recovery plan, a condition which is approved by the supervisory authority. However, in the case of an exceptional adverse situation, declared by EIOPA, and where appropriate after consultation with the ESRB, in which the financial situation of insurers representing a significant share of the market, or of the affected lines of business, is seriously or adversely affected, the supervisory authorities concerned could extend the recovery period by a maximum of seven years. This is particularly relevant in the current economic climate, as the Directive lists a “persistent low interest rate environment” as one of the conditions for an exceptional adverse situation.
149. **However, it should be noted that only a minority of EU Member States have a dedicated resolution authority for insurers.** This could lower the chances of developing ex ante coordination procedures with macroprudential authorities in the event of a resolution, both at national and at cross-border level.

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<sup>78</sup> See Article 138(4) of the Solvency II Directive.



## Section 7

### Conclusions and possible ways forward

150. **In recent years increasing attention has been paid to recovery and resolution (RR) frameworks for insurers.** The FSB has developed its Key Attributes on effective resolution regimes for the insurance sector, requiring these to be applied for global systemically important insurers (G-SIIs). In a 2015 report, the ESRB concluded that the current RR regimes in place at national level are unlikely to be fit to handle all distress scenarios related to the current low interest rate (LIR) environment and the “double hit”, and recommended the development and operationalisation of effective RR frameworks for insurers. EIOPA recently published a Discussion Paper and an Opinion outlining the rationale for, and potential building blocks of, a harmonised EU RR framework for the insurance sector. At national level, RR frameworks have been reviewed and reinforced in Romania, France and the Netherlands.
151. **The driving force behind the development of RR frameworks is the assessment that regular insolvency procedures may not always meet resolution objectives.** The key resolution objectives are the protection of policyholders and financial stability, with the aim of ensuring the continuity of critical functions, avoiding disorderly failures and preventing contagion to other parts of the financial system. These objectives should also consider possible cross-border implications for Europe. Regular insolvency procedures do not include these specific objectives, and without an effective RR framework in place, a lack of legal powers can constrain authorities when faced with a failing insurer.
152. **The identification and protection of critical functions and the prevention of spillover effects are relevant to macroprudential supervision.** The identification of the critical functions of an insurer depends on the impact of its failure and its substitutability at the time of default. Examples include protection from risks in areas such as trade credit, marine and aviation, and the provision of retirement income. Because of the interconnectedness of insurers in the financial system and their high share of cross-border business, the spillover effects of distress and, in the worst case, default, are possible, both within the financial system and across borders. These should be identified and managed.
153. **The current environment of low interest rates highlights the need for strengthening the RR framework.** The probability of an insurer facing financial distress or default increases in this environment. The deterioration of the balance sheets of insurers may occur gradually, allowing the authorities to prepare for different adverse scenarios. This highlights the importance of pre-emptive RR plans as well as the need to strengthen early intervention powers. If recovery and early intervention measures fail, the authorities should be prepared for the insolvency of a large insurer and for sector-wide insolvencies. Moreover, an LIR environment may make it difficult to use traditional resolution strategies (such as run-off and portfolio transfer), given the potential solvency shortfalls. Given the type of business conducted by life insurers, including the provision of retirement income, pressure on the state to bail out an insurer in distress cannot be excluded.
154. **A credible and consistent RR framework could help mitigate systemic risks.** RR plans could identify critical functions and contagion channels. Resolution and early intervention tools could enable such functions to be protected and prevent contagion. Moreover, they could allocate the costs of resolution to where the authorities believe they should be borne, establishing an escalation ladder of intervention. Coordination arrangements could prevent spillover effects across sectors and borders. EIOPA concluded recently that current national



RR frameworks are fragmented and do not contain all these elements (EIOPA 2016b and EIOPA 2017).

155. **A patchwork of RR frameworks at national level may increase existing fragmentation and exacerbate cross-border contagion.** The EU insurance sector has a higher proportion of cross-border activity, relative to its total activity, than the banking sector. National RR frameworks do not take cross-border considerations into account in the application of resolution tools. Moreover, a patchwork of national RR regimes and insurance guarantee schemes (IGS) would not contribute to financial integration in Europe and might create uncertainty for market participants over the level of policyholder protection and RR tools that could be applied in the event of an insurer failing.
156. **This calls for the development of a harmonised RR framework within the EU.** As the risks of a default of an insurer depend on time and context, the authorities should have at their disposal a broad and flexible set of tools, which could be used in parallel. Several resolution scenarios should therefore be feasible, including a run-off, a portfolio transfer, a restart after bail-in, and a liquidation. In light of current challenges stemming from, for example, the LIR environment, the framework should have broad coverage, without any prejudice to the principle of proportionality. This process would also result in the harmonisation of RR objectives and the definition of triggers across the EU, as well as ensure the consistency of RR regimes for financial conglomerates.
157. **The discussion on the RR framework should also encompass how resolution is funded.** The application of any resolution tool involves certain costs, such as the costs related to portfolio transfer or to setting up a bridge insurer. In order to have in place a reliable framework for dealing with the failure of an insurer without needing to use public funds, the resolution authority must have available resources at its disposal. Setting up a resolution fund or expanding the role of IGSs to contribute towards the use of resolution tools are factors which could be seen as part of the harmonised RR framework.
158. **Losses incurred through the failure of an insurer should be allocated first to shareholders and creditors other than policyholders.** An RR framework for insurers should allocate losses to the risk-bearing creditors of insurers. This would improve market discipline and protect critical functions. Given the business model of insurers, however, there might not be sufficient debt allocated to fully protect policyholders. Although requiring insurers to hold a minimum level of loss absorption capacity might protect policyholders, this might create more downsides than benefits. In particular, it would require changes to the existing business models and the funding structure, and would also increase interconnectedness within the financial system. Losses should only be allocated to policyholders as a last resort when all other resources have been exhausted and if the stability of the financial system is at stake or in case they would face larger losses than under the regular insolvency procedure.
159. **Policyholder protection, in the form of compensation by an IGS for losses incurred, is beyond the scope of this report, but needs to be considered further.** Policyholders would be protected by the NCWO principle from incurring losses greater than those resulting from ordinary insolvency procedures. Whether and to what degree they would be protected from these losses would depend on the existence and scale of an IGS. IGSs help create confidence in the insurance sector and some IGS exist at national level, albeit with differing scope and coverage. In contrast to the situation for bank depositors, there is no harmonised level of protection for policyholders in the event of the failure of an insurer, which results in a variable degree of consumer protection across the EU. The issue deserves further analysis.



160. **Against this background, the report advocates the development of a harmonised effective RR framework for insurers across the EU.** This includes the following:

- Existing RR frameworks should be evaluated and, if appropriate, enhanced and harmonised at EU level. Furthermore, efforts should be made to ensure their consistent implementation.
- The existing RR toolkit should be expanded. A majority of ESRB member institutions take the view that this should include giving resolution authorities the power to modify the terms of existing contracts as a measure of last resort and subject to adequate safeguards.
- The RR framework should cover the whole insurance sector, while allowing for proportionality.
- The financial stability objectives of the RR framework should be recognised, with a majority of ESRB member institutions taking the view that it should be put on an equal footing with the objective of policyholder protection. In addition, the interactions of the resolution authority with the macroprudential authorities should also be clarified.
- Work on RR frameworks should go hand-in-hand with discussion of resolution should be funded.



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## Abbreviations

<b>ART</b>	Alternative risk transfer
<b>BCBS</b>	Basel Committee on Banking Supervision
<b>BRRD</b>	Bank Recovery and Resolution Directive
<b>CCP</b>	Central counterparty
<b>CDS</b>	Credit default swaps
<b>CMG</b>	Crisis Management Group
<b>COM</b>	European Commission
<b>ComFrame</b>	Common Framework for the Supervision of Internationally Active Insurance Groups
<b>EEA</b>	European Economic Area
<b>EGBPI</b>	Expert Group on Banking, Payments and Insurance
<b>EIOPA</b>	European Insurance and Occupational Pensions Authority
<b>ESRB</b>	European Systemic Risk Board
<b>EU</b>	European Union
<b>FICOD</b>	Financial Conglomerates Directive
<b>FSB</b>	Financial Stability Board
<b>G-SIB</b>	Global systemically important bank
<b>G-SII</b>	Global systemically important insurer
<b>IAIG</b>	Internationally Active Insurance Group
<b>IAIS</b>	International Association of Insurance Supervisors
<b>ICP</b>	Insurance Core Principle
<b>ICPF</b>	Insurance corporations and pension funds
<b>IGS</b>	Insurance guarantee scheme
<b>IMF</b>	International Monetary Fund
<b>KAs</b>	FSB Key Attributes
<b>LIR</b>	Low interest rate
<b>M3E3</b>	Module 3 Element 3
<b>MOF</b>	Market own funds
<b>MREL</b>	Minimum requirement for own funds and eligible liabilities
<b>NCA</b>	National competent authority
<b>NCWO</b>	No creditor worse off
<b>NTNI</b>	Non-traditional Non-insurance activities
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>ORSA</b>	Own risk and solvency assessment
<b>RF</b>	Resolution fund
<b>RMBS</b>	Residential mortgage-backed securities
<b>RR</b>	Recovery and resolution
<b>SCR / MCR</b>	Solvency Capital Requirement / Minimum Capital Requirement
<b>SIFI</b>	Systemically important financial institution
<b>SRMR</b>	Single Resolution Mechanism Regulation
<b>TLAC</b>	Total Loss-Absorbing Capacity



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