



## **ESRB Secretariat staff response to the EIOPA Discussion Paper on the potential harmonisation of recovery and resolution frameworks for insurers (EIOPA-CP-16-009)**

### **1. Introduction**

On 2 December 2016 the European Insurance and Occupational Pensions Authority (EIOPA) released a Discussion Paper on the potential harmonisation of recovery and resolution (RR) frameworks for insurers<sup>1</sup> (“the DP”). Following the consultation process, EIOPA will further develop its view on harmonising RR frameworks for insurers and might decide to publish an opinion addressed to the EU institutions on this topic.

This response summarises the ESRB Secretariat staff views on the DP, with the aim of providing a macroprudential perspective. It has benefited from comments made by members of the ESRB Insurance Expert Group, the ESRB Instruments Working Group and the ESRB’s Advisory Technical Committee (ATC). The response has not been seen or approved by the ESRB General Board and does not constitute a formal position of the ESRB.

The ESRB Secretariat staff response draws on positions taken in previous reports by the ESRB and also reflects ongoing work. In previous reports, the ESRB noted that, under certain circumstances, failures in the insurance sector could pose systemic risks (ESRB 2015)<sup>2</sup> and that an effective RR framework for the insurance sector could be used to mitigate the financial stability implications of such failures (ESRB 2016a and ESRB 2016b). Furthermore, there is ongoing work within the ESRB regarding the macroprudential aspects of RR for insurers. The ATC discussed the issue at a meeting on 23 February 2017 and noted that there is a need for an RR framework for insurers in the EU. This framework would need to combine a certain degree of harmonisation across the EU with the necessary freedom for national authorities to take account of country specificities.

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<sup>1</sup> European Insurance and Occupational Pensions Authority, “Discussion paper on potential harmonisation of recovery and resolution frameworks for insurers”, available at <https://eiopa.europa.eu/Publications/Consultations/EIOPA-CP-16-009%20Discussion%20paper%20recovery%20and%20resolution%20for%20insurers.pdf>. For the purposes of this ESRB Secretariat staff response, “insurers” should be understood in the same way as in EIOPA’s Discussion Paper.

<sup>2</sup> The ESRB has identified four main channels of systemic risk transmission, namely (i) their involvement in non-traditional and non-insurance activities, (ii) procyclical behaviour in terms of investment and pricing, (iii) a collective failure of life insurers under a scenario with 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 which are vital to economic activity.

## 2. Description of EIOPA's proposal

EIOPA developed the DP in the context of Articles 8 and 25 of the EIOPA Regulation<sup>3</sup>. The DP provides an overview of existing national RR frameworks in the EU, discusses the rationale for harmonisation and presents possible building blocks for RR frameworks. The overview of existing RR practices is based on a survey of national supervisory authorities which was conducted by EIOPA in the first quarter of 2016.

EIOPA argues in favour of a minimum harmonisation of RR frameworks across the EU, although this minimum has been defined only with respect to providing an option for national authorities to introduce additional powers at the national level. The DP does not set out in detail how the proposed minimum should be aligned with global standards, what the tools in each building block should be and which tools should be left to national discretion.

Furthermore, EIOPA defines four possible building blocks along the different stages of a crisis management process. These are broken down further into eleven sub-building blocks. However, the building blocks are not to be interpreted as a formal proposal by EIOPA.

## 3. Conclusions and proposals

The ESRB Secretariat staff welcomes the DP. The conclusions and proposals which will be expressed in this response are designed to further strengthen the macroprudential perspective on RR frameworks for the insurance sector.

### 3.1. Financial stability objectives in the RR framework (related to questions 23 and 24)<sup>4</sup>

**The ESRB Secretariat staff welcomes the consideration that has been given to the objectives of the RR framework and the fact that these have been considered in a separate building block.** The ESRB Secretariat staff recognises that an EU-wide harmonised RR framework would ensure the pursuit of a common set of objectives across the EU.

**The ESRB Secretariat staff agrees with the view that financial stability must be recognised as one of the objectives in the RR frameworks for insurers across the EU.** This stems from the concern that, under certain circumstances, failures in the insurance sector could represent systemic risk (ESRB 2015) and that the financial stability implications of such failures could be mitigated by an effective RR framework for the insurance sector (ESRB 2016a and ESRB 2016b). Although RR and macroprudential policies are distinct from each other, they complement and reinforce each other. An effective RR framework may – through recovery – reduce the likelihood of individual entities failing and – through resolution – reduce the impact of failure on financial stability by, for example, avoiding contagion. By enabling the authorities to deal effectively with weak institutions, RR frameworks might contribute to strengthening market discipline and reducing incentives to take excessive risks. In turn, this could reduce the need for macroprudential intervention. In contrast, the lack of an RR framework might require more forceful macroprudential

<sup>3</sup> Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

<sup>4</sup> Q23: Do you agree with the objectives of resolution? Should other objectives be considered? If yes, what are these objectives?  
Q24: Should the objectives be ranked? If yes, how should this look like and which objective should be the primary objective? If no, how could potential conflicts between the objectives be resolved (e.g. between policyholder protection and financial stability)?

intervention. For RR and macroprudential policies to complement and reinforce each other most effectively, the financial stability objective needs to be recognised as part of the RR framework.

**The ESRB Secretariat staff does not believe that RR objectives should be ranked.** The staff considers consumer protection and financial stability as distinct but equal and interdependent objectives in the financial regulation framework. Indeed, different objectives can be found in prudential supervisory legislation (“going” concern) and RR legislation (“gone” concern) in the banking sector. Moreover, multiple and non-ranked objectives are present in the RR framework in the EU banking sector, including financial stability and the protection of depositors. Against this background, the ESRB Secretariat staff suggests departing from the use of Solvency II objectives, including the related ranking, in the RR context. Instead, the ESRB Secretariat staff is of the view that multiple and non-ranked objectives are relevant for an RR framework in the insurance sector and that the objectives recognised by the Financial Stability Board (FSB) Key Attributes (KAs) should be considered. These are, in no particular order, (i) to avoid severe systemic disruption; (ii) to avoid exposing taxpayers to loss; (iii) to protect vital economic functions; and (iv) to protect policyholders, beneficiaries and claimants. While this view is predominantly shared by ESRB members, the ESRB Secretariat staff recognises that, in the ATC written procedure, a few ESRB member institutions expressed a preference to assign an overarching role to policyholder protection in the RR context.

**The ESRB Secretariat staff believes that greater harmonisation of RR frameworks for the insurance sector would ensure that financial stability objectives were considered on an equal footing across the EU.** Currently this is not the case, as pointed out by the EIOPA survey: financial stability is not an objective of RR frameworks in all EU Member States and, in many cases, the financial stability objective is ranked below other objectives, in particular the protection of policyholders. Moreover, in the absence of an RR framework, Solvency II objectives are considered relevant for RR policies. This indicates that the harmonisation of RR frameworks for insurers in the EU could contribute to further convergence, in which the same RR objectives, including financial stability objectives, would be recognised and pursued across different jurisdictions.

### 3.2. Effective RR for cross-border failure (related to questions 1 and 2)<sup>5</sup>

**The ESRB Secretariat staff welcomes the discussion on the pros and cons of a harmonised RR framework for insurers.** It is of the view that increasing the effectiveness of existing RR policies in Member States is desirable and it sees merit in a harmonised EU-wide framework, as this would allow for a cross-border perspective.

**The ESRB Secretariat staff notes that national RR frameworks for the insurance sector continue to differ widely across the EU.** The recent financial crisis illustrated the possible consequences of a lack of effective crisis management for cross-border financial institutions, including insurers. In line with the saying “international in life and national in death”, the authorities in individual jurisdictions only have the powers to apply national resolution tools at the level of each entity, rather than at the level of cross-border groups. Furthermore, some rescue measures (such

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<sup>5</sup> Q1: Do you consider the arguments in favour or against a harmonised recovery and resolution framework, as identified and analysed in this chapter, exhaustive?

Q2: In your view, are there any other arguments in favour or against a harmonised recovery and resolution framework which should be considered? If yes, please provide an explanation for the arguments.

as guarantees) could, if applied only in a single jurisdiction, have adverse spillover effects associated with the risk of arbitrage, in the sense that there could be large flows of funds across the EU in search of the highest level of protection (European Commission 2009). While the insurance sector in the EU has a higher share of cross-border activity than the banking sector (EIOPA 2016a), national insurance RR frameworks, as well as national insurance guarantee schemes (IGSs), continue to differ widely, as pointed out by the EIOPA survey.

**The ESRB Secretariat staff believes that national frameworks in the EU might not give sufficient consideration to cross-border aspects, and that some degree of harmonisation is therefore desirable.** National frameworks might fall short of ensuring the consistent application of rules and the viability of resolution regimes in different countries. This could affect the maintenance of any shared operations of parent institutions with subsidiaries in different countries, as well as ex-ante coordination and transparent and predictable loss-allocation mechanisms between these countries. This implies that the existing national regulations may not take into account the cross-border implications of a complex failure, resulting in increased legal uncertainty, unequal treatment of domestic and foreign policyholders, the potential spillover of financial stability issues in host countries and possible competitive distortions of national actions. Moreover, the cross-sectoral implications of such failures, in particular in the case of conglomerates, would further contribute to this complexity. This view is consistent with that of the International Association of Insurance Supervisors (IAIS), which has pointed out that the tools available to authorities to resolve insurers with cross-border activity have not kept up with the evolution of the groups themselves in terms of their complexity or geographical and cross-sectoral interconnectedness (IAIS 2011). This indicates that a degree of harmonisation of the RR framework for insurers across the EU may be a step in the right direction. It would allow the implications of any national measure for other jurisdictions to be taken into account.

**The ESRB Secretariat staff is also of the view that implementing global standards supports the harmonisation of the RR framework across the EU.** This would avoid any further fragmentation and ensure the consistent implementation and application of both the existing standards (KAs) and the upcoming standards, which are currently under review, for all insurers (Insurance Core Principles, ICPs) and for Internationally Active Insurance Groups (IAIGs, within the Common Framework for the Supervision of Internationally Active Insurance Groups, ComFrame).

### 3.3. Scope (related to questions 5 & 6)<sup>6</sup>

**The ESRB has noted previously that the insurance sector is facing multiple challenges.** These include the low interest rate (LIR) environment, an ageing population and the retirement savings gap. The LIR environment increases the likelihood of a “double-hit” scenario. If the LIR environment coincides with a sudden increase in risk premia, there is a risk that life insurers in several countries could simultaneously come under stress. The 2016 EIOPA stress test highlights the vulnerability of EU insurers to this extreme scenario, which would have a negative impact on the excess of assets over liabilities and own funds.<sup>7</sup> Moreover, as highlighted by the International

<sup>6</sup> Q5: What is your view on the scope of a recovery and resolution framework?

Q6: What is your view on the approach to the proportionality principle, i.e. defining the specific applicability for each sub-building block separately?

<sup>7</sup> According to the 2016 EIOPA stress test results, the “double-hit” scenario (reflecting a sudden increase in risk premia combined with the low yield environment) had a negative aggregated impact on the undertakings’ balance sheets of close to €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

Monetary Fund (IMF), a high correlation of insurers' stock prices among themselves and with the market implies that many insurers might be hit by the same shocks at the same time (IMF 2016). Some institutions might prove unable to successfully adjust their business models to this new environment and, if other regulatory measures were to fail, their orderly exit should be assured.

**The ESRB Secretariat staff believes that an RR framework with a broad scope would be consistent with ongoing work at the global level.** The aforementioned challenges affect the insurance sector as a whole. In particular, the implications of the “double hit” scenario indicate that the failure of any insurer, even if not systemically important on its own, could be a significant contributor to systemic risk, e.g. if it fails at the same time as other insurers or financial institutions. This suggests that national authorities should have additional powers to use RR tools to deal with this possibility. This view is consistent with the on-going discussions at the global level, in particular at the IAIS and the FSB. The global discussion on effective RR frameworks originally targeted global systemically important insurers (G-SIIs), primarily with a view to addressing the “too-big-to-fail” issue. However, the principles in the KAs are also applicable to other insurers which could be systemic or critical if they failed. Moreover, current initiatives aim to strengthen global standards on RR matters for all insurers (in particular the discussion on ICP 12) and for IAIGs (in particular the discussion on incorporating ComFrame M3E3 into the ICP framework). This suggests that an effective RR framework should be applied to the whole sector and not only to G-SIIs.

**The ESRB Secretariat staff is of the view that an RR framework with a broad scope would not contravene the proportionality principle.** While the RR framework should in principle cover the whole sector, the benefits related to the application of some 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 insurers with less diversified portfolios. This indicates that national authorities should have the power to exempt some insurers from certain aspects of the RR framework, such as RR plans, without preventing authorities from applying all the powers at their disposal should the need arise. As in the RR framework for EU banks (Article 1(1) of the Bank Recovery and Resolution Directive)<sup>8</sup>, resolution authorities and competent authorities should, as a minimum, take into account the nature of the insurer's business; its shareholding structure; its legal form; its risk profile, size and legal status; its interconnectedness to other institutions or to the financial system in general; and the scope and complexity of its activities when applying the RR framework for insurers.

**The ESRB Secretariat staff believes that additional implementation costs are not a convincing argument against harmonisation at EU level, as a certain amount of costs may be incurred in any case to comply with global standards.** The DP reports additional costs as one of the arguments against harmonisation at EU level. While acknowledging that requirements such as pre-emptive resolution plans will lead to additional costs both for insurers and for supervisory authorities, the ESRB Secretariat staff is of the view that many of these costs may be incurred at national level even without harmonisation at EU level. The reason for this is that the ongoing work at the global level to strengthen the ICP 12 standard on resolution and the ComFrame M3E3 standard will likely require changes to national legislation. As the EU harmonised framework would implement global standards, it could be argued that the cost of

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liabilities. If long-term guarantees and transitional measures were not included, almost 75% of the sample would lose more than one third of their excess of assets over liabilities.

<sup>8</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.06.2014, p.190).

harmonisation at EU level would be largely related to the costs associated with transposing global standards into national legislation.

### 3.4. Resolution powers (related to questions 28-33)<sup>9</sup>

**The ESRB Secretariat staff agrees with the DP that a harmonised RR framework should provide for a common set of RR tools.** This includes a common definition of these tools and common conditions in which they can be applied. The harmonised set of RR tools and powers should not be exclusive, i.e. resolution authorities should be able to apply resolution powers which are available in other EU Member States.

**The ESRB Secretariat staff supports a broad set of RR tools which would provide competent authorities with the flexibility to tailor each resolution strategy to specific cases.** Building on the conditions for an effective RR framework given in the KAs, national authorities in all Member States should have a broad range of tools at their disposal. In particular, tools that are currently available in certain national RR frameworks for insurers (such as an asset and liabilities separation tool) could be added to the proposal in the DP. An asset and liability separation tool, for instance, could provide for further flexibility of the resolution strategy, e.g. one part of the insurer's liabilities and related assets could be transferred to a solvent insurer or a bridge institution, whereas liquidation or run-off could be initiated for the remaining part. Moreover, competent authorities should be able to use one or multiple tools, either combined or applied separately.

**Although bail-in is one of the resolution tools available, the ESRB Secretariat staff is of the view that this tool might be less effective in the insurance sector than in the banking sector.** The bail-in tool allocates losses to shareholders and creditors, including policyholders, in a manner that respects the hierarchy of claims in liquidation. It enables the resolution authority to restructure, limit or write down liabilities in order to either facilitate a transfer or recapitalise the insurer. Moreover, it provides continuity of critical functions and of viable parts of the insurer, contrary to ordinary insolvency procedure. However, given the particular structure of insurers' balance sheets, the bail-in tool is probably less effective in the insurance sector than in the banking sector, even if the share of debt financing in some insurers is not negligible. Generally, the restructuring of policyholder liabilities should be considered a tool of last resort.

### 3.5. Financial arrangements (related to EIOPA's questions 3 & 4)<sup>10</sup>

**The ESRB Secretariat staff is of the view that further consideration should be given to setting up financing arrangements funded with ex-ante contributions from the insurance sector.** The ESRB Secretariat staff agrees with the proposed main building blocks of RR frameworks in the DP. While EIOPA notes that funding arrangements are outside the scope of the DP, the ESRB Secretariat staff believes that, in order to achieve an effective and credible RR framework, the funding arrangements for resolution tools such as portfolio transfer and other operational costs should be considered jointly with the RR framework. The application of resolution

<sup>9</sup> Q28: Do you have general comments on the powers listed above?

Q29: Should other powers be considered? If yes, what are these powers?

Q 30 - Q33: Do you have specific comments on the power to bail-in....? In your view, what are the benefits and potential (wider) implications or side effects of the power to bail-in...?

<sup>10</sup> Q3: What is your view on the proposed building blocks for recovery and resolution?

Q4: Should additional building blocks be considered? If yes, what should these building blocks be?

tools has associated costs; for example, if the authorities create a bridge insurer, it will need capital or short-term loans to be able to operate. Moreover, the application of the resolution tools requires a reliable mechanism to provide appropriate compensation where needed. The “no creditor worse off than in liquidation” safeguard ensures that creditors (including policyholders) should have a right to compensation where they do not receive at least the amount that they would have received in a liquidation of the insurer under the applicable insolvency regime.

**An effective RR framework should ensure that these costs are not borne by taxpayers, but rather by the industry.** The funding mechanism could be based on ex-ante contributions in proportion to the size and risk profile of individual insurers, combined with ex-post contributions to replenish funding sources if needed. In line with the RR framework for the banking sector, setting up a resolution fund restricted to facilitating the resolution process should therefore be considered part of the RR framework. In principle, the role of existing IGSs could be expanded to also cover resolution costs. In practice, however, large differences in terms of IGS coverage might mean that this option would be difficult to implement. Notwithstanding the role IGSs could play in resolution funding, the question of adequate policyholder protection across the EU also warrants further attention.

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