Key priorities on the EU Insurance Recovery & Resolution Directive (IRRD)

Insurance Europe does not consider there to be a need to develop an extensive recovery and resolution framework for insurers. Should such a framework nevertheless be adopted, it should be properly tailored to the insurance sector and take into consideration the specific characteristics of the EU's different national markets.

The European Commission's proposal for an Insurance Recovery and Resolution Directive (IRRD) needs a number of significant changes to make it fit for purpose and to avoid subjecting European insurers and their policyholders to a greater and more costly unnecessary regulatory burden.

This paper outlines how the EC's IRRD proposal could be streamlined to deliver a pragmatic yet effective approach to resolution for Europe's insurance industry. The proposed changes are supplemented by an analysis of the need for an insurance recovery and resolution framework in Europe by considering the existing and relevant regulatory requirements and the key aspects of recovery and resolution.

Insurance Europe's key positions on the IRRD are:

DO

Ensure the scope reflects national features, current legislation and legal forms such as conglomerates

- National authorities should have the flexibility to make exemptions as well as to make adaptations to resolution tools and powers to cater for national features.

Have a targeted scope for recovery and resolution planning requirements

- The scope should be set using risk-based criteria, including the existence of critical functions and a public interest assessment, both for group and solo undertakings. In addition, there should be no requirements for minimum market coverage or similar.
- No subsidiary-level, pre-emptive recovery and resolution planning requirements if a group plan exists.
- There should be appropriate recognition of third-country group recovery plans.
- Low risk-profile undertakings should be fully excluded from any planning requirements.

Ensure seamless interaction with the Solvency II supervisory ladder of intervention

- Resolution should only occur in the event of a breach of the minimum capital requirement (MCR) where the short-term realistic finance scheme, as required by Art. 139 of Solvency II, does not restore compliance with the MCR within the three-month timeframe.
- Only national supervisory authorities (NSAs) (and not resolution authorities) should be empowered to trigger resolution.

DON'T

Introduce unnecessary, new supervisory intervention points

- The solvency capital requirement (SCR) is significantly above the MCR and was designed and intended as an early intervention point. Even earlier intervention points are not needed and would result in higher overall capital requirements.
- The EC's proposed powers for resolution authorities to address impediment to resolvability (Art. 15) are far-reaching and intrusive. These would permit early intervention of the resolution authority in the business decisions of undertakings which meet solvency requirements.
- Art. 83 of the IRRD, which amends Art. 141 of Solvency II, creates unnecessary new intervention points and should be deleted.

Require the creation of dedicated resolution authorities

- The delegation of resolution procedures to NSAs, or separate departments within NSAs, is a more proportionate approach.

Leave the development of important aspects of the IRRD to EIOPA guidelines or regulatory technical standards

- The criteria for the assessment of resolvability, the definition of critical functions and the content of pre-emptive and resolution plans are important aspects of the IRRD proposal and should be addressed as part of the Level 1 discussion.

Introduce a requirement for national resolution funding arrangements

- It should be left to member states to decide whether resolution financing arrangements should be introduced and their design. This means avoiding imposing *ex-ante* funding requirements.
- In the case of a single point of entry (SPE), member states should ensure that an undertaking that is a subsidiary undertaking is exempted from any obligations originating from national financing arrangements if that undertaking is included in the group resolution plan drawn up by Articles 10 to 12 and the ultimate (re)insurance undertakings or insurance holding companies contribute to the financial arrangements of the member state in which the ultimate (re) insurance undertakings or insurance holding companies are established.
- Restrict resolution funding to the administration costs of resolution tools and to policyholder and beneficiary compensation arising from the no-creditor-worse-off (NCWO) principle.

Background

In September 2021, the European Commission published its proposal for an Insurance Recovery and Resolution Directive. This proposal followed its earlier work on a Banking Recovery and Resolution Directive (BRRD) and the Central Counterparty Recovery and Resolution Directive (CCPRRD).

The EC's IRRD proposal took many stakeholders by surprise due to the extensive and unnecessary requirements for minimum standards of recovery and resolution for insurance companies across Europe.

The Commission has provided the following reasons for its proposal:

- The Solvency II Directive reduces the likelihood of failures and improves the resilience of the EU insurance industry, but it is not a zero-failure regime.
- To harmonise a set of resolution tools to intervene early and quickly when failures do occur.
- Corporate insolvency procedures may not be appropriate for insurance.

Insurance Europe considers that a comprehensive gap analysis of current legislation and insolvency laws is, in fact, needed to better frame the Commission's proposal and the wider IRRD discussions.

The insurance business

There are a number of aspects of the insurance business model that are relevant for the development of a recovery and resolution framework that is suitable for the sector.

1. **Insurance company failures happen over a period of time**. Insurers' liabilities crystallise gradually over time. This means that, in the event of an insurer failing, there is the possibility for a structured wind-down, so that policyholders are unlikely to be left without cover. Even if an insurance activity is a concern, liquidity risk does not play the role that it does in banking.

2. **Systemic risk is significantly lower in insurance than in banking**. Insurance liabilities are largely independent of each other and are not callable on demand since an insurance liability occurs at a specified point in time or following a pre-defined insured event. Insurance companies are also not highly interlinked via an inter-insurance market.

3. **Critical functions provided by insurers are very limited in comparison to banks**. Insurers provide only limited critical services on which the real economy and financial system depend, such as payment systems. In addition, most insurance products are highly substitutable.

These unique characteristics of the insurance business model stand in clear contrast to those of banks and central counterparties (CCPs). Resolution approaches should closely reflect that. The key difference between a bank's resolution and an insurer's is that the latter can be managed over an extended period. There is no need to rush into resolution, particularly because doing so could generate avoidable losses for policyholders.

Existing regulatory landscape — Solvency II

Solvency II provides extensive safeguards against the risk of a failing insurer which mitigate the need for far-reaching recovery and resolution tools. The key aspects of it which should influence the design of the IRRD are:

- **Prudent valuation of liabilities**: reserves that should meet the costs of all future expected claims and expenses, calculated using prudent assumptions and regularly verified by supervisors.
- **Risk margin**: The risk margin is a prudential buffer which is intended to ensure that, in the rare case that an insurer fails, there are enough funds available to transfer the liabilities to a third party to allow an orderly run-off of the portfolio. It currently totals €157bn[1].

The liability reserves and risk margin ensure that, in the event of failure, there is very likely to be sufficient funds available to meet policyholders' claims.

- **Pillar I capital requirements**: Solvency II requires every European insurer to hold capital of sufficient quality to cover the cost of potential unexpected claims and expenses. These are based on very extreme, 1-in-200-year stress events. In practice, most insurers set their own capital targets at a significantly higher level.
- **Supervisory ladder of intervention**: Solvency II has two clear capital levels: the MCR (about €238bn[1] for the industry) which represents the minimum capital that insurers must hold and the much higher SCR (about €679bn[1]).

These two key intervention points, determined on a risk-based assessment of the undertaking's capital needs, enable the triggering of proportionate and timely supervisory intervention as the financial condition of an undertaking deteriorates.

- **Recovery planning**: as soon as the SCR is breached, the company is required to provide a recovery plan and the supervisor can intervene with a ladder of intervention measures, such as restricting dividends and new business.

Existing regulatory landscape — international requirements

Insurance Europe considers that the proposed IRRD goes far beyond the international standards that have been agreed by the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) in terms of scope and design.

There are a number of international standards that influence developments at European level. These are primarily 1) the FSB's key attributes of resolution regimes for insurers designated as global systemically-important insurers (G-SIIs)[2] and 2) the IAIS's work on Insurance Core Principles (ICPs) and ComFrame, which set out standards on pre-emptive recovery planning and resolution powers.

The FSB guidance states that recovery and resolution plans should be applied as a minimum to all G-SII's and other firms that could be systematically significant or critical if they fail. The identification of firms is based on a set of criteria (nature, complexity, interconnectedness, level of substitutability, size and cross-border activities).

1 EIOPA Solo statistics FY2021

2 A G-SII is an insurer identified by the FSB, in consultation with the IAIS and national authorities, as globally systemically important. In 2020, the FSB suspended the G-SII designation.

EIOPA's analysis of the prudential need for a recovery and resolution framework

As part of its preparatory work on recovery and resolution, EIOPA published a report, "Failures and near misses in insurance"[3], that provides a comprehensive assessment of the European companies that have had solvency issues over the past 23 years.

Despite the fact that the report's assessment period includes multiple stress events including the 2007-2009 global financial crisis, the 2011 European sovereign crisis and the COVID-19 global pandemic, EIOPA's report shows:

- Between 1999 and 2020 there were 219 affected insurers in 31 EU countries. This equates to 0.35 insurers per country per annum.
- The most common causes for failures or near misses were linked to internal risks, ie, management or staff lacking skills, experience or professional qualities and inadequate or failing systems or corporate governance and overall control.
- Most failures and near misses presented in the report occurred before Solvency II was introduced. The capital levels and the quality of insurers' risk management systems have improved since the introduction of Solvency II.
- The number of cases of actual insolvency in the analysis was 83. Only in 14% of these cases, or in 13 cases, did the NCAs identify important gaps in their national toolkit.

These findings confirm that there is only a limited need for a recovery and resolution framework for European insurers.

Costs of the IRRD

Insurance Europe is concerned that the costs of the EC's proposal have not been properly assessed and are likely to outweigh its benefits.

The insurance industry considers that an evidence-based cost-benefit analysis is a prerequisite for any legislative proposal and would encourage the EC to undertake a more comprehensive assessment of the costs to allow these to be weighed against the potential benefits.

3 "Failures and near misses in insurance: Overview of recovery and resolution actions and cross-border issues", EIOPA, October 2021