Position Paper

Insurance Europe response to the European commission consultation on a possible recovery and resolution framework for financial institutions other than banks

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General comments

Insurance Europe welcomes the opportunity to respond to the Commission's consultation on recovery and resolution which encompasses financial market infrastructures and the insurance sector. Insurance Europe focuses its response on recovery and resolution plans for insurers and the wider debate on systemic risk.

Insurance Europe understands that, in the wake of the 2007-08 financial crisis, there is a need to assess whether sectors other than banks are prone to generate systemic risk and what measures might be needed to prevent a failure of such institutions impacting financial stability.

This being said, Insurance Europe finds the approach adopted by the consultation in addressing these concerns somewhat confusing. In particular, Insurance Europe is concerned about the fact that the Commission seeks to identify the right approach in terms of recovery and resolution to address systemic risk concerns in the absence of consensus about the sources of systemic risk in insurance.

Insurance Europe would therefore consider it vital first to identify the potential sources of systemic risk in insurance and then to work on ways to address the related concerns. Enhanced recovery and resolution could be considered as being one among several tools that could be used. Other and possibly more effective tools would include appropriate risk management and supervisory practices.

Insurance Europe is pleased to see a reference in the consultation to the on-going IAIS and FSB exercise to identify global systemically important insurers (G-SIIs). Insurance Europe has been an active participant in

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this process and has contributed to a number of IAIS consultations[1]. The IAIS is currently in the process of assessing whether enhanced resolution mechanisms will be required as part of a specific G-SII regulatory measures package.

In discussing recovery and resolution plans for insurers, it is important to highlight that insurance is very different to banking, as the potential for the failure of an insurer to become a "systemic event", which could negatively impact other sectors of the financial system and have a significant negative impact on the wider economy, is quite limited. Within insurance, it is generally agreed that only certain non-insurance activities can (if conducted on a massive scale) give rise to systemic risk concerns, and it is these activities that should be considered in more detail when considering the potential for systemic risk in insurance.

As mentioned in the Commission's consultation document, the IAIS is currently working on identifying sources of systemic risk in insurance, but that work has not yet been completed. Irrespective of the on-going work by the IAIS, Insurance Europe believes that as a consequence of the differing nature of the insurance and banking business models, potentially systemically risky activities in insurance are to be more effectively managed by supervision and appropriate regulation rather than through establishing specific resolution regimes.

In general Insurance Europe considers existing and forthcoming recovery and resolution mechanisms (such as those provided for by the Solvency II Directive) in insurance to be both appropriate and effective. In our view no new recovery or resolution measures beyond what is proposed by the Solvency II framework are required.

As highlighted by the consultation, there have been instances in other jurisdictions, such as the failure of HIH in Australia and the bailout of AIG in the US, where the effectiveness of existing insurance resolution mechanisms could be called into question. However, in our view, these cases are very specific and it is far from clear that the potential for systemic risk in both of these events was increased by the presumed lack of an appropriate resolution mechanism or that an appropriate resolution mechanism could have mitigated the potential for systemic risk. In our view these cases are examples where both the management of the firm and their supervisors failed to adequately address the build-up of risk[2].

In the following sections, a number of comments will be made on the issue of systemic risk in insurance, and on the specificities of recovery and resolution in insurance. Responses will then be provided to the questions raised by the European Commission.

1. Systemic risk in insurance

In contrast to banking, insurance has a limited potential to generate systemic risk. This was recognised by the IAIS in its November 2011 report "Insurance and Financial Stability". Insurance companies usually have a stable, up-front and long-term funding model, a simpler balance-sheet structure and significantly lower exposure to liquidity risk. Insurance assets and liabilities are generally linked through time, which avoids the potential for risk generated by a maturity mismatch of assets and liabilities.

i) A unique balance sheet

The balance sheet of insurers is economically relatively stable: fairly long-term policyholders' and shareholders' obligations, complemented by a limited amount of subordinated or hybrid debt (liabilities), offset

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[1]See http://www.insuranceeurope.eu/uploads/Modules/Publications/insurance_europe_response_iais-consultation-2.pdf
http://www.insuranceeurope.eu/uploads/Modules/Publications/comments_on_iais_methodology_for_isystemically_risky_insurers.pdf

[2]See appendix for further details

by corresponding invested assets. On the liability side, policyholder funds either cannot be withdrawn at all or can only be withdrawn at a penalty and subject to a cancellation period. Due to this unique balance sheet structure, there is a limited possibility of an insurer undergoing a liquidity crisis.

The assets of insurance companies have, for the most part, a similar duration to liabilities. Large insurance companies actively manage their balance sheets to ensure that the value of the assets funded by technical provisions develops in synchronisation with the value of the provisions. As part of this approach, a large portion of the asset allocation of insurance companies is driven by the cash-flow profile and risk characteristics of the liabilities that fund them.

Insurers within the EU are required to hold assets to cover technical provisions. The amount and nature of the technical provisions are subject to regular supervisory oversight. If this process functions effectively, in the event of resolution an insurer should have sufficient funds to cover its insurance liabilities. In addition, in EU member states if an insurer were to become insolvent, policyholders are granted a priority order for the payment of insurance claims on assets linked to technical provisions[3].

ii) Limited interconnectedness

There is generally limited interconnectivity within the insurance industry and insurance risks are generally independent of the economic cycle. Links between insurers and the rest of the financial system are limited and the nature of the insurance business model (no maturity mismatch between assets and liabilities) along with premium income means that there is little need for insurers to have access to substantial short-term market-based funding.

Limited connectivity with other financial institutions means the failure of an insurer is unlikely to negatively impact the solvency of another entity (insurer or not). In this respect the role of connectivity in the insurance sector is quite different to that in the banking sector in terms of potential transmission of systemic shocks and in terms of the likely economic impact of failure.

In general the connections between reinsurers and primary insurers are insignificant from a financial stability perspective. Roughly 7% of global premiums are ceded by primary insurers to reinsurers. Reinsurance can be an effective way for the ceding insurer to mitigate its risk exposure and benefit from capital relief. Reinsurance is very much a traditional insurance activity and the potential for reinsurance to generate systemic risk has been acknowledged as also being limited[4].

iii) Insurance is highly substitutable

The IAIS study "Insurance and Financial Stability" found that in general, "a lack of substitutability does not appear to be an issue in the insurance industry". Insurance markets tend to be fragmented and competitive and this allows for the smooth replacement of insurance coverage in the event of an insurer failure and ensures continuity of coverage for policyholders.

It is important to differentiate between systemic risk and an inconvenient or disruptive economic event. Exceptional events (such as the 11 September 2001 terrorist attacks) or changes in the regulatory environment can cause significant changes to the underwriting conditions of certain risks which can lead to (temporary) reductions in available capacity or sharply increased prices as markets adjust. Insurance Europe can agree that such events could have a disruptive effect on parts of the economy, as consumers and business operators may have to pay higher insurance rates, postpone their activities or take on higher risks themselves. However, this does not imply a lack of substitutability.

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[3] European Parliament and Council Directive 2001/17/EC on the reorganisation and winding-up of insurance undertakings

[4] "Reinsurance and financial stability", IAIS, July 2012, para 26-29

It is important to differentiate between the impact of an insurer withdrawing insurance cover as the result of a commercial decision and the potential impact of an insurer failure on the provision of insurance coverage. Insurers may decide to limit insurance coverage in certain circumstances where, for example, potential exposure becomes immeasurable or unknown. This is a vital process in the effective management of an insurer's financial position. If this option were to become unavailable, insurers would be practically forced to continue writing insurance which may ultimately destroy them. We would not support any interference with insurers' commercial decisions, which seek to safeguard their financial position and prevent failure. Additionally, if supervisors have powers to interfere in commercial decision-making of insurers, this may discourage insurers from engaging in classes where supervisors are most likely to force insurers to provide insurance coverage.

Insurance Europe would suggest that issues highlighted by the consultation in relation to market concentration, specifically the potential impact of an insurer failure in a highly concentrated national market, are most effectively managed through competition policy.

iv) Potentially systemically risky activities

Determining whether activities have the potential to generate or transmit systemic risk should be based on an assessment of the characteristics of those activities. Characteristics such as whether the activity involves maturity and/or liquidity transformation, the creation of money-like liabilities or the inappropriate use of leverage should be considered. We consider the recent FSB consultation on shadow banking to provide appropriate guidance as to the characteristics of potentially systemically risky activities[5].

The consultation refers to financial market activities such as CDS writing and securities lending. In the event of an insurer's engagement in such financial market activities either not being subject to appropriate regulation or being conducted on a significant scale, they could have the potential, should the insurer fail, to generate systemic risk. In the case of securities lending, the investment of cash collateral in illiquid securities can, in the event of a liquidity squeeze, result in the forced sale of assets which could negatively impact asset values and exacerbate losses. In the case of CDS writing, we consider the potential for systemic risk to be a result of the speed with which CDS contracts can fall in value and the high level of interconnectedness that they create within the financial sector.

However, it is important to remember that in general insurers undertake such activities to enable a more efficient and dynamic matching of assets and liabilities. For an insurer's balance sheet to function effectively, it is important that the values of 'matched' assets and liabilities move or 'flex' in tandem. In the absence of assets of appropriate duration, certain derivative instruments can enable a more dynamic matching between assets and liabilities.

The above-mentioned activities have the potential to generate systemic risk only under limited and specific circumstances, such as being undertaken on a massive scale, being undertaken with a speculative purpose and not being subject to appropriate risk management. Insurance Europe considers the potential for systemic risk in this case to be more effectively managed through specific activity-based measures rather than through the establishment of new and specific resolution mechanisms.

As part of the governance requirements under the proposed Solvency II Directive, insurers will be required to develop policies that specify the objectives and strategy underlying the use of such activities and the way in which they facilitate efficient portfolio management or contribute to a reduction of risk. In addition, insurers will be required to incorporate the impact of such activities in performing an Own Risk and Solvency Assessment (ORSA).

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[5] See http://www.financialstabilityboard.org/list/fsb_publications/tid_150/index.htm for further details

Conclusion

Given that the potential for systemic risk is limited in traditional insurance, the focus of institutions such as the IAIS and the FSB has been on activities which, if unregulated and not subject to appropriate management, could result in the generation of systemic risk. Activities such as credit default swaps and securities lending may potentially expose some insurers to systemic risk. Insurance Europe would consider the systemic risk potential of these activities to be more effectively managed by enhanced risk management and appropriate supervision through existing and proposed regulatory frameworks such as Solvency II (which, among other things, will require any such activities to be incorporated in an insurer's ORSA, and for the insurer to hold appropriate capital in relation to the risks of the activity), rather than through establishing specific resolution regimes.

2. Recovery and resolution in insurance

The resolvability of any institution is closely linked to its business model. In insurance, financial distress company usually plays out over an extended period of time and the assets of the insurer do not need to be liquidated until claims or benefits under the policies need to be paid. This is generally not a process that occurs in the short term[6], which ensures that both supervisors and management have sufficient time to instigate processes aimed at returning the insurer to solvency. In cases where insolvency is necessary, existing and proposed regulation provides for regulators to step in if necessary and impose measures (such as restricting asset disposals) that reduce potential losses to policyholders.

In addition, the proposed Solvency II Directive will introduce a system with two levels of capital requirements to ensure the early detection of financial problems. As envisaged under the Directive, in the event of a breach of a firm's solvency capital requirement (SCR), a firm will have up to six months from the observation of non-compliance to restore the business to solvency. If appropriate, this period may be extended by three months or longer in cases where the breach of the SCR is due to significant market disruption.

This approach creates a supervisory ladder of intervention which in our view is unique in the financial sector. It allows supervisory actions while an insurance company still has net assets to meet its obligations to policyholders. The possibility for the firm's management and/or supervisory authority to take measures at an early stage and the fact that the resolution of an insurer can generally be carried out in an orderly manner has meant that, in the past, insurers have rarely needed to benefit from government support and are in our view, less likely to do so in the future.

Conclusion

Insurance Europe considers that the structure of the balance sheet and the nature of the insurance business mean that the focus in insurance should be on recovery rather than resolution. Even if trigger events are sudden, crises within insurance entities generally evolve over time. The potential for disorderly and sudden failure arises from participation in certain non-insurance activities. Insurance Europe would consider the risk posed to financial stability by these activities to be more appropriately managed through supervision, rather than through specific new resolution measures for insurance business.

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[6] For example, the largest ever US insurance insolvency, Reliance, occurred in 2000 and is still being resolved today

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

Insurance Europe strongly believes that existing resolution tools in insurance are appropriate and would enable an orderly resolution of insurers. Currently Solvency I[7] and Directive 2001/17/EC on the reorganisation and winding-up of insurance undertakings provide for effective coordination between member states. The proposed Solvency II Directive will further strengthen these processes. In our view, the current framework, which will be further strengthened by the implementation of the proposed Solvency II Directive, does not appear to have failed. Consideration should also be given to the potential cost impact of unnecessary additional measures to European policyholders.

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

No. As previously outlined, Insurance Europe believes that the focus of efforts in insurance should be on identifying the activities or entities that have the potential to generate systemic risk and on ensuring that these are appropriately managed and supervised.

It is essential that the measures specifically target the systemically risky activities in which an entity engages and are proportionate to the potential of the activity to create systemic risk. As regards the application of further measures or powers, Insurance Europe is of the opinion that the approach should be based on a process consisting of a number of successive steps:

- The first step should be to identify activities that have the potential to generate or transmit systemic risk, based on their characteristics (such as the fact that they would involve maturity and liquidity transformation, the creation of money-like liabilities or the inappropriate use of leverage).

- As a second step, there should be an examination of whether the activity is being undertaken on a scale that is systemically relevant.

- Following this, supervisors could assess whether an insurance group involved in such activities can adequately deal with the risks through its internal risk management framework, capital position and internal control processes. Indeed, risks may be mitigated via appropriate internal risk governance measures, supervisory reporting and/or appropriate supervision.

Insurance Europe believes the existing and proposed mechanisms for prompting and undertaking recovery actions and for dealing with the insolvency or "resolution" of insurers to be both appropriate and effective. In our view no new recovery or resolution measures beyond what is proposed by the Solvency II framework are required and the first step in considering any additional measures should be to clearly outline in what way the Solvency II framework is viewed to be inadequate .

Any initiatives at EU level should be consistent with measures proposed at international level. It would be helpful for the Commission to provide guidance on how G-SIIs will be identified within the EU and whether measures will be applied at member state or EU level. If the G-SII identification framework being proposed by the IAIS is to be followed, then it is unclear whether further action is required, given our understanding that national supervisors will implement the IAIS G-SII identification framework where applicable.

[7] Council Directive 73/239/EEC

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

It is important to bear in mind that "resolution" is simply an accelerated form of insolvency. Therefore, the need to resolve an insurer is related to the degree to which it undertakes non-traditional or non-insurance (NTNI) activities that have the potential to generate systemic risk, since traditional insurance business does not give rise to the need for such an accelerated process. Importantly, subjecting insurance business to such measures could be detrimental both policyholders and the financial system as a whole.

Events such as the bail-out of AIG during the 2007-08 financial crisis highlighted the difficulty of effectively resolving an insurer engaged in systemically risky non-insurance activities. The difficulties that arose at AIG during 2008 were a direct result of a non-insurance subsidiary's transactions in the CDS market. Based on this experience, the primary consideration should be whether insurers are engaging in such activities and, if so, whether these activities could result in the need for a resolution or recovery process that is different from that undertaken in the case of a purely traditional insurer.

The identification of systemically risky NTNI activities should be based on the characteristics of the activity, such as whether it involves maturity and/or liquidity transformation, the creation of money-like liabilities or the inappropriate use of leverage. These characteristics should then be considered in terms of how they could negatively interfere with an insurer's ability to successfully undertake a recovery action.

We would consider that existing and proposed insurance regulation captures the vast majority of scenarios in which an insurer would need to engage in such actions. In particular, the proposed Solvency II Directive outlines the scenarios in which recovery actions are required by an insurer and these are restated on page 31 of the consultation. In addition, in the event of a significant market disruption that could negatively affect the value of an insurer's assets, Art 138 (Para. 4) of the Solvency II Directive allows supervisors to grant an extended recovery period to allow assets to return to their long-term economic value.

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

No. The key objective for the resolution of any insurer should be the protection of policyholders. This aligns with the key objective for the regulation of insurers as a going concern given the role insurers play in providing coverage for policyholders. It is not clear if or when an adequately managed and supervised insurer can become systemic. Therefore, there is no need to restate the overriding objective of insurance supervision for systemic risk issues, which would endanger the fair treatment of all policyholders.

Insurers do not provide services essential to the smooth functioning of financial services infrastructure such as payment, settlement and clearing systems. The failure of an entity deemed systemically relevant may result in the temporary loss of coverage; however it would not result in the kind of significant economic disruption that could occur in the event of the disorderly failure of a key institution within the payments system.

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

Title IV of the Solvency II Directive provides for recovery plans in cases where an insurer breaches the SCR. The existing and proposed structure of insurance regulation acknowledges the nature of the traditional insurance model, and the prolonged time period in which insurance insolvency progresses.

Rather than developing prescriptive recovery plans, insurers could focus on developing generic processes or guidelines that can be triggered to enable agile and effective recovery in stressed circumstances. This analysis, which should use existing risk management tools such as ORSA, could identify those events that are likely to require a response and then set out processes, including possible actions around the management of capital and liquidity, as well as governance that should be applied to manage the response to stressed circumstances.

Insurance Europe would consider management and insurance group supervisors/colleges of supervisors to be best positioned to exercise any tools or actions for winding up an insurance company in advance of formal insolvency proceedings, and this should not be diminished or confused by the creation of any separate authority specifically focused on resolution.

6. Do you agree that resolution should be triggered when a systemic insurer has reached a point of distress such that there are no realistic prospects of recovery over an appropriate timeframe, when all other intervention measures have been exhausted, and when winding up the institution under normal insolvency proceedings would risk causing financial instability?

As previously stated, insurance resolution takes time. It generally takes a significant amount of time to decide whether an insurer is insolvent, yet the consultation document's discussion of triggers and insolvency proceedings is based on the premise that an insurer would need to be wound-up overnight. Given the limited potential for the failure of an insurer to threaten financial stability, this is highly unlikely and inconsistent with the timing characteristics of insurance business.

Insurance Europe considers it important that the "point of distress beyond which there are no realistic prospects of recovery over an appropriate timeframe" is determined in consultation with the entity concerned. In addition, we would consider the point of distress as a concept that requires further definition.

Insurance Europe would suggest that the initiation of proceedings that would seek to expedite the resolution process could risk the unnecessary destruction of both shareholder and policyholder value and, in the case of a large insurer, could contribute to pro-cyclicality in the wider financial markets. This could be the case in situations where an insurer is "balance sheet" insolvent as the result of the negative impact of market volatility on asset values. A swift resolution process, which would involve an expedited disposal of assets and liabilities, could have the effect of realising losses on both long-term assets and liabilities which would result in an unnecessary destruction of value for policyholders. This could be avoided if time were allowed for assets to return to their long-term economic value.

In addition we consider clarity regarding what is meant by resolution to be important in avoiding confusion with insolvency proceedings. Many of the resolution tools described in the consultation paper could be applied to protect the interests of policyholders before actual insolvency proceedings are initiated.

We agree that winding-up should be the last option once all other intervention measures have been exhausted.

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

The consultation should clarify how the current insurance supervisory ladder of intervention, as outlined in the proposed Solvency II Directive, is felt to be insufficient.

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

As previously mentioned, insurance is quite different to banking and a number of the powers mentioned by the consultation do not appropriately reflect the differences between the two sectors. A number of the potential resolution tools mentioned were originally conceived to manage resolution in the banking sector and may not be appropriate for insurance.

In addition, it is important to recognise that prospective investors will price their investments based on their status in a resolution. This factor will, in particular, put significant pressure on listed insurers and needs to be reflected upon when considering whether or not to grant supervisors further powers.

Insurance Europe does not favour the creation of a separate "resolution authority" as this would overlap with the existing authority exercised by the supervisor or the appointed insolvency practitioner where formal insolvency proceedings have been initiated.

Remove and replace the senior management

Directors and senior managers in designated functions who are able to exercise significant influence are notified to and approved by insurance supervisors. The power to remove senior management, and by virtue of their removal instigate replacement, is already available to insurance supervisors.

Appoint an administrator

Where statutory insolvency is triggered under winding-up proceedings an administrator would be appointed. We believe that the supervisor should be involved in recommending a court-appointed administrator where an insurer is deemed to be in default in accordance with member state bankruptcy law.

Operate and resolve the entity including taking commercial decisions to restructure or wind down the entity's operations

Presumably this role would be undertaken by the administrator of insolvency.

Transfer of sell specified assets or liabilities to a third party

The portfolio transfer tool available to insurance supervisors would seem to have the same effect.

Establish a temporary bridge institution to take over certain critical functions

In insurance this is another means to undertake a portfolio transfer, however given the long-term nature of insurance liabilities there is not the same time impediment that exists in banking, so use of a bridge institution as a quick or interim solution is not necessarily in the best interest of policyholders. This would be better served through a transfer to an existing, well capitalised insurer able to exercise more freedom over its investment strategy.

Separate non-performing assets into a distinct vehicle

When considering a non-performing insurance business, both assets and liabilities should not be separated. As previously stated, an insurer's assets are generally matched to specific liabilities.

Recapitalise an entity by amending or converting the terms of specified parts of the balance sheet of the entity in order to allow for the continuity of essential functions.

As noted in 4.2 (5) of the consultation, the restructuring of liabilities, for example through a scheme of arrangement, is already an available tool.

Override rights of shareholders of the firm in resolution

The current ranking of creditors in insolvency gives policyholders privilege above others. It is not clear what benefit an additional power to override the rights of shareholders of a firm in resolution would provide.
In addition, the ability of supervisors to override shareholder rights would change the investment characteristics of insurance shares. However, clarity is needed on what "in resolution" is intended to mean, ie does this mean that insolvency proceedings have commenced?

Temporarily stay the exercise of early termination rights & Impose a moratorium on payment flows

These tools may be useful in a limited range of circumstances where the effectuation of the exercise of early termination rights or payments constitutes an immediate and significant threat to the financial position of an insurer. Nevertheless, these tools constitute a significant intrusion into the contractual rights of counterparties to an insurer and may effectively mean these rights are rendered useless. This means an increased counterparty risk that will be priced by an insurer's counterparties.

Effect the closure and orderly wind down of the entity

Presumably this would be the effect of statutory insolvency proceedings and would be conducted by a court-appointed administrator.

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

Measures should in all cases be adapted to ensure their applicability to insurance. We do not consider asset separation on the basis of performance to be an appropriate response in insurance.

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

Insurance Europe strongly believes that not all activities considered non-traditional should be automatically considered systemically risky. An insurer engaged in NTNI activities should not automatically be considered systemically risky; the nature of the particular activity as well as the scale of the insurer's involvement in the particular activity is also relevant. In our view, the scope of the Commission's definition of non-traditional and non-insurance activities is too broad and includes activities that are not necessarily undertaken by regulated insurers. An example here would be bond insurers or financial guaranty providers, which are entities not regulated as insurers.

As stated earlier, Insurance Europe considers existing and forthcoming measures (in Solvency II) for recovery actions by insurers, and for the winding-up and insolvency of insurers to be both appropriate and effective. In our view the case has not yet been made for the need for additional recovery and resolution measures, and the starting point of any such debate should be to identify under what circumstances the Solvency II regime would be inadequate.

Separation of systemically important non-traditional and traditional activities

It is not entirely clear that the separation of activities as part of a resolution action would be workable in the absence of an *ex-ante* separation of activities by insurers. Insurance Europe would reject the implication of the consultation that NTNI activities should be separated from an insurer's "traditional business" so as to facilitate the continuity of critical functions in a resolution action. In our view, the current working definitions of NTNI activities (such as that proposed by the IAIS) is too broad and incorporates a number of activities that cannot be considered a potential source of systemic risk. As a consequence, Insurance Europe would strongly oppose the mandatory separation of such activities for the purpose of facilitating smoother resolution.

The separation of activities could:

- create a series of connected entities, each exposed to strongly concentrated risks but without access to the group resources to absorb significant shocks, or the means of attracting sufficient resources to do so alone;
- introduce constraints on group capital management by limiting the fungibility of capital within a group and by eliminating the benefits of diversification:
- weaken the holding company's ability to secure external funding and the capacity of the group to support M&A operations;
- make operational management of certain activities complex and costly.

The conclusions of the CRO Forum paper on "Insurers' Risk Management Systems: Preparing for Recovery"[8], suggests that the focus of risk management should be on prevention and ensuring that an entity has the ability to adapt risk management systems to take account of events and experience. Insurance Europe would consider effective risk management, in tandem with effective supervision, as the means by which any risk associated with a systemically risky non-traditional insurance activity should be recognised and managed.

Given the extensive influence that supervisors are able to exert through their existing powers, we do not believe a separate and distinct recovery tool is necessary.

Asset separation with transfer of "bad" assets into a separate legal entity in resolution

It is not clear how this would be applied in insurance where, presumably, the "bad" assets would be matched to specific insurance liabilities. Insurance liabilities are generally long-term and the matched assets could potentially recover their long-term economic value. In addition, moving assets without the corresponding liabilities would reduce available capacity to meet future claims.

Debt write down or "bail in"

A bail-in tool is not an appropriate tool in insurance, since insurers are reliant on premium income, rather than the issuance of debt, for their funding. Bail-in is a tool designed to eliminate the need for recourse to public money in the event of a bank failure, given that a bank would be required to recapitalise from within using private capital. The nature of the insurance business model is such that an insurance crisis has a much longer time horizon than a bank one, making the value of a bail-in as a resolution tool in insurance somewhat questionable.

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

[8] http://www.thecroforum.org/recovery-and-resolution-2/

Insurance Europe believes that the existing structure of insurance supervisory colleges is appropriate for coordinating recovery and resolution. It is important to remember that existing Directive 2001/17/EC allows for coordination between national supervisors. The failure of an insurer is a rare event such that the establishment of a specific institution to manage the process would, in our view, be an unnecessary burden on a supervisor's resources.

In addition the Solvency II Directive contains provisions to manage the failure of cross-border insurers. Solvency II requires an insurance group that operates on a cross-border basis to have a group supervisor (from the jurisdiction where the largest part of the business is carried out). The group supervisor is responsible for coordinating work at group level in cooperation with local supervisors through a supervisory college. It is the responsibility of the group supervisor to monitor the financial strength of the group as a whole. EIOPA would also be involved in the college and will have the power to mediate.

Given the proposed establishment of supervisory colleges, Insurance Europe has strong doubts in relation to the value of establishing resolution colleges. Cross-border resolution processes are more appropriately managed through existing supervisory colleges.

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

As previously stated, we do not understand the need for swift decision-making powers to be granted to insurance supervisors. We do not see a need for additional supervisory tools or powers that would go beyond those proposed by Title III of Directive 2009/138/EC.

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

There is no evidence to date to suggest that centralisation at EU level would enhance existing member state processes. As previously stated, Directive 2001/17/EC allows for the coordination of member state resolution processes in the event of an insurer resolution.

14. Do you think that a recognition regime should be defined to enable mutual enforceability of resolution measures?
No.

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

We find it difficult to answer this question without further detail on both the nature and scope of the envisaged bilateral co-operation agreements. This being said, for those jurisdictions that receive "equivalence" status with Solvency II, co-operation on mutual enforceability of resolution measures will already be assured.

Annex 1- The failure of HIH

The collapse of HIH Insurance group in March 2001 was the largest failure of a commercial enterprise in Australian history, with total losses to creditors and policyholders of approximately AUS$ 5.3bn[9]. As stated by the HIH Royal Commission report[10], HIH collapsed because of a failure to correctly provision for incurred future insurance claims. In particular, the payment of insurance claims was based on policies that had not been properly priced when they were originally sold. As a result, the shortfall was increasingly financed out of current premium income. This resulted in chronic under-provisioning and culminated in HIH being unable to meet claims when they became due.

On the basis of the criteria established by the FSB, there is limited evidence to suggest that the failure of HIH resulted in a "significant disruption to the Australian financial system" or that it had a significant impact on real economic activity. The failure of HIH does not appear to have derailed the return to growth of the Australian economy following the bursting of the "dot com" bubble in 2000[11][12]. The Australian government in co-operation with the insurance industry established the "HIH claims supported scheme" which provided on-going coverage to HIH policyholders and resulted in the payment of over AUS$ 245m of insurance claims over a two-year period[13].

The failure of HIH was not a systemic event. The failure had no significant impact on either the Australian financial system or the real economy. HIH's failure did temporarily disrupt activity in the construction industry but cooperation between the Australian government and the insurance industry ensured that the disruption was temporary.

We therefore do not consider the failure of HIH an appropriate example to guide policy in Europe.

[9] "HIH Systemic risk or opportunity?", Insurance and Finance No. 8, August 2011

[10] "HIH Royal commission report", http://www.hihroyalcom.gov.au/

[11] "Systemic risk in insurance – An analysis of insurance and financial stability", appendix D, Geneva Association, March 2010

[12] ibid

[13] "Systemic risk vs. the 10-year old insurance failure in Australia", Insurance and Finance No. 8, August 2011

Annex 2 – The bail-out of AIG

AIG Financial Products (AIGFP) was a financial subsidiary of the AIG Group, which offered loss protection to investors in securitised assets such as collateralised debt obligations. AIGFP, which accounted for approximately 3% of AIG's 2007 revenues, sold credit default protection on CDOs to counterparties. The total notional value of the swaps arrangements was $2.7trn of which approximately $440bn was guaranteed by the AIG holding company. The swaps contracts resulted in AIG having a substantial and concentrated exposure to the US housing market with a substantial portion of the CDS being written on subprime housing loans[14].

As noted by AIG itself in its 2007 annual report, they had failed to adequately hedge or protect their exposure to collateral calls in the event of a fall in the value of the underlying CDOs[15].

The sudden increase in residential mortgage defaults in the US mortgage market resulted in a significant fall in residential mortgage-backed CDOs. AIG Holding did not have sufficient liquidity to post the required collateral and in September 2008 was on the verge of defaulting on its payments to counterparties in the swaps market. As a result, the US Federal Reserve took the decision to extend a credit facility to AIG to prevent a default which would have had significant implications for AIG's counterparties in the swaps contracts, some of whom were among the largest financial institutions in the world.[16]

AIG was an insurance company that ran into significant difficulty as a result of the activities of one of its non-insurance business groups. The default by AIGFP on its swaps contracts would have constituted a significant systemic event that could have resulted in the failure of a number of counterparties. However, what is far from clear is whether an enhanced recovery and resolution mechanism would have prevented AIG from becoming systemically relevant within the swaps market in the first place, or if it would have had a significant impact on the decision by the US authorities to provide funding to ensure AIG met payments to counterparties.

In the case of AIGFP, the presence of an effective resolution mechanism would have been insufficient to counteract the potential for systemic risk which the default of AIG FP would have generated. Effective regulation and, more specifically, greater coordination of regulatory efforts both at sectoral and international level, would have prevented AIG from ever gaining a position of systemic relevance within the global CDS market.

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[14] "Systemic risk in insurance – An analysis of insurance and financial stability", special report of the Geneva Association Systemic Risk Working Group, March 2010

[15] Ibid

[16] "Insurance: a unique sector. Why insurers differ from banks", Insurance Europe, June 2010. http://www.insuranceeurope.eu/uploads/Modules/Publications/1277383780_cea-report-insurance-a-unique-sector.pdf

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