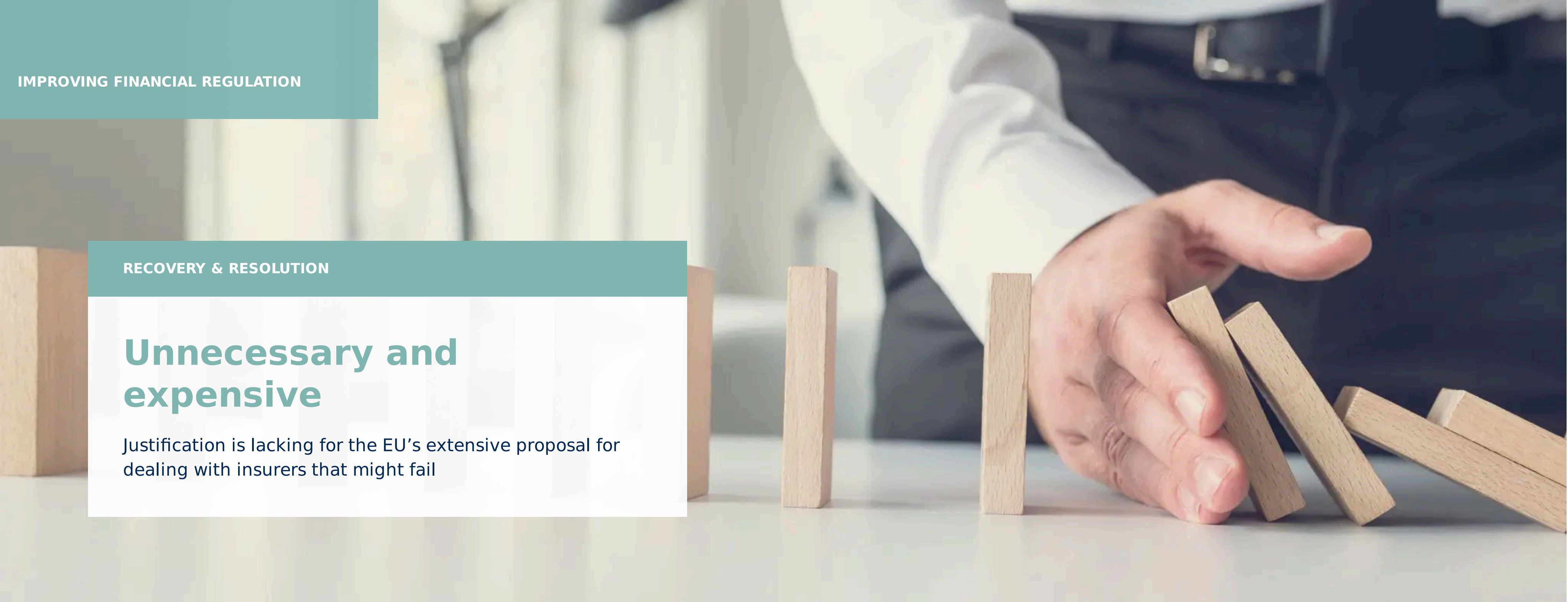


IMPROVING FINANCIAL REGULATION

RECOVERY & RESOLUTION

Unnecessary and expensive

Justification is lacking for the EU’s extensive proposal for dealing with insurers that might fail

Angus Scorgie

Head of prudential regulation & international affairs/reinsurance, Insurance Europe

Insurance is a business based on trust; customers need to be confident that their insurer will — and will be able to — pay their claims. An important part of ensuring that trust and confidence is to have effective and appropriate regulation, which is why the European insurance sector supports EU regulation that provides strong consumer protection and safeguards insurers' financial stability.

Surprisingly extensive EC IRRD proposal

The EU's prudential framework for insurers, Solvency II, provides extensive safeguards against the risk of an insurer failing, so the very wide-ranging proposal presented by the European Commission in September 2021 for an Insurance Recovery and Resolution Directive (IRRD) came as a surprise. At over 127 pages, the IRRD proposal also goes beyond the standards agreed at international level by the International Association of Insurance Supervisors.

The EU insurance industry recognises that some of the ideas and new requirements in the IRRD proposal may provide some benefits, but a number of significant changes are needed to make the proposed directive fit for purpose and to avoid subjecting EU insurers to an unnecessary, large and costly regulatory burden that would ultimately negatively affect their policyholders.

Instead of extensive, unnecessary requirements for new EU-wide rules for dealing with an insurer that may be in danger of failing, Insurance Europe would have preferred to first see a comprehensive analysis of any gaps in current legislation and insolvency laws. This would have provided the proposal and wider discussions on the recovery and resolution of insurers with a firm factual basis that was:

- focused on the limited real need for action;
- appropriately aligned to the specific characteristics of the insurance industry; and,
- proportionate to the limited risk of EU insurer failure and effect on financial stability.

Low risk of insurer failure

As the European Insurance and Occupational Pensions Authority (EIOPA) itself said and demonstrated in an October 2021 report[1], EU insurer failures are rare and have become even less likely since Solvency II was introduced. EIOPA's research identified 219 "economically significant" cases in which an insurer had solvency issues between 1999 and 2020, out of the around 3 900 insurers in 30 EEA countries (failures include UK cases prior to Brexit). This equates to an average of just 0.35 insurers per country per year. Actual insolvencies were even lower at 93, or an average of just 0.1 per country per year, and in only 13 cases did supervisors identify significant gaps in their national recovery and resolution toolkits.

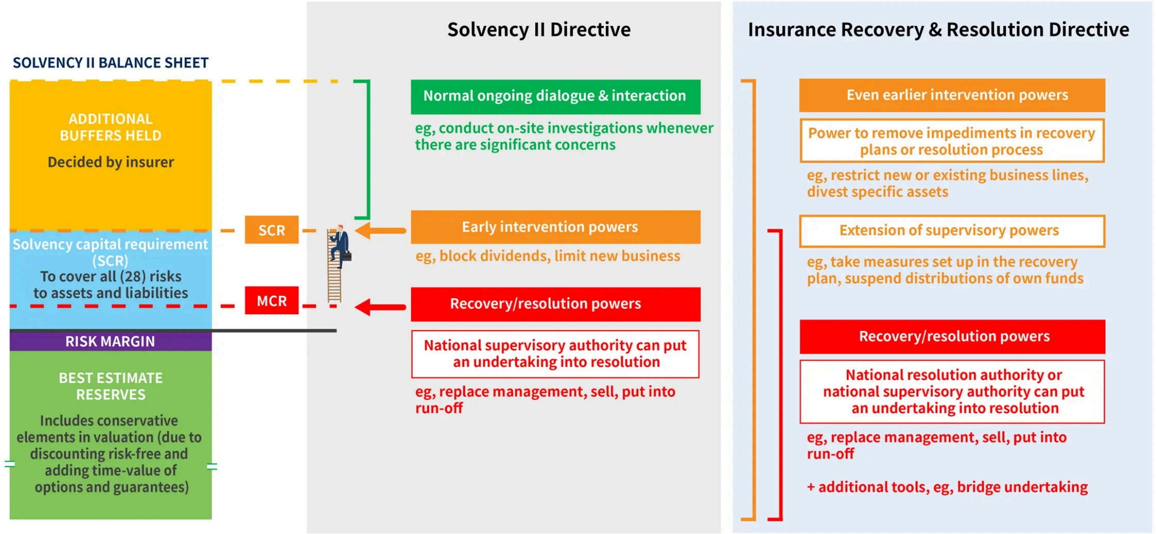
"Solvency II and supervision reduce the likelihood of [insurer] failures"

EIOPA, October 2021[1]

Most of these cases were before the introduction of Solvency II, whose extensive safeguards include:

- Conservative liability reserves and a risk margin that ensure that, in the event of failure, an insurer is likely to have sufficient funds to meet all claims.
- Prudent capital requirements that quantify and cover at least 21 different risks, ensuring that the probability of an insurer becoming insolvent during a year is no more than 1 in 200.
- A ladder of supervisory intervention, determined on a risk-based assessment of the insurer's capital needs, that triggers proportionate and early intervention, which means that in practice the likelihood of insolvency occurring is actually much lower than 1 in 200 years.
- Recovery planning: as soon as an insurer's solvency capital requirement (SCR) is breached, it is required to produce a recovery plan and the supervisor can intervene with measures such as restricting dividends or new business.

IRRD proposal significantly extends supervisory intervention and powers



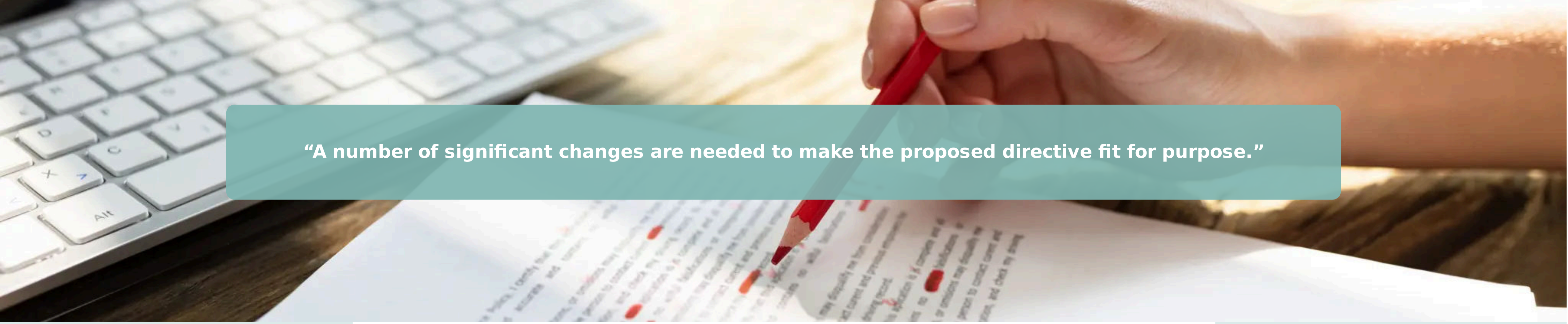
Why insurer failures are rare and orderly

The Commission's IRRD proposal is based extensively on its earlier work on recovery and resolution for the banking sector. However, the insurance business model is fundamentally different to that in the banking sector and the specific characteristics of the insurance sector need to be reflected in the recovery and resolution framework to avoid creating unnecessary and costly regulation with little or no benefit.

- Insurer failures happen over a period of time, allowing for a structured wind-down. An insurer's resolution can be managed over an extended period. Rushing to resolution could generate avoidable losses for policyholders.
- Systemic risk and the potential for financial contagion from an insolvency is significantly lower in insurance than in banking. Insurance liabilities are largely independent of each other, and insurance companies are not highly interlinked.
- Insurers provide only limited critical functions, unlike bank payment systems.

In addition, it is important to highlight the existing insolvency laws which already enable companies, including insurers, to be wound up in the case of failure. These are supplemented by provisions in Solvency II on the reorganisation and winding-up of insurance undertakings.

This is why the resolution tools set out in the proposed IRRD are only to be used in cases in which there is a need to ensure the continuity of critical functions, there are potential financial stability issues or there are concerns about the potential extent of reliance on public funds. And, as we have seen above, the potential for these aspects to materialise in an insurer insolvency are very limited.



“A number of significant changes are needed to make the proposed directive fit for purpose.”

Insurance Europe recommendations

Based on the limited need for action, the low risk of insurer failure and the specific needs of the industry, Insurance Europe is seeking the following improvements to the EC’s IRRD proposal so that it is a more pragmatic, effective approach to the recovery and resolution of EU insurers:

- Ensure its scope reflects national features, current legislation and legal forms such as conglomerates
- Apply a targeted scope to recovery and resolution planning requirements
- Base it on Solvency II’s ladder of early supervisory intervention and do not add unnecessary new intervention points
- Avoid requirements to create new dedicated resolution authorities
- Avoid leaving the development of key aspects to EIOPA guidelines or regulatory technical standards
- Do not require pre-funding of national resolution arrangements

What happens next?

Trialogues between the Council of the EU, the European Parliament and the Commission on the proposed Directive are expected to begin in the second half of 2023.

The Council position includes a number of improvements relative to the EC proposal, such as recognition of mutuals and conglomerates, a reduced scope of some of the planning requirements, the flexibility of the planning requirements and the powers to restructure insurance claims. However, it does not fully address the insurance industry’s concerns about the changes to the ladder of supervisory intervention or resolution financing and it continues to pursue the flawed idea of minimum market requirements for planning. Meanwhile, the Parliament’s texts appear to have addressed some concerns but are still under discussion.

While welcoming any moves that would make the proposal consistent with the existing regulatory framework and while awaiting the final details of its implementation, the insurance industry remains concerned that the Directive will subject EU insurers to unwarranted costs and administrative burdens that will not benefit policymakers or enhance financial stability.

Further reading:

- *"Key priorities on the EU Insurance Recovery & Resolution Directive (IRRD)", December 2022*

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