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RECOVERY & RESOLUTION

A solution in search of a problem

The EC's surprisingly extensive proposal for an Insurance Recovery and Resolution Directive is not justified by a real need

In September 2021, the European Commission presented its proposal for an Insurance Recovery and Resolution Directive (IRRDR).

Although a history of strong risk management and a focus on customer protection has meant that there have always been very few insurance failures in Europe, proposals on managing failures were expected in order to incorporate international standards developed by the IAIS. However, the decision to create a separate directive and the size and scope of the proposal took many by surprise. And despite the proposal being for a minimum harmonisation directive¹, it is already very extensive.

It includes, among other elements: proposals for the creation of 27 new resolution authorities; a requirement that pre-emptive recovery plans are prepared and updated annually for at least 80% of the EU market; a requirement that resolution plans are prepared and updated annually for at least 70% of the market; new powers of intervention for supervisors and resolution authorities; and extensive new powers for EIOPA.

As an industry, insurers recognise that some of the ideas and new requirements contained in the proposed IRRDR may provide some benefits. However, the Commission's proposal needs significant

¹ An EU minimum harmonisation directive sets a threshold that national legislation must meet but may exceed

improvements so that it is focused on the limited real needs, is appropriately aligned to the specific characteristics of the insurance industry and is proportionate to the limited risk that Europe's insurers pose to financial stability.

Banking regulation is not appropriate for insurance

The Commission's IRRD proposal is based on its earlier work in the banking sector, primarily the Banking Recovery and Resolution Directive (BRRD) which was developed and adopted in 2014 following the G20 and Financial Stability Board proposals that were developed after the 2008 global financial crisis to stabilise the financial system and the global economy.

Unfortunately, in the development of the IRRD proposal, the Commission appears to have overly relied on its previous work on the BRRD and its experience of the banking sector without sufficiently considering the limited risk posed by insurance companies and the specific nature of insurance business.

Insurance differs fundamentally from banking, and this has a significant impact on both the need for and the design of a recovery and resolution framework.

Firstly, it is important to note that the EU's regulatory framework provides several safeguards that should be reflected in any recovery and resolution framework for insurers. For Solvency II these include:

- A solvency capital requirement (SCR) that ensures a firm will remain able to meet all obligations to policyholders even after a 1-in-200-year loss event.
- A supervisory ladder of intervention that allows supervisors to begin taking actions when the SCR is breached and to fully take over the company if the lower, minimum capital requirement (MCR) is breached.
- An own risk and solvency assessment (ORSA) that requires insurers to do extensive stress- and scenario-testing.
- Provisions for the winding-up of insurers and national insolvency laws to complement these.

Secondly, traditional insurance business poses very limited systemic risks and is very different from banking. This is because, unlike banks, insurers are not institutionally interconnected. And liquidity risk is rarely, if ever, an issue due to the inverted production cycle business model, where policyholders pay premiums upfront and contractual payments are paid later — sometimes many years later — when an insured event occurs or when the contract ends. In addition, insurers operate with

very limited leverage. This means that, in the rare event of an insurer failing, it does not happen suddenly, as insurers' liabilities crystallise gradually over time, allowing for a structured wind-down, so that policyholders are unlikely to be left without cover.

Thirdly, the critical functions that insurers provide are insurance products, which are almost always substitutable by another insurer in the market. No evidence has been provided by the Commission or EIOPA to demonstrate the widespread existence of critical products or a lack of substitutability that would justify the extensive IRRD proposals.

Tailoring for the insurance sector

Much more detailed discussions are needed to develop a recovery and resolution framework that is fit for the insurance sector. It is clear that the limited amount of systemic risk, lack of critical functions and robust prudential framework mean that a much more limited set of requirements is appropriate:

- **Pre-emptive recovery and resolution planning should only be required where a real, risk-based need has been identified.** The Commission's proposals for minimum national market coverage of up to 80% creates an illusory level playing field given the diversity of the national insurance markets in the EU and only serves to unnecessarily increase regulatory cost and burden. Excessively prescriptive requirements will also reduce the usefulness of these exercises from a risk management perspective and make them a compliance exercise.
- **There should be no changes to the existing supervisory ladder of intervention.** There is no justification for the use of early intervention powers unless there has been a breach of Solvency II's SCR or MCR. The ladder of supervisory intervention already enables supervisors to step in when there is an imminent risk that capital requirements are breached. Further anticipating regulatory intervention would undermine a cornerstone of Solvency II crisis management.
- **EIOPA's role in the development and oversight of the IRRD should be focused on co-ordinating and facilitating good practice and convergence of practices among supervisors and resolution authorities.** The Commission proposes that EIOPA play a central role in the creation of the IRRD through the development of no fewer than 16 technical standards and guidelines. These would have a significant impact on its final scope and design; aspects that should remain in the control of the co-legislators. ■