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European insurance stress test: how to recover and resolve

On 6 July, the European Insurance and Occupational Pensions Authority published a long-awaited staff paper on the proposal for an Insurance Recovery and Resolution Directive. Below we take a look at its main points



The European Insurance and Occupational Pensions Authority EIOPA headquarters in Frankfurt, Germany

Setting the scene

In September 2021, the European Commission and the European Insurance and Occupational Pensions Authority (EIOPA) communicated that over the next couple of years one of their main focuses will be building a recovery and resolution framework for insurers, following in the footsteps of banking regulation, but taking into account the specifics of the insurance sector. On 6 July, EIOPA published a long-awaited staff paper on the proposal for an Insurance Recovery and Resolution Directive (IRR).

Due to interconnectedness, a failure of one insurer can bear threats not only to the stability of the financial system as a whole but also to policyholders, therefore EIOPA states that there is a need for a single EU framework in order to avoid cumbersome insolvency procedures and the use of taxpayers money. Solvency II is a risk-based regime that already significantly reduces the chance of failures, however, the near-misses are still not rare. While the Key Attributes of Effective Resolution Regimes for Financial Institutions issued by the Financial Stability Board set out general resolution tools, their application is lacking in a lot of countries.

Main aspects of IRRD

This comprehensive framework is set to cover a vast array of issues, such as recovery and resolution planning, preventive measures, resolution objectives and tools, and cooperation and coordination. The EU-wide application of the framework will facilitate the resolution of large insurers which operate in several countries. The main goal of the IIRD is to prevent a crisis. Insurers will be required to draft up preventative plans, while local resolution authorities (newly created type of authorities equipped with a minimum harmonised set of powers) will be in charge of resolution plans. The resolution authorities will have to meet the following objectives: protection of policyholders, the maintenance of financial stability, the continuation of critical functions, as well as the protection of public funds. This broad approach is different from the sole objective of the liquidator which is to achieve the best financial result for all the creditors (no creditor worse off principle still applies). Resolution procedures are triggered in case the insurer is believed to be likely to fail, there is no prospect to prevent failure within a reasonable timeframe, and resolution is necessary for the public interest. A balance should be found between not triggering resolution procedures too early when private-sector measures can still yield results, but also not too late. EIOPA sets out a broad range of resolution tools to provide maximum flexibility:

- Bail-in – write down or conversion
- Solvent run-off
- Sale of business to third parties
- Bridge undertaking
- Asset and liability separation
- Any additional national tools in line with the framework

EIOPA stresses that currently, the absence of a harmonised framework in the EU creates difficulties in the cooperation and coordination of cross-border crises. The lack of harmonisation in recovery and resolution practices in the EU complicates cross-border procedures.

IRRD versus BRRD

It is often argued that the insurance framework copies the bank framework. While IRRD and BRRD have certain similarities, the regimes are tailored to the sector specifics. General resolution objectives are similar, and so is the need for cooperation, conditions for resolution, and safeguards. However, BRRD imposed capital buffers, which EIOPA considers not necessary (at least at this stage) for the insurance sector as it would increase costs and inflate the balance sheet. EIOPA also doesn't foresee the creation of a Single Resolution Fund. While IRRD shares a lot of resolution tools with BRRD, it also has its specific tools, for instance, solvent run-off.

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