A resolution framework for insurers – what can industry expect?

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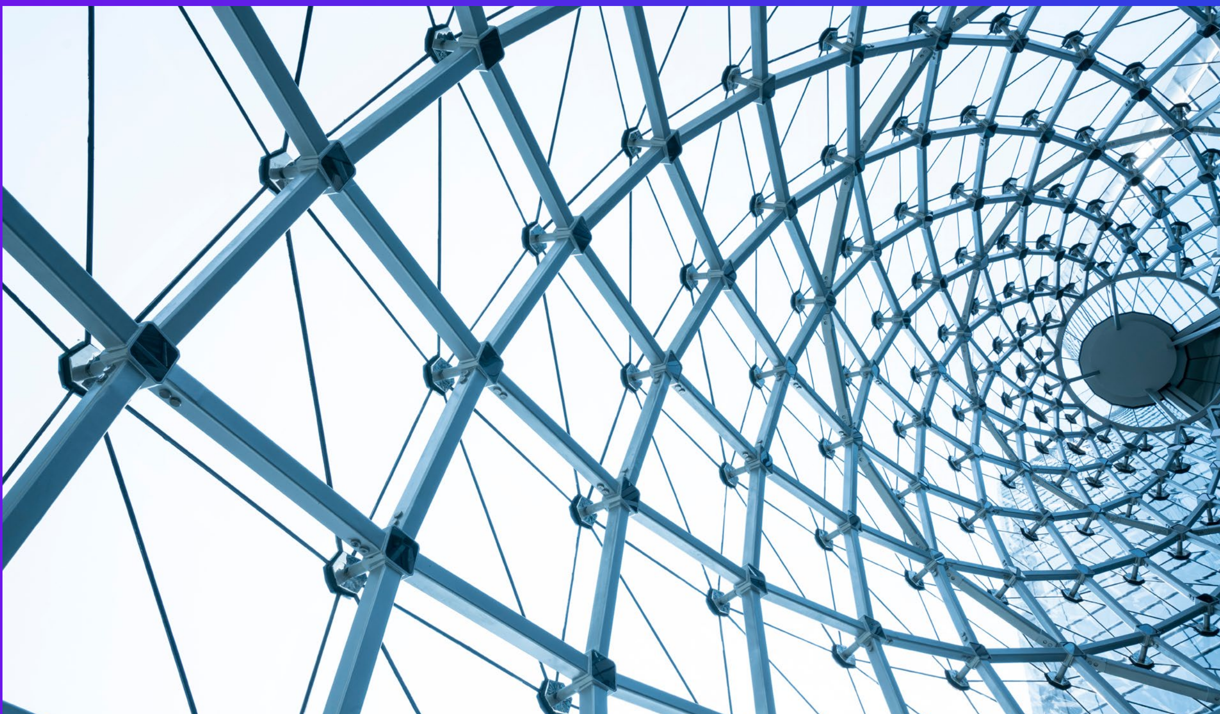


There is currently no comprehensive framework for the resolution of insurers in the UK. However, regulatory pressure has been ramping up and the Prudential Regulation Authority (PRA) has recently confirmed that one will be introduced in the foreseeable future.

This paper explores the PRA's current approach to recovery and resolution for insurers and considers what an augmented regime may look like. We also look at the experience of banks and what insurers may expect as the PRA turns its focus on them.

Background

> **"The PRA does not aspire to a zero-failure regime.... What we do have is a very low appetite for disorderly failure... The UK does not yet have a resolution authority for insurers, as recommended in the FSB's key attributes. Assessing firms' preparedness for exiting the market in an orderly manner, and working with boards to make improvements where needed, will be an increasing focus of our supervision in the next few years."**

So said Sam Woods, CEO of the PRA in his "Brave New World" speech at the ABI in March 2021[1]. And, in its January 2022 Dear CEO letter[2], the PRA confirmed that it is working with the UK Government to develop a targeted resolution framework for the insurance sector.

The focus on recovery and resolution stems from the experience of governments and regulators during the Global Financial Crisis (GFC). The Financial Stability Board (FSB), established by the G20 in the aftermath of the GFC, first set out its 'Key Attributes[3]' in 2011. These attributes are the core elements necessary for an effective resolution regime for financial institutions. The FSB's objective was to enable regulatory authorities to resolve financial institutions around the globe in an orderly manner, without the need for taxpayer money, while maintaining continuity of their vital economic functions.

Regulators initially focused on banks, given their interconnectedness and greater perceived threat to financial stability. However, recovery and resolution requirements for insurers have been developing along similar lines, albeit at a slower pace. In 2014, the FSB adopted guidance on how the Key Attributes should be applied to insurers, and in 2016 it released guidance[4] on resolution planning for systemically important insurers.

Some national authorities have made more progress than others, notably Romania, France and the Netherlands – all of which have introduced their own resolution frameworks. Most significantly, in September 2021, as part of the Solvency II Review, the European Commission published its legislative proposal for an Insurance Recovery and Resolution Directive (IRRD)[5].

The timeline below sets out in more detail the evolution of the UK recovery and resolution framework for banks and a comparative view for insurers.

1 Brave new world - speech by Sam Woods | Bank of England – 16 March 2021

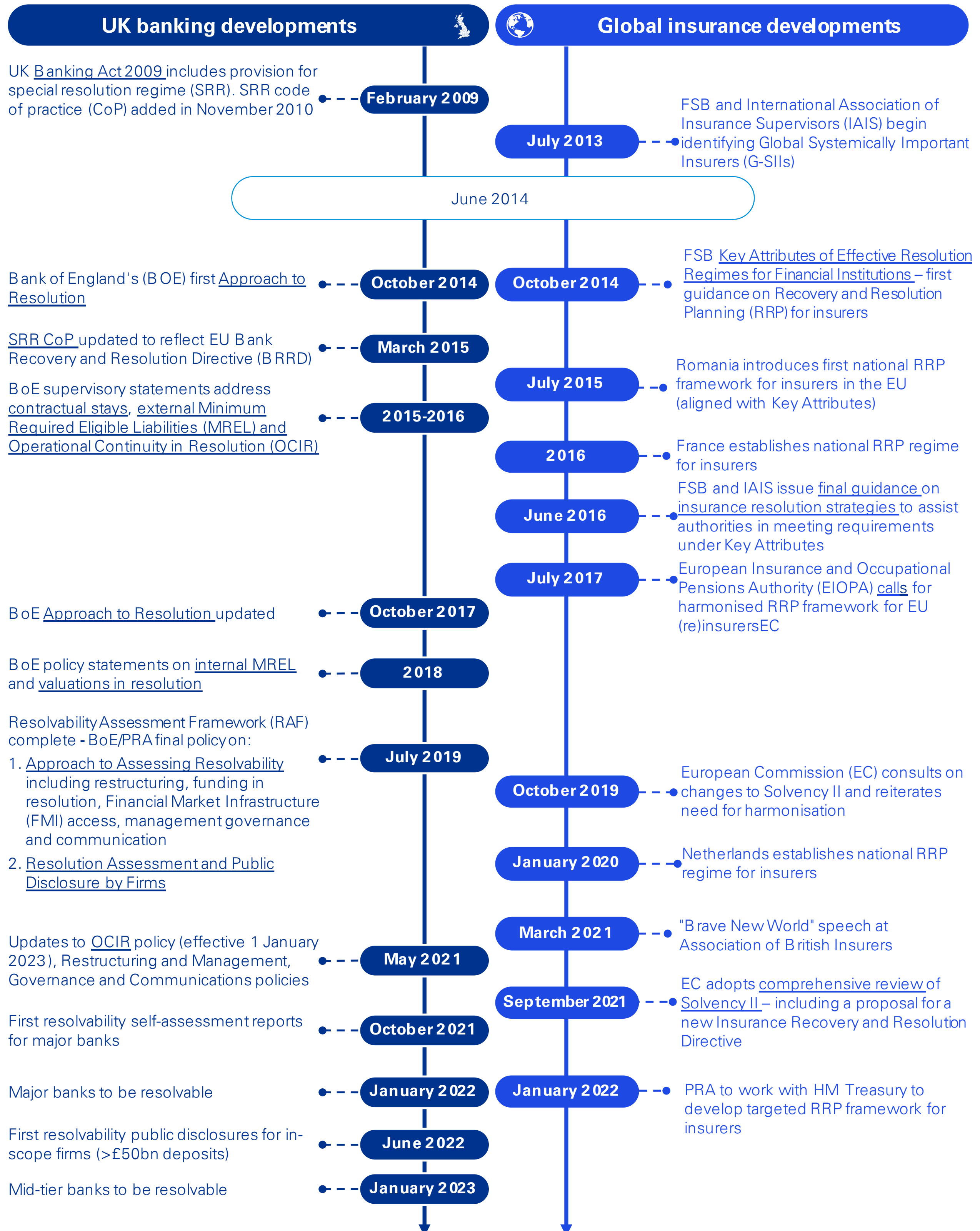
2 DCEO Letter 'Insurance Supervision: 2022 priorities' (bankofengland.co.uk)

3 Key Attributes of Effective Resolution Regimes for Financial Institutions (fsb.org) – October 2011, revised 2014

4 Final guidance on insurance resolution strategies (fsb.org) – 6 June 2021

5 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021PC0582&from=EN – 22 September 2021

The regulatory timeline



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What are recovery and resolution and what is current practice in the UK?

Recovery and resolution planning are closely related and are based largely on the same information. The key difference is that they fall at separate points along the stress continuum.

Recovery planning applies in contexts where an institution comes under stress which, though severe, does not inhibit its ability to return to business-as-usual operations. Recovery planning is driven by the financial institution itself, rather than any external authority.

Resolution planning, on the other hand, applies in contexts where an institution experiences a stress so severe that it is pushed past the inflection point of 'failing or likely to fail'. Beyond this point, the institution no longer attempts to recover, but instead executes management actions to facilitate an orderly wind down. Rather than being internally-driven, resolution planning is executed by an external resolution authority, which is required to step in and can operate within or outside general company insolvency law.

Solvency II gives powers to supervisory authorities to intervene to protect policyholders, via its supervisory ladder of intervention, when the solvency position of an insurance company deteriorates. These powers include a requirement for insurers to submit realistic recovery plans within two months of a breach of their Solvency Capital Requirement (SCR). However, insurers are not required to provide recovery plans, nor are supervisory authorities empowered to intervene before a breach in SCR.

The UK already goes further than what is strictly required by Solvency II. The PRA uses Fundamental Rule 8 as set out in its Rulebook ("a firm must prepare for resolution so, if the need arises, it can be resolved in an orderly manner with a minimum disruption of critical services") together with the latest approach to Insurance Supervision[7] (October 2018) to establish its expectations for firms. The approach document sets out the PRA's Proactive Intervention Framework (PIF), including the five stages of proximity to failure to which all insurers are mapped and the possible supervisory actions at each stage (including intensifying recovery or resolution actions).

"The PRA has so far focused on Category 1 and 2 firms whose size and type of business mean that there is 'very significant' or 'significant' capacity to cause disruption to the interests of a substantial number of policyholders. This has been done at both legal entity and group level, where relevant. Requests for recovery and resolution plans from these insurers are becoming more complex, more onerous and more regular."

The PRA's January 2022 Dear CEO letter mentions a raft of other regulatory initiatives that impinge on recovery planning. These include the PRA's new operational resilience framework (including outsourcing and third party risk management), financial resilience (as assessed by Insurance Stress Tests), liquidity risk management, and navigating the financial risks from climate change.

To date, the UK has successfully dealt with the exits of small and medium-sized firms from the market by employing the range of strategies available under UK statute and via the PRA. These principally involve the run-off or transfer of business under Part VII of the Financial Services and Markets Act (FSMA). However, they also include a scheme of arrangement or restructuring plan under the Companies Act, a range of insolvency options (including administration, compulsory or voluntary liquidation) and a court approved write-down of contracts (including a proposal to make this available before insolvency).

The Financial Services Compensation Scheme has successfully supported policyholders for a number of smaller insurers unable to meet their obligations. However, there is less certainty over the UK's ability to deal with the failure of a significant insurer, an Internationally Active Insurance Group (IAIG) (of which the UK has three – Legal & General, Aviva and Bupa) or an insurer with complex financing arrangements, a large derivatives portfolio or significant stock lending activity.

6 Fundamentalruleprinciples.pdf (bankofengland.co.uk)

7 PRA's approach to supervision of the banking and insurance sectors | Bank of England

Expanding the UK framework

Current PRA practice and guidance already has many of the ingredients necessary for a fully-fledged recovery and resolution regime. However, there is more to do. The International Association of Insurance Supervisors (IAIS) sets out 24 Insurance Core Principles (ICPs) comprising statements of principle, standards and guidance, as a globally accepted framework for insurance supervision. The Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)[8] builds on the ICPs and establishes supervisory standards and guidance focusing on the effective group-wide supervision of IAIGs, including the need to establish recovery and resolution plans.

The latest IMF Financial Sector Assessment Program, completed in March 2022, found that the UK observes fully or largely all 24 ICPs apart from ICP 12 ("Exit from the Market and Resolution") which is only partly observed. The PRA and HM Treasury (HMT) have acknowledged the gap created by the lack of a comprehensive resolution regime for insurers and have committed to developing such a regime aligned with international standards. This would extend the PRA's current entity-level powers to the highest level of insurance groups, thereby allowing for a group-wide approach to resolution.

The proposed EU IRRD, together with the FSB's 2016 guidance on resolution strategies, provide a good indication of what the final UK regime could look like in three key areas:

1. Definition of critical functions and operational continuity
2. Resolution tools
3. Regime scope

1. Critical functions and operational continuity

There has been much debate around whether insurers perform critical economic functions (CEFs) in the same way as banks.

The FSB identifies the key functions of insurance as writing new business, maintaining existing cover and paying claims.

Under the IRRD, critical functions are defined as activities, services or operations performed by an insurance or reinsurance undertaking for third parties that:

- Cannot be substituted within a reasonable time or at a reasonable cost, and
- Where the inability of the insurance and reinsurance undertaking to perform the activities, services or operations would be likely to have a significant impact on the financial system and the real economy in one or more Member States, including by:
  - Affecting the social welfare of a large number of policy holders, beneficiaries or injured parties or
  - Giving rise to systemic disruption or by undermining general confidence in the provision of insurance services

Many insurance products are highly substitutable. However, given their long-term nature, life insurance policies should ideally be continued since the policyholder may not easily be able to procure replacement cover on similar terms. Therefore, in resolution, it could be helpful to use a bridge insurer (as an alternative to administration) to provide continuity of cover and payments for existing policyholders.

Operational continuity, as defined by the FSB, relates to ensuring ongoing operation of the critical shared services that are necessary to maintain the provision or facilitate the orderly wind down of a firm's critical functions in resolution. These services are split into finance-related (e.g., treasury function, risk function, actuarial and accounting) and operational (e.g. IT, HR, payroll, transaction processing, real estate).

8 191115-IAIS-ICPs-and-ComFrame-adopted-in-November-2019.pdf (iaisweb.org)

Expanding the UK framework (cont.)

2. Resolution tools

The IRRD aims to ensure that EU Member States have a harmonised and credible set of resolution tools to facilitate timely and effective intervention. In many respects, the regime is modelled on the 2014 EU Bank Recovery and Resolution Directive (BRRD), although with adaptations to reflect the different business model of insurers (as accounted for in the FSB guidance on resolution planning for systemically important insurers).

The proposed resolution tools include:

- Solvent run-off and withdrawal of authorisation to write new business
- Sale of whole or part of the business
- Transfer of all or part of an undertaking's business to a publicly controlled entity (bridge institution), with the aim of selling the business to a private purchaser
- Write-down or conversion of capital instruments and eligible liabilities on the basis of a specified hierarchy to recapitalise the institution
- Temporary moratorium on payment of claims under insurance policies
- Stays on the redemption rights of policyholders in relation to life insurance contracts to support use of other resolution tools e.g., short stays on early termination or surrender could be used to gain time for implementation of other resolution tools while preserving value

Resolution authorities may apply the resolution tools individually or in combination.

3. Regime scope

- Under IRRD, most insurers (approximately 80% of the market) will need to prepare pre-emptive recovery plans describing the remedial action to be taken against a framework of indicators and scenarios of financial stress (including system-wide events and idiosyncratic events). Plans will need to be updated annually and upon any material change to the business. The PRA already requires recovery plans, although the scope is likely to expand to include more firms.
- Insurers will be required to submit resolution plans, covering 70% of the relevant insurance market, to new resolution authorities. Stand-alone insurance companies classified as low-risk profile undertakings under Solvency II, will be exempt, however groups, regardless of size or significance, will be in scope.
- The IRRD aims to ensure that the resolution authorities are able to take resolution action at an earlier stage than through normal insolvency proceedings. The establishment of a UK resolution authority for insurers will be a new addition to the regulatory landscape with this authority taking on greater powers of intervention at legal entity and group level.

The experience of banks and consequent insights for insurers

Regulators have largely modelled insurance recovery and resolution regimes on those of banks – while reflecting the differences between the two business models.

A key difference is that the failure of an insurer is typically managed over a long period of time rather than a single 'resolution weekend'. This longer runway period allows for the implementation of a structured wind down, typically through run-off or portfolio sale/transfer. Insurers are also not usually as heavily interconnected as banks.

Nonetheless, the experience of banks can provide practical insights for insurers:

1. For banks, a standard balance sheet diagnostic is usually applied to determine appropriate management actions. Once these are identified, appropriate work-flow tools and a data-base to store the management actions can be developed so that they are ready for deployment.
2. The management actions typically seen in a bank's recovery or resolution plan can be assigned levels to be used in cascading order depending on the severity of the stress:

- Level 1: utilisation of liquid asset buffers and central bank facilities
- Level 2: disposal of less-liquid assets, business units and non-core activities
- Level 3: solvent wind-down of businesses and entities

Insurers may wish to adopt a similar model based on a different set of management actions.

3. A bank's governance team typically involves a Recovery and Resolution Plan (RRP) Centre of Excellence that deals with horizon scanning, management action updates, liaising with regulators and ad hoc stress testing. This team will be proportional to the size and complexity of the entity, and also be influenced by the geographic footprint and the number of regulatory stakeholders.
4. Banks have found that certain resolution capabilities are more time-consuming and expensive than others, for example:

- The operational continuity in resolution (OCIR) capability requires complex analysis to accurately identify an entity's "critical services". Moreover, this capability should remain aligned to related regulations such as the proposed EU Digital Operational Resilience Act (DORA) and UK operational resilience policy.
- The valuations in resolution (VIR) capability requires both banks and insurers to perform three valuations: (i) a valuation to support the authorities' decision to enact resolution, (ii) a valuation to determine resolution action, and (iii) a valuation to confirm that no creditor is worse off compared to an insolvency. These necessitate significant investment in data and modelling capacity.

5. Banks which implemented recovery and resolution frameworks well and treated regulatory requirements as more than tick-box compliance exercises, have reaped the benefits. Alongside improved relationships with regulators, they discovered commercial benefits which could be carried forward into business as usual:

- Creating tooling to identify which businesses are underperforming (and the ability to determine whether these should be discontinued)
- Analysing stress scenarios, including capital and funding stresses, and their potential impacts
- Insight on where and how to invest going forward
- Identifying actions to make the business safer

6. Successful implementation programmes tended to share particular features:

- Clear objectives and a full and proper regulatory diagnostic at the outset
- Appropriate up-front investment, the building of an effective project team and robust governance
- Sufficient review and challenge throughout the programme, including second opinions from risk and internal audit and external assurance where appropriate
- Early checking and testing including 'fire drills' to ensure operational excellence and reviewing against objectives

Looking ahead

Overall, the regulatory direction of travel could not be clearer, though it comes at a time when UK insurers may struggle for bandwidth as they contend with the raft of initiatives mentioned in the Dear CEO letter as well as Solvency II reform and IFRS17 implementation.

In his speech[9] at the ABI Dinner in February 2022, and in HMT's Review of Solvency II consultation, former Economic Secretary to the Treasury John Glen set out key reforms to make the UK insurance sector "more dynamic, prosperous and internationally competitive". He reiterated the essential public policy objectives of the safety and soundness of insurers and the protection of policyholders.

With this is mind, recovery and resolution planning may become an even more significant tool in helping regulators ensure financial stability and monitor risk within the insurance sector. As the risk landscape continues to evolve – reflecting climate change, increasing levels of investment in illiquid assets, cyber, pandemic, geopolitical instability and inflation – the need for robust recovery and resolution planning is as important as ever. We expect the UK framework to develop at pace. Insurers would be wise to consider now how they can best position themselves to respond, and just as banks have had to do in the past, consider how these become more than esoteric regulatory exercises and help to drive value in the organisation.

How KPMG can help

KPMG professionals have extensive experience in supporting banking clients through the recovery and resolution planning and implementation process. Combined with our insurance-focused industry expertise, including helping with their responses to regulatory queries on recovery and resolution plans, we are ideally placed to help clients with both regulatory and strategic mandates.

KPMG in the UK's experience:

- Acting as a strategic adviser for the recovery and resolution journey, helping firms to bring together the various related elements of recovery and resolution planning – strategy, operational continuity, loss absorbing capacity, valuation, and resolution assessment
- Challenging thinking around proposed solutions – review and challenge of key inputs, assumptions, and outputs
- Assessing the impact of these elements on commercial viability and exploring ways of maintaining and enhancing this viability
- Integrating these elements into governance, risk appetite and risk tolerance, management, internal controls and reporting procedures and processes
- Designing and implementing solutions that remove impediments to resolvability

We can support you with:

- Board/senior management training
- Impact assessment/gap analysis
- Implementation and programme support
- Fire drill exercises
- Financial resource optimisation

9 Speech by John Glen MP, Economic Secretary to the Treasury, to the Association of British Insurers Annual Dinner - GOV.UK (www.gov.uk)

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