

Effective Resolution Regimes: Who, What, When and How

**Navigating the Way Forward for
the Last-resort Protection to Policyholders**

16 June 2021

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A Knowledge Sharing Webinar
Organized by:



International
Forum of Insurance
Guarantee Schemes
IFIGS



WORLD BANK GROUP
Finance, Competitiveness & Innovation

Insurance Guarantee Schemes

- Insurance guarantee schemes serve as the final safety net for policyholders when bankruptcy occurs despite all possible supervisory measures.
- As such, they should be considered a part of the resolution framework.

Insurance Guarantee Schemes

- An effective resolution framework is even more critical when there is an insurance guarantee scheme:
 - the more protection offered to the policyholders during the resolution phase through an effective framework,
 - the less burden is placed on the guarantee scheme,
 - and therefore, the whole insurance industry, as any scheme is ultimately funded by the contributions of the industry.

Need for a Specialized Resolution Regime

- Regular corporate bankruptcy procedures are not designed to protect the stability of the financial system when a financial institution fails.
- When an insurer becomes non-viable without a specialized resolution regime, there are two equally unattractive choices:
 - either be wound down through existing corporate bankruptcy procedures,
 - or be rescued through a public bailout.

Need for a Specialized Resolution Regime

- Neither option would prevent the effect on the overall financial system, transmitting the resulting financial stress to all the market participants.
- An effective resolution process:
 - helps to protect policyholders, and
 - contributes to the stability of the market and the financial system.

Preconditions for an Efficient Resolution Regime

- a well-established framework for financial stability, surveillance and policy formulation,
- an effective system of supervision, regulation and oversight of insurers,
- effective mechanisms for the protection of policyholders,
- a robust accounting, auditing and disclosure regime,
- a well-developed legal framework and judicial system,

Weaknesses in these areas may undermine the quality and effectiveness of resolution.

Effective Resolution Regimes: WHO

- The structure and roles of resolution authorities vary across jurisdictions:
 - resolution authority and the supervisor may be one single authority,
 - resolution authority may be the guarantee scheme,
 - one or more separate authorities may share the responsibility.
- Certain resolution powers may be exercised or overseen by the courts!

Effective Resolution Regimes: WHO

- Nonetheless, each jurisdiction should have a designated administrative authority or authorities responsible for exercising the resolution powers.
- If there are multiple resolution authorities with respective mandates, roles and responsibilities should be clearly defined and coordinated.

Effective Resolution Regimes: WHO

- The resolution authority should have:
 - operational independence, by law and in practice,
 - transparent processes,
 - sound governance,
 - adequate resources,
 - legal protection,
 - accountability.

- It is critical that the authority has the expertise, resources and the operational capacity to implement resolution measures, especially with respect to large and complex firms.

Effective Resolution Regimes: WHO

- Operational independence does not mean that the authority can have no functions other than resolution.
- An authority that carries out resolution functions may also carry out other functions, such as supervision or policyholder protection.
- Provided that adequate governance arrangements are in place to manage any conflicts of interests that may arise from combining those functions within a single authority.

Effective Resolution Regimes: WHO

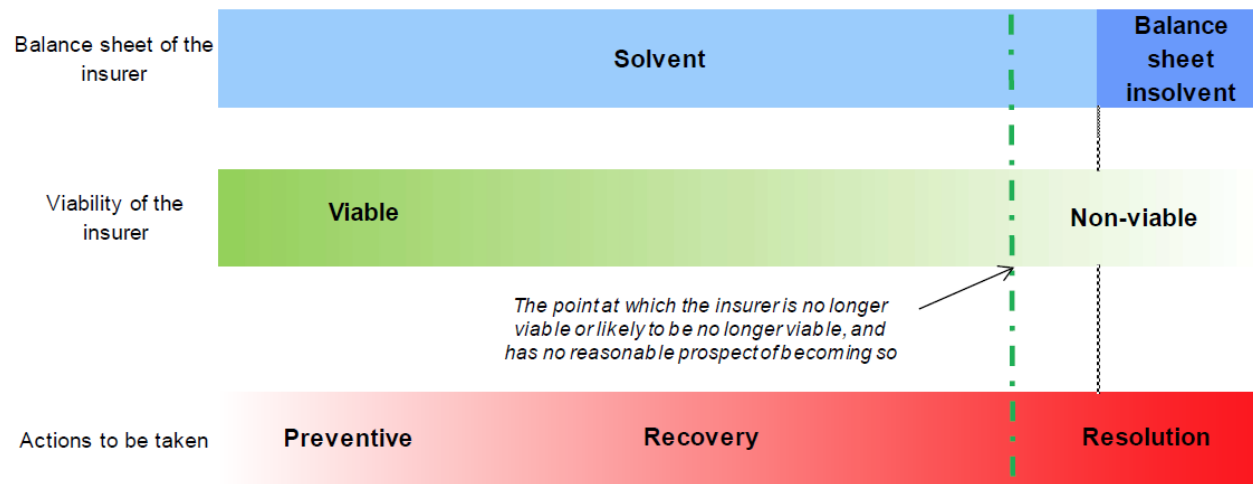
- The resolution authority and its staff should be protected against liability for actions taken and omissions made while discharging their duties in the exercise of resolution powers in good faith.
- The resolution authority should have unimpeded access to firms where that is material for the purposes of planning, preparation and implementation of resolution measures.

Effective Resolution Regimes: WHO

- The resolution authority should be the one authorized to initiate the resolution of an insurer.
- In many jurisdictions, all resolution actions, including liquidation, may only be initiated by the insurance supervisor and/or resolution authority.
- However, in some, the liquidation process can be initiated by another person (such as a creditor through the court). In such cases, at a minimum, the legislation should ensure prior coordination with the supervisor. Otherwise, the legislation should provide that the supervisor may challenge the initiator's action.

Effective Resolution Regimes: WHEN

- Resolution should be initiated when an insurer is no longer viable or likely to be no longer viable and has no reasonable prospect of becoming so.
- The resolution regime should provide for timely and early entry into resolution before a firm is balance sheet insolvent and before all equity has been fully wiped out.



Insurance Core Principles. IAIS. 2019. Figure 12.1

Effective Resolution Regimes: WHEN

- No uniform, single fixed point of non-viability can be defined that will be appropriate for applying resolution measures in all circumstances.
- Whether to apply resolution measures and the type of measures implemented will depend upon the factual circumstances of the resolution scenario.
- The concept of non-viability should permit the exercise of resolution powers before an insurer is insolvent and before all equity has been entirely wiped out.

Effective Resolution Regimes: WHEN

- 'No reasonable prospect of return to viability' means that:
there are no measures that the insurer could reasonably take,
including recovery measures identified in its recovery plan or supervisory
early intervention measures,
that are likely to restore the insurer to viability in a reasonable timeframe
having regard to the circumstances and risks to financial stability and
policyholders associated with the insurer's non-viability.
- The assessment of non-viability should not, therefore, require proof
that the insurer is insolvent. Relying exclusively on criteria closely
aligned with insolvency or likely insolvency would not meet the test for
timely and early entry into resolution.

Effective Resolution Regimes: WHEN

- examples of non-viability could include:
 - regulatory capital, assets backing technical provisions, or other prudential requirements fall below specified minimum levels;
 - the insurer will be unable to pay liabilities as they fall due;
 - the insurer's access to market-based funding sources is seriously impaired;
 - the insurer depends or would depend on official sector financial assistance to sustain operations,
 - recovery measures have failed, or there is a strong likelihood that proposed recovery measures will not be sufficient.

Effective Resolution Regimes: WHAT

- The resolution powers may be exercised by the resolution authority directly or through an appointed administrator with appropriate objectives.
- The resolution authority should be able to:
 - apply one or a combination of resolution powers, with resolution actions being either combined or applied sequentially;
 - apply different types of resolution powers to different parts of the business.
- Nevertheless, the powers should have certain features that distinguish them from powers used for ordinary supervisory purposes, and from ordinary corporate insolvency regimes.

Effective Resolution Regimes: WHAT

- Ability to interfere with third party rights
Resolution powers enable the resolution authority to interfere with third-party rights (for example, by imposing a moratorium on the enforcement of claims and imposing a temporary stay on early termination rights) and to allocate losses to creditors and shareholders.
- Exercisable by an administrative authority
If the resolution regime makes provision for a court order or confirmation, it is vital to ensure that such requirements do not impede rapid intervention.
- Exercisable without shareholder, reinsurer or creditor consent
Resolution powers must not require or be contingent on the cooperation of the failing insurer or its shareholders and should be exercisable without the consent of the insurer, its shareholders, creditors, or reinsurers.

Effective Resolution Regimes: WHAT

■ Examples

- Remove and replace the senior management and directors
- Appoint an administrator to take control,
- Operate and resolve the firm,
- Terminate contracts, continue or assign contracts, purchase or sell assets, write down debt,
- Override rights of shareholders, including requirements for approval by shareholders of transactions, to permit a merger, acquisition, sale of substantial business operations, recapitalization,,
- Establish a temporary bridge institution to take over and continue operating certain critical functions and viable operations,
- undertake a portfolio transfer moving all or part of the insurance business to another insurer without the consent of each policyholder;
- discontinue the writing of new business while continuing to administer existing contractual policy obligations for in-force business (run-off).

Effective Resolution Regimes: WHAT

- The resolution framework should ensure that the only remedy obtainable from a court through judicial review of resolution measures taken by resolution authorities acting within their legal powers and in good faith is **compensation**.

Effective Resolution Regimes: HOW

- The resolution framework should support the objective of protecting policyholders.
- A resolution regime should respect the legal system's claims hierarchy; yet still, policyholders should receive high priority in the resolution process, so that policyholders rank above ordinary unsecured creditors.
- Mechanisms, such as insurance guarantee schemes, may mitigate the need for the absorption of losses by policyholders.

Effective Resolution Regimes: HOW

- It is possible that a higher priority (over policyholders) is given to a limited number of other categories of claims. These may include claims:
 - by liquidators, such as claims for expenses arising from the liquidation procedure;
 - by employees;
 - by tax or fiscal authorities;
 - by social security systems;
 - claims on assets subject to rights in rem (through collateral, lien, mortgage).

- In some jurisdictions, policyholders receive higher priority but only on a determined part of the insurer's assets (such as technical provisions). In these cases, for this portion of the insurer's assets, policyholders' claims are generally subordinate only to liquidation expenses.

Effective Resolution Regimes: HOW

- The resolution framework, as a general principle, should observe the principle of equal (*pari passu*) treatment of creditors of the same class.

- The framework should permit departure from that principle where it is necessary:
 - to protect financial stability by containing the potential systemic impact of the insurer's failure;
 - to maximize the value of the insurer for the benefit of all creditors.

Effective Resolution Regimes: HOW

- For example:
 - two categories of policyholders of equal rank (*pari passu*) where one is covered by an insurance guarantee scheme while the other is not;
 - two categories of creditors of equal rank (*pari passu*) but the creditors are different in nature (direct policyholders versus cedants).