



# Navigating the options on recovery and resolution

As recovery and resolution planning becomes a focus for regulators, Eoin King, Bridget MacDonnell and Eamonn Phelan explore the requirements for re/insurers and the possibilities for recovery measures

**R**ecovery and resolution planning for insurers and reinsurers has been attracting a lot of regulatory attention of late. Globally, we have seen requirements for recovery and resolution plans (RRPs) come into force for global systemically important insurers (G-SIIs), following in the footsteps of similar requirements across many parts of the banking industry.

In a European context, the Solvency II directive requires re/insurers to submit realistic recovery plans to their regulatory authority following breaches of solvency capital requirements. To this end, the European Insurance and Occupational Pensions Authority launched a consultation in early December and several national supervisors have identified recovery and resolution planning as a focus for 2017.

## DRAFTING AND GOVERNANCE OF RRPS

There is a lot of material available to companies beginning to look at recovery and resolution planning. The Financial Stability Board's (FSB) paper, Key Attributes of Effective Resolution Regimes for Financial

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Institutions, contains useful guidance, such as the need for recovery plans to include credible options to cope with a range of scenarios and processes to ensure timely implementation of such plans.

An important consideration in recovery and resolution planning is the governance

arrangements that need to be put in place when drafting and maintaining plans. Guidance from the FSB and insight from banking publications, such as those of the European Banking Authority, can help companies understand what they need to do in this area. In particular, the FSB's key attributes paper discusses the need for companies to have a robust governance structure and clearly defined responsibilities to support the planning process.

In order to develop RRPs, companies should investigate options that would be available to them in the event of financial difficulty by examining a range of adverse scenarios and coming up with a shortlist of options and a broad set of principles which it can apply to almost any situation.

As solutions will inevitably need to be tailored to the exact circumstances giving rise to an adverse financial situation,

RESTRUCTURE	IMPROVE LIQUIDITY	DE-RISK	RAISE CAPITAL
<ul style="list-style-type: none"> <li>• Portfolio transfer</li> <li>• Closure</li> <li>• Group restructure</li> <li>• Other options</li> </ul>	<ul style="list-style-type: none"> <li>• VIF monetisation</li> <li>• ILS (insurance-linked securities)</li> <li>• Investment portfolio rebalancing</li> <li>• Product structure</li> <li>• Other options</li> </ul>	<ul style="list-style-type: none"> <li>• Reinsurance</li> <li>• Capital markets</li> <li>• Investment strategy</li> </ul>	<ul style="list-style-type: none"> <li>• Equity and debt</li> <li>• Contingent capital</li> <li>• Group finance</li> <li>• Off-balance sheet</li> </ul>

Table 1: Addressing the Problem - Recovery Measures

recovery and resolution plans containing a well-developed set of principles can prove invaluable in enabling an effective and coordinated response to be implemented within as short a timeframe as possible.

**RECOVERY AND RESOLUTION STRATEGIES**

According to the FSB, a recovery plan “identifies options to restore financial strength and viability when the firm comes under severe stress.” In exploring the toolkit available to re/insurers should they get into financial difficulty, we have grouped various recovery strategies into broad segments based on whether they serve primarily to improve liquidity, to raise capital, to de-risk the balance sheet or to restructure the company/group.

Table 1 summarises the key strategies.

In the remainder of this article, we consider some of these approaches in more detail.

**IMPROVING LIQUIDITY**

One of the more interesting and effective means of improving liquidity is through the use of a value in force (VIF) monetisation arrangement. The primary benefit of VIF monetisation is typically the uplift to the company’s liquidity position arising from the receipt of an upfront commission from a reinsurer or another third party in return for an illiquid asset representing capitalised future expected profits.

Depending on the regulatory regime, the capital position may also improve if the deal contains an element of risk transfer or if the value of future profits was not already included on the balance sheet.

A number of VIF monetisation transactions took place in Spain and

Portugal in 2012 and 2013, enabling banks in financial difficulty to monetise blocks of life protection business in their insurance subsidiaries.

**RAISING CAPITAL**

There are several ways of raising capital, but a particularly interesting and topical way is via the issuance of subordinated debt. Subordinated debt can be used to improve a company’s capital position as, in the event of liquidation, the company will not repay the lenders of subordinated debt until all

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other liabilities and secured creditors have been paid.

Norwegian insurer Gjensidige recently issued NOK1bn (\$120m) of notes, which would be classified as restricted tier 1 capital under Solvency II. These bonds allow the company to write down this debt upon breaching certain thresholds based on the Solvency II capital requirements.

However, there are a number of considerations to consider before issuing such an instrument, such as the cost of the interest payments relative to the benefit of this form of capital in comparison to tier 2 capital.

**DE-RISKING**

By reducing the risks that it assumes, a re/insurer can reduce its capital requirements, thereby boosting its solvency coverage

position. There are a number of capital management tools which can achieve this, such as reinsurance structures, capital markets solutions and investment strategies.

From a reinsurance perspective, in territories where risk-based solvency regimes exist, a treaty could be structured in such a way that the re/insurer is protected against the occurrence of an adverse event that is linked to the risk-based stresses used to derive its capital requirements. Such cover could be relatively cheap given the low likelihood of the event occurring.

However, companies will need to ensure that there is a reasonable level of risk transfer associated with any reinsurance arrangements. There has been some evidence of late that regulators are not in favour of reinsurance deals that are structured with the primary aim of reducing capital requirements, for example by only covering losses associated with very specific extreme stresses whilst leaving companies exposed a wide range of other events.

**RESTRUCTURING**

By changing the structure of insurance companies or groups, capital and liquidity can be raised or alternatively capital requirements can be reduced through the disposal of capital intensive business or by achieving capital efficiencies through increased diversification benefits. Groups could set up branch structures whereby subsidiaries are grouped under a single head office so as to maximise diversification benefits. This option has been used by both Zurich and MetLife, for example. Both set up pan-European hubs based in Ireland with branches in other European territories.

Another option for groups would be to dispose of certain entities or lines of business for strategic reasons. The large-scale restructuring that took place at AIG spanned multiple territories across the world, incorporating several different strategies, including M&A deals. These included the public listing of AIA in Asia and the sale of Alico in the US along with the sale of several smaller Asian insurers. The funds generated by these activities helped repay the money provided to AIG by the US taxpayer via the Federal Reserve Bank of New York and the US Treasury Department.

**RESOLUTION**

Sometimes, however, recovery plans are not enough. The FSB refers to resolution as the situation in which a firm “is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so.”

Whilst many resolution strategies may, in fact, be pursued by regulatory authorities rather than by re/insurers themselves, it is certainly useful for companies to be familiar with the types of actions which may be considered by regulators when drafting their own resolution plans.

The resolutions of insurance companies in Japan between 1997 and 2001 could provide a precedent for national regulators developing their own resolution regimes. Many interesting and unprecedented actions were taken at insurance companies in Japan during this time, such as cutting policyholder benefits through a reduction in interest rate guarantees, enforcing additional surrender charges, allowing

for possible policyholder participation in future upside (i.e. dividends) and involving court-appointed rehabilitation trustees working together with a newly established Policyholder Protection Corporation.

There can be a fine line between recovery and resolution. Extreme measures such as closing the company to new business or changing the corporate or ownership structure such that the company survives, albeit in a different form, probably lie somewhere between recovery and resolution.

**CONCLUSION**

It is difficult to see a situation whereby regulators do not place an onus on re/insurance companies regarding recovery and resolution planning as they begin to develop their regimes in this regard.

Business continuity plans prepare companies for events such as information technology failures or the loss of buildings. By the same token, recovery and resolution

plans should serve to aid the continuity of companies from a financial point of view or alternatively to ensure, in the words of the US Federal Reserve, the “rapid and orderly resolution” of a company with no viable option other than to fold. ■

This article is based on a recent paper, *Recovery and Resolution Plans – Dealing with financial distress*, written by Eoin King, Bridget MacDonnell and Eamonn Phelan at Milliman in Dublin, Ireland. Email:



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