Pre-emptive recovery planning for insurers

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Under normal circumstances, (re)insurers manage to levels of capital, liquidity and operational performance that are consistent with their strategic objectives and the expectations of key stakeholders (e.g., policyholders, regulators, etc.). However, as circumstances change, a firm may find itself straying from these targets and, particularly in adverse scenarios, may need to take action in order to recover to the optimal position. A divergence from target levels can arise from external events, such as increased volatility within global financial markets or material changes in regulation, or from internal factors such as an operational risk event. All firms should be concerned with their resilience to such events, and a proactive approach which considers the recovery response in advance is likely to lead to a more resilient firm than a reactive 'wait and see' approach.

In recent years, regulators have demonstrated an increasing interest in recovery and resolution planning. For example, more requests are being made of insurance companies to provide details on the nature and extent of their current recovery and resolution planning. Whilst a formal requirement to produce such plans only applies to the very largest of insurance firms, we are aware of regulatory requests to smaller, less systemically important firms, particularly those taking strategic actions, such as significant acquisitions, or new firms seeking an insurance licence.

The European Insurance and Occupational Pensions Authority (EIOPA) has been quite vocal on the topic of recovery and resolution for (re)insurers. An EIOPA paper published in July 2018, titled 'Failures and near misses in insurance,'[1] investigates the characteristics of firms that have experienced a recovery event. A 'near miss' is defined by EIOPA to be 'a case where an insurer faces specific financial difficulties and the supervisor feels it necessary to intervene or to place the insurer under some form of special measures.' Of course, most firms would strongly prefer to avoid this form of regulatory interaction. As such it is critical to develop an internal recovery process that kicks in well before reaching the point of a 'near miss.'

The paper on failures and near misses follows an EIOPA opinion[2] issued in 2017 which recommended a recovery and resolution framework for all insurers, as well as an open consultation and discussion paper[3] on resolution funding and national insurance guarantee schemes, and references to recovery planning in the recent EIOPA Macroprudential Tools paper.[4]

Whilst risk-based capital regimes are intended to ensure companies hold a sufficient level of capital to meet their guaranteed liabilities in extreme circumstances, there is little in the way of formal requirements or guidance on how firms should recapitalise following an extreme adverse event. Moreover, capital alone is not an adequate mitigant. For example a strong capital position offers relatively little help if a firm's liquidity position or operational capabilities are under stress.

Recovery planning involves identifying and explaining the steps a firm anticipates taking both in the immediate aftermath, in order to avoid further deterioration over the short term, and the steps necessary to restore and maintain a sustainable business over the long term. Effective recovery planning will explore how to return an individual (re)insurer to a target position in terms of a variety of key outcome metrics such as capital, liquidity and operational performance. More detailed planning should build on high-level strategies, allocating roles and responsibilities to key individuals and establishing the lines of communication required to execute the recovery plan.

Capital recovery planning encompasses a spectrum of strategies and actions available to (re)insurers, from more straightforward management actions appropriate to specific types of scenarios to complex, large-scale actions such as group restructuring. Despite the breadth

1 EIOPA (2018). Failures and Near Misses in Insurance. Retrieved 6 September 2018 from https://eiopa.europa.eu/Publications/Reports/EIOPA_Failures_and_near_misses_FINAL%20%281%29.pdf.

2 EIOPA (5 July 2017). Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for (Re) Insurers Across the Member States. Retrieved 6 September 2018 from https://eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-148_Opinion_on_recovery_and_resolution_for_%28re%29insurers.pdf.

3 EIOPA (30 July 2018). Discussion Paper on Resolution Funding and National Insurance Guarantee Schemes. Retrieved 6 September 2018 from https://eiopa.europa.eu/Publications/Consultations/EIOPA-CP-18-003_Discussion_paper_on_resolution_funding%20and.pdf.

4 EIOPA (2018). Other Potential Macroprudential Tools and Measures to Enhance the Current Framework. Retrieved 6 September 2018 from https://eiopa.europa.eu/Publications/Reports/EIOPA%20Other%20potential%20macroprudential%20tools.pdf.

FIGURE 1: RECOVERY PLANNING ACTIONS

RESTRUCTURE	IMPROVE LIQUIDITY	DE-RISK	RAISE CAPITAL
▪ Portfolio transfer ▪ Closure ▪ Group restructure	▪ Unit-linked matching ▪ ILS (Insurance Linked Securities) ▪ Asset portfolio rebalancing	▪ Reinsurance ▪ Capital markets ▪ Investment strategy	▪ Equity and debt ▪ Contingent capital ▪ Group finance ▪ Off-balance sheet

of potential responses available, the prevailing objective is to improve the capital position of a firm. From a capital perspective, the more material types of recovery action are set out in the table in Figure 1.

Though closely related, recovery planning is a distinct exercise from resolution planning, the latter being initiated when a firm is no longer viable, or likely to become unviable. When a firm (in its current state) reaches this point, strong regulatory intervention is almost inevitable so that the regulator can ensure policyholders are protected and any adverse impacts on wider financial stability are minimised. In reality, the distinction between recovery and resolution will be blurred, and regulators are more likely to progressively increase the level of intervention if recovery efforts are unsuccessful and the firm's position continues to decline rather than operating to a binary cutoff point, beyond which it completely takes over the management of the liabilities. In resolution, significant regulatory or third-party intervention (from creditors, insolvency accountants etc.) occurs, and management will ultimately be required to surrender much of the decision-making authority. Although the responsibility for the development and execution of the resolution plan would, in practice, lie with the relevant regulator (or resolution authority[5]), companies are often required to submit to the regulator detailed considerations in relation to their resolutions. These plans will typically cover areas such as legal entity structure, interconnectedness, business model, priorities to ensure operational continuity, and many other practical aspects.

Existing requirements

A Recovery Plan documents the firm's intended recovery plan, and (given its importance to global financial stability) producing such a plan is currently a formal requirement for firms designated as Global Systemically Important Insurers (G-SIIs). Even for firms outside of this category, the formal regulatory requirements (as recommended by EIOPA[6]) are still a useful reference point for recovery plans. Particularly as these requirements will likely inform a regulator's review of a firm's recovery plan they may, ultimately, form the basis for requirements which are applicable to a wider range of firms.

A number of national regulators have already instigated various requirements for non-systemically important insurers to engage in recovery and resolution planning. For example, a new recovery and resolution framework for all insurers is expected to come into force in 2019 in the Netherlands. Another example is the Central Bank of Ireland (CBI), which now requires that a recovery plan be submitted as part of the insurance licence application process.

A requirement for recovery planning exists already in the Senior Managers Regime in the UK, with the responsibility described as:

> *Responsibility for developing and maintaining the firm's recovery plan and resolution packs, and for overseeing the internal processes regarding their governance.*

Though currently limited to banks, building societies and Prudential Regulation Authority (PRA)-designated investment firms, current regulatory expectations in the UK are set out in the recent supervisory statement (SS) released by the PRA, SS9/17 'Recovery planning.'[7] The paper details the PRA's expectations on the content of recovery plans, and could inform and influence the principles of similar regulation in the insurance industry.

In addition, where formal requirements for insurance companies to develop preemptive recovery plans do not exist, this area is certainly becoming a regulatory expectation in many jurisdictions. The EIOPA opinion and the work of the International Association of Insurance Supervisors (IAIS) on development of Insurance Core Principle (ICP) 10 and ICP 12, in particular, all set the scene for an industry that is readying itself for a recovery and resolution regime to come into force. As a result, a number of companies are taking a proactive approach to engaging in this area.

5 According to the EIOPA opinion on recovery and resolution frameworks, member states should have in place a designated administrative resolution authority for insurers to ensure an orderly resolution process as well as to avoid confusion or potential conflict among various authorities.

6 EIOPA Opinion on Harmonisation, ibid.

7 PRA (December 2017). SS9/17: Recovery Planning. Retrieved 6 September 2018 from https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2017/ss917.pdf.

Benefits of recovery planning

The fundamental benefit of preemptive recovery planning is to improve the quality and clarity of strategic decision-making processes in times of crisis. Developing a strategy during an extreme stress can limit the scope of the planning, the detail of the review, and the efficacy of decision making. It may also reduce the number of available strategies, as certain credit facilities and financial options can only normally be secured in advance of calling on such a facility. A promptly executed recovery plan could limit the extent of further deterioration in capital ratios and contribute to a speedier recovery, allowing firms to pursue opportunities in the wake of such an event.

The strategies employed in recovery planning vary in complexity, size, timescales, and ultimately, their benefits to the firm. They will scale in line with the extent of the recovery required. When planning, an individual (re)insurer is likely to initially consider options that are well established within the firm or that are familiar concepts in the market. But there is also benefit from investigating less standard or familiar strategies, as they might provide more efficient or cost-effective solutions. It is also useful for firms to know, in advance, where and when certain strategies might be unsuitable or unavailable, e.g., reinsurance becoming prohibitively expensive in certain scenarios. A robust approach to this planning should ensure a rapid response to evolving circumstances, with a clear strategy to return to acceptable solvency, liquidity and operational levels supported by defined responsibilities and actions.

Planning the recovery

Many existing policies and internal exercises, such as the Own Risk and Solvency Assessment (ORSA) and business continuity planning, can form the foundations of recovery planning. By expanding these exercises to properly consider recovery scenarios, a firm can probe how well its existing policies and processes and other mitigation strategies might fare when applied in such conditions. This testing can be incorporated into regular risk exercises in order to provide the board with greater confidence in the resilience of the firm. The recovery plan should consider severe stress scenarios, to the extent that they are not already covered in the ORSA, and identify a set of possible recovery options to be used in those situations. Recovery planning is, of course, closely related to reverse stress testing. However, whereas the objective of reverse stress testing is to determine the conditions that could lead the company to fail, the focus of recovery planning is on the credible management actions that could be taken to restore a company's financial strength when it comes under severe stress so as to avoid a failure of the business.

There are many issues to consider when approaching the recovery planning exercise. Firms may examine the source and nature of the recovery situation under consideration. For example, the source could be localised to the firm, such as the failure of a critical third party, or it could be industry-wide, such as a global economic downturn. This deeper review is crucial to determining the appropriateness and availability of recovery strategies, as events that have the potential to materially affect the wider industry may render certain strategies involving third parties less viable, e.g., readily entering risk transfer agreements at an acceptable price. Early engagement with regulators will likely be a component of many plans; however, if actions taken by the firm have led to a recovery situation, more proactive communication could also be an important factor in the assessment of a firm's conduct.

A firm may have a range of (as yet) unused recovery options which are available under normal conditions. However, stressed conditions are likely to affect which of these options remain open, and influence the effectiveness and relevance of them. Some strategies may have adverse direct or indirect effects, beyond the primary impact, and they may effectively rule out these options or at least make them much less desirable. The urgency required to implement actions and the time taken for effects to manifest will also be important drivers in decision making, and they should typically be considered in the context of the expected speed at which a particular adverse scenario would be expected to develop. Where an instantaneous shock has occurred, firms are likely to have a greater need for actions which provide a more immediate recovery benefit.

Alongside financial considerations such as capital and liquidity, it is vital that critical services, processes and operations necessary to continue the day-to-day operations of the company are maintained throughout the recovery process. The exact operational processes which are considered critical will vary by firm, but they might be expected to include areas such as policy administration, claims processing, reinsurance arrangements, investment management and information technology (IT) services. It will also be critical to maintain a core decision-making and governance framework, for example the ability to quickly convene meetings of key decision makers.

Challenging the practical aspects of recovery strategies is an important feature of recovery planning. To be confident about the potential success of these plans, and the related roles and responsibilities, they must be clearly defined and the credibility, feasibility and efficacy of them should be subject to thorough testing. Embedding recovery planning activity more firmly as a business-as-usual activity and engaging the firm's board and senior management in all parts of the process are likely to significantly improve the effectiveness of any recovery strategy.

Milliman's experience in recovery planning

Milliman has supported a range of clients in developing and documenting recovery plans, in response to both regulatory requests and internal risk management initiatives. If you are interested in discussing recovery planning in more detail, contact a Milliman consultant.

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