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# Recovery & Resolution Plans

## Dealing with Financial Distress

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# The need for Recovery & Resolution Plans

# Agenda

# Introduction
## Regulatory Background

# Financial Stability Board (FSB) Definitions

| | |
|---|---|
| **Recovery Plan:** | "Identifies options to restore financial strength and viability when the firm comes under severe stress" |
| **Resolution:** | "When a firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so" |

- Regulators typically heavily involved
- Measures to write down obligations

# Requirements for Large Companies

## FSB

- Global Systemically Important Financial Institutions (G-SIFIs)
- Undertake recovery and resolution planning
- Paper: “Key Attributes of Effective Resolution Regimes for Financial Institutions”

## IAIS

- International Association of Insurance Supervisors
- Requirements adopted for Global Systemically Important Insurers
- Papers on methodology for identifying G-SIIs and set of policy measures

# Some General Requirements for Insurers

- US: Financial companies designated for supervision by the Fed

- EIOPA 2016 Annual Work Programme:
  - *"… to actively contribute to the development of a European approach to crisis management with particular focus on recovery and resolution plans as a preventive tool."*

- At European Insurance Forum in March 2016, Sylvia Cronin of the CBI noted, *"Recovery and resolution for insurers is an area of interest for the Central Bank, particularly during 2016"*

# Our Focus

Recovery and resolution planning for (re)insurers

Options Available

Governance for implementation

Market practice (including case studies)

# Governance and Decision Making

# Parties to be involved

*"In order to be effective, a recovery plan needs clear governance arrangements, both in terms of the processes and procedures that govern its development (who develops the plan), maintenance (who updates the plan), implementation (who applies it when needed) and execution (who makes sure that the plan is applied)"*

**Source: EBA Recovery Planning - Comparative Report on Governance Arrangements and Recovery Indicators**

All parties ideally involved in development of RRPs

# Guidelines for drafting plans

**FSB's Key Attributes Paper**

Structure of plans & items to include

- High-level summary of strategies and plan for implementation
- Strategic analysis that underlies the strategies
- Conditions for intervention
- Concrete and practical options for recovery and resolution measures
- Preparatory actions to ensure measures can be implemented effectively and in timely manner
- Details of potential impediments to execution of plan

# Other governance considerations

Plans will need to be refined as the business evolves

Management Information Systems:

- Details of inter-group exposures
- Asset and liability exposures
- General e.g. number of policyholders, products sold, management structure, etc.

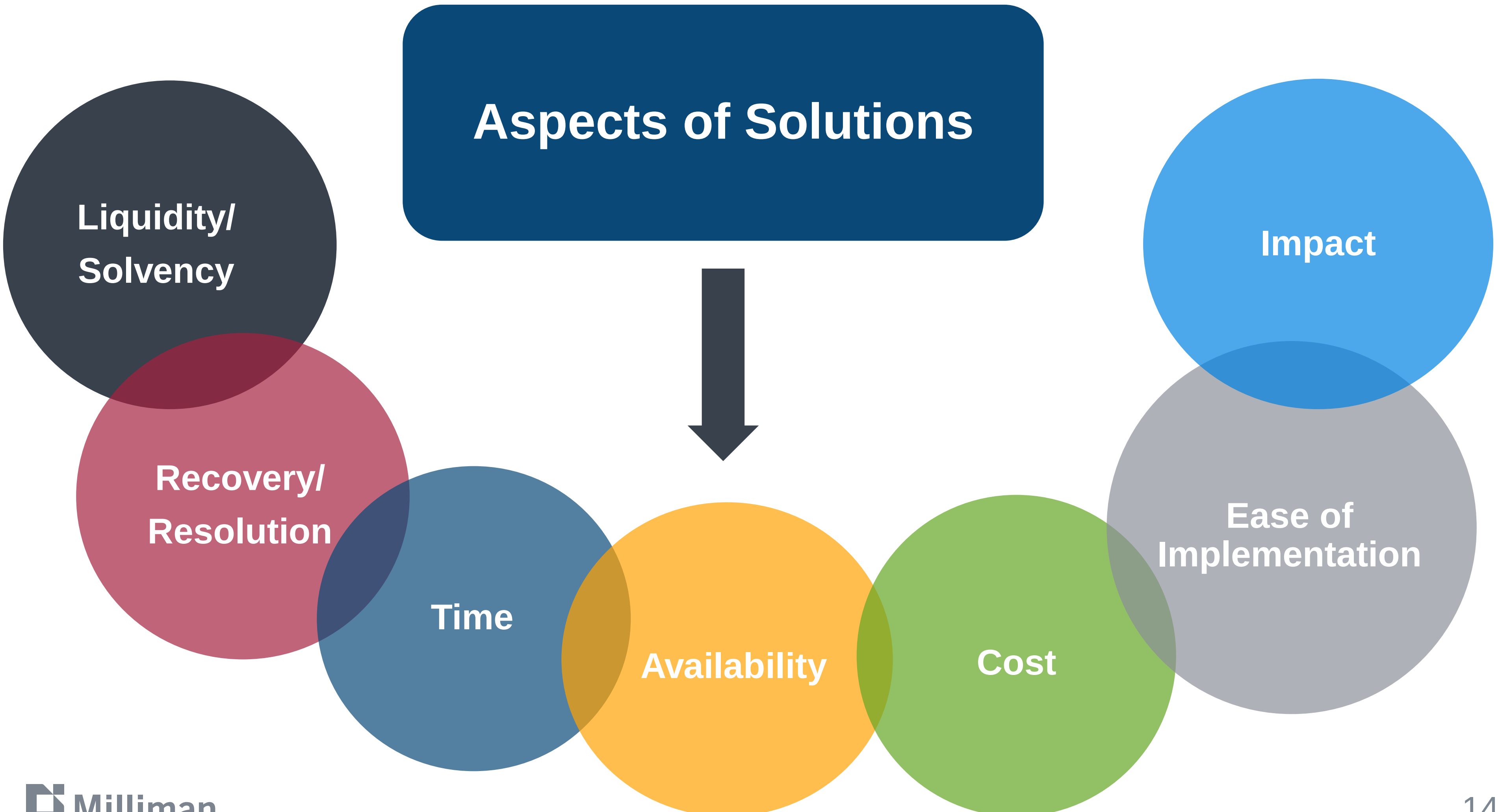
# Considerations when choosing a strategy – company specifics

Cause of financial difficulty might imply which particular course of action is best

## Other Considerations

1. Type of business
2. Products
3. Ownership structure
4. Nature of assets and liabilities
5. Regulatory Jurisdiction
6. Credit History
7. Profitability
8. Group considerations

# Considerations when choosing a strategy



# Monitoring

Identify when plans need to be implemented

Could use indicators already in place

Several indicators needed to assess:

1. Solvency
2. Liquidity
3. Potential future issues

Forward looking stress testing

# Recovery Strategies

# **Recovery Strategies:**
# Improving Liquidity

# VIF monetisation

Economic value of future profits associated with an in-force book

**VIF monetisation:**

- Realising a portion of the VIF as an upfront payment from a third party
- Exchange a share of the expected future profit stream as it emerges

**Benefits:**

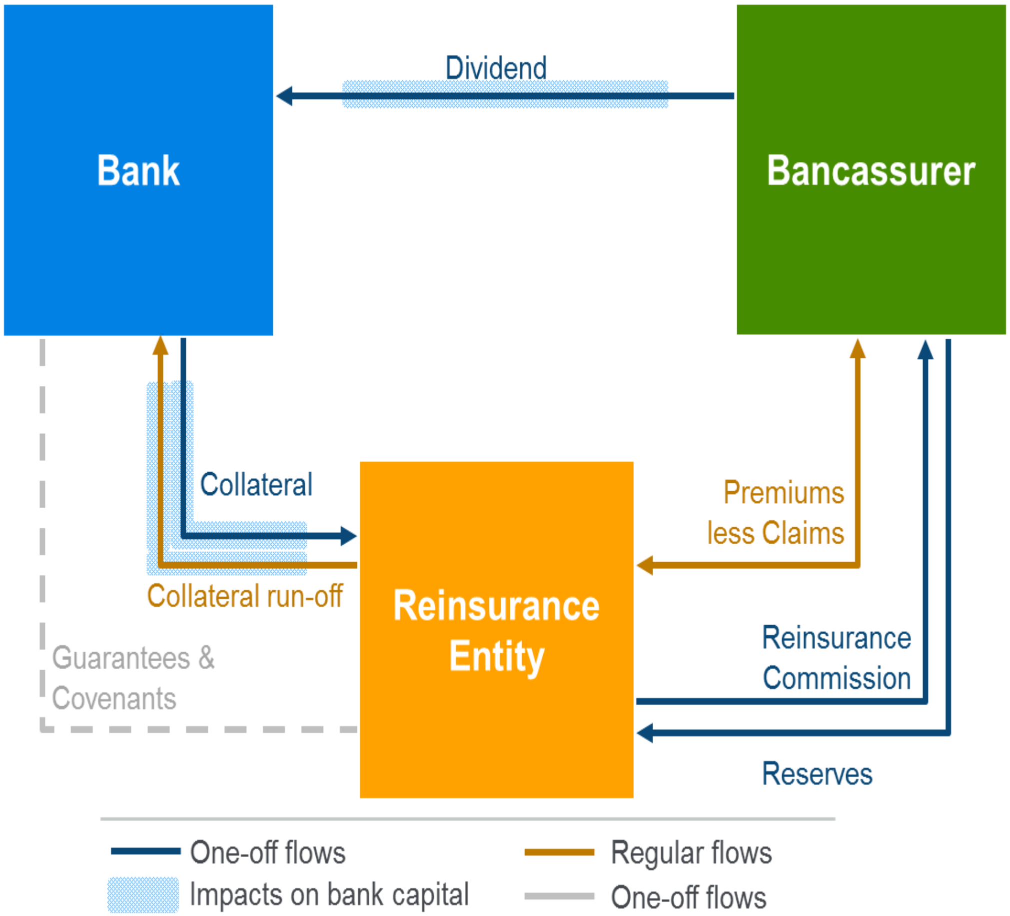
- Liquidity can be boosted (upfront payment)
- Possible transfer of risk associated with future profits
- Impact on solvency position depends on the prevailing regulatory regime

**Downsides:**

- Won't get full value as VIF will be discounted
- May not improve solvency position
- Less interest in smaller deals

# Case Study: VIF monetisation in Spain & Portugal

## Simplified Structure




- Mostly through reinsurance treaties (except Santander)
- Reserves, future premiums and future claims swapped for upfront commission
- PVFP onto insurer’s balance sheet that could be used by the bank as capital / dividends

# Case Study: VIF monetisation in Spain & Portugal

## Sample transactions

| Parties Involved | Size | Scope |
|---|---|---|
| Santander/Deutsche Bank & Abbey Life | €490m | Spain & Portugal |
| CaixaBank/ Berkshire Hathaway | €600m | Spain |
| BBVA/SCOR | €630m | Spain |
| NovaBanco/ Munich Re | 40bp CT1 | Portugal |

# Investment Portfolio Rebalancing

- Sell surplus assets to generate cash
- Divest from positions not core to strategy
- $2^{nd}$ order impacts – may get lower yield if moving into less risky assets
- Longer term solution is needed – ALM strategy, regularly rebalanced

**Example:**
CNO Financial Group (formerly Conseco)

- 2002 - Chapter 11 bankruptcy (US)
- Sold a number of non-core assets
- e.g. stake in a riverboat casino for US$260 million and General Motors Building in NYC for $1.4 billion

# Other Liquidity Options

- Securitisation
- FinRe
- Debt financing
- Product restructuring
- Suspension of dividends
- Arrange overdraft or loan facility
- Convert receivables to cash  (factoring)
- Request a credit extension
- Seek court protection from creditors

# **Recovery Strategies:** Raising Capital

# Subordinated Debt

- Subordinated:
  - Lenders not repaid until all other liabilities/secured creditors paid
  - Interest payments typically higher than regular debt
  - Does not increase the net assets - liability must also be created
  - May improve capital position

- Canadian group Great-West Lifeco
  - C$2.3 billion subordinated debentures
  - US$300 million bond with RBC-based triggers

- Norwegian insurer Gjensidige Forsikring bond August 2016
  - Write down of debt upon breaching certain Solvency II SCR/MCR thresholds

# Hybrid Capital

- Contingent capital – hybrid between debt and equity capital
  - Debt allowed to convert to equity following pre-specified events
  - Alleviates financial pressure
  - Eligibility to cover solvency capital requirements varies
- Example: Convertible bonds

FBD

- €70m convertible bond to Fairfax (Canadian holding co.)
  - 10 year instrument, 7% annual coupon (payable twice yearly)
  - Convertible into ordinary share capital at 37% premium
  - Convertible any time between years 3 and 10 with one exception
  - Admissible as Tier 2 capital under Solvency II

# Other Capital Options

- Equity Capital
- Group Finance
- Off Balance Sheet Capital

# **Recovery Strategies:** De-risking

# Recovery strategies – de-risking

May lead to reduction in technical provisions or capital requirements

**Reinsurance:**

- Quota share can reduce technical provisions and capital requirements (but, company could be ceding profitable business)
- XoL or Stop-loss can reduce capital requirements for catastrophe risk
- Counterparty risk introduced but can be mitigated
- Need to convince regulators

**Longevity transfer:**

- Can be based on specific experience i.e. indemnity based or based on an index (basis risk)
- Aviva example: £5billion longevity swap for staff pension scheme to Munich Re, Swiss Re & SCOR

# Genuine Transfer of Risk

*"...the Bank will be monitoring closely if firms become active in longevity reinsurance regularly and exclusively for motivations other than seeking a genuine transfer of risk…"*

**Source: PRA speech, "Risk transfer – and the risks it creates: a prudential regulatory perspective"**

*"'To avoid regulatory arbitrage, the authorities are recommended to analyze unusual reinsurance transactions where material, to see if sufficient risk has been mitigated or transferred to justify the capital benefits gained."*

**Source: IMF Country Report No. 16/311**

Real Transfer of Risk

# Recovery strategies – de-risking

May lead to reduction in technical provisions or capital requirements

**Catastrophe bonds and swaps:**

- Issue a bond with repayment contingent on catastrophes not occurring
- Offers good diversification to investors
- Source of liquidity (and may reduce capital requirements)
- But more likely to be issued by a company wanting to write large risks than by a company in financial difficulty

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Transferring risk to capital markets since 1994

2015: US Storm Risk Cat Bond raised $1 billion

2014: $400 million raised

# Other De-risking & Capital Management Options

| Investment related solutions | Other Capital Management Measures |
| --- | --- |
| ▪ ALM<br>▪ Hedging<br>▪ Unit under-funding (Solvency II specific concept | ▪ (Partial) Internal Models<br>▪ Undertaking Specific Parameters |

# **Recovery Strategies:** Restructuring

# Recovery strategies - Restructuring

Branch structure

- Single group entity with branches in different territories
- Enhanced diversification
- No need to hold minimum capital for companies that not of sufficient scale
- Could help with capital fungibility

**Examples:**

MetLife and Zurich have European hubs in Dublin

MetLife ZURICH

# Recovery strategies – M&A

Sale of a number of subsidiaries (or raising funds through IPO)

- Raises liquidity
- May raise capital through recognition of goodwill

**Case Study**

AIG

# Recovery Strategies - Restructuring

- Difficulty due to involvement in trading MBS & CDS and in securities lending
- Federal Reserve Bank of New York & US Treasury stepped in to provide support

# Other Restructuring Options

## New business options

- Repricing new business
- Changes to underwriting policy
- Closure

## Existing business options

- Increase reviewable charges
- Reduce reviewable benefits

## Internal Restructuring Measures

- Cost reductions / outsourcing
- Company-funded staff pension schemes

# **Resolution**
# (and Extreme Recovery Measures)

# Harmonised national regimes

*"At present, there is no harmonised recovery and resolution approach for insurers in the European Union."*

*"One of the lessons learned from the recent financial crisis is the need to have in place adequate recovery and resolution tools which will enable national authorities to intervene in failing institutions and resolve failures when these materialise in an effective and orderly manner"*

**Source: EIOPA chairman, Gabriel Bernardino, speech at EIOPA annual conference in Frankfurt, 18th October 2016**

# Winding Up

**Winding Up**

- Close to new business and authorisation withdrawn
- Liquidator - responsible for orderly wind-up
- Policyholder liabilities typically settled or transferred
- May be differences in winding-up regimes in different territories
- Ranking of repayments can vary

**Dismantling Operations**

- Sell portions and run off business which cannot be transferred
- Government assistance may be available (last resort)

Equitable Life

# Equitable Life

- Collapse of oldest mutual life company in the UK in 2000
- Policies with Guaranteed Annuity Rates (GARs) (i.e. minimum rate of interest)

**1999**
High Court upholds not paying or reducing non-guaranteed final bonuses for policies where the guarantee had been exercised

**2000**
Court of Appeals/House of Lords rules against the company

**2001**
Sold Permanent Insurance

**2002**
"Compromise scheme" implemented

1990 - 1999 | 2000 | 2001 | 2002

**1990s**
Interest rates fall below guaranteed rates – insufficient reserves

**Dec 2000**
Closed to new business, unable to find a buyer

**2001/2002**
Received £750m in total from Halifax in exchange for a portion of the company's assets, staff and operations

# Reducing Policyholder Benefits

Extreme measures whereby policyholder benefits are reduced

**FSB guidance in relation to insurance companies:**
*"Authorities or the courts would need to determine how a potential shortfall is allocated over time and across creditors and policyholders, subject to respect of the creditor hierarchy."*

**Bankrupt insurers in the USA and Canada in the 1990's:**

- Executive Life, First Capital, Confederation Life and Mutual Benefit
- Number of cases where policyholders did not receive full value of policies
- Other cases had delay in receiving what was due to policyholders

# Resolutions in Japan

## Roots of the Crisis

**What happened?**

**7 Japanese life insurers failed** (April 1997 - March 2001)

**Root Causes?**

- Life companies - phenomenal asset growth in 1970s & 1980s
- Rapid growth in economy
- Unsustainable equity and real estate bubble
- Insurer assets ballooned
- Bubble burst

**Long term guarantees proved unsustainable:**

- Equity prices fell by almost 60% - real estate prices followed
- Government bonds yields fell from 5–6% to 1–2%

# Resolutions in Japan

## First Failure - Nissan Life (April 1997)

- Deficit of ca. ¥300 billion, or 15% of reported liabilities
- Sales suspended, surrenders temporarily banned, administrators ...

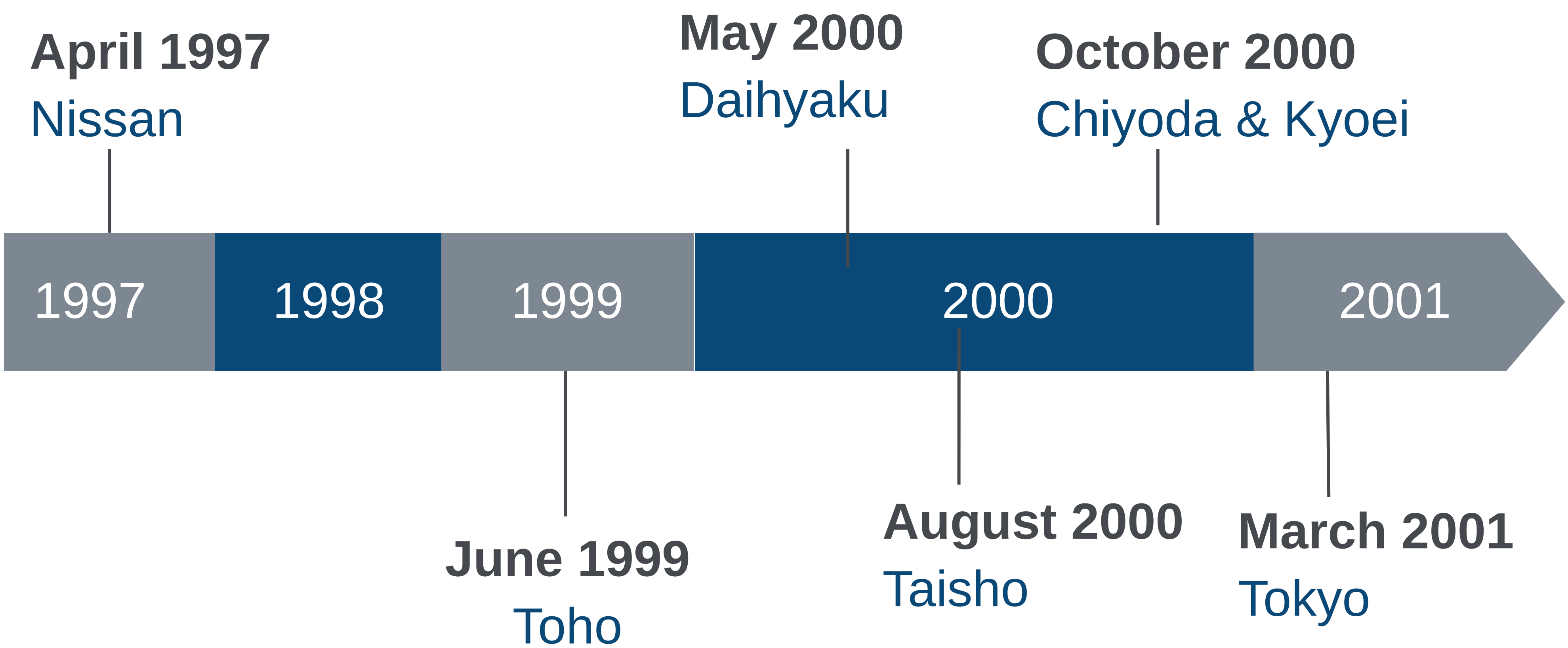
**Industry leading role in developing solution:**

- Creation of a new insurance company, owned by the LIAJ (“Aoba” Life)
- Replacing senior management
- Reduction of interest rate guarantees
- Additional surrender charge
- Transfer of restructured policies to Aoba
- Contribution of ¥200 billion in assets from LIAJ members (via Policyholder Protection Fund)

**Created viable runoff co., later sold to French conglomerate Artemis**

# Resolutions in Japan

## Other failures



# Resolutions in Japan

## Japan's attempts at a resolution process

- Failed attempt at "Oldco/Newco" restructuring plans
- 1998 – Policyholder Protection Corporation (PPC) established
- Court-appointed rehabilitation trustee working together with the PPC
- Capital provided by the white knight & financial assistance from PPC
- Policyholder reserve/cash value reduction (limited to 10%)
- Reduction in guaranteed interest rate
- Possible policyholder participation in future upside (dividends)
- Many possible legal structures for the relief company

# Resolutions in Japan

## Lessons Learned

### 1. Early action helps to preserve policyholder value

- High lapses led to substantial cash outflows
- Investment management had to focus simply on liquidity

### 2. Benefits of an institutionalised, well-defined process

- Substantial infrastructure and policyholder value was preserved

### 3. Think holistically and reflect on all sources of value

- Significant sources of value beyond balance sheet assets:
  - Sales infrastructure & customer base
  - Potential unique franchises (e.g. affinity groups)
  - Employee expertise
- Value can dissipate quickly if action is not taken

# Questions?

# Reliances and Limitations

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# Thank you