NautaDutilh

Recovery and Resolution (Insurers) Act

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FCS Financial Law

*On 27 November 2018, the Recovery and Resolution (Insurers) Act (Wet herstel en afwikkeling van verzekeraars, the "***Act***"), which creates a reinforced legislative framework for the recovery and resolution of insurers, was adopted by Dutch parliament. Consequently, Dutch insurers again face major supervisory changes, as they did following the introduction of Solvency II. Although no date for the Act's entry into effect has yet been announced we expect it, together with a decree containing further details, to enter into effect on 1 January 2019. In this newsletter we discuss a number of the most important changes introduced under the Act and the accompanying decree. The newsletter builds on our earlier newsletter of 2 September 2016 about the consultation version of the Act.*

KEY ELEMENTS

- A new recovery and resolution framework with new obligations for insurers and new resolution powers for the Netherlands Central Bank (DNB).
- No basis in EU law, but influenced by the BRRD/SRM recovery and resolution tools for banks.
- The framework applies to all insurers that are subject to DNB's prudential supervision and to certain group entities.
- Two phases are distinguished: recovery and resolution planning by the insurer and DNB (the preparation phase) and resolution by DNB (the resolution phase).
- Prior to resolution, the steps in the existing Solvency II intervention ladder have to be followed.
- DNB has the following resolution tools: (i) bail-in, (ii) the sale of business tool, (iii) the bridge institution tool and (iv) the asset separation tool. These constitute 'reorganisation measures' under Solvency II and are therefore recognised EEA-wide.
- There are certain safeguards for shareholders and creditors (including policyholders). These parties must not suffer greater losses as a result of resolution than they would have in the event of the insurer's bankruptcy (the 'no creditor worse off'-principle).
- All insurers may be required to make an *ex post* contribution in case of the resolution of another insurer.
- Unlike for banks under BRRD/SRM: no possibility to carry out a bail-in of capital instruments prior to resolution; no mandatory minimum amount of 'bail-inable' capital (i.e. no MREL); no requirement for insurers to include a bail-in clause in non-EEA contracts.
- The emergency regulations for both banks and insurers will be abolished, but the possibility of expropriation under part 6 of the Financial Supervision Act will remain in effect. A number of powers under the emergency regulations have been moved to the Bankruptcy Act and vested in the bankruptcy trustee.

1. Background

According to the explanatory memorandum to the Act (the "**Explanatory Memorandum**"), there is a need for an effective and efficient framework for the orderly resolution of insurers. A disorderly resolution can lead to social unrest in view of the insurance sector's social function, the risk of contagion effect to other entities in the insurer's group and the effect on public confidence in the industry as a whole. The Explanatory Memorandum concludes that the existing framework under the Financial Supervision Act (*Wet op het financieel toezicht*) is inadequate. The Act therefore creates a new recovery and resolution framework under which certain obligations are imposed on insurers and certain resolution powers are conferred on the Netherlands Central Bank (*De Nederlandsche Bank*, "**DNB**").

The Act is not the direct result of specific EU legislation. The Netherlands legislature was, however, influenced by the recommendations of the Financial Stability Board (FSB) and the European Insurance and Occupational Pensions Authority (EIOPA) for the recovery and resolution of insurers and by the recovery and resolution tools introduced for banks pursuant to the EU Bank Recovery and Resolution Directive (BRRD) and Single Resolution Mechanism (SRM). The Explanatory Memorandum acknowledges the existence of differences between the banking and insurance industries and between the different types of insurers but says it is up to DNB to exercise the appropriate recovery and resolution powers, taking into account these differences, market conditions and whether the insurer is to be resolved as a gone concern or as a going concern.

The new recovery and resolution framework attaches great importance to the interests of policyholders, charging DNB with the duty to apply the tools in the way most advantageous to them. However, it cannot be ruled out that even policyholders may have to bear part of the losses when an insurer is resolved.

2. Changes to existing intervention framework

The approach taken in the Act is to abolish the existing mandatory transfer arrangements (based on the Intervention Act), the emergency regulations (also with respect to banks) and the safety-net scheme for life insurers and replace all of these with a new recovery and resolution framework. However, certain elements of the current measures have been incorporated in the new framework.

This means that many of the rules introduced by the Intervention Act will be repealed. Only the powers of the Minister of Finance under part 6 of the Financial Supervision Act will remain in effect. These include the power to expropriate assets owned by, or securities issued by or with the cooperation of, insurers or other financial undertakings (or their parent companies).

A number of the powers conferred on the administrator by the emergency regulations have been moved to the Bankruptcy Act and vested in the bankruptcy trustee. For example, a bankruptcy trustee will have the power, after obtaining court authorisation, to simultaneously transfer an insurance agreement to a third party and modify the terms of that agreement.

3. Scope

The new recovery and resolution framework applies to the following Netherlands-based entities:

- All insurers subject to DNB's prudential supervision, e.g. life insurers, non-life insurers (including health care insurers), reinsurers, benefit-in-kind insurers and funeral expenses insurers.
- Insurance holding companies, mixed financial holding companies and mixed insurance holding companies that are part of an insurance group ('group' as defined in Solvency II).
- Branches of non-EEA insurers, other than insurers excluded from the scope of Solvency II because of their limited size (called 'Solvency II Basic' insurers);
- other undertakings that are part of an insurance group if they perform services of crucial importance to the group's daily activities.

In the case of a group consisting of one or more insurers and one or more banks (a financial conglomerate), the recovery and resolution powers in the new framework may be exercised only against the insurer(s). The bank(s) in the group will be subject to the BRRD/SRM recovery and resolution regime.

If an entity falls within the scope of both the resolution regime for banks and the corresponding regime for insurers (for example, because it is a mixed financial holding company), the regime for banks will have priority because of its basis in EU law.

In the case of a cross-border insurance group, the measures under the Act can be taken only against the Netherlands-based undertakings in that group.

Because the Act is limited to insurers that are subject to DNB's prudential supervision (and certain affiliated undertakings), the resolution and recovery framework does not apply to the smallest Netherlands-based insurers, i.e. non-life insurers and funeral expenses insurers that are permitted to provide coverage up to a maximum of EUR 12,500 and that satisfy certain other criteria.

4. Recovery and resolution tools: the preparation phase

The Act distinguishes two phases: the preparation phase and the resolution phase. During the preparation phase each insurer is required to draw up a preparatory crisis plan and DNB is required to draw up (and periodically evaluate) a resolution plan for each insurer. To enable measures to immediately be taken if an insurer gets into financial trouble, the insurer and DNB must have already drawn up these plans.

Preparatory crisis plan

A preparatory crisis plan must be drawn up by Netherlands-based insurers and holding companies. In such a plan, which is to some extent comparable to the recovery plan drawn up by a bank, the insurer must provide insight into the restorative measures that can be taken in the event of a significant deterioration in the insurer's financial position. For example, what is the possibility of recovery if the insurer ceases to meet, or is in danger of ceasing to meet, the solvency requirements under Solvency II (SCR or MCR)? More detailed rules on, among other things, the contents and submission of the plan will be laid down in the

Recovery and Resolution (Insurers) Decree (*Besluit herstel en afwikkeling van verzekeraars*).

A preparatory crisis plan must be drawn up in financially healthy times and precedes the recovery plan for insurers and short-term finance scheme provided for in the Financial Supervision Act, both of which are only required if the insurer in fact ceases to meet the solvency requirements. Obviously, however, the preparatory crisis plan may serve as a basis for drawing up a recovery plan and short-term finance scheme, if required.

Solvency II Basic insurers and branches of non-EEA insurers are excepted from the obligation to draw up a preparatory crisis plan. Where such a plan has been submitted by a holding company, individual insurers in the group are not required to draw one up.

DNB's resolution plan

During the preparation phase, DNB is in principle required to draw up a resolution plan for each insurer that is not part of a group and for each group, and to periodically (at least once every three years) evaluate that plan. An evaluation is also required in the event of a material change in the insurer's or group's legal or organisational structure, business activities or financial position; any such change must immediately be notified to DNB by the insurer.

The resolution plan must describe, among other things, the possibility of applying the resolution tools and powers. In this regard, DNB must set out the strategy for resolution, the tools to be used and the main features of the insurer that are of relevance for its resolution (such the existence of derivatives and investment insurance contracts). The requirements that the resolution plan must meet and the subjects it must cover will be elaborated in the Recovery and Resolution (Insurers) Decree.

If DNB encounters substantial obstacles when implementing the resolution plan, it can require the insurer or, in the case of a group, any entity in that group to take specific – possibly far-reaching – measures to remove them. These include measures aimed at the sale of specific assets, discontinuation of existing activities or changes to the legal or operational structure.

DNB may only refrain from drawing up a resolution plan if, in its view, there are sufficient guarantees of the insurer's or group's resolvability.

DNB is not required to draw up a resolution plan for Solvency II Basic insurers and branches of non-EEA insurers. As stated earlier, both of these categories are excepted from the obligation to draw up a preparatory crisis plan. This means that if they are not part of an insurance group, Solvency II Basic insurers and branches of non-EEA insurers are in fact not covered by the preparation phase.

5. Recovery and resolution tools: the resolution phase

Recovery possibilities

A decision to proceed with resolution can only be taken after each of the steps in the Solvency II intervention ladder has been followed. These steps include the implementation of the recovery plan and short-term finance scheme. An exception applies if it is clear from the outset that the insurer's financial situation will not improve as a result of the above steps.

Conditions for resolution

DNB is required to resolve an insurer if all of the following three conditions are met:

1. the insurer is failing or likely to fail;
2. there is no reasonable prospect that alternative measures would prevent the insurer's failure within a foreseeable period;
3. resolution is in the public interest.

In the case of insurance groups and branches of non-EEA insurers additional conditions must also be met. Following the responses to the consultation version of the Act, it has been decided that DNB will not have the power to use resolution tools if, in the case of a group, only the holding company is based in the Netherlands.

The Act elaborates on the above conditions. A noteworthy point is that according to the Explanatory Memorandum, the first two conditions will in any event be met if implementation of the short-term finance scheme (based on Solvency II) has not led to the desired result. With regard to the third condition, DNB must proceed with resolution if this condition is also met, i.e. if resolution is in the public interest. If this is not the case, DNB must choose between resolution and bankruptcy. In this connection, the protection of the interests of policyholders may be a decisive factor for DNB to opt for resolution.

Resolution tools

In the event of the resolution of an insurer or of an insurance group, DNB has at its disposal the following tools, which can be used individually or in combination:

- bail-in;
- the sale of business tool;
- the bridge institution tool;
- the asset separation tool.

Bail-in

Bail-in enables DNB to write down the insurer's liabilities to providers of debt capital and other creditors (including policyholders) or convert those liabilities into shares or other instruments of ownership of the insurer, its parent company or a bridge institution. Unlike for banks, the Act does not make a distinction between, on the one hand, the write down and conversion of the insurer's capital instruments (abbreviated in the legislative history as 'AFOMKI' based on the full name in Dutch) and, on the other hand, the bail-in of its other liabilities. The entire liability side of an insurer's balance sheet is in principle subject to bail-in.

Certain liabilities, such as those protected by a security interest (e.g. a pledge, mortgage or title transfer financial collateral arrangement), are excluded from bail-in. In addition, DNB can decide to refrain from applying bail-in to liabilities that would otherwise be eligible. An example given in the Explanatory Memorandum is that of derivatives used for risk-hedging. If such derivatives have a negative value, it can nevertheless be preferable to retain them as protection rather than apply bail-in. Moreover the Act provides that, in the case of derivatives, bail-in can only be applied after close-out and, where a derivative is subject to a netting clause, only on a net basis (i.e. only after close-out netting).

Bail-in is applied in reverse order to the order in which claims against the insurer's bankruptcy estate would be eligible for payment. In other words, while shareholders are the last to be paid in bankruptcy, they are the first targets of bail-in. In contrast, policyholders are the first to be paid in bankruptcy and the last targets of bail-in, reflecting their privileged position.

The Explanatory Memorandum points out that, as a general rule, bail-in is aimed at preserving the continuity of the insurer's contract portfolio and not the continuity of the insurer itself. A policyholder will generally benefit more from the continued existence of the insurance agreement, even after bail-in, than from a bankruptcy distribution (although there are of course exceptions). In the event of an insurer's resolution, the continuity of its insurance contract portfolio can be achieved by using bail-in to re-launch the insurer as a going concern or by transferring all or part of that portfolio to a third party through one of the tools described below, whether or not in combination with bail-in (gone concern scenario).

Transfer tools: sale of business, bridge institution and asset separation

DNB can use (i) the sale of business tool or (ii) the bridge institution tool to sell shares or other instruments of ownership issued by or with the cooperation of the insurer, or the assets and/or liabilities of that insurer, to a private party or bridge institution on commercial terms. The asset separation tool is similar to the other transfer tools but can only be applied to an insurer's assets and/or liabilities. In addition, it can only be used in combination with other resolution tools and only, so as to avoid an unfair competitive advantage. A transfer tool can be applied to eligible liabilities either before or after the bail-in of those liabilities.

Valuation

A decision to proceed with resolution can only be taken after a valuation of all of the insurer's or group's assets and liabilities has taken place. This *ex ante* valuation serves as the basis for deciding whether the condition 'is failing or likely to fail' is met. It also serves as the basis for the decision to apply one or more resolution tools in the event that the conditions for resolution are met. As the resolution of an insurer can be a lengthy process, DNB must ensure that the valuation is periodically updated.

Once the resolution process is largely complete and it has been determined what losses have been suffered by creditors, an *ex post* valuation must be conducted. The purpose of this is to determine whether shareholders and creditors have suffered greater losses following the application of the resolution tools than they would have if the insurer or group had been wound up in bankruptcy proceedings (see below under 'No creditor worse off').

A complicating factor in the valuation of claims in a fictive bankruptcy scenario is that such claims are, in principle, wholly or partly dependent on an uncertain future event. For this reason, provisions containing additional guidelines that must be taken into account in such a valuation are expected to be laid down in the Insurance Claims (Bankruptcy) Valuation Decree (*Besluit waardering verzekeringsvorderingen in faillissement*) (this decree is still in draft form).

DNB's special powers

In addition to the abovementioned resolution tools and corresponding powers, the Act gives DNB special powers to take actions such as the following:

- to take over the management of an insurer under resolution;
- to appoint a special director to take over the insurer's management;
- to convert the insurer into a different legal form if this is necessary to apply bail-in;
- to terminate or modify the terms of an agreement to which the insurer is a party.

Exclusion, restriction and suspension of contractual rights

Under the Act a counterparty of (i) the insurer under resolution or, in some cases, (ii) a subsidiary of that insurer, is prohibited from exercising certain contractual rights (such as termination and close-out rights) and rights attached to security interests if those rights arose as a result of the application of a recovery or resolution measure or an event directly linked to the application of such a measure. However, this only applies if the insurer under resolution continues to perform its substantive obligations under the relevant contract, including payment and delivery obligations and the provision of collateral. Contractual rights arising as a result of an event other than the application of a recovery or resolution measure or a directly linked event are not covered by the prohibition.

In addition, DNB may suspend and/or restrict the payment or delivery obligations of an insurer under resolution or a counterparty's rights to terminate an agreement with the insurer under resolution or enforce a security interest. However, a counterparty's termination rights may only be suspended if the insurer continues to meet its substantive obligations to that counterparty.

Safeguards

The Act provides for certain safeguards for shareholders and creditors (including policyholders) of an insurer under resolution.

No creditor worse off

The principle no creditor worse off means that shareholders and creditors must not suffer greater losses as a result of the application of a resolution tool than they would have suffered if the insurer had been wound up in normal bankruptcy proceedings immediately before the resolution decision was taken. Thus, for example, DNB can apply bail-in to reduce death benefits received under a life insurance policy or distributions received under a non-life policy if this would leave the policyholder better off than would be the case in the event of the insurer's bankruptcy.

DNB must adhere to this principle when taking a resolution decision. However, this does not mean that equally-ranked creditors must receive the same treatment, provided that there is a justification for unequal treatment and provided that all such creditors are better off than they would have been in the event of the insurer's bankruptcy. After resolution, an *ex post* assessment will be made to determine whether any shareholders or creditors are 'worse off'. If so, they will be entitled to compensation for the difference, to be paid out of funds raised from other insurers (see section 7).

Partial transfer of assets and/or liabilities; modification of contractual terms

The Act contains rules for the protection of linked assets and liabilities of the insurer under resolution – such as assets and liabilities that are subject to a netting arrangement – in the event of a partial transfer of these assets and liabilities. Under the relevant rules, rights under certain agreements or arrangements may not be impaired (i.e. can still be exercised in full) by a decision to transfer part of the assets and/or liabilities of an insurer under resolution, a decision to terminate or modify the terms of an agreement to which that insurer is a party, or a decision to replace that insurer with a transferee as a party to an agreement/arrangement. The rights that may not be impaired are rights under: (i) financial collateral agreements (e.g. GMRAs, GMSLAs or CSAs entered into in connection with an ISDA Master Agreement), (ii) covered bonds, (iii) structured financing arrangements, (iv) close-out netting agreements (as set out in an ISDA Master Agreement), (v) set-off agreements and (vi) security agreements.

In addition, the Act provides that if DNB takes one of the decisions described in the preceding paragraph, the following rules apply:

- assets and liabilities falling under among others a financial collateral agreement, a set-off agreement or a netting agreement may only be transferred together;
- rights and obligations protected under such agreements (e.g. a right of set-off) may not be terminated or modified;
- the insurer under resolution may not be replaced with a transferee as a party to such an agreement;
- security arrangements may not be impaired in certain ways, for example by transferring assets subject to the arrangement without also transferring the corresponding secured obligation and the benefit of the security or by terminating or modifying the terms of the arrangement as a result of which the obligations would no longer be secured.

If linked assets and liabilities are not transferred together or if DNB otherwise fails to comply with the above rules, this does not result in the transfer, termination or modification being void or voidable. However, rights under the types of agreements and arrangements listed above remain unimpaired. This means, for example, that rights under e.g. set-off agreements and financial collateral agreements can still be exercised despite a partial or split transfer.

Fraudulent preference

Under the Act, if the application of a resolution tool results in the transfer of shares or other instruments of ownership issued by or with the cooperation of an insurer under resolution or of assets and/or liabilities of that insurer to another entity, such a transfer cannot be invalidated on the grounds of the fraudulent preference rules (*actio Pauliana*).

Systems

The Act also provides for the protection of systems as defined in the Settlement Finality Directive. The protection entails that transfer orders that have already been entered into such a system cannot be revoked as a result of a resolution measure. In other words, such transfer orders must be executed despite the resolution measure. Nor can any exclusion or suspension of contractual rights (see above) affect the operation of systems and rules of systems covered by the above Directive.

Other EEA member states and third countries

In the case of a cross-border insurance group, the measures under the Act can be taken only against the Netherlands-based undertakings in that group. However, such measures can nonetheless also have consequences in other EEA member states and even in non-EEA countries (third countries). According to the Explanatory Memorandum, such measures fall within the definition of reorganisation measures under Solvency II and will therefore in any event be recognised and effective elsewhere in the EEA. With regard to third countries, the Explanatory Memorandum points out that there are no provisions in the Financial Supervision Act that preclude the inclusion by DNB of assets in such countries in a resolution. However, whether measures taken by DNB will be effective in a third country depends on whether that country recognises and gives them effect in its territory.

6. Legal Protection

The legal protection of resolution measures applicable to insurers corresponds with the regular system of legal protection provided for in the Financial Supervision Act. However, an exception is made for the resolution decision, which can be appealed directly to the Trade and Industry Appeals Board (*College van Beroep voor het bedrijfsleven*). It is not possible to first file an objection with DNB. The period for lodging an appeal is only 10 days and a decision by the Board on the appeal is required within 14 days. The lodging of an appeal does not suspend the effect of the resolution decision, although the Board can be asked to order provisional measures while the appeal is pending.

7. Financing arrangements

The Act provides for the resolution of insurers to be funded through financial contributions by other insurers. The Explanatory Memorandum clarifies that this is an *ex post* arrangement, meaning that – unlike under the BRRD/SRM framework– it does not entail the establishment of a fund. Another difference compared to banks is that the Act expressly states that the contributions may not be used to recapitalise or absorb the losses of insurers under resolution. Their main purpose is to compensate creditors based on the no creditor worse off principle.

Contributions must be paid by all Netherlands-based insurers and all branches in the Netherlands of non-EEA insurers (other than Solvency II Basic insurers). Interestingly, under the wording of the Act the smallest insurers would also have to contribute, even though they are excluded from the recovery and resolution framework.

Rules on the amount of the contributions are set out in the Recovery and Resolution (Insurers) Decree, which states that the amount to be contributed by each insurer will be calculated based on the amount of that insurer's technical provisions.

8. Amendments to Bankruptcy Act

Under the Act, new provisions have been added to the Bankruptcy Act. Among other things, these require the bankruptcy trustee to make certain distributions to policyholders prior to the final distribution, provided that the policyholder is a natural person or small or micro-business. Following the creditors' meeting and at the time of the final distribution, the distribution already made will be offset against the amount to which the policyholder is ultimately found to be entitled. In addition, the criteria for declaring an insurer bankrupt have been amended so as to be consistent with the first and second conditions for resolution discussed above in section 5. Lastly, policyholders' claims for compensation of damage have been given a higher ranking.

9. Conclusion

Finally, we highlight a few points that have drawn our attention in the Act and the Explanatory Memorandum.

- The Act does not provide for early intervention measures akin to those included in the recovery and resolution framework for banks, such as the appointment of a temporary administrator (as the next step after the appointment of an undisclosed administrator, which is also possible for insurers) or the convening of a general meeting. According to the report on the consultation, it was decided that the recovery and resolution framework for insurers did not need to be supplemented with early intervention measures during the going concern stage and, furthermore, that such measures would be incompatible with Solvency II, which lays down a fully harmonised set of rules for this stage.
- Under the recovery and resolution framework for banks, the European Commission can adopt delegated regulations (with direct effect in the Netherlands) for the interpretation of provisions in the BRRD or SRM. Some of these regulations have been incorporated in the recovery and resolution framework for insurers. With regard to the others, the consultation report states that the BRRD level 2 and level 3 regulations can be used by DNB as a source of guidance in the exercise of its powers.
- Derivatives have a special position in the event of bail-in (see section 5). However, the Financial Supervision Act does not define the term 'derivative'; nor has a definition of the term been included in the Act. Consequently, the scope of the bail-in rules is unclear. The obvious solution is to apply a definition of derivative in European legislation, the approach also taken in the recovery and resolution framework for banks.
- It is noteworthy that when discussing DNB's powers to terminate or modify the terms of agreements entered into by the insurer under resolution the Explanatory Memorandum states that the terms modified can be those which result in the policy being qualified as usurious (referred to in vernacular Dutch as a '*woekerpolis*'). It has been explained that the significance of this is that the modification of such terms can considerably improve the chances of a transfer to another insurer.
- The Act does not provide for a tool equivalent to the write down and conversion of capital instruments that may be applied to banks and, accordingly, DNB does not have the power to apply bail-in to all of the capital instruments of an insurer prior to resolution. In addition, the Act does not impose an MREL (the requirement to hold a minimum amount of own funds and eligible liabilities that can be used for a bail-in). Lastly, whereas under BRRD banks are required to include a recognition of bail-in clause (under which – in brief – the counterparty acknowledges and accepts the application of bail-in) in non-EEA law governed contracts, no such requirement is imposed under the Act.

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