ACPR
BANQUE DE FRANCE

Resolution

Identification of the critical functions of insurance undertakings

Resolution Directorate

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IDENTIFICATION OF THE CRITICAL FUNCTIONS OF INSURANCE UNDERTAKINGS

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I. BACKGROUND

France was one of the first EU Member States to adopt a regime for the recovery and resolution of insurance undertakings. Introduced by Section 47-V of Act 2016-1691(so-called "Sapin 2" French Law) of 9 December 2016 and by French Ordinance No. 2017-1608 of 27 November 2017, this regime applies:

- to insurance and reinsurance undertakings, mutual insurers and provident institutions and unions subject to Solvency II;
- to insurance group companies;
- to entities of an insurance group providing services which are essential for the activities of the group;
- to occupational pension institutions.

The preventive part of this regime, which requires for insurers to establish preventive recovery plans and for the resolution authority to establish preventive resolution plans, applies in particular to insurance undertakings the total assets of which, valued in accordance with the provisions of the Solvency II framework, have exceeded the EUR 50 billion threshold at least once in the last three annual financial years[1]. Since 2019, 14 insurance undertakings are subject to the preventive part of this regime.

The objectives of insurance resolution are set out in Article L.311-22 of the *Code des assurances* : "the Resolution College shall ensure the continuity of critical functions resulting from the activity of that entity, avoid or mitigate negative effects on financial stability, protect the State's resources from recourse to exceptional public financial assistance and protect the rights of policyholders, underwriters, members, participating members and beneficiaries of insurance coverage".".

According to Article L.311-2 of the *Code des assurances*, "**critical functions**" shall mean a person's activities, services or operations[2] matching the following characteristics:

- they are provided by said entity to unrelated third parties;
- the inability of said entity to perform them would be likely to have a significant impact on financial stability or on the real economy;
- said entity's contribution cannot be replaced at a reasonable cost and within a reasonable time.

The ACPR Resolution College establishes a preventive resolution plan[3] for each of the groups subject to the preventive part of the resolution regime. The plan covers various elements, including a mapping of the critical functions carried out by the group considered, together with resolution measures and tools aimed at maintaining these functions, where appropriate.

[1] Pursuant to Article L.311-5 of the *Code des assurances*
[2] As defined in Article L.311-1 of the *Code des assurances*
[3] Pursuant to Article L.311-8 of the *Code des assurances*

In view of the drafting of the first preventive resolution plans for all groups subject to the preventive part of the resolution regime, this document presents an initial approach to identifying critical functions. As far as critical functions are concerned, this document replaces the one relating to the "Operational implementation of the preventive recovery plan regime for the insurance sector"

This approach builds on the international-level principles developed by the Financial Stability Board[4], and the relevant stakeholders were consulted prior to its drafting. It only concerns activities carried out in France by insurance undertakings or insurance groups.

It comprises two steps:

1. The definition of a list of functions deemed critical due to their nature.
2. The determination of a criticality threshold intended to identify, for each of these activities, the most significant insurance undertakings and groups.

The identification of critical functions is an iterative process and this first approach may be subsequently amended and supplemented, based on the additional information that may be collected and further analyses that may be carried out.

Moreover, as critical functions are those that must be maintained in the context of crisis management, it seems necessary to identify them clearly, not only in preventive resolution plans but also in preventive recovery plans. Therefore, insurance groups must take into account the critical functions identified when drawing up or updating their preventive recovery plans.

II. METHODOLOGICAL PRINCIPLES FOR IDENTIFYING FUNCTIONS DEEMED CRITICAL DUE TO THEIR NATURE

The definition of a list of functions that are deemed of a critical nature is derived from:

- the analysis of the activities' characteristics;
- the assessment of the impact the insolvency of an entity would have on the real economy or on financial stability (without taking into account elements of substitutability);
- the analysis of substitutability at a reasonable cost and within a reasonable time.

Impact assessments and substitutability analyses make the assumption that an entity is failing, without examining the circumstances and scenarios that could have led to the failure of that entity. Conversely, preventive resolution plans must incorporate a detailed description of the various resolution strategies that could be applied depending on possible scenarios.

[4] Refer to the consultation paper published by the FSB (Financial Stability Board) in October 2014 – " Recovery and Resolution Planning for Systemically Important Insurers – Guidance on Identification of Critical Functions and Critical Shared Services "

A. Characteristics of the activities

Certain characteristics should be considered in the criticality analysis, including:

a) the nature of the insurance coverage, and especially **whether it is compulsory** or not. By design, compulsory insurance is considered by legislators to be necessary to the real economy or to financial stability, and the failure of an actor with significant market shares may have a significant impact on the economy. Beyond the legal nature of the requirement for certain types of coverage, the **de facto** compulsory nature was also taken into account for other guarantees (e. g. loan insurance);

b) the duration of the liabilities, distinguishing **between long-term guarantees** (e. g. retirement savings, construction, disability, liability) and **short-term guarantees** (automotive, health). It is thus presupposed that an inability of a failing undertaking to honour its commitments will have a greater impact on long-term commitments;

c) the type of counterparty, distinguishing between individual and collective contracts subscribed by individuals, companies, associations or any other professional organisation.

B. Impact assessment

The assessment of the impact of an undertaking or group failure on the real economy (RE) or financial stability (FS) stems from two analytical dimensions:

- on the one hand, the impact analysis of a breach of protection on policyholders and beneficiaries;

- on the other hand, the impact analysis, on policyholders and beneficiaries, of an inability for the relevant group to honour its commitments (including the payment of claims).

For these two dimensions, the contagion effects on other economic actors are also examined.

This impact assessment, which falls within the context of an **idiosyncratic** crisis, does not take into account, *inter alia*, the following elements:

- the possibility to substitute one or more insurance groups to the failing group, the substitutability analysis being carried out separately;

- the existence of guarantee funds;

- the possibility of using public funds or government intervention[5];

- the existence of a ring-fencing mechanism set up by the undertaking or group as part of certain guarantees. Such ring-fencing mechanisms, excluding those framed by law, are

[5] One of the objectives of resolution is avoiding the use of exceptional funding support from authorities.

relevant from a purely accounting-based perspective but do not grant any privilege in the event of default.

1. Impact resulting from a breach of protection

The assessment of impact resulting from a breach of protection (or a breach of insurance coverage) encompasses, as a first step, the identification of all the adverse impacts that this breach of protection would have on policyholders or beneficiaries and, as a second step, the identification of the possible contagion effects on associated or related counterparties.

These impacts of a varying nature may limit the exercise of a personal or professional activity of the policyholder (or beneficiary). In some cases, especially where insurance is compulsory, the policyholder (or beneficiary) may be obliged to cease his activity due to the lack of coverage of the risks incurred, which may jeopardise the business itself and, in some cases, cause its default.

For other types of insurance, negative consequences may also be observed, such as:

- the impact on the health of insured persons when postponing medical care;

- the impact on income (greater or lesser loss depending on the type of guarantee considered) or on savings (in the form of life insurance or for retirement).

All these impacts directly affecting the policyholder (or beneficiary) can also affect, through contagion effects, other economic actors such as:

- **competitors**: in the event of the failure of a major life insurance player, a loss of confidence from customers of other organisations could result in massive early withdrawals for competitors;

- **intermediaries**, brokers, agents, asset managers: these counterparties could suffer a contagious drop in their activity and revenues;

- **customers**, **suppliers, creditors**, with an impact on the financial situation of these counterparties.

2. Impact resulting from an inability to honour commitments

The assessment of the impact resulting from a group's inability to honour its commitments (especially the payment of claims) consists in identifying, firstly, all the negative consequences on policyholders (or beneficiaries) and, secondly, any contagion effects on associated or related counterparties.

These impacts are all the more important as the activity analysed corresponds to a long-term guarantee. The failure of an entity may result in:

- a drop in the income or a decrease of the assets' value of policyholders or beneficiaries, with a possible contagion effect on the economy (following massive surrenders in the life insurance sector) or on potential heirs (societal impact in particular);

- financial difficulties for policyholders with consequences on firms (cash flow difficulties…) which could even lead to bankruptcy and an impact on the real economy;

- contagion effect to players in specific sectors such as construction or agriculture following the default of a major player.

C. Substitutability analysis

Several elements are to be taken into account in the substitutability analysis:

a) The volume of portfolios to be transferred: the larger the size of a portfolio (in particular in terms of number of policyholders or contracts), the more complicated the transfer to one or more other players will be, especially if the market is highly concentrated and not very competitive;

b) The degree of standardisation of products (existence of similar products offered by competitors): the more complex the products, the less easy it will be for one or more other players to take over.

  - a high number of customised products within a portfolio makes it atypical compared to the market and complex to transfer to one or more potential buyers;

  - products designed for individuals and professionals (individual or "open group-contracts"), especially in property and casualty insurance, are more standardised and often less complex than products adapted for firms ("closed group contracts");

  - concerning savings products in Euro, some market participants hold portfolios with guaranteed rates higher than those observed on the market. In a low interest rate environment, this can reduce the appetite of potential buyers.

c) The degree of market concentration and the level of competition depends on the markets considered: the more concentrated the market and the weaker the competition, the less easy it will be for one or more other players to take over.

  - high-concentration market observed, for instance, for loan insurance (a market that is also highly competitive and profitable);

  - medium- concentration market observed, for instance, for savings, retirement, and provident insurance (excluding loan insurance, see above), motor insurance, multi-risk home insurance…

- low-concentration market observed, for instance, for health insurance.

d) The appetite and ability (in particular technical ability) for competitors to take over activities depend on several criteria:

- the license that is required for the line of business to be taken over or the possibility to obtain such authorisation quickly (case of insurance guarantee 26 "group pension schemes calculated on the basis of retirement points" with a small number of authorised companies);

- sufficient size and adequate financial soundness, especially in terms of the solvency ratio (SCR), to take over the business;

- sufficient appetite, depending on:
  - the overall strategy of the potential buyer (in the low interest rate environment, the appetite of insurers for taking over a savings portfolio in euro with high guaranteed interest rates may be lower than their appetite for other non-life activities);

  - the attractiveness of the portfolio (in terms of profitability and technical complexity): some insurance activities are recognised to be profitable, such as loan insurance; health is recognised as a technically non-complex class, unlike construction, credit insurance or bonding.

e) The obstacles to the transfer, with the analysis of the absence of constraints or problems of different kinds:

- regulatory issues: with a particular focus on the dominant position risk[6];

- legal issues:

  - transfers of contracts (e.g. service agreements) which are useful for business continuity;

  - a possible refusal from reinsurers regarding the novation of reinsurance treaties in the context of the transfer of insurance contracts to a potential buyer.

- operational issues and risks related to:

  - the takeover of the administrative and technical management of contracts with, however, a few elements that may mitigate difficulties: management of the

[6] The analysis of dominant position is within the remit of the *Autorité de la concurrence* pursuant to à Article L.430-1 et seq. of the *Code de commerce*

portfolio kept by the selling entity or existence of subcontractors, partners (e.g. co-insurers) or brokers in charge of contract and claims management.

- IT migration (portfolio transfer issues in case of multiple IT systems that may be specific to the entity and may require complex maintenance);

- the HR aspect, with massive departures of staff from the failing undertaking, making it impossible to ensure an orderly transfer or leading to a lack of expertise on the buyer's side, particularly where the takeover includes new or complex activities.

f) The reasonable time and costs, which mainly depend on the size of the portfolio to be transferred. The time limit is not specified by regulatory texts but a period of approximately 6 months could be considered reasonable.

III. DETERMINATION OF A CRITICALITY THRESHOLD

The criticality threshold is intended to identify the most significant insurers or insurance groups for each of the activities that are deemed critical by nature.

It appears that market share plays a crucial role in assessing the materiality of the activities carried out by each group.

Indeed, the greater the market share:

- the greater the impact on the real economy or financial stability is likely to be, due to the large number of policyholders likely to be affected (several million in the case of motor insurance) and to the potential multiplier effect resulting from contagion (with impacts on the market, taking the example of savings in euros);

- the less easy the substitutability (takeover of the activity by a competitor) will be, in particular due to:

  – issues related to portfolio transfer within a limited timeframe (constraint related to the forty-day period following the withdrawal of authorisation of a defaulting organisation, at the end of which the cover ends[7]);

  – the complexity linked to the need to split up certain large portfolios to make it possible to transfer them to several competitors.

Therefore, the market share criterion is used to set the criticality threshold.

[7] Article L.326-12 of the *Code des assurances* "In the event of the dissolution of an undertaking mentioned in points 2° or 3° of Article L. 310-1 following a decision by the *Autorité de contrôle prudentiel et de résolution* taken pursuant to Articles L. 326-1 or L. 326-2, all contracts entered into by such undertaking shall automatically cease to have effect on the fortieth day at noon, as from the publication in the Official Journal of the Authority's decision pronouncing such decision.. "

The market share is expressed as a percentage of:

- outstanding amounts (liabilities) for the identified long-term guarantees that are savings (in euros and unit-linked) and retirement;

- amounts of annual earned premiums gross of reinsurance, for short-term guarantees but also for all other long-term guarantees excluding savings and retirement (construction, civil liability…)

For the first exercise, the **criticality threshold is set at a 10% market share**.

IV. PRESUMPTION OF CRITICAL FUNCTIONS/ACTIVITIES

Based on the methodological principles, six functions are deemed of a critical nature:

- savings, in euro and unit-linked;
- motor vehicle including civil liability;
- medical liability;
- construction;
- agricultural insurance;
- credit insurance and bonding.

The main criticality factors, for each critical function, are detailed in the annex.

Further analysis, which could lead to a broadening of the list of critical functions, could especially concern:

- loan insurance;
- regulated professions[8] public liability other than medical liability.

In addition, a more granular approach could be considered for the following activities in particular: savings, with a distinction between euro-denominated and unit-linked activities (especially with the possibility of retaining an outstanding-based threshold approach), motor insurance with a distinction between the contracts for individuals and those for companies, and agricultural insurance.

Finally, the application of the criticality threshold might not be automatic. The definition of the degree of criticality could also involve an expert judgement component, making it possible, on the basis of a case-by-case analysis, to include, for a given undertaking or group, an activity despite a market share below the set threshold (or, conversely, to exclude an activity despite a market share above 10%).

[8] In particular brokers, real estate agents, architects, auditors, notaries, lawyers…

ANNEX

Functions/activities deemed critical

PRESUMPTION OF CRITICALITY…
…EURO AND UNIT-LINKED SAVINGS ACTIVITIES

Long/short term guarantee	long
Compulsory insurance	no

Impact/Breach of protection

On policyholders — Spillover effect

- Decrease in saving rates and loss of the tax benefit resulting from contract maturity
- Spillover effect:
  - Decrease in long-term savings
  - Reputational risk and massive withdrawals for all life insurers
  - Decrease in activity for ditributors, asset managers

Impact/Inability to comply with commitments

On policyholders — Spillover effect

- More or less significant loss of accumulated capital (for unit-linked insurance, risk of loss usually accepted by the policyholder when the contract is signed)
- Inability to perform a heritage transfer in the event of a policyhorlder death
- Spillover effect:
  - Reputational risk and massive withdrawals for all life insurers
  - Impact on the financial market in the event of a mass sell-off of assets
  - Impact on the value of assets held by competitors

Impact on the real economy (RE) or financial stability (FS)

- **Significant impact** on financial markets (impact on **financial stability**)
- **Significant impact on the real economy** with:
  - A significant impact on population savings, across all relevant income groups and
  - A decrease in policyholders' investments and/or spending

Substituability

Presence of players with substantial market shares (based on outstanding)

Existence of guaranteed yield contracts (more or less significant share)

Low profitability of the portfolio in the low interest-rate environment for euro contracts

Highly competitive market

Standard product

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PRESUMPTION OF CRITICALITY…

MOTOR VEHICLE INSURANCE, INCLUDING CIVIL LIABILITY

Long/short term guarantee	short
Compulsory insurance	Yes (liability)

Impact/Breach of protection

On policyholders — Spillover effect

- Third party liability : compulsory
- Inability for policyholders lacking insurance to use their vehicle (or company fleet) with major repercussions:
  - private individuals (isolation, loss of employment)
  - professionals and companies (drop in business activity, even default with the halt of cars/trucks)
- Splillover effects:
  - e.g. for companies, repercussion of the drop in activity (or even default) on customers (for companies in the transportation sector, impact on their customers in the industry, distribution and construction sectors, etc.)

Impact/Inability to comply with commitments

On policyholders — Spillover effect

- For third party liability, high impact:
  - for policyholders (very large sums to be paid to third parties, particularly in the event of an at-fault accident; for large claims, pensions > EUR 1 million)
  - for victims (if ultimately compensation by policyholder not possible)

  For damages: economic difficulties for the policyholder (e.g. impact on cash flow if self insurance or impact on business if inability to carry the extra burden)
- Spillover effect:
  - e.g.: for companies, passing on cash flow difficulties to suppliers (inability/difficulty to pay suppliers)
  - impact on the activity of professional repairers/garages

Impact on the real economy (RE) or financial stability (FS)

Significant impact on the RE

For private individuals (rising unemployment; isolation)

For companies/ professionals (potential default) in various economic sectors or geographic areas in the event of a complete halt of fleet traffic (trucks and cars)

Substituability

Concentrated market

(top 3 > 40% of market shares)

Constraints related to the 40d time limit

Difficulty for the market to absorb several million customers over a short period of time

Highly competitive market

Standard product/ customer relationship entry point

PRESUMPTION OF CRITICALITY …

…MEDICAL LIABILITY INSURANCE

Long/short term guarantee	Short
Compulsory insurance	Yes

Impact/Breach of protection

On policyholders

Spillover effect

- Impossibility for persons exercising the professions concerned (doctors, pharmacists, nurses, etc.) to continue their activity (jeopardising their activity/default)

- Spillover effects:
  - Repercussion of the cessation of these activities on patients/customers with multiple health, societal/social and economic impacts that are potentially significant

Impact/Inability to comply with commitments

On policyholders

Spillover effect

- High impact for the policyholder in the event of a claim (potentially very large sums to be paid to third parties/victims, in particular in the event of an at-fault accident) and for the third parties/victims (if ultimately, compensation by the policiyholder is not possible)

Spillover effects:

- Possible repercussions on various counterparties (customers/patients, suppliers/creditors) of the difficulties encountered by policyholders and victims

Impact on the real economy (RE) or financial stability (FS)

Significant impact on the RE

Multiple impacts (health, societal, economic) given the very wide range of professions concerned

Impacts resulting from the impossibility for the various insured parties to continue their activity and/or from non-settled claims

Substituability

Niche market; very few players;

Constraints related to the 40days time limit

Relatively standard product as it is regulated

PRESUMPTION OF CRITICALITY…

…CONSTRUCTION INSURANCE

Long/short term guarantee	long
Compulsory insurance	Yes

Impact/Breach of protection

On policyholders

Spillover effect

- Ten-year civil liability (« RC décennale »): mandatory for builders (broad definition; see Art. 1792-1 of the French *Civil code*); building damage insurance : mandatory for the project owner (individual, developer,..)
- 10-year civil liability: impossibility for the insured parties (builders) to continue their activity (jeopardising their business / default)
- Building damage insurance: Impossibility for the policyholder (project owner) to carry out works
- Spillover effects:
  - Impact of the shutdown/drop in activity on various counterparties (customers, suppliers, creditors) and on co-insurers
  - Potential shutdown of several building works with a major impact on the construction industry

Impact/Inability to comply with commitments

On policyholders

Spillover effect

- High impact for the insured parties in the event of a claim (particularly with regard to the ten-year civil liability): the unit costs of claims can be high and claims can occur over the entire duration of the covered period; potentially very heavy financial losses, which could generate defaults on policyholders (builders, developers...)
- Spillover effect:
  - Potential impact of these difficulties on various counterparties (customers, suppliers, creditors), particularly in the construction industry.

Impact on the real economy (RE) or financial stability (FS)

Moderate impact on RE

- Potentially large impact but mainly limited to the construction industry
- Impact resulting from the impossibility for the various policyholders to continue their activity and/or settled claims

Substituability

Concentrated market (top 3 > 40 % of market shares; trend towards concentration)

Technically complex products

Recent proven difficulty in recovering portfolios from failing insurers operating under FPS

Strong appetite of competitors

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PRESUMPTION OF CRITICALITY…

…AGRICULTURAL INSURANCE

Long/short term guarantee	short
Compulsory insurance	Yes, for some specific risks

Impact/Breach of protection

On policyholders — Spillover effect

- Namely multi-risk agricultural insurance and mulri-risk insurance for crops (not mandatory); tractor insurance (mandatory)
- Risk for farmers should they continue their activity: consequence is a potential drop or even cessation of their activity (default)
- Spillover effects:
  - Repercussion of the potential decrease or cessation of farmers' activity on agri-food businesses
  - Impact on the businesses of the defaulting insurer's partners and distributors.

Impact/Inability to comply with commitments

On policyholders — Spillover effect

- High impact in the event of a claim (various kinds of accidents affecting buildings and farm equipment, tractors or crops) for the insured parties: potentially very heavy financial losses affecting an already weakened sector, which could generate defaults
- Spillover effects:
  - potential repercussion on various counterparties (customers, suppliers, creditors) and especially on agri-food businesses

Impact on the real economy (RE) or financial stability (FS)

Significant impact on RE

Potentially significant impact on the agricultural sector and, through a spillover effect, on agri-food businesses

Substituability

Niche, highly concentrated market (2 major players/specialists)

Mostly uncompetitive and unprofitable market (especially for crops)

Tailor-made products

Constraints linked with the 40d time limit

Entry point for the subscription of other insurance products by farmers (health related, multi-risk home insurance policies,…)

PRESUMPTION OF CRITICALITY…
…CREDIT INSURANCE / BONDING

Long/short term guarantee	short
Compulsory insurance	no

Impact/Breach of protection

On policyholders

Spillover effect

- Difficulty for policyholders in terms of selecting their customers and adapting payment terms to their risk typology
- Strain on the cash flow of policyholders
- Cessation of activities requiring mandatory guarantee (real estate agency, Seveso sites...)
- Spillover effect:
  - Modification of payment periods granted to companies (shortened or even abolished)
  - Decline in national and international trade activity
  - Benefit at standstill or uncovered risk for guarantee beneficiaries, which could lead to a risk of failure

Impact/Inability to comply with commitments

On policyholders

Spillover effect

- Strain on the cash flow of the policyholders in the absence of payment of claims
- Difficulties in taking out a new guarantee contract during the course of building works or of an operation
- Spillover effect:
  - Businesses failure (policyholders in the absence of compensation …) which can trigger a spillover effect on suppliers
  - Rising unemployment and decreasing investments

Impact on the real economy (RE) or financial stability (FS)

Significant impact on RE & FS

- Businesses failure
- Decrease in national and international trade activities
- Rising unemployment rates
- Discontinuation of certain regulated activities and risk of default for beneficiaries of the guarantee

Substituability

Market concentrated around three players.

Technical knowledge of the market required

Bonding: products that are sometimes also offered by banks