

## **Approach and lessons learned from EIOPA's first crisis walkthrough exercise**

### **1. Introduction**

Crisis preparedness and simulation exercises can be considered a key element of a crisis management framework. The authorities in charge of financial stability need to develop very flexible crisis management procedures in order to deal with unexpected events and to mitigate as quickly as possible the consequences of a developing crisis.<sup>1</sup> Provided that the financial system is becoming increasingly interconnected and integrated, and with many financial groups operating on a cross-border basis, inter-jurisdictional coordination becomes more important than ever.

In the past few years, financial crisis exercises have become an important instrument to test the decision-making, cooperation and crisis procedures, with a view to assessing whether the internal processes and relevant staff would be sufficiently prepared to respond to a sudden crisis.

Financial crises generally entail considerable elements of surprise and develop suddenly.<sup>2</sup> Hence the importance of conducting testing exercises in normal times, with a view to enhancing the crisis management capacity. Similarly, it is also crucial to strengthen the preparedness, cooperation and coordination between EIOPA and the different NSAs.<sup>3</sup>

All in all, from EIOPA's perspective, the added value of carrying out a crisis exercise can be summarized below:

- It is a good crisis prevention and management mechanism to identify strengths and weaknesses in crisis procedures and preparedness.

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<sup>1</sup> See for instance National Bank of Belgium (2008).

<sup>2</sup> To quote Paul Auster's *Winter Journal*: "You think it will never happen to you, that it cannot happen to you, that you are the only person in the world to whom none of these things will ever happen, and then, one by one, they all begin to happen to you, in the same way they happen to everyone else."

<sup>3</sup> This emanates from the EIOPA's Regulation and is also stated in EIOPA's Single Programming Document 2019-2021.

- It can improve the decision-making process (efficiency and effectiveness) and familiarise relevant staff with the existing internal processes.
- It contributes to assessing the information exchange, communication and coordination procedures among EIOPA and the NSAs.

In June 2019, EIOPA conducted, together with one NSA (from now on “the participating NSA”), its first walkthrough exercise. The methodological approach and main lessons learned are described in the following sections.

## **2. General considerations**

A walkthrough exercise can be considered a type of crisis exercise in which the involved parties (here, EIOPA and one NSA that volunteered to participate) gather together in a room and within a few hours “walk through” a process or a range of processes, in this case related to a particular Group simulating a period of several months.

A walkthrough exercise is thus a kind of table-top exercise, which can be differentiated from other types of exercises, as summarized in the table below.

	<b>Communication test</b>	<b>Walkthrough exercise</b>	<b>Simulation exercise</b>	<b>Stress test</b>
<b>Focus</b>	Communications	Decision-making processes	Decision-making processes	Vulnerabilities of institutions
<b>Elements tested</b>	Communication agreements (e.g. contact lists)	One or several crisis processes	One or several crisis processes	Balance sheet
<b>Staff involved</b>	Senior management	Senior management supported by their staff	Senior management supported by their staff	Technical experts
<b>Location</b>	Decentralised (unknown)	Centralised (i.e. in a meeting room)	Decentralised (i.e. in the respective headquarters)	Decentralised (i.e. in the respective headquarters)
<b>Scenario-based</b>	Usually not	Yes	Yes	Yes
<b>Temporal sequence</b>	Real time	Times are simulated	Real time	Times are simulated
<b>Duration</b>	A few minutes	Around one to four hours	Around a working day or longer	Varying
<b>Degree of complexity</b>	Low	Medium	High	High

As portrayed above, the main difference between a walkthrough exercise and a simulation exercise, is that the former is not as challenging and complex as the latter. In the case of a walkthrough exercise, the timeline of events is simulated, the duration of the exercise is shorter (half a day maximum), and the run is conducted in a centralised manner.

## **3. Objectives and approach of EIOPA’s walkthrough exercise**

### **3.1. Objectives**

The main objective of the walkthrough exercise was to test the crisis processes and procedures and assess the way in which participants interacted in terms of exchanging information, cooperating and adopting decisions. The involved parties thus “walked through” a range of crisis processes deriving from situations emanating from the crisis scenario.

As mentioned, there were two main parties involved in the exercise, whose processes were tested (i.e., EIOPA and one participating NSA). The rest of parties involved were simulated (e.g. affected Group and other authorities).

It should be stressed that the objective of the exercise was not to achieve a pre-defined specific decision or outcome. In a walkthrough exercise there is generally no right or wrong ending. The exercise aimed instead at making participants think what could be the best course of action that they could follow in a given situation, and make them aware of potential inconsistencies or limitations in their decision-making processes.

### 3.2. Approach/Methodology

In the development of the exercise, the following steps were considered :

	Steps	Approach
<b>Preparation</b>	<b>1. WHO will participate in the exercise? (And who takes part in the organisational team)</b>	<ul style="list-style-type: none"> <li>• Select a suitable Group that can be used as a reference (i.e. to frame the exercise and make it more realistic) and its corresponding Group supervisor</li> <li>• Agree on the participants (“players”) that should take part in the exercise (Senior Management)</li> </ul>
<b>Design</b>	<b>2. WHAT is the scenario of crisis? (And what are the objectives of the exercise)</b>	<ul style="list-style-type: none"> <li>• Design of a credible and severe scenario: <ul style="list-style-type: none"> <li>➢ Agree on the high-level features of the crisis scenario (e.g. idiosyncratic/systemic, time horizon, risk dimensions, etc.)</li> <li>➢ Expand the scenario based on the high-level structure. Define the timeline and starting state, and develop the chain of critical events occurring over time, as well as the necessary pieces of information (called “injects”).</li> </ul> </li> <li>• Define the key objectives/decisions to be tested in the scenario of crisis. <ul style="list-style-type: none"> <li>➢ For example: What is the level of cooperation and coordination between authorities based on these incidents? What are the internal and external communications to be done? What remedial actions could be taken?</li> </ul> </li> <li>• Carry out a first rehearsal (pre-test of the exercise) without the actual “players”</li> <li>• Fine-tune the exercise based on the rehearsal(s)</li> </ul>
<b>Execution</b>	<b>3. HOW to run the walkthrough?</b>	<ul style="list-style-type: none"> <li>• Participants gather together and take decisions based on the scenario and the injects provided</li> </ul>
<b>Assessment</b>	<b>4. Aftermath steps</b>	<ul style="list-style-type: none"> <li>• Obtain feedback from the participants and prepare the lessons learned</li> </ul>

For this exercise, a team of EIOPA and NSA experts (i.e. the organisational team) was set up to design the scenario of crisis and manage/run the

exercise. It should be mentioned that the design of the exercise and the specific features were kept secret to the participants in the actual exercise, who were only informed about the dynamics and logistics of the exercise.

Concerning the mentioned participants, it was Senior Management from both EIOPA and the NSA who participated in the exercise run. Considering the fact that walkthrough exercises are focused on the strategic decision-making process, participants should be those who would take key strategic decisions in a real crisis.

The preparation and design of the exercise took approximately one year.

### **3.3. Crisis scenario design**

The main goal was to create a credible, well-researched, severe but plausible stress scenario, in order to put the Group used as a reference in a near-default situation, gradually triggering the decisions by the participants. To this aim, the expertise and knowledge of the relevant NSA supervisors was key for successfully developing a credible and realistic scenario.

Once the high-level structure of the crisis scenario and the main impacts in solvency/liquidity were obtained, the information injects were prepared (to be distributed at different points in time during the exercise). This included fictitious news, press releases, analyses carried out by rating agencies, simulated internal briefings/reports by the NSA, emails, etc. Other figures and stock prices were also provided during the exercise. The organisational team prepared the material as realistically as possible, using available data from the Group and other internal sources of information.<sup>4</sup>

The exercise was organised in two different phases, split by the type of shock:

1. Idiosyncratic event: This essentially involved a liquidity and reputational shock, with the aim of testing the crisis management procedures of the participating NSA and the affected Group, including the potential management actions to be taken. Another aim was to assess the cooperation between EIOPA and the participating NSA.
2. System-wide event: This follow-up shock resulted from a combination of geopolitical tensions and a global cyber-attack, resulting also in the deteriorating solvency position of the Group. One of the aims of this phase was to test also the EIOPA's crisis prevention and management processes and escalation procedures as per the EIOPA Regulation or the Solvency II Directive.

A key element in the design phase was the consideration of "what if" scenarios and the potentially available responses by the relevant participants. Although it is clear that not all possible courses of action can be anticipated, the organisational team considered potential different outcomes in a kind of decision tree.

To ensure that the appropriateness of the material, the exercise was rehearsed by the organisational team, together with an EIOPA observer that

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<sup>4</sup> For instance, the ORSA or recovery plan scenarios may provide a good basis for the preparation and testing of idiosyncratic (institution-specific) scenarios in crisis exercises.

also participated in the actual exercise. As a result of this rehearsal, the scenario and information injects were adapted where needed.

### **3.4. Execution**

The actual exercise took place in June 2019 at EIOPA's premises and lasted approximately 3 hours. At first, EIOPA and NSA participants were located in different meeting rooms. As part of the dynamics of the exercise, the participants decided to set up calls and teleconferences with each other. At some point, they agreed to physically meet and continued together for the remaining duration of the exercise.

## **4. Lessons learned**

Even if by its own design and features, a crisis exercise has a number of limitations compared to a fully-fledged real simulation exercise, the exercise carried out allowed for identifying several important lessons learned, which are summarised below.

The assessment of this walkthrough exercise was based on three main elements. Firstly, the observation by the organisational team during the whole exercise run. Secondly, a short feedback questionnaire to participants distributed directly after the exercise, capturing the immediate impulse reaction. Lastly, a more in-depth questionnaire, which gave participants with enough time *ex post* to think about the main lessons learned and potential improvements for future exercises.

### **➤ The need to have in place comprehensive crisis procedures and to test them**

It is clear that all crisis situations cannot be foreseen in advance and that flexibility is needed. However, having a comprehensive crisis roadmap in place allows to identify potential vulnerabilities, facilitates crisis management and orderly escalation, and provides Senior Management and relevant staff with a structured way of thinking.

According to the feedback received, the walkthrough exercise proved to be a very useful "stress test" of the abovementioned procedures, both at EIOPA and at the NSA level.

Several areas of improvement were identified. In particular, some terminology currently embedded in the EU regulatory framework may be confusing or require further clarification to make them operational.<sup>5</sup> Furthermore, some of the EIOPA Crisis Handbook processes established might be too rigid to cope with sudden and severe crisis. Therefore, an accelerated fast-track process **could be considered for specific stress situations**.

Currently, the EU insurance regulatory framework considers three types of situations (adverse developments, emergency situation and exceptional adverse situations). Given that they have different features in terms of the legal basis, scope and responsible institution, it should be clear what the

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<sup>5</sup> For example, the difference between adverse developments as defined in Article 18 of the EIOPA's Regulation or an exceptional adverse situation as per Solvency II.

purpose of each of them should be. Furthermore, it is also important to consider the potential interactions between them.

	Adverse development	Emergency situation	Exceptional adverse situation
<b>Legal basis</b>	Article 18(1) of EIOPA Regulation	Article 18(2) of EIOPA Regulation	Article 138(4) of Solvency II
<b>Scope</b>	EU-wide/National	EU-wide	National
<b>Who declares?</b>	N/A	EU Council	EIOPA
<b>Other comments</b>	The process for the assessment of adverse developments does not necessarily lead to the identification of an emergency situation in each and every case		There may be linkages between an exceptional adverse situation and an emergency situation, but the former does NOT necessarily lead to the latter

### ➤ **The importance of testing the relevant documents of the groups**

A real crisis might look different than any of the forecasted scenarios by groups in their own stress testing or risk management related documentation. However, having credible and realistic plans, processes and roadmaps can help undertakings and groups identify potential vulnerabilities, try to minimise their impact and assess the effectiveness of the measures considered.

For supervisors, risk management and pre-emptive crisis management processes (emergency plans, ORSA, recovery plans, etc.) should not be seen as a “tick-the-box” exercise. There is a need to critically assess and challenge the available documentation, where necessary.

One of the ways to perform this is by conducting a walkthrough exercise, which can incorporate the plans of one or several undertakings or groups as part of the crisis scenario. This way, several elements may be realistically tested, such as the assumptions, the recovery measures and the time until they take effect, or the assumed solvency position in times of stress.

Indeed, in the banking sector, there is an increasing trend towards conducting very specific, severe tests of the bank’s recovery plans (e.g. dry-runs), in a manner similar to institution-specific crises exercises.<sup>6</sup>

### ➤ **The need to supplement the current regulatory toolkit with additional recovery and resolution tools**

During the exercise, the need for management actions and recovery measures to be potentially taken was debated by participants, as the simulated insurance group faced severed distress and even near-default.

There was broad agreement on the need to supplement the current regulatory toolkit with potential new tools which could be appropriate in the recovery or resolution phases.

Several of these views go in line with the Opinion already expressed by EIOPA. A comprehensive toolkit “should help to better achieve the resolution

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<sup>6</sup> See for instance, “Report on Recovery Plans”, ECB Banking Supervision, July 2018.

objectives, such as better protecting policyholders by enabling the continuity of insurance contracts and the continuity of payments to policyholders".<sup>7</sup>

➤ **The importance of cooperation among NSAs and EIOPA during idiosyncratic crises**

The exercise showed the relevance of cooperating among all relevant parties. One of the critical aspects analysed was whether or when the NSA would contact EIOPA and/or other potentially affected stakeholders in an idiosyncratic crisis (i.e. institution-specific), which *ex ante* may seem to be contained at national level and not pose any EU-wide impact yet.

An early dialogue between EIOPA and the NSAs turned out to occur concerning the crisis situation of the affected Group. Another relevant issue discussed by participants was how cooperation could take place, e.g. via already existing platforms, such as the Colleges of Supervisors or Crisis Management Groups. Furthermore, the issue of the confidentiality of the information and the need to be extremely careful with the information shared was also discussed.

➤ **The need for EIOPA to coordinate in EU-wide insurance crises**

Article 18(1) of the EIOPA Regulation assigns a facilitation and cooperation role to EIOPA in case of adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union.

During the exercise, the EIOPA and NSA participants communicated with each other, both telephonically as well as by way of physical meetings. Although in the exercise only one NSA participated, it became clear that the wider the impact of the adverse developments, the more important the role of EIOPA should be in terms of facilitation and, where necessary, coordination of any actions undertaken by the relevant NSA(s).

➤ **The importance of a clear communication strategy**

The exercise showed the importance of a clear communication strategy (internal and external), as a key element for the success of crisis management. This appears to be relevant for all stakeholders, and particularly when it comes to making public statements.

Indeed, having a clear view on *when* and *what* to communicate is paramount. All relevant EU authorities, NSAs and/or other parties should be involved in the crisis communication process to avoid non-aligned or contradictory messages and actions that may end up aggravating the crisis.

## **5. Follow-up considerations**

In the written feedback questionnaires, participants rated the exercise as good or very good in terms of usefulness, pointed out that it met their expectations and considered it extremely beneficial in order to test the crisis procedures of EIOPA. For the NSA, the exercise proved to be also particularly useful to test the NSA internal procedures in case of crisis.

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<sup>7</sup> [Opinion to Institutions of the European Union on the Harmonisation of Recovery and Resolution Frameworks for \(Re\)insurers across the Member States.](#)

Regarding the design of the scenario and injects, participants considered that the exercise was very well organised, and that the scenario and related pieces of information were very realistic and challenging.

Participants identified several aspects as crucial for the success of the walkthrough exercise:

1. The relevance of the preparatory work. The quality of the preparatory work is crucial for the success of the exercise. To ensure realism in the exercise and a sufficient level of implication by the participants, it is paramount that the scenario is severe but plausible.
2. The length of the exercise. The number of information injects should be adapted to the length of the exercise. Participants should have sufficient time to absorb the information and decide on the course of action.
3. The number of participants. The number of participants should be restricted as necessary to make the exercise realistic, without making it too complex. Additional participants can be simulated if needed.

As follow-up of this exercise, EIOPA and the participating NSA plan to update their crisis management process where deemed necessary. Furthermore, these methodological considerations will be taken into account in light of potential future exercises.

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