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Recent regulatory developments and systemic risk debate

Recent regulatory developments around RRP

The financial services industry has faced much criticism and fallout from the global financial crisis. Subsequent debate and developments have focused on the causes of the crisis and how to avoid a recurrence in the future.

- **Since 2009, FSB reviewing SIFIs and initially concentrating on Banks**
- **July 2011, FSB considers certain Insurers as SIFIs**
- **November 2011, G20 endorse FSB paper on SIFIs**
- **June 2012, EC Draft Recovery and Resolution Directive**
- **August 2012, HMT paper on broadening resolution regime**

"What the PRA will seek to do is two things – first, to minimise the probability of firm failure, and second to bring about a situation where the impact of such a failure, both on policyholders and on the financial system, is also minimised". " Julian Adams, Director of Insurance Supervision, FSA, April 2012.

The systemic risk debate

Both FSB and HMT considers that some insurance companies could pose systemic risk.

- The FSB has defined systemic risk as "the risk of disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system;
  and (ii) has the potential to have serious negative consequences for real economy."
- FSB criteria to identify systemic importance of markets and institutions:
  - Size
  - Complexity
  - Lack of substitutability
  - Interconnectedness
- HMT described areas where it thought the disorderly failure of some insurers could have wider impact:
  - Direct impact
  - Indirect impact on financial markets
  - Policyholder impact and public confidence

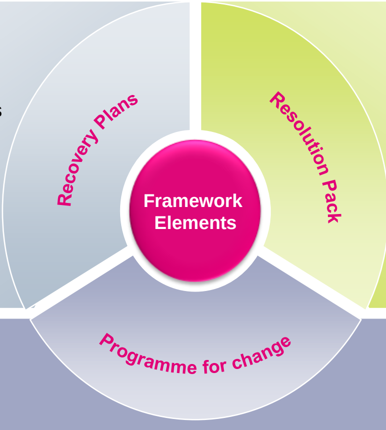
Insurance Regulator's focus includes:

- Strengthening Resolution Regimes
- Cross boarder cooperation agreements
- More effective and intrusive supervision
- Greater focus on non-core insurance activities and off-balance sheet items
- Recovery and Resolution Planning
- Crisis Management Groups (CMGs)

What is a Recovery Plan and a Resolution Pack?

Key supervisory tool to:

- Identify options to recover financial strength and viability under severe stress
- Extend the current processes for managing capital and liquidity under stress
- Ensure the business model and risk appetite incorporate a 'Plan B'



Bring transparency to operating structures:

- Legal entity structure
- The financial and operational dependencies between significant legal entities
- The financial and operational dependencies between critical products/services (CFCA)

The iterative approach to RRP is designed to create recovery optionality and resolution flexibility by identifying and then removing structural, financial and operational dependencies that prevent legal entities and/or critical products/services being separated from the rest of the organisation

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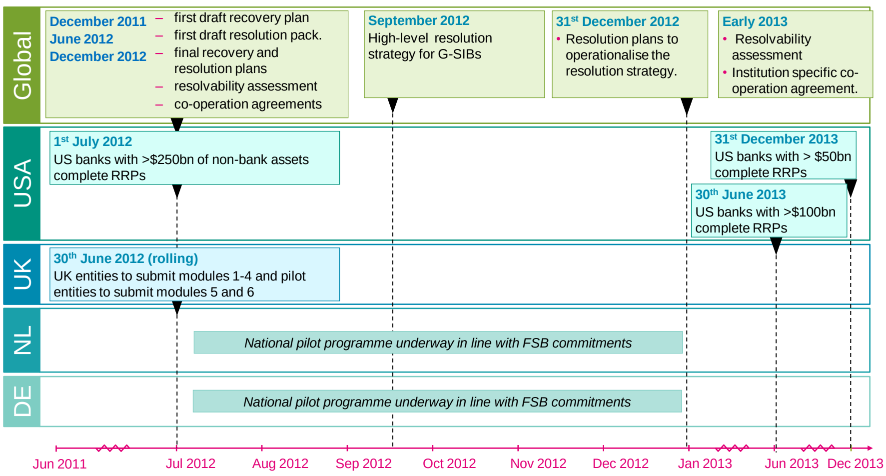
Learnings from banking industry around RRP

Banking RRP timetable



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PRA direction on recovery plans

"Firms will have to draw up a recovery plan, outlining credible steps that they could take in the event of a stress to maintain their business and restore it to a stable and sustainable condition"

– Source: 'PRA approach to supervision', Oct 2012

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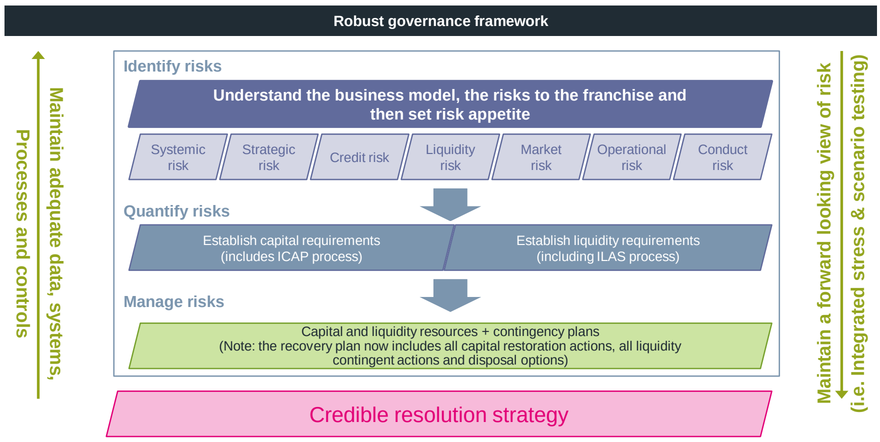
RRP within PRA Supervision

Key principles: Assess viability, sustainability and resolvability



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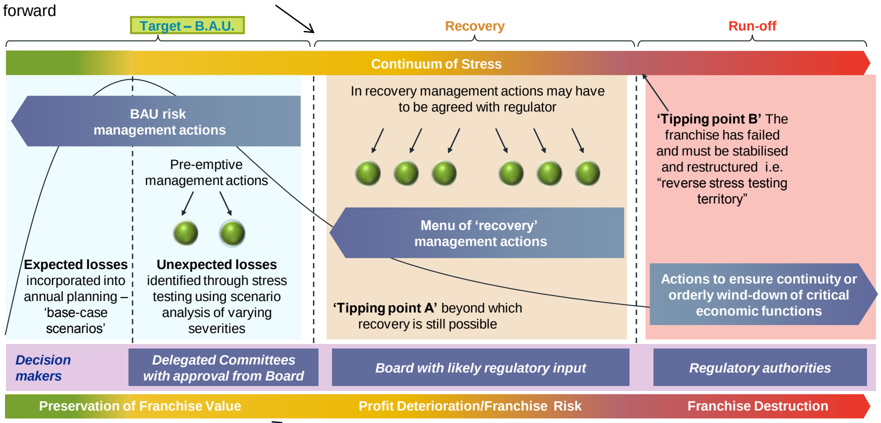
Recovery – managing risk along the continuum of stress

Recovery planning as part of a wider risk management framework

Quantitative/qualitative triggers to identify when management need a formal discussion with regulators to agree the way forward



Early warning indicators track the current (and forward looking) level of stress along the continuum [*linkage to risk appetite*]

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What does a recovery plan actually look like?

Key components (see guidance in FSA FS 12/01):

- Short list of potential recovery options management can take (note: must "move the dial").
- Recovery triggers – qualitative and quantitative
- Early Warning Indicators
- Governance and embedding

Recovery option	Potential impact – CT1 capital (bps) & £m	Change in Capital Usage (RWAs) £m	Potential impact – liquidity £m	Assumptions to quantify liquidity/capital impact	Timing to realisation of the benefits	Summary of hurdles/ risks to implemen-tation	Franchise Impact (Low, Medium, Low, Medium High, High)	Likely effectiveness Franchise Impact (Low, Medium Low, Medium High, High)		Ownership within the firm
								Firm-specific stress	Market-wide stressed	
Option 1										
Option 2										
Option 3										
Option 4										
Option 5										
etc.										

Recovery Planning insights

Common questions:

- *How do I go about identifying recovery options (sensitivities)?*
- *How detailed is the write-up of recovery options?*
- *How can I test the resilience of my recovery options and triggers?*
- *How could I link my EWIs, triggers and options?*
- *What does an adequate recovery plan look like?*

Key success factors:

✓ Agree Board ownership of recovery planning
✓ Recognise that recovery plans will become a key supervisory tool
✓ Create as broad a menu of recovery options as possible to demonstrate recovery optionality
✓ Construct a comprehensive early warning indicator framework and agree a recovery trigger which meets expectations
✓ Demonstrate that governance is effective when preparing, maintaining and communicating the plan
✓ Ensure consistency with the broader regulatory dialogue and reporting

Importance of resolution planning (UK)

PRA Approach to Supervision (Oct 2012):

- "The PRA will apply its resolvability requirement to firms incorporated in the United Kingdom, including subsidiaries of overseas firms. It will also be critically important for overseas firms that operate as branches in the United Kingdom to have robust recovery and resolution plans in place."
- "We will . . . require new entrants to satisfy us on their resolvability in order to be authorised".

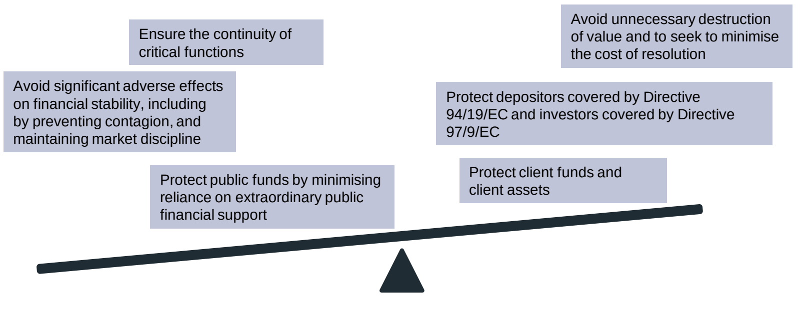
FCA Approach to Supervision (Oct 2012):

- "Firms where a disorderly failure would have a significant impact on the market in which they operate (for example, because a particular market is highly concentrated, so that a disorderly failure of one player could not easily be assimilated by the others, and/or where there are significant client asset and money holdings). For such firms the Individual Capital Guidance will be set at the minimum of the going-concern requirement or the orderly wind-down requirement – whichever is the greater. The FCA also want to have a satisfactory wind-down plan from the firm."

Commitment to extend the framework to non-bank financial firms and Financial Market Infrastructure (FMI) in line with FSB commitments

Objectives of a successful resolution

The authorities need to balance a number of different objectives in resolution e.g.:



UK Resolution pack

In order to determine whether operationalising the resolution strategy will require changes to the business model and/or operating structures, the firm supply regulators with a resolution pack:

Module 3 – Group and legal entity information	Module 4 – Economic function identification	Module 5 – Critical functions analysis	Module 6 – Overcoming barriers to resolution
• Thorough description of bank's legal entity structure. • Details of how it relates to businesses, the group balance sheet, financial and operational interdependencies.	• Information on nature and scale of each business to establish impact of closure on UK financial stability. • To allow the regulators to identify which is a Critical Economic Function.	• Assessment of how each Critical Economic Function could be separated from the group. • Focus on financial, legal entity and operational interdependencies and implications for networks such as payment systems.	• Identify actions to address barriers to resolution identified in M3 and M5. • Associated assessment of feasibility, costs, risks and issues.
Identify the barriers to separating significant legal entities?	Which products/ services are critical economic functions? Rules of thumb?	Identify barriers to unplugging/ winding down critical economic functions?	Range of solutions to remove barriers to resolution? WIP for banks!

Contents are specified by regulator – see FSA FS/12/01 guidance pack

UK Resolution planning – Module 3 & 5

Legal considerations:

- Overview of group structure and process for identifying the significant legal entities are these within the scope of the UK legal system?
- Use of branches and subsidiaries and the challenges these present in resolution (including overseas branches supplying products/services into the UK economy) and where might the UK need to cooperate with foreign regulators?
- Use of centralisation support functions – how would you continue to get access to these vital support services in resolution?

Remember that regulators are attempting to understand how challenging it would be to separate legal entities/unplug critical economic functions using their legal tools, therefore, try to help them to:

- Understand whether the legal structure complex
- Identify what comes within direct legal control of the UK
- Identify jurisdictional uncertainties and where the need for cross border cooperation arises

UK Resolution planning – Module 3 & 5

Financial considerations:

- Is fungible capital and funding held outside the significant legal entities?
- Can each significant legal entity meet capital and liquidity requirements (regulatory, credit rating agency, counterparties and clients) post resolution?
- Are intra-group financial dependencies:
  - Resulting in capital, income or assets being inappropriately transferred from the regulated entity, or result in intra-group creation of capital resources (ie double or multiple gearing)?
  - Acting as a substitute for financial resources (eg using a guarantee or loan rather than capital held at the subsidiary)?
  - Being implemented on terms or under circumstances which third parties would not accept?
  - Adversely affecting the solvency, liquidity and profitability of individual entities within the group?
  - Resulting in contagion risk, thereby precipitating knock-on effects on financially sound entities when one entity within the group experiences stress?
  - Complicating group structures and therefore obscuring the supervisor's view of the group and/or legal entities that operate within their jurisdictions, thus affecting both the ability to supervise on an ongoing basis, and resolution and recoverability?
  - Being used as a means of regulatory arbitrage to evade capital or other regulatory requirements altogether?

UK Resolution planning – Module 3 & 5

Operational considerations:

- Access to and continuity of operational support (e.g. IT systems, data, infrastructure)
- Access to market infrastructure (e.g. payment, clearing and settlement)

Key success factors:

- Need senior executive sponsorship
- Require involvement from all functions and businesses
- Some of the information will not exist – don't underestimate the task!

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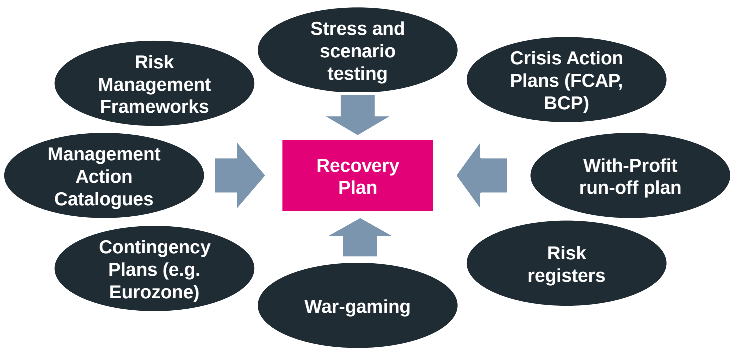
Next steps for insurers

Recovery Planning – what already exists?

These activities already take place within Insurers, but is it coherent and embedded?



The development of the ORSA has insurers thinking about how to most appropriately scope, gather and present this information

Key elements to remember

- Recovery planning – provides a new framework for something that insurers often already do
- Resolution planning involves:
  - Creating a high-level resolution strategy for resolving the company
  - Demonstrating where the existing business model and operating structures facilitate resolution (i.e. the good news stories)
  - Identifying where the existing business model and operating structures create dependencies between legal entities or products/services and understanding whether client/commercial/market practice current prevents their removal (i.e. industry wide issues to be tackled collectively)
  - Propose a range of solution to remove any firm specific barriers to resolution in advance if the resolution tools cannot address these after the event

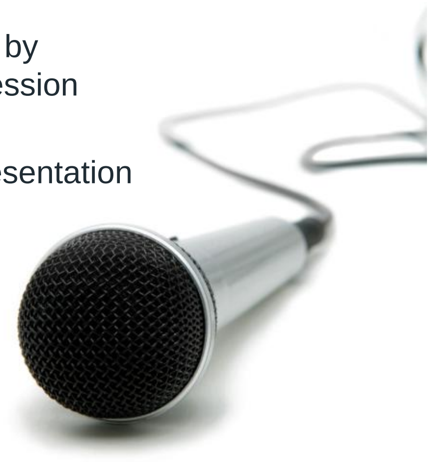
What should insurers be doing now?

- Identify which elements in your existing risk management framework align with recovery and resolution planning and identify any gaps;
- Think about resolution from a regulator's perspective i.e. given the resolution objectives and available legal toolkit, what could a high-level resolution strategy look like?
- Consider the trade off between commercial imperatives and resolvability
- Track industry developments, this is a fast moving topic globally, regionally and nationally and divergence across jurisdictions already exists

Questions or comments?

Expressions of individual views by members of The Actuarial Profession and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



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