Systemic Risk and Recovery and Resolution Planning

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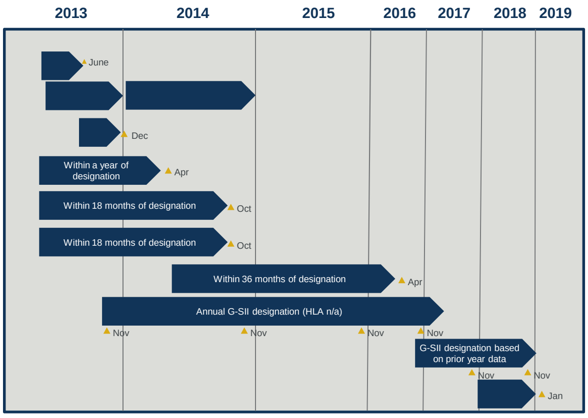
Agenda

Discussion of the FSB approach to recovery and resolution and possible implications for the industry
The insurance sector's response
The risk continuum approach
Operations and IT implications
Possible next steps

Proposed International Association of Insurance Supervisors (IAIS) timelines

Key implementation activities

1. Globally Systemically Important Insurers (G-SII) designated.
2. Start of enhanced supervision and effective resolution.
3. IAIS provide further details of proposed High Loss Absorption (HLA) capacity measures.
4. Crisis Management Groups (CMG's) established.
5. Other resolution measures completed.
6. Systematic Risk Reduction Plan (SRRP) completed.
7. SRRP implementation assessed.
8. G-SIIs designated annually (with HLA not applicable until 2019).
9. G-SIIs designated based on 2016 data (with HLA applicable from 2019).
10. HLA capacity requirements apply based on assessment of implementation of structural measures.



In addition to this global perspective, the PRA and FCA in the UK will be looking for firms to demonstrate progress and improvements in this area

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Background and IAIS Proposed Policy Measures

FSB key objectives of effective resolution regimes for financial institutions:

- Lower probability of failures – recovery.
- Lower cost of failures – resolvability.
- Maintenance of critical functions in resolution.
- Losses to be absorbed by shareholders and creditors not tax payers.
- Less complex structure.
- Lower moral hazard: credibility of 'no bail-out'.
- Strengthened market discipline.

29 institutions designated as global SIFIs and 48 GSIs (not formally disclosed). G-SIIs yet to be determined

1. Bank of America
2. Bank of China
3. Bank of New York Mellon
4. Banque populaire cde
5. Barclays
6. BNP Paribas
7. Citigroup
8. Commerz Bank
9. Credit Suisse
10. Deutsche Bank
11. Dexia
12. Goldman Sachs
13. Group Credit Agricole
14. HSBC
15. ING Bank
16. JP Morgan Chase
17. Lloyds Banking Group
18. Mitsubishi UFJ FG
19. Mizuho FG
20. Morgan Stanley
21. Nordea
22. Royal Bank of Scotland
23. Santander
24. Société Générale
25. State Street
26. Sumitomo Mitsui FG
27. UBS
28. Unicredit Group
29. Wells Fargo

IAIS proposed policy measures

- IAIS are working alongside FSB and G20 to identify G-SIFIs.
- IAIS have developed proposed policy measures that identify market threatening insurers.
- G20 leaders have endorsed the FSB's framework for reducing moral hazard posed by G-SIFIs.
- Proposed policy measures intended to reduce moral hazard and negative externalities of potential G-SII failing.

Three main types of policy measures:

1. Enhanced Supervision.
2. Effective Resolution.
3. Higher Loss Absorption (HLA) Capacity.

Effectively these proposals aim to reduce the probability and impact of failure of G-SIIs

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Desired Outcomes of the three proposals

Enhanced Supervision	• Supervisor determines a set of measures to reduce the risks posed by the G-SII. • A group wide supervisory framework that applies to the group as a whole. • Supervisor has clear visibility of internal control systems and risk management. • The G-SII has internal controls and limits that are appropriate, investment and reinsurance arrangements that are appropriately diversified.
Effective Resolution	• Resolution of G-SIIs can take place without systemic disruption/exposing taxpayers to loss. • Protect vital economic functions so shareholders can absorb losses that respects the hierarchy of claims in liquidation. • Ensure that policyholder protection arrangements remain as effective as possible.
HLA Capacity	• The G-SII will be more resilient to low probability but high impact events. • Supervisors intervene earlier than they would for non-GIIs.

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Possible determination of a G-SII – current IAIS thinking

The IAIS have proposed 18 indicators by which G-SIIs are designated, each with a varying degree of weight attached. Each of the indicators fall under one of the following groupings:

Size	• Assessed by the total assets held and total revenues from all sources. (5-10% weighting).
Global activity	• Revenue derived from outside of the home country; and the number of countries in which the group operates. (5-10% weight).
Interconnected-ness	• Intra-financial assets and liabilities, reinsurance, derivatives, large exposures, turnover, level 3 assets. (30-40% weighting).
Non-traditional/ non-insurance activity	• Non-policy holder liabilities and non-insurance revenues (in final methodology, this indicator will focus on financial activities), derivatives trading, short-term funding, financial guarantees, variable annuities, intra-group commitments. (40-50% weight).
Substitutability	• Premiums for specific business lines. (5-10% weighting).

We would expect that local regulators may use similar criteria when assessing which organisations are systemically important at the country level (e.g. Regional or Domestic-SII)

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UK perspectives on Supervision (from Oct 2012 Approach documents)

PRA approach	*"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	*"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."*

The PRA and FCA have both outlined how important this area is within their approach to Insurance company supervision

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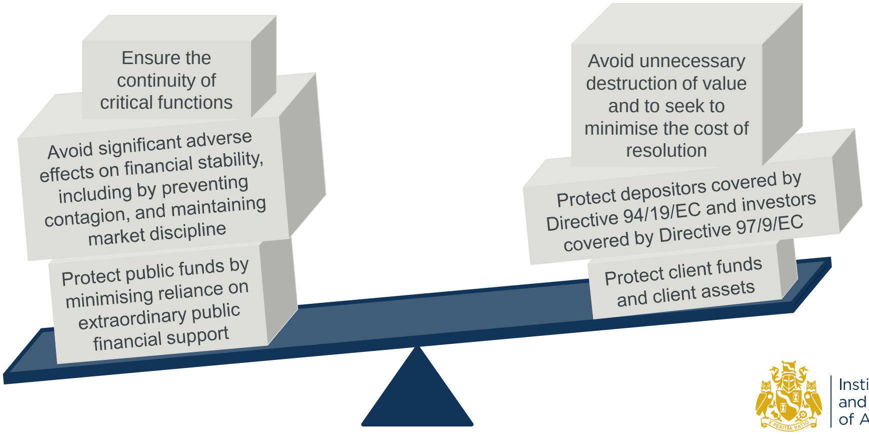
Balancing objectives

The authorities need to balance a number of different objectives with RRPs:



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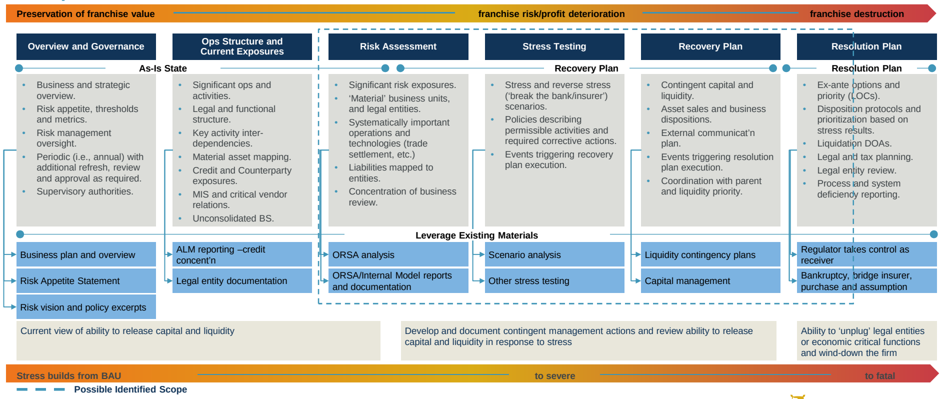
The risk continuum

Risk Spectrum



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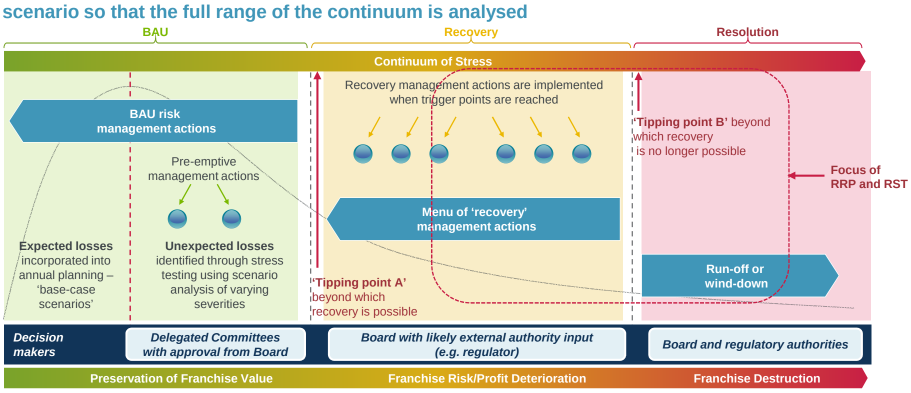
Stress continuum – demonstration of trigger points and management actions

It is important to understand where scenarios fit on the continuum of stress and to consider a range of scenario so that the full range of the continuum is analysed



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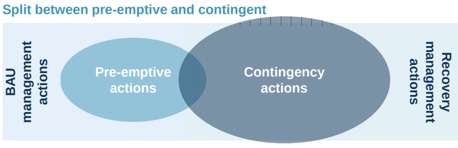
Management actions

Articulating and documenting management actions is an integral part of the Stress and Scenario Testing. Firms should identify 'credible', 'realistic' and 'objective' management actions

Split between pre-emptive and contingent



Contingency actions	Pre-emptive management actions
• Actions which can be taken as a scenario develops • Allows to limit the impact of a scenario • Contingent – not implemented today • Developed as part of Stress and Scenario Testing • Regularly assessed and refreshed	• Undertaken today to reduce the chances of an event occurring • May be implemented immediately by the business • Supports implementing contingency plans quickly and effectively • Need to be refreshed regularly • Fall into BAU process

Management action analysis process

Identify a long list of management actions → Refine a short list of management actions → Quantify and assess → Documentation and governance

All Stakeholders | Cost of Implementation | Time Required to Implement | Company specifics

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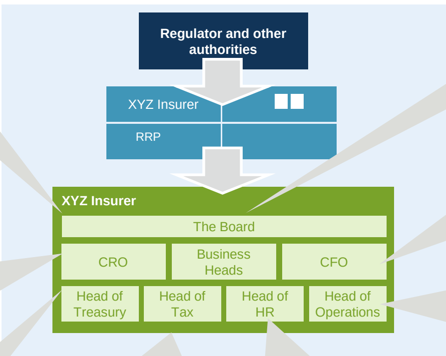
Impact on insurers – key issues

- What will be the impact of RRP on our business strategy?
- How will we embed recovery and resolution planning into our governance structure?
- How are our competitors responding to these challenges?
- What changes do we need to make to risk appetite and governance?
- Which businesses should be considered for disposal/acquisition.

- What is the impact of RRP on our ability to take risk?
- How do we determine early warning and recovery triggers and align these with risk appetite.
- What is the impact on policies for risk taking and management?
- How do I ensure that our risk management structures are not compromised eg. three lines of defence/roles and responsibilities?

- What will be the future TOM for treasury?
- Do we have sufficient subordinated debt to support recovery options? Where is this within the group?
- Can we preserve capital for critical economic functions in resolution.
- What is the impact of resolution planning on the funding cost of the insurer?



- What are the implications of any structural change for our existing tax planning strategies (eg transfer pricing)
- Will structural changes crystallise capital gains.
- What are the implications for my Vat groupings and recoverability.

- What are the implications of resolution planning/structural change for my employment arrangements?
- How do I align employees with critical functions in resolution?
- Will any structural separation result in a need to restructure my pension schemes?

- How will recovery and resolution planning impact the viability of my business?
- What opportunities does RRP present?
- What cross-subsidies will separation analysis reveal?
- How do I manage a business or entity identified as a 'recovery' option.

- What new data will be required to support our plans.
- How will I adapt/rationalise the group's legal entity structure to meet the requirements?
- What new reporting and disclosure will be required to shareholders and providers of finance?
- How will I preserve economies of scale? Supply chain?

- Do we understand the essential end-to-end support for all critical economic functions?
- Can critical systems be separated or can we specify how a TSA would work in resolution?
- Can we provide a robust Single Customer View supporting policyholder protection levels?
- What is the impact of resolution on key infrastructure suppliers and payment systems?

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Some capital and liquidity considerations

Focus of continuum analysis should be on the appropriateness of management actions concerning capital and liquidity management

Capital/solvency analysis

- Pre-loss balance sheet.
- Potential asset loss and revaluations analysis required.
- Analysis of whether any haircuts required for non-regulatory capital e.g. subordinated debt.
- Analysis of potential transferability restrictions between jurisdictions.
- Fungibility of existing intra-group arrangements.
- Post-loss balance sheet and capital raising ability, de-risking options.

Liquidity analysis

- Counter-party impact (e.g. reinsurers, banks) on liquidity positions (level of financial section inter-connectedness).
- Major dependencies identified of liquidity sources (key subsidiaries and any surplus capital above minimum requirements).
- Impact of rating triggers at group and subsidiary levels (e.g. drawing of committed facilities).
- Contingent capital – likelihood of availability in times of stress.

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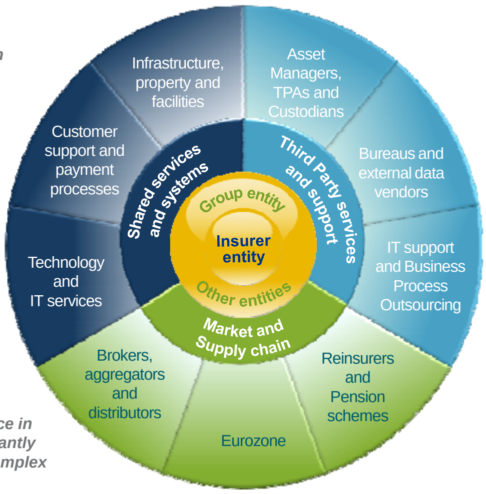
Operations and IT Implications

Complex insurance organisations have a critical dependency on their technology



Technology risk management isn't just about security. Its about making technology play its part in delivering business and regulatory goals

Gartner estimates $20 billion is spent annually to address Technology Risk and yet failures persist, because the complexity and impact of risks is often not fully understood

The trust they can place in their systems is constantly under threat from a complex landscape of risks

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Possible next steps – known areas of focus for supervisors

Greater focus on non-core insurance activities and off-balance sheet items	AIG syndrome
Should there be mandatory use of reverse stress testing?	New initiatives which go beyond the current ORSA regime
Should ORSA include explicit statement that an insurer may pose to the wider economy?	HIH scenario
Should there be a better ladder of intervention?	Further levels between MCR and SCR/PCR built-in
Should the role of a CRO be formalised?	Similar to forming an actuarial function
Should there be formal requirements relating to company culture and ethics?	Compensation measures could be addressed
Should there be further enhanced Board requirements and for senior management?	Formal reviews undertaken by supervisors of all Board members and senior appointments

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Q & A

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