The Actuarial Profession

making financial sense of the future

Recovery and Resolution Planning – "Living Wills"

James Latto and James Isden

16th May 2012

Contents

Context and latest developments on Living Wills

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.
Initially concentrating on Banks

April 2011, Geneva Association Orientation Paper on SIFIs

July 2011, FSB considers certain Insurers as SIFIs

September 2011, FDIC approve Dodd-Frank act

November 2011, G20 endorse FSB paper on SIFIs

"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.

What is systemic risk?

FSB considers that some insurance companies would 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.

The FSB view is that some insurance companies would pose systemic risk. Consequentially, the FSB has made it clear that it expects some insurers to be designated as SIFIs and so will be required to prepare recovery and resolution plans.

Do insurers pose systemic risks, no?

Insurers differ from banks:

- No “deposit run” on Insurance Companies.
- Match between assets and liabilities maturities.
- Not direct participants of payment systems.
- Insurance risks largely independent of the economic cycle.
- Size and stability often positively correlated.
- Less interconnected.

This debate has been thoroughly explored by the Geneva Association[1]

1 Insurance and Resolution in Light of the Systematic Risk Debate, February 2012, The Geneva Association.

Do insurers pose systemic risk, yes?

Policymakers may consider insurers to be of systemic importance.

Systemic risk through the financial sector.

- “Core” versus “Non Core” activities (i.e. asset backed securities, credit protection...).
- Interconnectedness with other parts of the financial services industry (i.e. reinsurers...).

Systemic risk directly to the real economy.

- Critical economic functions which cannot easily be substituted (i.e. specialists marine insurances, pension...).

Historic insurers failures have impacted economy or tax payer.

AIG

Equitable Life

HIH

Three key components of the FSB's work on SIFIs

FSB has recently published a consultation paper (Communiqué: G20 Leaders Summit. Cannes, 4 November 2011) on the requirements that SIFIs should meet:

- Capital surcharge (initially for G-SIFIs but widening out to national SIFIs in due course)
- Policy measures to resolve failures (including establishing effective cross-border resolution arrangements).
- Recovery and resolution plans (RRPs).

Insurance Regulator’s objectives from RRPs

Broadening the classifications of SIFI’s

Establishing a better ladder of intervention

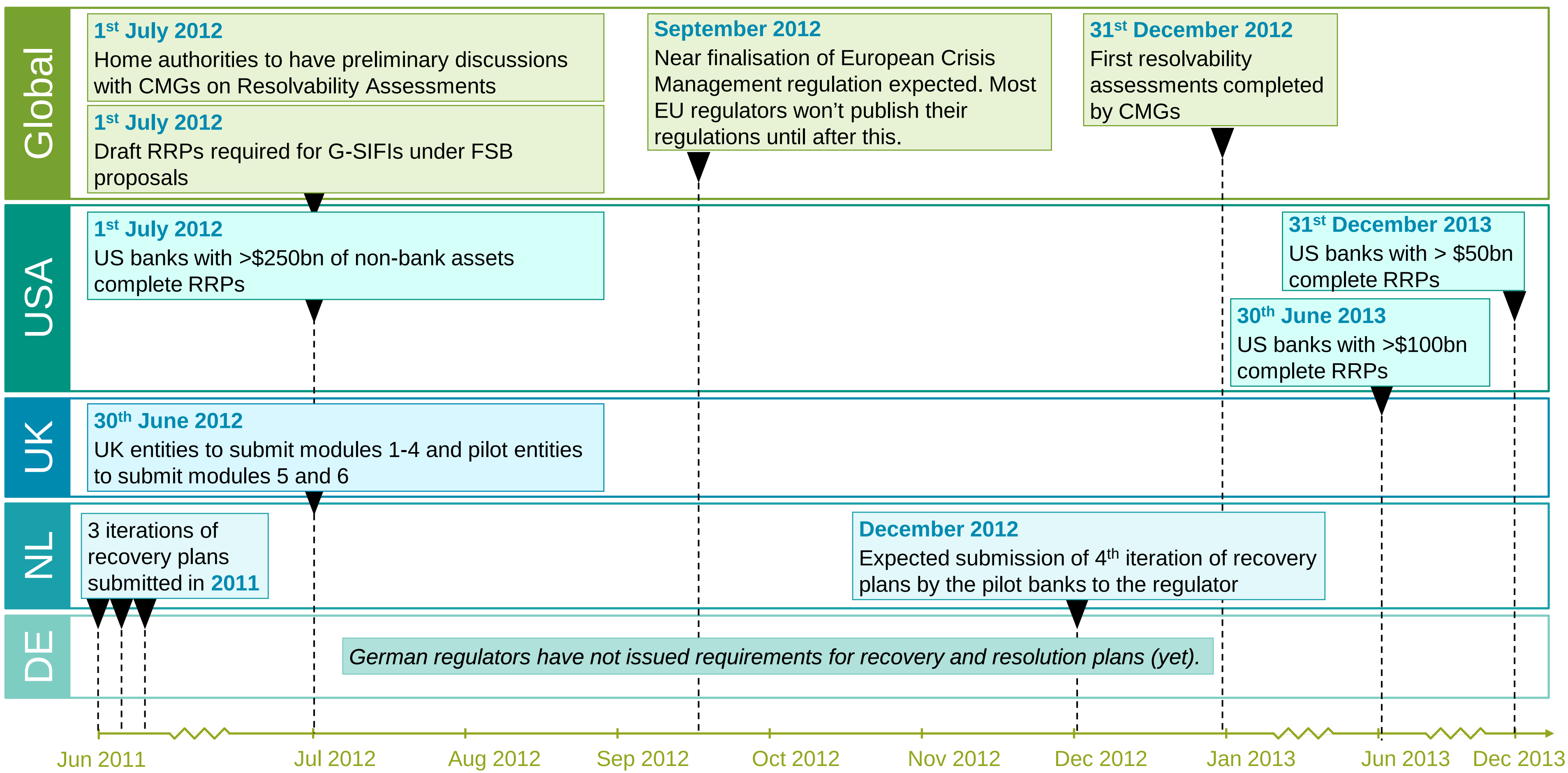
Increased use of stress and scenario analyses to improve risk appetite and strategic considerations

Greater focus on non-core insurance activities and off-balance sheet items

Requiring an analysis of the concentration of business written

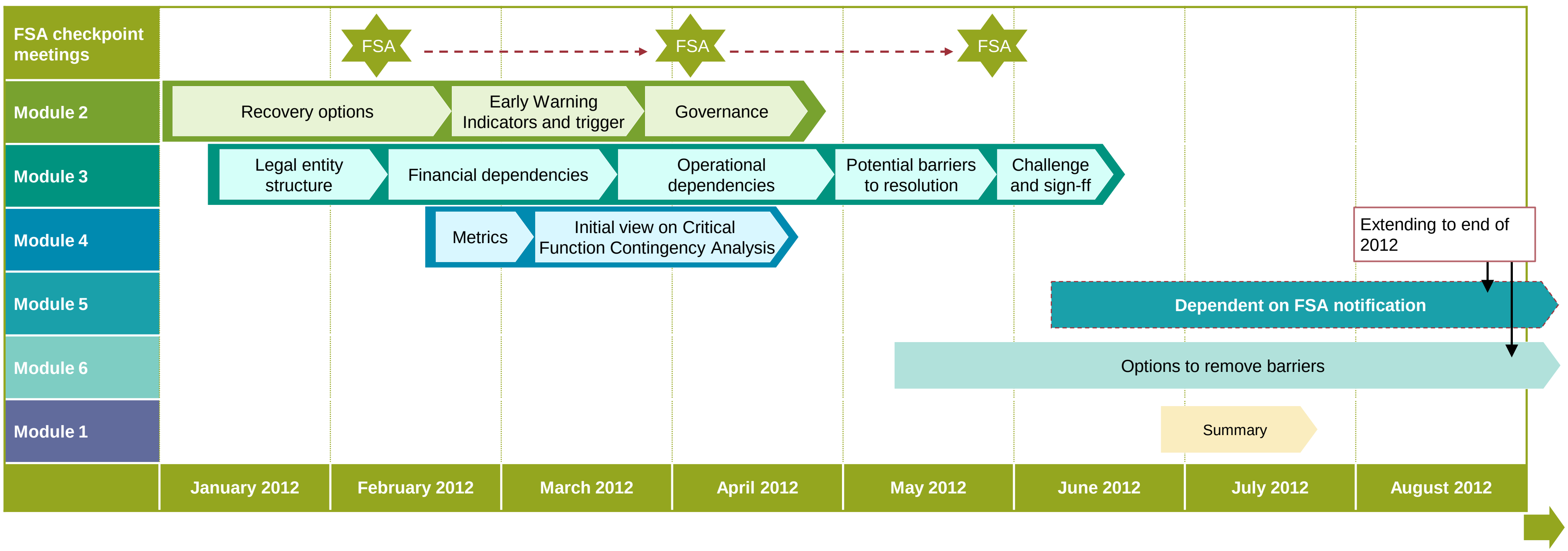
Establish a global insurance accord

Global RRP timetable – Banks

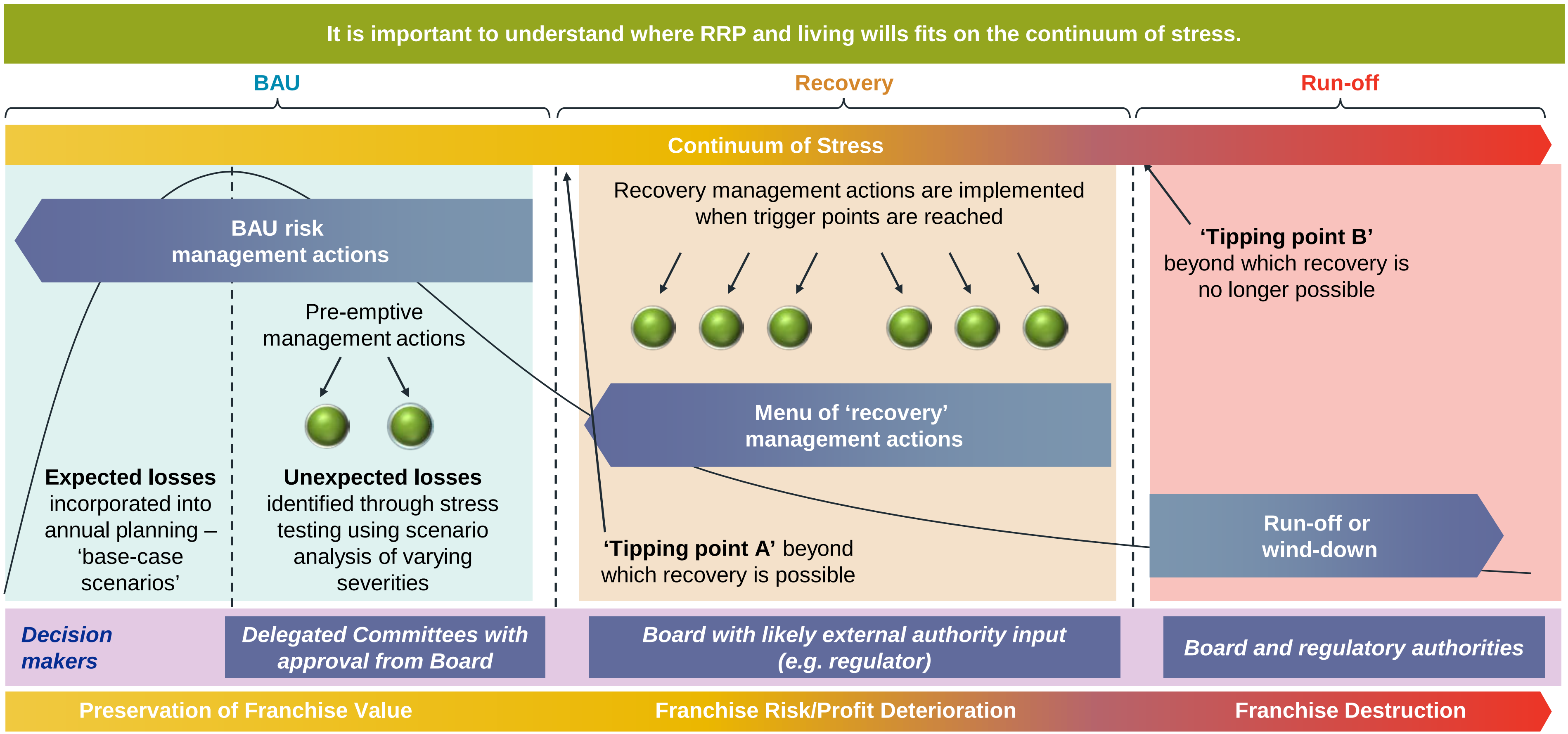


UK RRP modules roadmap – Banks

Module 2 – Recovery plan	Module 3 – Group and legal entity information	Module 4 – Economic function identification	Module 5 – Critical functions analysis	Module 6 – Overcoming barriers to resolution
• Menu of options for dealing with extreme financial stress. • Focus on the bank's list of recovery options. • How and when they would be triggered, what steps the bank would need to take.	• 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.



Continuum of stress



Recovery and Resolution Plans

Recovery and Resolution Plans

Recovery Plans

Options covering a range of idiosyncratic stresses and market wide scenarios

The **recovery plan** outlines the steps management plans to take to prevent the institution from failing and to restore capital and liquidity.

Resolution Plans

Firms prepare a resolution pack to allow authorities to resolve them in case of failure.

The **resolution plan** outlines how management will prepare for the failure of the firm, with procedures in place to manage the process in a controlled manner.

Potential key elements of the RRP

Regulators have begun to crystallise their expectations for the content of RRPs.

Structure of RRPs[1]

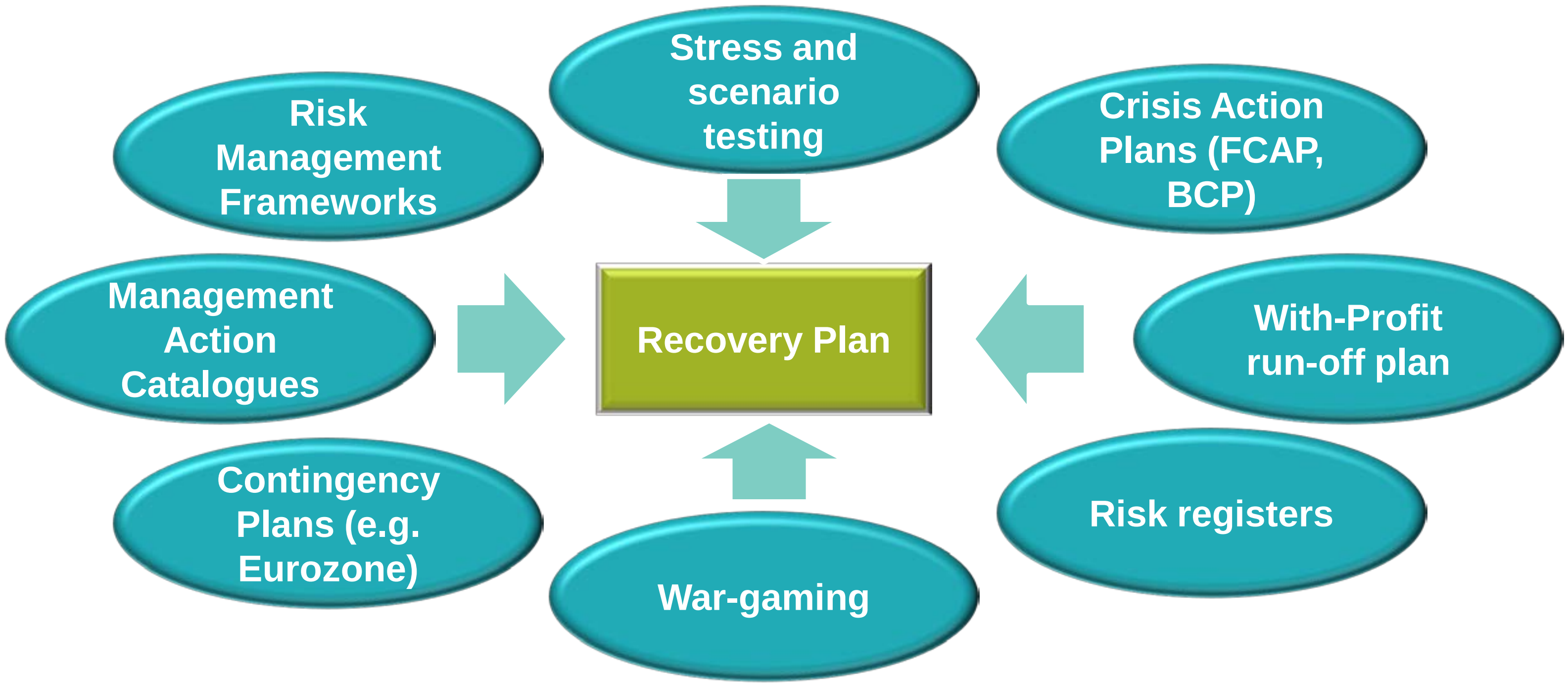
- Executive summary;
- **Strategic analysis**;
- **Intervention conditions describing necessary and sufficient pre-requisites for triggering the implementation of recovery or resolution actions**;
- Concrete and practical options for recovery and resolution measures;
- Preparation actions to ensure that the measures can be implemented effectively in due time; and
- Responsibilities for executing preparatory actions.

This will be reviewed regularly and underpinned by accurate and available management information

1 Consultative Document, Effective Resolution of Systematically Important Financial Institutions, 19 July, 2011, Financial Stability Board, http://www.financialstabilityboard.org/publications/r_110719.pdf.

RRP – Existing insurance risk management activity

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

RRP – Required management information

Regulators have an expectation that in times of crisis robust management information will be available at a legal entity level, suitably summarised

In times of crisis, the expectation will be that the following will be available:

- A detailed inventory of the key management information used in the material legal entities;
- Have previously identified and addressed legal constraints on the exchange of information within the organisation;
- Be able to collate all relevant documentation within a short time period (e.g. 24 hours).

Potential data required:

- All relevant MI;
- Asset ledgers;
- Out-sourcing contracts;
- Re-insurance contracts;
- Policyholder contract terms and conditions;
- Intra-group contracts
- Group/company structure;
- IT systems and architecture;
- Relevant HR contracts;
- Key crisis management roles and responsibilities.

This information is expected to be summarised at a higher level in Solvency II reporting; SFCR, RSR and ORSA

Firms are also making additional corporate governance disclosures in their public reporting.

Potential key elements of the RRP – Strategic analysis

Firms need to broaden the input to the risk management process and identify their systematically important functions and core strategy

Strategic analysis[1]

- **Identification of systematically important functions;**
- Actions necessary for maintaining operations of, and funding of, these systematically important functions;
- **Assessment of the viability of any business lines and legal entities which may be subject to separation in a recovery or resolution scenario;**
- Likely effectiveness and potential risks of each material aspect of the recovery and resolution actions, including impact on customers, counterparties and market participants;
- Estimate of timing required to implement each material aspect of the plan and any barriers to it's implementation;

1 Consultative Document, Effective Resolution of Systematically Important Financial Institutions, 19 July, 2011, Financial Stability Board, http://www.financialstabilityboard.org/publications/r_110719.pdf.

Potential key elements of the RRP – Recovery Plan

Much of this activity is an extension of current risk management practices

Under a recovery plan[1] firms should:

- Identify clear backstops and escalation procedures;
- Identify necessary actions to strengthen their capital position;
- **Identify possible re-structuring;**
- Ensure an organisational and operational set-up is in place to enable them to continue to operate during a recovery phase;
- **Develop a proper communication strategy with financial markets for times of distress;**
- Ensure effective preparation of the above measures.

FSA have expressed similar expectations in their recent publications and provided more detailed guidance to Banking sector.[2, 3]

1 Consultative Document, Effective Resolution of Systematically Important Financial Institutions, 19 July, 2011, Financial Stability Board, http://www.financialstabilityboard.org/publications/r_110719.pdf.

2 FSA communication, 10 May 2012, http://www.fsa.gov.uk/library/communication/pr/2012/052.shtml,

3 RRP Information pack for firms, FS 12/1, http://www.fsa.gov.uk/pubs/discussion/fs12-01-info-pack.pdf

Recovery Plans – Extension to the existing insurance risk management activity

Even the firms with the most mature risk management functions and processes would have additional work to meet RRP requirements as drafted

Potential additional analysis required

- Commentary on the impact of closure on certain economic functions;
- **Enhanced focus on fungible capital and liquidity;**
- Assessment of viability of remaining functions;
- **Review of non-insurance risks or those raised by non-insurance entities.**

Potential outstanding questions

- **Has the firm really thought broadly enough or the unthinkable?**;
- How would contagion from other parts of financial system affect the insurer (e.g. ABS or liquidity swaps)?;
- Have the management actions been properly investigated and ranked?;
- **Have associated early warning indicators been properly aligned with contingency plans and risk management framework?;**
- **Do the Board really own the contingency plans?.**

Potential key elements of the RRP – Resolution Plan

The requirements of the resolution plan pose new questions which, in our experience, are not currently being addressed

Under a resolution plan[1, 2, 3] firms should extend the work conducted under the strategic analysis and recovery plan:

- Contingency plans in the light of regulatory failure;
- Detailed assessments of potential problems in winding down any relationships;
- Relationships with different entities within a single group, such as legal status, financial exposure, and staffing, along with contingency arrangements in case of interruption to the relationship.

The natural extension is that these considerations should be part of the decision-making criteria at all times.

1 Consultative Document, Effective Resolution of Systematically Important Financial Institutions, 19 July, 2011, Financial Stability Board, http://www.financialstabilityboard.org/publications/r_110719.pdf.
2 FSA communication, 10 May 2012, http://www.fsa.gov.uk/library/communication/pr/2012/052.shtml,
3 RRP Information pack for firms, FS 12/1, http://www.fsa.gov.uk/pubs/discussion/fs12-01-info-pack.pdf

Implications for Insurers – Regulatory and business tensions

Business

Shared core functions
- Payments
- Operations
- Treasury
- Distribution

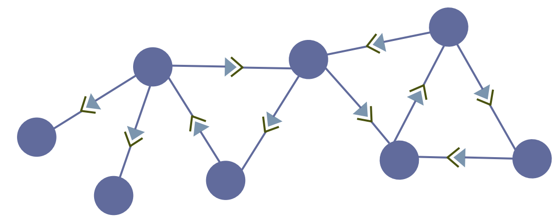
Shared Enterprise functions
- IT
- Finance
- HR

- Aims to maximise shareholder value.
- Divisions tightly integrated to maximise revenue and minimise capital.
- Cost synergies through horizontal integration and economies of scale.

Tension

New operating models and industry structures will emerge from this tension

Regulators



- Aims to protect tax payers money and whole system.
- Business managed on a legal entity basis
- Each legal entity capitalised on a standalone basis
- A network of loosely coupled functions.

RRP – Potential benefits

There may be benefits to addressing the questions raised by RRPs

- Embed the existing risk management framework enhancements to benefit the business;
- Provide impetus to MI and data development;
- Firms may seek to re-evaluate their core strategy, including the removal of un-rewarded risks;
- Enhanced understanding of reliance on wider economic functions, e.g. payment systems;
- Become “transaction ready”;
- Consider RRP issues in contract negotiations contain clauses to ensure continuity in distress;
- Demonstrate engagement in the process to regulators.

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.