



Institute
and Faculty
of Actuaries

Open Forum: Recovery and Resolution Planning (RRP)

IFoA Recovery and Resolution Working Party

26 November 2013

“Too big to fail”: financial crisis exposed taxpayers to unaffordable losses

Financial Stability Board (FSB), an international body has issued guidance and consultation papers on the steps needed to ensure that future failures are less damaging. Main focus of problems was banks, but thinking being extended to financial sector as a whole.

IFoA has responded to the following consultations on Recovery and Resolution:

- **HM-Treasury** - Financial sector resolution: Broadening the regime
- **European Commission** - Possible framework for the recovery and resolution of nonbank financial institutions
- **Financial Stability Board** - Information sharing for resolution purposes
- **Financial Stability Board** - Application of Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions
- **Financial Stability Board** - Assessment Methodology for the Key Attributes of Effective Resolution Regimes for Financial Institutions

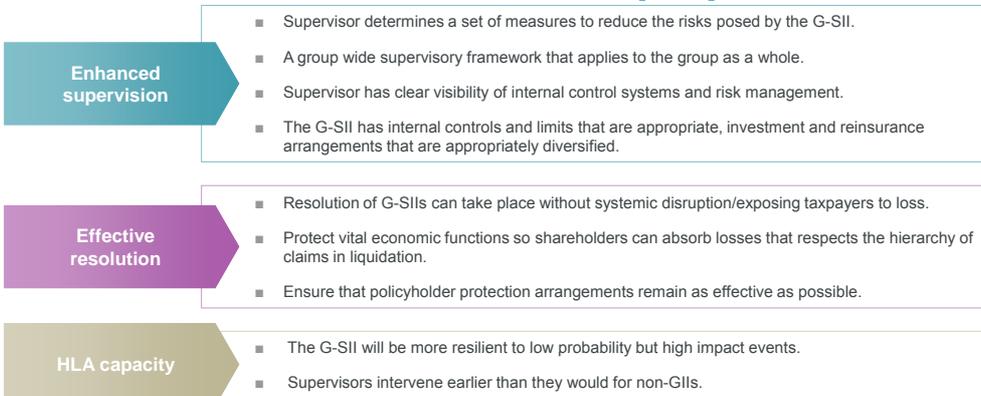
RRP implementation timeframe and obligations for G-SIIs

Proposed FSB/ IAIS implementation timeframe	Current state of regulatory and supervisory framework
<ul style="list-style-type: none"> July 2013: IAIS designated the initial cohort of G-SIIs using 2011 data October 2013: IAIS to prepare workplan to develop group-wide supervisory and regulatory framework for IAIGs July 2014: CMGs to be established for the initial cohort of G-SIIs SRMP to be completed for initial cohort of G-SIIs IAIS to recommend G-SII status of major reinsurers September 2014: IAIS to finalise straightforward, backstop capital requirements November 2014 Review of G-SII designation, annually in November End 2014: RRPs (including liquidity) for the initial cohort of G-SIIs to be developed and agreed by CMGs. EIOPA paper expected . End 2015: IAIS to develop HLA implementation details July 2016: Implementation of SRMPs to be assessed November 2017: FSB to designate cohort of G-SIIs, based on the IAIS methodology and 2016 data January 2019: G-SIIs designated in November 2017 to apply HLA requirements 	<ul style="list-style-type: none"> ■ G-SII (Globally systemically important insurers) policy measures on enhanced supervision, including development of the SRMP and effective resolution, are effective immediately after the initial cohort of G-SIIs has been designated. ■ Implementation of the G-SII policy measures will require strong cooperation among supervisors across multiple jurisdictions. ■ This is expected to come from the IAIS's Insurance Core Principles (ICP) and IAIS's in-development Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). ■ National supervisors are expected to take a similar approach for domestic systemically important insurers; increasing supervisory activity in recovery and resolution planning.

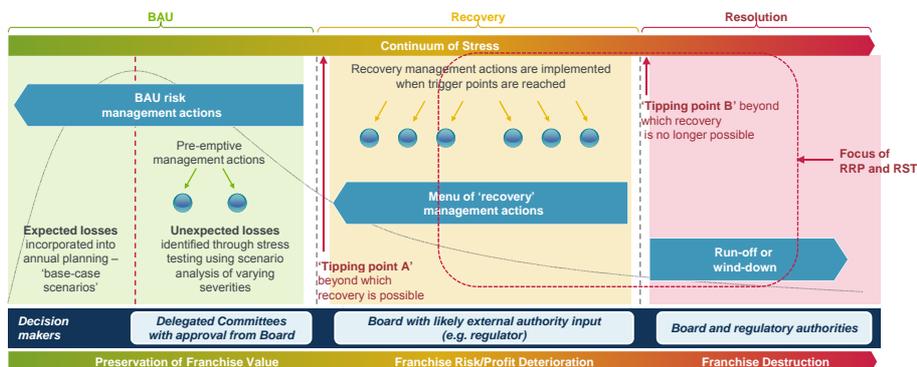
Guide for Relevant Material for Recovery and Resolution Planning (RRP)

Date	FSB Paper and hyperlink	Summary + Relevant Sections
October 2011	<p style="text-align: center;">Key Attributes of Effective Resolution Regimes for Financial Institutions (45 pages)</p> <p style="text-align: center;">http://www.financialstabilityboard.org/publications/r_111104cc.pdf</p>	<p>Sets out 12 Key Attributes (KA1 to KA12) that the FSB considers to be necessary for an effective resolution regime.</p> <p>KA11 (page 16-18) and Annex III (page 33-40) set out guidelines for what institutions needs to include in their RRP</p>
August 2013	<p style="text-align: center;">Application of Key Attributes to Non-Bank Financial Institutions (52 pages)</p> <p style="text-align: center;">http://www.financialstabilityboard.org/publications/r_130812a.pdf</p>	<p>Consultation on Resolution of Insurers and how KAs above should be applied.</p> <p>For Insurers, Pages 5,9 set the scene. Pages 10,11 set out the Questions 22-31 that FSB requested views on. Pages 31 to 42 (Appendix II) are for Insurers.</p>
	<p style="text-align: center;">Assessment Methodology for Oct 2011 Paper (145 pages)</p> <p style="text-align: center;">http://www.financialstabilityboard.org/publications/r_130828.pdf</p>	<p>Consultation paper – mostly for regulators. For each of the 12 Key Attributes, a set of Essential Criteria (EC) and Explanatory Notes (EN) is proposed as methodology to assess the effectiveness of any resolution regime.</p>

Desired outcomes of the IAIS proposals

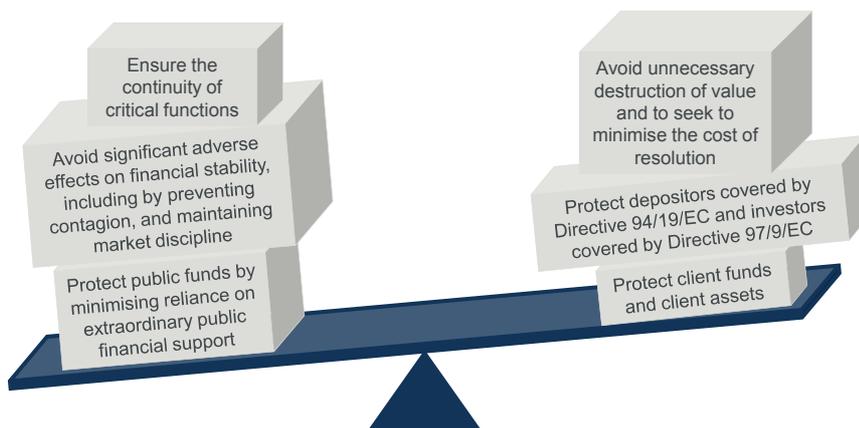


Stress continuum – demonstration of trigger points and management actions



PRA/FCA - balancing objectives

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



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UK perspectives on Supervision

PRA approach to insurance supervision

"Firms can adversely affect the stability of the financial system either through the way in which they carry on their business or by failing in a disorderly manner. It will not, however, be the PRA's role to ensure that no firm fails. Rather, the PRA will seek to ensure that any firms that fail do so in a way that avoids significant disruption to the supply of critical financial services, and thus to the PRA's statutory objectives"

"We strongly believe that failure of some insurers could have the potential to pose risks to the stability of the financial system and therefore this will be reflected in the PRA's approach to supervision. While we recognise that failing insurers usually exit the market in an orderly manner, we cannot be confident that this will be the case for all insurers in all circumstances. We will therefore continue to work at a domestic and international level to review, assess and enhance the resolution arrangements for insurers"

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

Potential PRA approach to DSIIIs (domestic)

- At a recent conference, PRA indicated that they would be focussing on the G-SIIIs and that there will be no rush to progress the D-SII agenda.
- They indicated that:
 - There would be no formal public designation of D-SIIIs (ie unlike the G-SIIIs no formal public list)
 - The regime for D-SIIIs will flow down effectively from the approach the local supervisor adopts to the G-SIIIs
 - In time large domestic insurers will be subject to measures similar to those that apply to the G-SIIIs

Proposed PRA categorisation of insurers

- Supervision based on the scale, nature and complexity of risks a firm poses to the UK financial system – **firms divided into 5 categories**
- Increased focus on competence, roles and responsibilities of the Board, Non-Executive Directors and senior management
- Increased focus on **operational mitigation** as much as on financial mitigation through the use of a **robust risk appetite framework** and **control functions**
- Focus on **risk culture and behaviour** in **1st line** at the point of origination
- Increased focus on Liquidity and Resolvability

Category 1
Insurers whose size (including number of policyholders) and type of business mean that there is **very significant capacity to cause disruption** to the interests of a substantial number of policyholders.

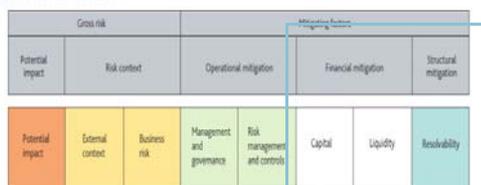
Category 2
Insurers whose size (including number of policyholders) and type of business mean that there is **significant capacity to cause disruption** to the interests of a substantial number of policyholders.

Category 3
Insurers whose size (including number of policyholders) and type of business mean that there is **minor capacity to cause disruption** to the interests of a substantial number of Policyholders.

Category 4
Insurers whose size (including number of policyholders) and type of business mean that there is **very little capacity to cause disruption** to the interests of a substantial number of Policyholders.

Category 5
Insurers whose size (including number of policyholders) and type of business mean that there is **no capacity to cause disruption** to the interests of a substantial number of policyholders.

Figure 1 The PRA's risk framework



Source: Bank of England, The PRA's approach to insurance supervision, October 2012

Main issues from FSB consultation

Key uncertainties remain	<ul style="list-style-type: none"> ■ FSB asked 12 specific questions in consultation ranging from: <ul style="list-style-type: none"> ■ Should resolution distinguish somehow between insurance and 'NTNI' – Non-Traditional Non-Insurance activities ■ wide ranging issues about NCAs having sufficient powers
Significant judgements required	<ul style="list-style-type: none"> ■ Suggested review of resolution plan by National Competent Authority involves significant subjective elements e.g. : <ul style="list-style-type: none"> ■ (i) the likely availability of a transferee or purchaser for any insurance business that is to be sold ■ (v) the quality of management information systems and the documentation of insurance contracts ■ (xi) the extent to which any interconnections or interdependencies between group entities or with third-parties affect the implementation
Long term solutions required	<ul style="list-style-type: none"> ■ Jurisdictions should have in place privately-financed policyholder protection schemes that can assist in: <ul style="list-style-type: none"> (i) securing continuity of insurance coverage and payments by the transfer of insurance policies to a bridge insurer or third party or use of any other resolution powers; and (ii) compensating policyholders or beneficiaries for their losses in the event of a wind-up or liquidation. ■ Potential changes to primary legislation e.g. insolvency laws, powers to NCAs to e.g. prevent cessation of reinsurance coverage, or policy-holder lapsation

Further issues evident from FSB consultation and response

Regulator focused on resolution	One size does not fit all	Practical considerations
<ul style="list-style-type: none"> ▶ More about resolution than recovery <ul style="list-style-type: none"> ▶ Although regulatory focus is on resolution, insurers need to recognise that recovery and resolution are part of the same continuum ▶ Management should be focused on both recovery and dealing pro-actively with the national regulator in drafting resolution plan ▶ Preparing for resolution <ul style="list-style-type: none"> ▶ Ex-ante actions need to be identified ▶ Greater legal clarity is required, e.g. how insolvency law and FSCS provisions interact ▶ Management need to consider the separability of critical functions, both internally and externally (e.g., service companies) ▶ Companies (and regulators) will need to consider triggers for action and likely actions. ▶ Need for Interaction with e.g. existing risk appetite / risk tolerance triggers and forthcoming EWIs for Solvency II regime 	<ul style="list-style-type: none"> ▶ Insurers vary significantly in complexity across the globe: <ul style="list-style-type: none"> ▶ Single country entity vs one with entities in many different jurisdictions ▶ Simple fund structures vs multiple funds governed by e.g. Schemes of Transfer ▶ One simple line of business vs material amounts of business where management discretion is required, e.g. WP business ▶ Interactions of different parties (inc regulators) has potential for difficulties. <ul style="list-style-type: none"> ▶ Not just different regulators, but different solvency and compensation regimes in different countries ▶ Discretionary benefits e.g., WP policyholders, mean potential issues with other assets / policyholders and need for FCA / PRA interaction. ▶ Risks are different for each company <ul style="list-style-type: none"> ▶ 'Retail' vs 'Wholesale' is a key issue, currently reinsurance is often treated pari passu with other creditors 	<ul style="list-style-type: none"> ▶ It is likely that there will be some significant practical challenges. <ul style="list-style-type: none"> ▶ For example, regulators may need to execute a resolution plan quickly and finding the right people at short notice (i.e. corporate insolvency specialists) may be difficult: <ul style="list-style-type: none"> ▶ This will be less of an issue in an 'idiosyncratic' scenario, but may be difficult in a 'systemic' scenario ▶ Local regulators need to ensure contractual arrangements are in place to access expert help when necessary ▶ This is particularly important for companies with material NTNI activities, where expertise required may be very different from normal area of regulator expertise

What needs to be done?

Regulatory bodies need to be joined up

- ▶ **A sensible, joined up approach is required from regulators**
 - ▶ Responsibilities of the PRA and FCA need to be defined. Resolution actions for insurers will clearly interest both authorities in e.g. cases with material WP business
 - ▶ Intended joint lines of action could be formalised before events occur (e.g., an MoU between the PRA and FSCS)
- ▶ **The role of the FSCS needs to be defined.**
 - ▶ Currently if entity is insolvent, tools like portfolio transfer will be ineffective. Can FSCS e.g. provide contingent capital as an alternative?
- ▶ **It cannot be assumed that current arrangements are adequate**
 - ▶ There is a need to explore existing legislative requirements
 - ▶ As changes to primary winding up legislation may not be achievable in the short term, is it possible to modify secondary requirements more readily? (e.g. FSMA 'cram down' provisions)
- ▶ **Many companies are part of wider European groups, so linkages with the College process need to be considered** as part of a single European prudential framework. Multi-lateral rather than bi-lateral?
- ▶ Solvency II aims to harmonise solvency requirements across European member states. There may be merit in engaging with EIOPA to harmonise e.g. early warning triggers on which solvency of insurers is threatened

Agreement is required on the ranking of various stakeholders

- ▶ **Agreement needs to be sought on a number of interesting points in regard to how different stakeholders are treated when an insolvency event occurs.** For example, it might be expected that policyholders are afforded a higher degree of protection versus other creditors.
- ▶ In addition, there is the issue of reinsured / wholesale policyholders, and questions about how are pensions are considered. For example, around the rights of Trustees of pension funds?
- ▶ **There will also be policyholders who are outside the FSCS** but who might still be considered 'vulnerable' policyholders e.g. are all SME corporate buyers considered experienced investors.
- ▶ **We also need to consider how different blocks of policyholders are treated:**
 - ▶ Ring-fencing for actuarial purposes may not work in an insolvency situation
 - ▶ What is fair for policyholders needs to be considered. Particularly if e.g. WPF is in surplus but SHF / NPF are in deficit.
 - ▶ How would a sale in an insolvency situation be achieved i.e. how would you value a particular book of business and what would be the role of the FSCS?

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What needs to be done?

Practical considerations

- ▶ **It is important to consider how a resolution system would work in practice**
 - ▶ The PRA should consider what it and other regulatory authorities can do to help insurers define their resolution and recovery plans
 - ▶ What is PRA's main objective in resolution? Re-build capital for some rump? Bail-in, swap debt for equities? Note there is potential for conflict between an insurance regulator (e.g. in respect of a bail-in) and the insolvency laws governing non insurance entities
 - ▶ In the case of business transacted fully, or in part, overseas (e.g. an overseas reinsurer) the PRA need to formulate an approach to enforce contracts
- ▶ **In the immediate aftermath of a resolution situation one needs to be careful in regard to:**
 - ▶ the advice that is given to policyholders, e.g. is it sensible to keep paying premiums?
 - ▶ who is providing this advice
 - ▶ there are many different sets of circumstances.

Other market issues

- ▶ **The main objective of designing living wills was to address issues in banks and insurance companies without recourse to public funds.**
- ▶ It should be noted that there are additional wider issues that still need to be considered:
 - ▶ **Market disruption** – e.g. derivative transactions / collateral if they were large enough
 - ▶ **Continuity of cover** – this could be considered in 2 categories
 - ▶ Continuity for vulnerable classes of policyholders e.g. annuitants and ensuring they continue to be paid
 - ▶ Market continuity e.g. compulsory classes of general insurance business (e.g., motor) and professional indemnity insurance covers needed for commercial purposes (e.g. marine, aviation and credit insurance covers)
 - ▶ **Contagion to the banking system** e.g. liquidity lent to banks from insurers. There may also be an issue also with bancassurance regarding potential for cross sectoral issues e.g. banks propping up insurers and vice versa

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Recovery and Resolution Working Party

Background:

- Formed in response to the launch of a number of consultations looking at Recovery and Resolution Regimes and associated issues
- Originally, a Life Board Working Party, but has been expanded to reflect the cross-practice nature of the subject

Themes identified in consultation responses

- More about resolution than recovery
- What can be done in advance to prepare for a resolution.
- Different considerations for individual companies and industry as whole
- Would be practical challenges, finding the right people to resolve v quickly (i.e corporate insolvency specialists).
- Interactions of different parties (inc multiple regulators) has potential for difficulties.
- Risks are different for each company
- Companies (and regulators) will need to consider triggers for action and likely actions.

Banking versus insurance

- Apart from one insurer that traded derivatives heavily, all the focus in the last crisis was on the banks.
- Banks are more heavily geared, and had a major problem with asset impairment.
- Bank depositors did not (normally – this is under reconsideration) have priority creditor status – so rescuing depositors meant rescuing all lenders and counterparties. This contrasts with policyholder priority for insurers.
- We think inter-group complexities making resolution difficult are typically greater in banks than in insurers
- Danger of complacency with insurers: long term liabilities may not be sufficiently recognised in relation to future asset performance (witness phasing in of full Solvency2)
- Danger of complacency with insurers: what if the banks had been allowed to fail properly, and the bank bondholders had been hit / wiped out / converted to equity?
- When “too big to fail” is tackled, potential failure becomes more real for insurers too.

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Paul Tucker speech

- Worth reading “solving too big to fail: where do things stand on resolution”, delivered 12 October 2013, by Paul Tucker, Deputy Governor Financial Stability at the Bank of England.
- It discusses how banking groups will need to restructure to make resolution practical. But the principles seem relevant to insurance groups too.
- Draws distinction between two possible resolution strategies: single point of entry (SPE) and multiple point of entry (MPE)
- SPE: losses in subsidiary first transfer to holding company (if necessary through holding company issuing loans to subsidiary that can default). Failure takes place at holding company, so holding company bondholders now own the group.
- MPE: subsidiary less protected by the ability to call on holding company, will focus regulatory attention on the amount of capital available to the subsidiary

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Looking insolvency in the eye

- We are used to discussing solvency in terms of assets, liabilities and balance sheets.
- But we rarely consider exactly what happens when a company fails (unless we are insolvency specialists).
- If we are to avoid “too big to fail”, it needs to be clear just how the big companies will be permitted to fail.
- This means that markets will have a better appreciation of the risks of investing in the debt of financial institutions.
- And investors such as insurance companies may need to hold more capital themselves; and may look for more equity capital or higher returns when lending.

How can we help?

- What could insurers do to develop current activities to meet PRA objectives?
- What are key activities which could be viewed as barriers to resolution?
- What should be the key tasks for the Working Party going forward?
- What support could we offer to PRA to help them in their work?
 - What concerns do members have?
 - What solutions do they recommend?
- What do members feel IFoA should be doing to support them on this subject?