



The Actuarial Profession

making financial sense of the future

Consultation Response **European Commission**

Consultation on a possible framework for the recovery and
resolution of nonbank financial institutions

21 December 2012

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

21 December 2012

Dear Sir/Madam

Consultation on a possible framework for the recovery and resolution of nonbank financial institutions

The Institute and Faculty of Actuaries welcomes the opportunity to respond on this matter. As the representative professional body for actuaries in the UK, our members work both in the UK and worldwide in the types of institutions referred to in the consultation document and specifically in the Life Insurance and General Insurance industries. As such, this response has been prepared based on the views of actuaries from a range of different types of insurers.

We hope our contribution will be of interest as you seek to develop your work in this area of recovery and resolution for other (nonbank) financial institutions. If you have any questions about the content, or wish to seek further views from us, please contact Helena Dumycz, Policy Manager at the Institute and Faculty of Actuaries, on 020 7632 2118 or helena.dumycz@actuaries.org.uk.

We have restricted our comments to the sections dealing with insurers in section 4 of the Consultation document

We refer you also to our response to HM Treasury's consultation, *Financial Sector Resolution: Broadening the Regime* of earlier this year in which we expressed views similar to those presented below.

1. Are the resolution tools applicable to traditional insurance considered above adequate? Should their articulation and application be further specified and harmonised at EU-level?

We believe that the resolution tools (in conjunction with existing and planned prudential regulations such as Solvency II) are adequate and we cannot identify further benefits that would come from extending their articulation and application further at EU-level. We would also advise that resolution tools require careful definition and application so as to prevent interference in the normal operations of the market.

2. Do you think that a further framework of measures and powers for authorities, additional to those already applicable to insurers, to resolve systemically relevant insurance companies is needed at EU level?

This consultation has been careful to identify systemically relevant insurers as those that are integrated with the rest of the financial system such that they would prove a risk to that system if they were to fail. The nature of insurance regulation involves ring-fenced funds; hence it is difficult to envisage individual insurers becoming so integrated that their failure would represent a systemic risk to the financial system.

The Actuarial Profession is the brand name of the Institute and Faculty of Actuaries

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We believe that the existing regime of resolution tools and prudential regulations is fit-for-purpose and that additional powers and measures would be unnecessary given the low systemic risk of insurance businesses.

In countries with large insurers and reinsurers, there is normally an established regulator with an understanding of the risks surrounding these, responsible for the prudential oversight of these firms. We therefore see no rationale for moving an established oversight to a centralised European body. The risks of such a move are evident, and could result in dislocation of the market and its regulation. We would cite the example of HIH in Australia, where the Response of the HIH Royal Commission¹ is informative in its analysis that the implementation of the new regulatory regime in Australia created problems for APRA (the Australian Prudential Regulatory Authority) in its supervision of the HIH group. It also makes reference to the relocation of the regime from Canberra to Sydney which created managerial distractions and high levels of valuable staff attrition. A similar transfer of authority could result in similar (or worse) results for the supervision of large and complex European insurers and reinsurers.

Financial Groups that include insurance alongside other business activities which do have the ability to create systemic risks would be better managed through the existing mechanisms, rather than creating a new EU framework for the insurance risks.

3. In your view, which scenarios/events might lead to the need to resolve a systemically relevant insurance company? Even before that, which types of scenarios systemic insurers and authorities need to be prepared for which may imply the need for recovery actions if not yet resolution?

We would question whether 'systemic insurers' exist in the terms described above. We recognise that certain catastrophic events could, in the extreme, lead to the failure of an insurer. The need for risk transfer from individuals to pooled arrangements is the rationale for the existence of insurance companies and can create conditions where an insurer failure could occur. However, this is the justification for the prudential reserving regime in the UK. The UK regime actively protects insurance companies against failure due to the requirement to hold a sufficient level of regulatory capital, for example in both Life and General insurance this provides a minimum capital adequacy for operation relating to a 0.5% probability of failure over one year.

Traditional insurance

- In the case of traditional life and non-life insurance, we believe it is reasonable to suggest that there are no scenarios that may render individual insurance entities as systemic, other than in the case of such an entity being part of a larger group with that group having exposures to markets that may themselves be considered systemically risky. Therefore, whilst business failure of a systemically risky group may occur it is extremely unlikely that the traditional insurance element could solely be responsible for creating this failure.
- Traditional insurance operates within a competitive market and a competitive market, open to new entrants, would be expected to have sufficient capacity and the commercial appetite to take on additional risk should a company fail. Insurance companies achieve additional security from exposure to specific risks through diversification by geography and product line. This diversification generates a reduction in the risk of a systemic failure of global companies.
- It is plausible that systemic risk exists in either a non-competitive market and / or a market where an insurer achieves a dominant market position, such as a niche market. However, by definition this would generally be a small part of any insurer's business portfolio and, should the market be wiped out, not critical to the general business and economic environment.
- We would add that most insurance markets around the world are open to new entrants, which limits the ability of one or two market participants to achieve market dominance. Even if one or two participants obtain significant market shares in a particular sector, this does not necessarily mean that systemic risk

¹ Report of the HIH Royal Commission, April 2003, Volume I – The failure of HIH: a critical assessment

exists. Any question of systemic risk only arises if a loss of capacity cannot be easily replaced (and this is dependent upon the precise nature of the cover offered).

Potential sources of systemic risk

- We agree with the IAIS that the greatest risk to policy holders lies in the possible systemic collapse of non-traditional or non-insurance businesses.
- One way in which insurers may expose themselves to systemic risk is potentially observed where the opacity of the reinsurance process leads to an accumulation of exposures greater than intended. Such events may occur when reinsurers buy protection (i.e. acquire a contingent asset) from other reinsurers. Under such circumstances, reinsurance is purchased to bring net exposure to an unfavourable scenario down to acceptable levels in relation to free capital. However, if reinsurers subsequently buy cover from each other, there is a possibility that when the event occurs, the recycled claims that arise in the form of reinsurance claims are higher than planned for.
- A similar situation might arise for groups that have entities in multiple jurisdictions. There can be many subtle interrelationships via risk transfer instruments between the entities. In this situation it can be difficult to identify the outcome of capital flows under extreme scenarios, particularly if individual country regulators act to protect the interests of local policyholders. In this case there may be a role for a supra-national regulator to be able to step in and ensure fair and efficient resolution mechanisms are put in place that apply across national borders.

With these issues in mind, however; we reiterate the point that the current insurance regulatory and resolution regimes – domestically and internationally – are capable of dealing with such issues before they become systematically contagious.

4. Do you agree with the above objectives for resolution of systemic insurance companies? What other objectives could be relevant?

As outlined in our responses to Questions 2 and 3, we doubt that in practice sufficient examples of systemic insurers exist to render the burden of a further level of EU regulation justifiable when a full cost-benefit analysis is performed.

5. Do you think that recovery plans should be developed by systemic insurers and resolution plans by resolution authorities? Do you think that resolution authorities should have the power to request changes in the operation of insurers in order to ensure resolvability?

We agree with the sentiment of this question with the caveat that authorities should not interfere in the regular operation of the markets (we would include the failure of firms here). It would not be appropriate for such authorities to restrict the commercial operations of firms or, conversely, to mandate a compulsory purchase by other firms.

In the absence of an EU-wide governance system, insurers should continue to be regulated and agree resolution plans in line with local regulations. The EU should act to ensure local regulations are of equivalent strength and penetration across all jurisdictions.

6. Do you agree that resolution should be triggered when a systemic insurer has reached a point of distress such that there are no realistic prospects of recovery over an appropriate timeframe, when all other intervention measures have been exhausted, and when winding up the institution under normal insolvency proceedings would risk causing financial instability?

Solvency II and other prudential regulations are intended to prevent firms reaching the point that the circumstances outlined above would be reached. As such, we would argue there is no need for additional regulation.

7. Should these conditions be refined? For example, what would be suitable indicators that could be used for triggering resolution of systemic insurers?

A situation that would require such resolution would be one where contingency plans are unlikely to provide cover. An event such as a catastrophic collapse would create a void in the market, for example, insurance for nuclear power stations is still required even if the specialist capital is destroyed by an event. Resolution tool utilisation may then be necessary where there is no likelihood of others filling the void in the instance of the failure of a firm, particularly in the case of mandatory insurances.

8. Do you agree that resolution authorities of insurers could have the above powers? Should they have further powers to successfully carry out resolution in relation to systemic insurers? Which ones?

We would not object to any of the tools listed, however; we would suggest in the case of the power to 'Transfer or sell specified assets or liabilities to a third party entity', that this only relates to the right to sell and does not order compulsory purchase.

These powers, with the above proviso accepted, appear sufficient.

9. Should they be further adapted or specified to the specificities of insurance resolution?

These powers appear to cover the issues related to the resolution of insurance collapses.

10. Would the tools mentioned above be appropriate for the resolution of systemic insurers? What other tools should be considered and why?

Such tools seem appropriate for the resolution of systemic insurers (where such firms exist). We reiterate our response to Questions 2 and 3 that we do not see in the market firms that present the systemic risks which would require an EU-level resolution authority beyond the existing state-specific resolution authorities and domestic and international prudential regulations designed to prevent, where reasonable, such collapses.

11. Do you think that, within the EU, resolution colleges should be set up and involved in resolution issues of cross border insurance groups?

The fact that a firm operates cross-border does not of itself make it a systemic risk to the financial system. Clarity in regulation can best be served by the lead regulator continuing to have overall responsibility for ensuring that cross-border firms are regulated appropriately. We do not feel that establishing and involving resolution colleges would be of benefit beyond the existing regimes.

12. How could the decision-making process be organized to make sure that swift decisions can be taken? Should this be aligned with the procedures already set out in Title III of Directive 2009/138/EC?

Swift decision making can best be facilitated by ensuring that there is clarity on who the lead regulator is for each firm and that these regulators are appropriately resourced to carry out their obligations.

13. Alternatively, do you think that responsibility for resolving systemic insurers should be centralised at EU-level?

We feel that responsibility lies with domestic regulators and authorities and that EU-level involvement is unnecessary and potentially an impediment to the swift action required in the case of the collapse of a systemic insurer.

14. Do you think that a recognition regime should be defined to enable mutual enforceability of resolution measures?

Ultimate compliance with any resolution measures that are agreed as a result of this consultation will need to form part of any negotiations regarding equivalence of regulatory regimes outside of the EU.

15. Do you think that to this end bilateral cooperation agreements could also be signed with third countries?

We see no reason why such agreements could not be signed once it is clear that the relevant third countries have appropriate regulatory frameworks to make such agreements useful and enforceable.

Yours faithfully,

A handwritten signature in black ink that reads "David Hare". The signature is written in a cursive style with a long horizontal stroke at the end.

David Hare
President-elect
The Institute and Faculty of Actuaries