The Actuarial Profession

making financial sense of the future

# Consultation Response

## HM Treasury

### Financial Sector Resolution: Broadening the Regime

24 September 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.

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Financial Stability – Contingency Planning Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

24 September 2012

Dear Sir/Madam,

**Financial Sector Resolution: Broadening the Regime – The Institute and Faculty of Actuaries' Response**

The Institute and Faculty of Actuaries welcomes the opportunity to respond to this consultation. In preparing our response, this consultation was referred to the Life Consultations Committee and the General Insurance Practice Executive Committees. These groups are comprised of fellows of the Institute and Faculty of Actuaries who have significant experience working on issues relevant to this topic.

The key points we would like to make in response to this consultation are as follows:

- We are of the opinion that the regime currently in place satisfactorily balances the difficult issues involved in protecting both life assurance and general insurance policy holders from the worst effects of a collapse of the firms writing these policies.
- The existing prudential regulation regime, and the Solvency II regime which is being developed to replace it, both require that insurers maintain high standards across their activities which reduces the probability of an insurer being unable to meet their obligations. The Solvency II regime requires insurers to operate to a 0.5% probability of failure over a one year view.
- There have been recent examples of insurance company failures that have occurred because those had subsidiaries that were involved in non-insurance businesses (i.e. subsidiaries that are banks or write banking type products) that ran into difficulty. Whilst the introduction of Solvency II will bring these subsidiaries into the same prudential regime as the parent company, this is not currently the case. Actuaries who are advising these companies do, and will continue to need to, consider what additional risks are placed on the parent company from holding such subsidiary business.
- One area in which we believe there is potential for a systemic vulnerability within the financial system relates to the class of general insurance industry products known as "miscellaneous financial loss policies" which share many characteristics with banking products.
- We agree with the assessment of the IAIS that the greatest risk to policy holders lies in the possible systemic collapse of non-life businesses based on the assumption stated in section 1.10 of the consultation paper.
- Furthermore, systemic risks to the economy may exist if there is a withdrawal of capital from the general insurance industry, potentially following the collapse of a general insurer, or in response to an overall fall in the profitability of the business. General trade would suffer if it became impossible, or prohibitively expensive, for businesses to insure against the risks to which they might be exposed.

We now consider the questions posed in Chapter 5.

**1. Do you consider that some insurance institutions have a degree of systemic potential?**

We do not believe that life companies have a degree of systemic potential and would consider the current regime sufficient for managing normal life activities. Systemic risk could occur from the acceptance by the industry of types of risk that could hit the entire market, such as dramatic improvements in longevity in the annuity business. In the event that very large market-wide losses occur, any relief given by reinsurance cover may be over-stated if reinsurers have themselves bought protection from other reinsurers. Although, whilst we believe that the systemic risk in life insurers is limited, there are potential instances where general insurance or re-insurance may result in systemic risks.

It is possible that systemic risk may occur between sectors where insurers are required to invest in assets to cover liabilities, where those assets are not sufficiently secure (for example loans to governments, businesses, or financial institutions in Eurozone states), then the promises made by insurers on which people rely may fail, with the extent of the failure too great for any compensation scheme to cope with. This is more of a problem with the assets than with the insurers per se, but it is not possible for shareholder capital in insurers to absorb that sort of systemic, catastrophic scenario.

There may be more systemic risk inherent in the general insurance industry. Work from the PPO working party suggests that general insurers will look increasingly like life companies. This may be undesirable from a policyholder protection/firebreak standpoint (having moved away from the composite insurance model) and its implications should be considered carefully.

General insurance systemic risk also arises where one or two market participants crowd out others and obtain a market dominance. This is particularly important in statutory classes, but also those on which economic activity depends. The Australian market experience following the collapse of HIH is instructive as they had a dominant position for medical malpractice and builders' warranty amongst other markets.

One way in which insurers can expose themselves to systemic risk can be seen in the example of the "LMX spiral" in the London Market where the opacity of the reinsurance process led to an accumulation of exposures greater than intended. Such events occur when reinsurers buy protection (i.e. acquire a contingent asset) from other reinsurers. Under such circumstances, reinsurance is bought to bring net exposure to an unfavourable scenario down to acceptable levels in relation to free capital. However, if reinsurers then 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.

This occurred in the Lloyd's and London Market in the late 80s / early 90s, and the loss was embarrassing to the market – not as a result of the size of the loss event (e.g. Piper Alpha or European storms) but because the recycling of reinsurance served to concentrate the loss in some places.

**2. Do you agree with the Government's overarching objectives that any insurer should be able to exit the market without disorderly impact, and that the interests of policyholders should be appropriately protected? If so, what is the most appropriate means of achieving these objectives?**

We largely agree with the Government's overarching objectives as stated. We reassert our position as stated in answer to question 1, that the current regime is broadly fit for purpose in this regard.

The Financial Services Compensation Scheme (FSCS) is designed to ensure that 90% of the value of claims is met in the event of an insurer's failure. In a highly intermediated market, such as those that exist for insurance, we believe that restricting protection to less than 100% of the full value of claims is an important control to ensure intermediaries and their customers consider both the financial stability of the insurer and the premium rate before deciding who to place business with. Increasing this protection to 100% would introduce a moral hazard in the sense that customers would select the lowest premium offered, confident in the knowledge that their claims would be met in full by the FSCS. This would make it more likely that the insurer would price close to the margins and ultimately fail.

Such mechanisms appear robust enough; however, there may be incidences where political pressure means that exceptions may be necessary. A possible example could be regarding recipients of major bodily injury awards who may have limited scope to accept a reduction in their compensation payments.

There may be a logical case for giving a higher priority (with perhaps a 100% payout) to that part of a claim paid for by premiums paid after the announcement of an insurer's failure. Theoretically, this should permit a more orderly transfer of business between insurers. However, there will be many practical difficulties to overcome in making this approach viable.

**3. Do you consider that the insolvency framework for dealing with the failure of insurers needs to be enhanced? What form should improvements take to provide greater clarity and certainty around securing continuity of cover for policyholders?**

We believe greatest care should be taken in ensuring continuity of cover for compulsory insurances. It is important that policyholders are able to enjoy continuity of cover in the short term to ensure there is an orderly transition following the failure of an insurer.

We believe the current systems are largely fit for purpose but note that consideration is being given to introducing a power of transfer. We are of the opinion that this could be a useful addition to the regulators tool kit provided the practical realities of how this power could be used are considered.

As noted in the introduction, the proposed Europe-wide regulations of Solvency II further reduce the probability of an insurance failure. Whilst Solvency II is a non-zero failure regime, it is complemented with a second pillar that is substantially stronger than that in the banking sector. The Own Risk and Solvency Assessment (ORSA) is a key element of this and one option to prepare companies for possible future problems could be to strengthen further this element. The ORSA could possibly contain a form of 'living will' that could anticipate how the company could be wound up with as little harm to the policyholders and the market as possible. The ORSA could also be used to analyse where the company is connected so that it can have systemic relevance.

**4. Do you consider that the UK authorities should have resolution tools in the event that the failure of an insurance company raises public interest concerns because it is likely to have systemic implications?**

We can envisage circumstances where such powers would be useful, however; care would be required in defining such tools to ensure that they would not disrupt the normal operation of the market.

As stated, it is unlikely that a life insurer would expose itself to systemic risk in practice and that the current regime is adequate to deal with any failure of life companies. The long-term package for Solvency II which is currently being negotiated will have an important role to play in making sure that all insurers continue to be both well-funded and able to write new business in more extreme financial markets.

The failure of a general insurer is only likely to have systemic impact if it leads to a broader withdrawal of capital from the general insurance market.

One important issue that requires addressing is provision in the event of certain types of catastrophic collapse of a general insurer, e.g. who insures the nuclear power stations if the specialist capital is destroyed by an event? What short term steps are needed to maintain liability insurance capacity while tort reform is put in place?

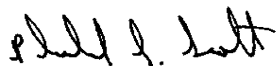
**5. Do you consider that a portfolio transfer power should be introduced for use as a preventative supervisory tool?**

We believe a portfolio transfer power should be considered as a potential step in the instance of the failure of a business. This would be over and above the current power of the FSA to halt the writing of new policies. We envisage that this power would enable the FSA to instruct the management of the firm to seek a purchaser. However, it would not be appropriate for the regulations to restrict the commercial operations of other firms. We would therefore, resist any mechanism that included the ability for any government body to impose a compulsory purchase element upon other firms.

The experience of what we believe to be the most recent insolvency of a life insurer is relevant here. In 1991, a relatively small company writing limited amounts of business called Oak Life failed. An issue arising at this time surrounding the inability of administrators to find a buyer to take on these liabilities resulted in the paying-out of policies under the Policyholders Protection Act (1975).

This implies that for the portfolio transfer tool to be useful to regulators, they will need to be able to use it prior to the company becoming insolvent. This power is only needed once regulatory assets are sufficient to cover regulatory liabilities, as the prudential margins provide a buffer. If this power were to be introduced, it might be useful to consider whether funds from the FSCS could be used either to increase assets or take some liabilities off the balance sheet so that taking over the portfolio is a more attractive proposition.

Yours faithfully,



Philip Scott
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