Comments

of the German Insurance Association

on the Financial Stability Board (FSB) consultative document:

Guidance on Identification of Critical Functions and Critical Shared Services

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General Comments:

The German Insurance Association gladly takes the opportunity to offer feedback as regards the FSB' considerations on critical functions in the insurance sector. We acknowledge the valuable and important contribution of the **FSB' work to ensure the stability of global financial markets.** The FSB plays an essential role in detecting potential drivers for crisis situations and preventing them to unfold with a cross-border and cross-sectoral magnitude. It is our understanding that the FSB is not supposed to resume the responsibilities of a superordinate regulator, but to cover possible blind spots of sectoral regulation in terms of global systemic risk issues and promote co-ordination and information exchange among supervisors.

This is why we are deeply concerned that the FSB draft **guidance on critical functions in insurance crosses the line between global and jurisdictional matters** and intervenes in issues which should be reserved to the competence of local prudential and competitive regulators. These supervisors are in the best position to assess the implications of an insurers' failure on their local economies and are well equipped to strike the adequate balance between consumers' protection and financial stability preservation.

Against this background, it remains **unclear which regulatory goal the elaboration on critical functions of insurers is supposed to serve**, not least because even the FSB itself admits that very few critical functions are expected to be identified as a result of this exercise. This not only raises serious questions in terms of proportionality given the tremendous burdens both supervisors and insurers are confronted with.

Moreover, a reasonable **distinction between critical and non-critical functions is hardly possible** due to the ambiguity of the framework. Instead, given the variety of business lines listed in the Annex almost every insurance product might eventually qualify as a critical function. As a result, **traditional insurance business would be classified as systemically significant or critical**. This is not only at odds with the prior conclusions of the IAIS - endorsed by the FSB - as regards the limited exposure of insurers to systemic risk. The considerable degree of discretion given to regulators when determining critical functions is likely to end up in different implementations between jurisdictions which could seriously **impede the level playing field** among competing insurers.

In addition, we would like to point out that the failure of **key players of other important industry sectors** such as energy/infrastructure, (digital) communication or transportation might have an even **greater impact on economic activity** and the ability of individuals to go about their daily lives.

As a consequence, the FSB would need to extend its analysis of critical functions well beyond banks and insurers in order to be consistent with its ambition. We strongly believe that the FSB neither has the mandate nor the resources to conduct such an elaboration.

In essence, the paper **lacks an adequate differentiation between the criticality of single insurers and the insurance industry as a whole.** It is indisputable that the insurance sector provides a wide range of critical functions and services to consumers and the economy. However, the significance of an entire industry needs to be taken account of by appropriate macroprudential surveillance. In contrast, the risk of an individual failure is exhaustingly captured by the ongoing prudential regulation and supervision of insurers.

After all, we continue to believe that the **particularities of the insurance industry, especially in contrast to banks, are still not fully taken into account**. For instance, the FSB seems to assume that primary insurers and reinsurers are highly interconnected. As a result, reinsurers are supposed to have a greater potential to spread contagion as its failure could lead to the failures of many primary insurers. It needs to be reiterated that no individual reinsurer claims a dominant market position. Nor would the failure of an individual reinsurer have a systemic impact on primary insurers since a very limited percentage of global primary insurance premiums are ceded to reinsurers.

Important and unique **business features** such as the pre-funding by constant premium inflow and the effective calibration of investments in order to match the long-term nature of liabilities **prevent insurers from experiencing sudden crisis situations that may inflict damage to financial stability**. Therefore, we strongly request the FSB the reconsider whether additional requirements to recovery and resolution regimes for insurers are actually necessary.

Response to the specific questions:

1. Are the definitions of “critical functions” and “critical shared services” appropriate for the insurance sector?

The terminology may be appropriate from a macroeconomic perspective, e.g. if the significance of the entire insurance sector for economic growth and stability is taken into account. In contrast, these measures inevitably fail to justify an increased level of supervision on an individual basis. Critical or important functions of single insurers are subject to close supervision on an ongoing basis, irrespective of size and market share. These categories do even reinforce the risk bearing capacities of insurers and make them more resilient to stress conditions.

2. Should critical functions be identified based on whether the disruption of the activity would adversely impact the stability of the financial system or the functioning of the real economy, or both?

There is, of course, no reasonable doubt that the disruption or absence of important insurance services would cause serious harm to both the stability of the financial system and the functioning of the real economy. However, the same is true if essential services and functions such as logistics, infrastructure, and energy would not be available anymore. As apparent, neither the FSB nor regulators on a domestic level do seriously consider putting key players of such market segments under increased surveillance in terms of recovery and resolution, although the corresponding market structures are not much different or even less diversified compared to the insurance sector and, in theory, more likely to cause massive disruptions to the economy due to the failure of individual undertakings. As a consequence, we do not believe that abstract criteria such as criticality of functions are suitable to discuss prudential measures on an individual level.

3. Is the methodology for identifying critical functions laid out in the paper appropriate for the insurance sector? If not, what aspects are missing or need to be changed?

No. The proposed methodology remains vague and abstract, thus neither adequate nor proportionate to justify strengthened requirements on grounds of critical functions. For instance, it is hardly possible to reliably assess the impact of the sudden discontinuance of an insurance function on the spending behavior of policyholders and the corresponding consequences for the economy. Nor it is realistic to expect sound predictions about the policyholders' activities if they experience a loss of coverage. As a consequence, almost each kind of insurance service could end up to be classified as critical, depending on the more or less sophisticated projection of supervisors.

4. Do the six broad categories of activities outlined below cover all relevant and potentially critical functions? What additional categories, if any, should be added? (i) Insurance coverage as a precondition for economic activity; (ii) Insurance coverage as a precondition for individuals to go about their daily lives; (iii)Insurance payments that are vital to individuals' financial security; (iv) Investment in and lending to the real economy;
(v) Acting as a counterparty in derivatives, repo and securities lending markets; and
(vi) Pooling of risk, particularly reinsurance, as an economic function;

The mentioned categories would not only capture presumed critical functions, but each and every insurance product. There is always some kind of connection between an insurance product and the expected benefit on the individuals' financial security. Otherwise, policyholders would not have any incentive to sign a contract and pay premiums. As repeatedly mentioned, the broadness of the categories does not enable regulators to identify individual insurers which may deserve increased regulatory scrutiny.

Category (iv) refers to the function of the insurance industry as a major investor in real economy ventures. It is hardly comprehensive that insurers should be punished for maintaining this essential function by being subjected to tightened recovery and resolution requirements. The public interest to preserve these funding channels would be served more effectively if regulators would keep a keen eye on the viability of lenders.

Categories (v) and (vi) do not refer to activities or functions which are directly relevant for policyholders or the economy. Instead, acting as counterparty in derivative transactions for hedging purposes and pooling of risks, particularly in reinsurance, are indispensable features or techniques that are characteristic for the business model of insurers. As such, they can't be measured in terms of an impact assessment or a substitutability analysis.

5. Is the methodology for identifying critical shared services laid out in the paper appropriate for the insurance sector? If not, what aspects are missing or need to be changed?

We understand that the methodology for critical shared services is based on the assumption that critical functions have been identified in a first step. Furthermore, we understand that the increased requirements on recovery and resolution planning should help to maintain continuity of critical functions under stressed conditions. Consequently, we would assume that a corresponding resolution strategy or operational plan naturally includes measures to protect the internal processes necessary to maintain these functions. Therefore, we do not see the rationale for providing different and artificially separated methodologies for critical functions and critical shared services. Apart from that, we reiterate our concerns against the concept of determining critical functions to justify additional regulatory requirements for individual insurers as repeatedly stated in our comments above.

6. Is the framework flexible enough to cover the different types of business undertaken by G-SIIs? Are the non-prescriptive lists of examples of functions that could be critical helpful?

The first part of the question implies that the business of G-SIIs is different from other insurers. Actually, the G-SIIs were not designated due to particularities of their business model. They were chosen from a predetermined list of insurance groups which was apparently compiled solely due to the size of the candidates. Thus, our concerns against the identification of critical functions and the imposition of additional recovery and resolution requirements apply to all insurers regardless of their designation as G-SII.

As stated above, the listed examples for critical functions are not helpful since they cover almost the entire spectrum of traditional insurance product. As a result, the identification of critical functions will be dominantly influenced by categories like size and substitutability. Both indicators are not suitable to justify increased requirements for individual insurers in terms of recovery and resolution.

7. Is the framework flexible enough to take account of the external environment in which failure is occurring, for example, an idiosyncratic event or a broader situation of more severe distress in the financial system?

No. This is one of the main reasons why we question the feasability of ex-ante recovery and resolution planning. Both supervisors and undertakings need to target the concrete triggers for the stressed conditions. However, it is not possible to anticipate any imaginable scenario that could put an insurer under pressure and define a management plan that is tailor-made for that situation. As a result, recovery and resolution plans may even squeeze supervisors and undertakings into a specified schedule and prevent them from executing the necessary measures to adequately deal with the crisis.

8. Are there any other issues in relation to the identification of critical functions and critical shared services that it would be helpful for the FSB to clarify in further guidance?

No.

Berlin, 15 December 2014