IAIS

IAIS response to the FSB consultative document "Recovery and Resolution Planning for Systemically Important Insurers: Guidance on Identification of Critical Functions and Critical Shared Services"

1. General comments

- The IAIS paper "Insurance and Financial Stability" (November 2011) states that "*The financial crisis of 2008/09 has shown that, in general, the insurance business model enabled the majority of insurers to withstand the financial crisis better than other financial institutions… While impacted by the financial crisis, insurers engaged in traditional insurance activities were largely not a concern from a systemic risk perspective. However, insurance groups and conglomerates that engage in non-traditional or non-insurance activities are more vulnerable to financial market developments and importantly more likely to amplify, or contribute to, systemic risk.*"[1]
- The terms "products" and "functions" are both used interchangeably in the draft Guidance, but they are not interchangeable and there needs to be clarity when each of the terms is used if the FSB does, indeed, mean products in some cases and functions in other cases.
- Review of the IAIS G-SII Assessment Methodology might affect the identification of critical functions.

2. Responses to each question

FSB Question	IAIS response
1. Are the definitions of "critical functions" and "critical shared services" appropriate for the insurance sector?	The proposed definition of critical functions should be amended as follows. *For the purposes of this Guidance, a critical function has the following two elements:* *(i) it is provided by an insurer <u>that could be systemically significant or critical if it fails</u> to third parties not affiliated to the firm; and* *(ii) the sudden failure to provide that function would be likely to have a material impact on the financial system and the real economy, give rise to contagion, or undermine the general confidence of market participants <u>due to the systemic relevance of the function for the third parties</u>.*

[1] Paragraphs 3 and 4 on page 3. http://www.iaisweb.org/view/element_href.cfm?src=1/13348.pdf

	The sudden failure to provide a certain function would be likely to have a material impact on the financial system and the real economy in a case where the function is provided by an insurer that could be systemically significant or critical if it fails. The first element above (i.e. (i)) should clarify this by inserting "that could be systemically significant or critical if it fails" after "an insurer." Also, it is essential to clarify that the sudden failure to provide of a certain function could have a material impact on the financial system and the real economy because of the systemic relevance of the function for third parties, which can be done by adding "due to the systemic relevance of the function for the third parties" to the second element above. These changes will make the proposed definition of critical functions in the Guidance consistent with that in the Critical Function Guidance for banks.* *[Note*: The definition of critical functions in the Critical Function Guidance for banks is the following.* *"For the purposes of this Guidance, a critical function has the following two elements:* *(i) it is provided by a firm (G-SIFI) to third parties not affiliated to the firm; and* *(ii) the sudden failure to provide that function would be likely to have a material impact on the third parties, give rise to contagion or undermine the general confidence of market participants due to:* *o the systemic relevance of the function for the third parties; and* *o the systemic relevance of the G-SIFI in providing the function."]*
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	In light of the objective of an effective resolution regime stated in the FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions**, critical functions should be identified based on whether the disruption of the function could adversely impact the stability of the financial system "**and**" the functioning of the real economy.

economy, or both?	*[Note*: The KAs say that "The objective of an effective resolution regime is to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation."]*
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?	It would be an appropriate approach to assess criticality of certain functions to the financial system and the real economy from the proposed three aspects, i.e. impact, substitutability, and firm specificity. Having said that, the following two different things should not be mixed up in the assessment: (i) importance of insurance (insurance products) to the economy and/or economic activities and (ii) criticality of insurance (insurance products) to the financial stability. Insurance itself is an important function in the economy, but it does not mean that any functions performed by and any insurance products provided by insurers are necessarily critical to the stability of the financial system. This is comparable to the considerations in the banking sector regarding whether payments, custody, clearing, and settling could be critical. Due to the inherent nature of insurance, insurance coverage works as a precondition for economic activities and insurance benefits are relied upon by policyholders (including beneficiaries/claimants) for their daily lives. However, for most insurance products, it would be unlikely that discontinuity of insurance coverage would adversely affect the stability of the financial system in the same manner and to the same extent that discontinuity of certain functions of banks does. This should be clearly stated in the introductory part (after the fourth paragraph on page 8) of the Guidance as follows. "*Due to the inherent nature of insurance, insurance coverage works as a precondition for economic activities and insurance benefits are relied upon by policyholders (including beneficiaries) for their daily lives. However, for most insurance products, it would be unlikely that discontinuity of insurance coverage would adversely affect the stability of the financial system in the same*

	<u>*manner and to the same extent that discontinuity of certain functions of banks does.*</u>" In addition, the IAIS fully acknowledges that ensuring continuity of (certain types of) insurance coverage is important in order to protect policyholders (so that they continue to engage in economic activities and to have their daily lives) and insurance regulation and supervision needs to consider possible impacts on the real economy and the insurance market as a whole. These continue to be on the agenda of the IAIS.
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 six categories cover all functions and activities that should be in the scope of the assessment of criticality. However, it should be understood that the sudden failure to provide most types of insurance products that are captured by the categories (i) to (iv) are unlikely to have a material impact on the financial system and the real economy (see the response to question 3), although there could have an adverse impact on the real economy (including economic activities and policyholders' daily lives) if it were to occur on a mass scale and over a prolonged period of time. The IAIS strongly suggests that the category (v) come first and then it is followed by (i) to (iv) and (vi). See also the comment to question 6.
5. Is the methodology for identifying critical shared	In Section 4.2 (page 24) the distinction between the first bullet (impact) and the third bullet (firm-specific) is not necessarily

services laid out in the paper appropriate for the insurance sector? If not, what aspects are missing or need to be changed?	clear-cut. The first sentence on page 25 says that "For the purposes of this analysis, there should be a clear understanding of the following aspects of the shared services at the legal entity level" and therefore the third bullet on page 24 can be taken out, which makes the methodology for the identification of critical shared services in the Guidance for insurers consistent with that in the Guidance for banks.* *[Note*: The Critical Function Guidance for banks has the following two bullets.* • *How severe are the consequences of the failure of a particular service on one or more critical functions?* • *How quickly will the failure of a particular shared service lead to a collapse of one or more critical functions?]*
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?	Compared to the Critical Function Guidance for banks, the proposed Guidance for insurers looks less flexible. The Guidance for banks contains, in the body, *Definition and Determination of critical functions for critical functions and Definition, Determination of critical functions, and Key considerations for critical shared services*. On the other hand, the proposed Guidance for insurers contains, in the body, Functions that could be critical (Section 3) and Shared services that could be critical (Section 5) as well - this gives an impression that the framework for insurers is more prescriptive. To solve this, the two sections should be moved to an annex. Annex "Examples of possible critical functions" by itself is less helpful as the list is not self-explanatory in that it is not explained why those functions can be critical. To make the list more useful, Section 3 should be moved to the annex. These amendments will make the structure of the Critical Function Guidance for insurers both clearer and also more consistent with that for banks.
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	(No comment.)

broader situation of more severe distress in the financial system?	
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 comment.)

3. Specific comments

Page	IAIS comment
2	**The 3rd paragraph should be deleted or amended as follows** unless any concrete materials supporting the argument are provided since the paragraph is not only non-persuasive but also misleading. For example, a sentence says that "like non-insurance financial markets, certain insurance markets are highly concentrated, and rapid withdrawal of underwriting capacity or expertise by a key player…could disrupt the functioning of that market…," but no evidence or examples supporting this statement are given. Another sentence says that "For example, certain commercial insurance lines require…," but, again, no concrete examples are provided. "*Like non-insurance financial markets, if certain insurance markets are highly concentrated, ~~and~~ the rapid withdrawal of underwriting capacity or expertise by a key player, such as a G-SII with a large market share or other critical market role, could disrupt the stability of the financial system, the functioning of that market and the ability of third parties to obtain insurance in a timely fashion and on reasonable terms. For example, if (i) certain commercial insurance lines that require specialised underwriting skills ~~and~~ are dominated by a small number of firms with high market shares~~. If~~ and (ii) one of those firms were to fail and to cease underwriting, other market participants might be unable to assume the failing insurer's market share ~~role~~ and, thus, coverage might become temporarily unavailable. Absent ~~this~~ coverage, the commercial activities that rely on this insurance could cease for a period of time. The extent to which such a disruption has an adverse impact on the stability of the financial system and ~~to~~ the real economy ~~is systemic or not would depend on the facts and~~ would be assessed by supervisors using ~~determined by~~ the three step analysis described in Section 2 of the Guidance ~~by the regulators~~.*"
4	**The 1st bullet in Section 1 should be modified as follows** as it mixes up (i) the

	importance of insurance (insurance products) to the economy and/or economic activities and (ii) criticality of insurance (insurance products) to financial stability. See also the response to question 3. For instance, examples provided are not necessarily appropriate as discontinuity of such products (e.g. motor insurance covering third party bodily injury, professional indemnity insurance for doctors, and marine cargo insurance or aviation insurance) are unlikely to have an adverse impact on the stability of the financial system, even if those products are essential from economic perspectives. Another reason is that the insurance sector itself is one of the main providers of investment in economic activities as described, but it does not serve the purpose of discussions on financial stability to discuss the investment elements in the context of the possibility that discontinuity of a function could have an adverse impact on the stability of the financial system. "*Critical functions are activities performed for third parties where failure would lead to the disruption of services that are vital for financial stability and the real economy due to the insurer's size or market share, external and internal interconnectedness, complexity or cross-border activities, or lack of substitutability. ~~Examples might include insurance cover that is mandated by statute, or insurance cover that participants require in order to provide essential services or to undertake activities that underlie the functioning of the real economy.~~ <u>For example, f</u>ulfilling payments to policyholders that have fallen due may ~~also~~ be a critical function if those payments are necessary for the policyholder to settle day-to-day <u>financial transactions smoothly</u> ~~living expenses~~. ~~Taken as a whole, the insurance sector functions, in part, as a conduit for investments in businesses and infra-structure projects by acting as a medium between policyholders with a desire to save and businesses with a demand for investment.~~ Disruption to financial stability could occur through connections with other financial institutions and markets ~~or through a loss of confidence in the sector~~ or simultaneous responses by many insurers to a crisis.*"
4	**The definition of critical functions should be amended**. See the response to question 1.
4	**The following sentence should be added** after the definition (i.e. after point (ii) starting with "the sudden failure...") for clarification purposes. (Note: The same sentence is in the Guidance for banks.) "*<u>The absence of any one of these elements indicates that a function is not critical.</u>*"
9	**Section 3 should be moved to the annex** and combined with a list of possible critical functions appropriately. Also, 3.5 should come first and then it should be

	followed by 3.6 and 3.1 to 3.4. See the response to question 6.
14	**The second paragraph** is not written in a balanced manner and **should be modified as follows**. For example: the first sentence does not mention a case where a PPS does not exist; the third sentence implies that payments from the fund should be done very quickly; and the last sentence is not applicable to a case where there is no guarantee fund. "*Payments not supported by policyholder protection schemes or supported by unfunded policyholder protection schemes may be more likely… to policy beneficiaries. Certain types of policies that provide individuals with critical payments, such as workers' compensation policies, are supported by guaranty pools funded, after claims arise, by other insurers active in the market in some jurisdictions but are not supported by such funds in other jurisdictions. ~~Such~~ Even in the former case, such guaranty funds may not be able to generate liquidity quickly enough within a reasonable timeframe ~~in the short-term~~. Furthermore, the failure of a member insurer may cause other insurers distress by requiring them to increase their contributions to the fund in a case where the guaranty scheme is ex-post funded. ~~Unless the pool is insolvent, existing beneficiaries will not lose their payments entirely.~~*"
22	**The last sentence of the first paragraph could be modified as follows** considering that the G-SII Assessment Methodology gives the size indicator only 5%-weight. "*If a significant amount of reinsurance capacity were lost and not replaced, then the nature of the insurance market may change and perhaps either move towards a co-insurance model or for direct insurers to grow or merge in order to increase their underwriting capacity. Alternatively, there may be no capacity to take on those risks at the previous pricing levels (i.e., insureds would need to accept lower coverage or pay a higher premium or both). The insurance market may become more concentrated, reducing competition and choice offered to customers. In such an event, ~~Larger~~ larger insurers ~~may~~ could be more likely to pose a systemic risk or the result could be more likely to be a market transforming event rather than an event that impacts the real economy or financial stability.*"
23	**The second paragraph should be modified as follows** as, for example, it is not appropriate to describe government-backed pools as a system that could put taxpayers at risk (i.e. the system is necessary to the economy and thus costs for such a system need to be shared) and the last sentence below is not relevant to "drivers of criticality." "*Government-backed pools are not critical functions merely because they are supported by the Government ~~their failure puts taxpayers at risk~~. Certain pools are established for risks which would not be accepted without a degree of*

	government support. These might be risks related to terrorism or nuclear accident. The support may be provided by government-mandated levy arrangements on all insurers or part of the insurance industry or by direct government guarantees (which may be limited in amount). Arrangements which depend on levies can increase contagion to other insurers. However, the fact that the failure of a participant in such a pool may result in a call being made on the government ~~(at a cost to taxpayers)~~ does not mean that this function is necessarily a critical function. Where a government has accepted such risks prior to any insurer failure, then a resolution plan which involved a government providing the anticipated support may still be an acceptable plan, notwithstanding the aims of the Key Attributes for effective resolution regimes."
25	**All the examples in Section 5 should be taken out from the body of the Guidance and put in the annex**. See the response to question 6.