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Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
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Re: Developing Effective Resolution Strategies and Plans for Systemically Important Insurers; Consultative Document 3 November 2015

This letter sets forth comments on the draft guidance for Developing Effective Resolution Strategies and Plans for Systemically Important Insurers.[1] These comments cut across several of the questions submitted for public comment, which will be noted for each comment.

*Points of entry [Question 2 ].*

It is common in bank resolution to form bridge institutions consisting of the bank's good assets together with its deposit liabilities. This enables the resolution authority to find an acquirer with a minimum infusion of cash. This strategy recognizes the need for massive liquidity on an emergency basis. By cherry picking the best assets and assembling what amounts to a functional good bank, the resolution authority reduces the need to dig into the taxpayer's pocket. This strategy does not apply to insurance companies because insurance products are fundamentally different.[2]

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[1] The author is a lawyer who has practiced insolvency in the United States for the past thirty seven years including many cross-border matters and matters involving failed or failing financial institutions. The author's particular focus is on insurance company insolvency. The author holds a designation of Certified Insurance Receiver -- Multi-line from the International Association of Insurance Receivers, and has written many articles on insurance receivership topics. The observations made in this letter are the views of the author only, and not those of his firm or of any client.

[2] In addition, the formation of a bridge company consisting of insurance company assets would present enormous practical problems in the United States. Such a company would need to be licensed in every state where policyholders reside otherwise, the company would be unable to sell products to new customers and the existing policyholders would lose guaranty association protection in a subsequent insolvency.

Bank deposits are demand obligations on the institution. It has been observed that certain types of life insurance and annuity products have redemption features that allow an owner to obtain cash on demand. But observing the similarity misses the fundamental difference between bank deposits and insurance products. The primary purpose of the insurance products is not liquidity. Consumers do not purchase annuities or life insurance policies with the expectation that the entire value is available all at once to purchase basic needs of daily living. The fundamental point of these products is value distributed over time or at an uncertain time in the future upon the occurrence of an event. As such, a stay on redemption with a guaranty of coverage for ordinary benefits as they become due provides policyholders with the benefit of their fundamental bargain. This would not be the case for bank deposits.

The second fundamental difference between deposits and insurance liabilities is that deposits are readily quantifiable with precision from the records of the bank. Insurance liabilities emerge over many years and can only be estimated. As such, the emergence of experience over an extended period resulting in increased certainty in liabilities may enable an insurance receiver to effectuate a better transaction with a third party for the assumption of the liabilities.

Once it is recognized that insurance resolutions do not entail immediate liquidity commitments (beyond what guaranty associations can provide), and that longer term disposition of assets and liabilities is advantageous, it follows that intervention at the holding company level is not an efficient or effective way to resolve insurance insolvencies. It also follows that having capital at insurance holding companies provides very little incremental benefit in resolution, and imposing capital requirements that increase the amount of assets at the holding company does not promote institutional stability in any meaningful way.[3]

A point of entry at the holding company level would make sense if the distress in the organization was above the insurance companies in the capital structure. AIG was a notable example of this situation. But that situation is well out of the norm for insurance company groups, and using it as a template to devise resolution strategies and capital models is unwise.

*Conflicting objectives [Questions 2, 7].* The Consultative Document states: "Authorities should develop resolution strategies with the aim of maintaining financial stability and, to the fullest extent possible, protecting policyholders when an insurer fails." This statement indicates that the first obligation of the regulator is to the system rather than policyholders.

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[3] This is particularly so in the U.S. where the regulator does not control the holding company. This lack of control over the holding company is a serious shortcoming in the U.S. system that ought to be corrected. It has led to regulators having to negotiate with affiliated companies for the ongoing provision of services and, in several well publicized cases, payment to holding companies for the use of tax attributes to avoid tax liability of the insolvent insurance company. Non-insurance company affiliates have the ability to commence completely separate insolvency proceedings in federal bankruptcy court. The commencement of such proceedings adds considerable uncertainty to a wide range of questions including how third party recoveries are treated, how tax returns are filed, how operating assets are disposed of and how intercompany claims are enforced. This is an area where U.S. law should be improved.

This approach presents both policy and practical problems -- particularly under the law of the United States.

The United States has a well-developed state law system of allocating loss and spreading it across a range of constituencies. In the first instance, shareholders and non-policyholder creditors are required to absorb losses from insurance company failure. If there is insufficient loss absorption capacity in the companies, then the guaranty associations step in and pay claims. The cost of the associations is spread out to the rest of the insurance industry through assessments and further spread, to a limited extent, back to the public in the form of premium tax offsets and increased insurance premium rates.

The duty of the receiver of an insolvent insurance company is "the protection of the interests of insureds, claimants, creditors and the public generally. . ." Insurer Receivership Model Act, Section 101 (E); Insurers Rehabilitation and Liquidation Model Act, Section 1(D). This typically entails the use of the system to maximize the recovery of the policyholders and the guaranty associations. Though protection of the public is mentioned among the duties, this provision is not typically construed to impose on a receiver the duty to protect the financial stability of the larger financial system, and is unlikely to ever be construed to put the interests of the financial system ahead of the interests of policyholders.

Imposing such an obligation on a receiver could result in decisions not to use the loss allocation system in the ways that it was intended. For example, the receiver of an insolvent insurance company may have to make decisions as to whether to maintain and perform derivative contracts. The abandonment of such contracts might confer a significant benefit on the estate but create financial distress for counterparties, while honoring the contracts would deplete the assets of the estate without conferring a commensurate benefit on policyholders. From the perspective of state receivership law, the receiver's choice would be clear -- abandon the contracts. The choice becomes even clearer when the insolvency of a large company results from widespread economic dislocation that affects small insurance companies as well. The law cannot reasonably require the receiver to select a course of action that would be adverse to the policyholders of a large company when receivers of smaller companies were free to select a course more beneficial to policyholders. There is no policy basis which would support the proposition that policyholders of a large company should bear losses differently than policyholders of smaller companies.

The legislative scheme in the United States permits the federal government to inject funds into an insurance holding company system through payments into the holding company, but does not give the federal government the right to assume control over the insurance company resolution (unless the state regulator refuses to act).[4] It may prove feasible for the federal government to get receivers to take action that promotes the stabilization of the financial system through financial inducement. However, this system remains untested at present.

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[4] *See* Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010) (the "Dodd-Frank Act"), 12 U.S.C. § 5384(d) (regarding funding for orderly liquidation); 12 U.S.C. §§ 5383(e)(1), (e)(3) (regarding the conduct of proceedings under state law unless the state insurance regulator fails to act).

*Legal analysis [Questions 5, 6]* Any development of a resolution plan must begin with a rigorous and realistic analysis of the resolution law and practice in the relevant jurisdictions. The Key Attributes are solid principles for the creation of an insolvency system, but they are not in force everywhere, and even where they are, the implementation of those attributes may differ from place to place.

For example, policyholder protection schemes in the United States are not mechanisms that permit receivers to depart from the system of pari passu distribution. Guaranty associations participate in distributions of assets through subrogation and other mechanisms.[5] Their claims are entitled to equal and ratable treatment with the claims of uncovered policyholders as well as the uncovered portions of claims held by covered policyholders.[6] In fact, guaranty associations in the United States are entitled to early distributions from the assets of an insolvent company ahead to distributions to other creditors, although the ultimate distributions are to be trued up at the end of the case.[7] While guaranty associations have provided funding to transfer business to solvent companies, they are not available to infuse capital into insolvent companies for rescue purposes.

In some jurisdictions (particularly the United States), the courts play a significant role in the implementation of the resolution laws. The Consultative Document suggests that the involvement of the courts may be largely an issue of timing. This underestimates the role of the courts in resolution planning. Developing a resolution strategy will require not only an assessment of the statutes in play, but also the attitude of the courts that will be involved. In some jurisdictions, the courts can reliably be predicted to implement the proposals of the regulator, thereby enabling creative plans, whereas in other jurisdictions, the courts have been less deferential to regulators, thereby making the range of options far more limited. The courts' role in resolution plans is not simply a matter of delay.

*Political realities [Questions 6,7,8].* Insurance company failure has a political dimension that will override planning and international agreement when the consequences of failure are severe. If policyholders are not going to be paid in full or the triggering of policyholders protection will sink other companies or substantially burden the government, the insolvency will draw public attention and the intervention of elected officials. Under those circumstances, governments will not feel bound by understandings reached by regulators which extend across borders. This is particularly so as to the movement of funds. It would be unacceptable politically for a regulator to agree to transfer funds in support of a foreign entity if there were any possibility that a domestic one could fail, leaving policyholders or the government at risk for loss. Because insurance company liabilities are inherently unpredictable, governments will be reluctant to release assets until liabilities are far better known.

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[5] Life and Health Insurance Guaranty Association Model Act, Sections 8K and 14C.

[6] Insurer Receivership Model Act, Section 801; Insurers Rehabilitation and Liquidation Model Act, Section 42.

[7] Insurer Receivership Model Act, Section 803 (A), (F); Insurers Rehabilitation and Liquidation Model Act, Section 34.

This observation is not intended to denigrate the effort of developing plans and understandings among regulators because there is a great deal more to managing the resolution of an insurance company than just funding. The maintenance of common operational shared services makes resolution efforts vastly more efficient, and this is far less likely to be politically sensitive than the transfer of funds. The maintenance of finance-related shared services would also be highly desirable, but may be far more sensitive if it could entail the transfer of assets from one entity to another (whether deliberately or inadvertently).

There is also a tremendous benefit to the planning exercise even where the plan itself is defeated by political considerations. The groundwork for resolution will have been laid. One of the key issues in any resolution among competing participants is to make sure everyone is dealing with the same information. Having a common set of information ahead of a problem will be invaluable. Moreover, the maintenance of access to key information systems across an enterprise should not be politically sensitive. Another key element to developing a plan is a common understanding of how an enterprise functions. This is unlikely to change even if unpredictable events occur. Finally, the acquaintance of regulators with one another and their respective organizations will be an important foundation for building a new plan or resolving the enterprise even if a new plan is infeasible.

*Conclusion.* The enterprise of planning for the resolution of major insurers is worthy of the effort. But in pursuing it, regulators need to recognize that insurance companies are fundamentally different from banks. The top-down strategies that make sense for banks in light of their massive liquidity demands, do not make sense for insurance companies. Regulators also need to recognize that the plans that they devise may not stand up to the political realities of an actual failure. As Colin Powell, a famous United States general, said, "No battle plan survives contact with the enemy." But the process of planning will vastly improve any resolution even if the plan itself cannot be brought to fruition.

Thank you for providing the opportunity to comment on this interesting and important endeavor.

Sincerely,

Harold S. Horwich