



Financial Stability Board, Consultative Document: Effective Resolution of Systemically Important Financial Institutions. July 2011

The ABI's Response.

Introduction

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, employing over 275,000 people in the UK alone. The industry is also one of this country's major exporters, with a fifth of its net premium income coming from overseas business.

The ABI is the voice of the UK insurance, representing the general insurance, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

Underpinning its business activities members have assets under management of £1.7 trillion (end 2010) and in addition manage substantial sums on behalf of third parties. ABI members are major holders of bank equity and bank debt and also the sovereign credit which has traditionally stood behind national banking systems.

We welcome the opportunity to comment on this consultation. ABI members have considered the FSB Consultative Document from two perspectives. First from the viewpoint of insurers, and secondly from the viewpoint of users of banking services - that is as investors in banks and, most importantly, investors in the real economy and with specific reference to bail-in and creditor hierarchy.

Summary

- **We are concerned by the very ambitious timeline** set out for implementation of recommendations relating to globally systemically important financial institutions, and urge the FSB to confirm that a separate timetable will apply to the consideration of insurers.
- The scope and processes of a statutory **bail-in** regime must be clearly defined to give clarity and transparency to market participants. Without a detailed model it is difficult to assess whether, overall, bail-in is likely to be beneficial. We are strongly of the view that statutory bail-in should be applied only at the point of non-viability. The uncertainty introduced by bail-in, combined with the reduction in the implicit state guarantee, will impact pricing across the spectrum of bank debt instruments. Instructions with bail-in characteristics will be less attractive to insurers and other investors who require predictable cash flows.

- Maintenance of the **creditor hierarchy** principles is important for investor confidence, consequently we take the view that **depositor preference** should be limited to insured deposits.
- We recognise that the proposals in the paper apply mainly to banks, and re-iterate our view that **it is difficult to envisage circumstances in which the failure of an insurer would significantly impair the financial system** – and that we do not consider traditional insurance activities to represent a systemic risk.
- **The differences between banking and insurance business must be fully recognised** both in terms of risk and impact of failure, in particular the fact that insurance liabilities crystallise gradually over time ensuring the inherent provision of breathing space to organise a structured wind-up
- We therefore emphasise that **recovery and resolution** tools designed for the banking business model should not be applied to insurers.
- **Additional resolvability requirements should not be imposed where existing regulatory architecture is sufficient** to resolve a failing firm without systemic impact.

Full response to the consultation

Effective Resolution Regimes (Q1-2)

Clearly there is limited scope for comment on the resolution regime as a whole from the perspective of the insurance industry before guidance for non-banks has been issued – however it is vital that any extension of the resolution regime or additional requirements for non-bank SIFIs must be tailored to address the risks posed by the specific areas of business in which the institution operates. In particular, what may be appropriate requirements for banks must not be automatically applied to insurance companies.

There is some inconsistency in the consultation drafting over the extent to which the current proposals are to apply to insurers. In the introduction (p.11) it is clearly acknowledged that not all the resolution powers set out in the consultation are suitable for all sectors and in all circumstances – specifically noting that where insurers conduct bank-like activities, it may be appropriate to apply banking-sector resolution tools “to such activities rather than to the insurer as a whole or to its core traditional insurance business”.

We welcome the commitment to developing sector-specific guidance for insurers and others separately. It is therefore surprising to find specific powers being recommended in this paper (Annex 1 section 4.1(iv)) in advance of that guidance. To begin prescribing supervisory tools without having even established the rationale, methodology or criteria that could establish an insurance company as a SIFI is premature and unhelpful.

Specific resolution powers have been shown to be necessary for G-SIFI banks, where swift and decisive action is key to maintaining market confidence and preventing contagion, particularly for the functioning of the payment system. The role and function of insurers is very different, as highlighted in recent studies by the

Geneva Association^{1 2}, the IIF³ and the IMF⁴. Beyond the application of such resolution tools to bank-like activities as initially suggested, it is not clear that additional powers are necessary or even helpful in resolving a distressed insurer. Furthermore, the range of activities that are considered to fall within the definition of 'bank-like' needs to be clearly specified.

Banking resolution tools must not be simply transposed to the insurance sector: instead, we recommend that the FSB considers the extent to which existing and proposed insurance-specific national arrangements (including Solvency II) already achieve the objectives intended to be addressed by the resolution arrangements proposed for banks.

Finally, and more widely, it is essential that any circumstance in which G-SIFI resolution powers could be used to alter the structure of any financial institution as a going concern rather than letting it fail commercially are very clearly defined in the regime – and provision made for firms to make representations to the resolution authority, and for any disputes to be settled fairly.

Deposit insurance schemes

There are a number of references throughout the consultation to insurance guarantee schemes and deposit insurance. It is vital that insurance and banking sectors bear their own costs and insurers do not cross-subsidise banks. As is widely accepted, the nature of insurers' business models exposes them to a different set of risks than banks. It therefore follows that failure of banks should not be paid for by insurers.

Cross-border Co-operation (Q9-11)

We support the ability of resolution authorities to co-operate with foreign authorities, and strongly agree with the stipulation that there should be no statutory obligation to act in any jurisdiction as a result of official intervention in any other jurisdiction.

Any work on cross-border co-operation in supervision of insurance companies should take into account the co-ordination that already exists at the EU level and also that being taken forward internationally through ComFrame. Where existing co-operation requirements and provisions are already sufficient for effective resolution of insurance companies or groups, care should be taken not to add further, unnecessary layers of requirements.

Resolvability Assessments (Q12-13)

The objective of effective resolution in the context of this paper is described as "resolution ... without severe financial disruption and without exposing taxpayers to loss, while protecting vital economic functions" (Annex 1, preamble).

¹ *Systemic Risk in Insurance – an analysis of insurance and Financial Stability*, Geneva Association, March 2010

² *Considerations for Identifying Systemically Important Financial Institutions in Insurance—A contribution to the FSB and IAJS's discussions*, Geneva Association, April 2011

³ *The implications of financial regulatory reform for the insurance industry*, Institute of International Finance, August 2011

⁴ *Possible Unintended Consequences of Basel III and Solvency II*, IMF, August 2011

The ABI strongly maintains that it is difficult to envisage circumstances in which the failure of an insurer would significantly impair the financial system. The nature of insurance risk, the limited capacity for inter-company contagion, and the fundamental difference between the profile of funding for insurance companies and for banks mean that insurers are simply not subject to the liquidity or interconnectedness risks that banks face.

Even if an insurance company were to be designated as systemically significant, there is no evidence to suggest that it would not be resolvable via existing (or developing) regulatory regimes, standard insolvency procedures or run-off. This is because insurance liabilities crystallise gradually over time providing breathing space to organise a structured wind-up without resorting to the vicious cycle experienced by banks of fire-sales, leading to devaluation of assets, leading to further loss of market confidence and further liquidity pressure, and prompting yet more fire-sales.

In contrast, the incidence of insurance claims is largely unaffected by market sentiment and instead is conditional on specified events; insurers are not reliant on unpredictable wholesale market funding for liquidity; they are not integral to the global financial infrastructure as providers of payment mechanisms.

Furthermore, risk arising from interconnectedness of insurance companies (such as reinsurance contracts) is mitigated by several factors. The total risk is limited to the underlying value of the items insured and dependant on the occurrence of an insured event, as set out in the insurance contract; insurance risks are more diverse than pure credit risk; reinsurance contracts spread a proportion of the risk through a transparent mechanism; and the regulatory regime already requires insurers to assess the risks of connections and hold capital. In this way, transmission of financial shocks is limited and the impact more clearly determinable.

For non-banks, particular consideration should therefore be given to the type of business that is undertaken by the firm – and this should be the primary determinant of whether additional resolvability requirements are necessary. If the nature and activity of the firm is such that existing or developing regulation, including resolution tools and procedures, are sufficient to resolve the firm without systemic disruption or recourse to taxpayer funds, then no additional resolution requirements should be imposed.

Recovery and Resolution Plans and Improving Resolvability (Q14-19)

Stage 1 of the proposed resolvability assessment includes “capacity to apply [recovery and resolution plans] at short notice to the specific SIFI in question”. Given the aforementioned characteristics of insurance business, implementation of recovery or resolution measures is less time-critical than for banks.

When insurance companies fail, they do so in a fundamentally different way than banks – for the reasons outlined above. For a bank, the difference of a few days may have a substantial impact on the potential for successful recovery - or even of resolvability. For insurers it is less time-critical – a reasonable interval for implementation of a recovery plan would be counted in months rather than days (in the case of Solvency II, three months is deemed sufficient). Imposing the same

recovery and resolution requirements on insurers would therefore bring additional costs and burdens without any corresponding improvement in outcomes.

Specifically, a standing recovery plan, no matter how often it is updated, risks being overtaken by events. Keeping a standing recovery plan on the books is useful for a banking institution, where liquidity, market confidence and even successful resolution outcomes are highly dependent on immediate action. By contrast, an insurer that reaches a point where recourse to a recovery or resolution plan is needed will not suffer the same challenges – and will be better served by understanding the range of management actions available specifically in and for the circumstances at hand.

We expect that where resolution authorities are separate from the supervisory authority, and except in crisis situations, the supervisory authority should be the point of interface with regulated firms. The resolution authority should obtain any firm data that it needs from the supervisory authority, to ensure that the burden on firms is minimised.

With respect to Question 14, some confusion remains in the drafting over the extent to which the RRP proposals outlined in the consultation will apply to insurers. Whereas in the introduction to Annex 5 it is stated that all G-SIFIs should have an RRP, later drafting (for example paragraph 1.17) suggests that the proposed requirements have been drawn up with banks in mind.

We are gravely concerned at the prospect of requirements which may be sensible and necessary for banks being applied unnecessarily and with questionable benefit to insurers.

EU regulators already have the power, in the case of insurers, to require a struggling institution to prepare a recovery plan. Solvency II will reinforce these powers. Given the fundamental differences in the structure and operations of insurance business as compared to banking, it should not necessary for insurers to maintain standing recovery plans – and if any such requirement is introduced, it certainly should not need to extend to the same level of detail as banks.

Therefore we oppose a blanket requirement for all G-SIFIs to hold standing recovery plans. Furthermore, given that resolution of insurance companies is considerably less problematic than for banks, we anticipate that in the event that it is felt that an insurer is determined a G-SIFI authorities should be able to develop and maintain appropriate and credible resolution plans using the information gathered through existing regulatory reporting and disclosure requirements.

For any insurance company designated as a G-SIFI, it would be sufficient to require preparation of a recovery plan if and when a breach of the Solvency Capital Requirement (for example, as set out by Solvency II) occurred.

Timelines for the implementation of G-SIFI related recommendations (Q20)

The ABI is extremely concerned about the proposed timetable, which is very ambitious if it is to be applied to all G-SIFIs let alone only to banks. Although co-ordinated efforts have been in place for some time to establish agreed criteria for

identifying G-SIBs, progress on developing corresponding criteria for other institutions (including insurers) has barely begun.

The milestones set out in this consultation would therefore give inadequate time for insurers to make reasonable preparations. This is especially pertinent given that many of the proposed requirements for G-SIFIs are bank-specific and either cannot or should not be applied to insurers.

We assume therefore that these milestones will apply only to G-SIBs and that a separate timetable will follow once the many questions about the existence and identification of G-SIFI insurers have been more thoroughly explored.

The ABI welcomes the recent acknowledgement by the IAIS that work to identify whether any insurers are G-SIFIs will continue into next year. We urge the FSB to confirm this extension at the earliest opportunity.

Bail-in Powers (Q 3-8, Annex 2)

For the purposes of our comments we accept much of the framework set out on page 12 and in Annex 2 of the Consultative Document, that is to say the objective of bail-in, the likely use of bail-in in combination with other resolution tools and the legislative requirements for a successful bail-in regime.

Our members' views on bail-in are mixed. At one end of the spectrum are those who take the view that this further complication of bank capital is unwarranted and that a bank failing to meet regulatory authorisation requirements should be subject to insolvency procedure, like any other corporate, with the safeguard that shareholders and creditors should be offered a last brief opportunity to remedy or rescue the situation so that the institution might be returned to going concern status. At the other end of the spectrum are those who would apply bail-in (in varying degrees of severity) to all debt liabilities largely irrespective of maturity, whether secured or unsecured or involving large numbers of counterparties (with implications for the stability of the financial system).

Irrespective of which end of the spectrum to which our members gravitate the general expectation is that, following the 2008 crisis, regulators will insist on some form of bail-in. What is not clear to them is how beneficial this will be, if at all, particularly if applied in a systemic crisis rather than the idiosyncratic circumstances of one failing institution. The drivers of their concerns are based on the features noted in the Consultative Document, namely clarity and transparency together with consistency and the impacts and consequences, intended or otherwise, of implementation. The key lies in definitions.

In Annex 2 relatively little attention is given to the triggers for bail-in. The definition of the point of non-viability, at which point the trigger is activated, is key for fixed income investors to be able to assess the risk and pricing of any bail-in instruments and the consequential impact on other elements in the bank capital structure. Triggers based on regulatory discretion, such as the failure to meet threshold conditions will be treated by the markets with suspicion and will impact on the cost of capital for banks accordingly. Hard triggers, such as capital ratios are straight forward by comparison, but suffer from being manipulable. A trigger based on a liquidity event suffers from the inability to present a tight definition.

In addition to the points made above, for many fixed income investors an integral part of the point of non-viability would be that existing equity is wiped out in line with creditor hierarchy, and management replaced. However, the latter criteria raise important issues as our members are also equity investors in banks. We return to these corporate governance matters later.

To be effective the scope of bail-ins has to be appropriately drawn. Discussion in various fora has covered the possible exemptions from bail-in including secured funding e.g. covered bonds, short maturities and collateralised contracts or indeed whether existing debt should be grandfathered at least over a transitional period. We would note that a key bank funding product senior unsecured debt which currently accounts for perhaps 5-6 % of the capital structure, is likely to become less attractive if exemptions from the bail-in regime are extensive, thereby generating the likelihood of a more severe haircut on this sector. This factor contributes to the need for consideration of whether authorities should monitor firms' balance sheets to ensure they cover minimum levels of bail-in debt. Absent detailed bail-in proposals our members have no specific comments to make on these issues at this stage. They also note that whilst bail-in can help to re-capitalise a firm it does not provide new liquidity which could be essential and would therefore warrant super-senior status with attention, as noted in Annex 2.11, to the creditor hierarchy.

There are also wider sectorial implications. The availability of bail-in on a large scale clearly signals the limiting of state support for a national banking sector and thereby reduced contamination of the sovereign rating. Sovereign credit is an important asset class for insurers. However, notwithstanding some members' preference for value recovery through resolution rather than insolvency there is a risk that the exercise of bail-in on a wide scale, in a situation of systemic stress, could spread contagion to other sectors such as insurance and the real economy more generally through the impact on investment values.

Turning to bail-in in the banking sector and the investable products it provides, members note that they themselves as insurers are regulated entities and that many of their funds, and those of their pension clients, require predictable cash flows. Thus, other things remaining equal, their appetite for debt with bail-in features is likely to be diminished and they question where the investor base is for bail-inable instruments. For these investors bail-in will also alter their appetite for other bank assets in ways which cannot be easily predicted. Their clients may change mandates to exclude the banking sector altogether. Alternatively fund managers may be given the discretion to invest in individual banks in either or both of covered bonds and subordinated debt, dependent on the risk-adjusted reward criteria employed in fund mandates. This raises the possible prospect of covered bonds becoming the new "senior unsecured" as a bank funding instrument, potentially raising regulators' concern at the level of encumbrance on the balance sheet. If covered bonds were exempt this would limit the efficacy of bail-in in a resolution scenario.

At a more general level our members note that the introduction of bail-in carries with it the possibility of encouraging pro-cyclicality as investors game regulators' actions. This is one factor which could encourage greater spread volatility and implications for the cost of bank capital.

Notwithstanding the view of our fixed income investors that bail-in should be triggered only at the point of non-viability, complex corporate governance issues arise if authorities trigger bail-in at a point before existing equity has been wiped out. As noted above our members invest in both bank equity and debt. The provisions of Annex 2 paragraph 3.2 provide for the issue of new shares on an expedited basis without shareholder consent and existing shareholders pre-emption rights overridden. This is contrary to a fundamental principle of company law as it operates in the EU and which applies to all companies. We believe that any provision to override shareholder authorisation requirements and pre-emption rights should only be operative after the point at which shareholders have demonstrated that they are no longer prepared to commit further equity capital. We consider that accelerated timetables for shareholder authorisation, which concept was proposed in the EU's consultation, would enable urgent equity recapitalisation of banks to be effected.

The proposals would in practice weaken the rights of shareholders and potentially diminish their willingness to enter into constructive engagement as major challenges arise. The overall impact of bail-in in this scenario would be a diminished appetite from the current investor base for bank equity and an increase in the cost of equity capital to reflect the perceived risk. The scenario is not without problems for fixed income investors as the issuance of extra equity to that already existing, at the same time as debt suffers a haircut, impacts on priority ranking (see creditor hierarchy comments below).

Creditor Hierarchy, Depositor Preference and Depositor Protection in Resolution (Q21-25, Annex 7)

ABI fixed income investors fully endorse the statement that “clarity and predictability as regards the order of seniority or statutory ranking of claims in insolvency is a necessary prerequisite for effective resolution” (p.67)

Whilst greater consistency and convergence in statutory ranking of creditors might theoretically promote cross-border cooperation in effective resolution the practical difficulties suggest that this is, at best, a very long-term objective where any change proposed should be evidenced by appropriate cost benefit analysis.

These investors take the view that depositor preference should be limited to insurance via a deposit guarantee scheme. Wider depositor guarantee or general depositor preference, they note, presents encouragement to moral hazard. It also reduces the potential scope of bail-in. Protection whether by insurance guarantee or preference is distortive. Preferential treatment should be reflected in pricing i.e. lower yields. It is also inconsistent: large corporates, for example, have the alternatives of placing money on deposit or in the money markets.

Depositor preference is seen as a minor element and investors distinguish between preference as established in statute and that as established by their understanding of the political environment at any particular time and which would be reflected in market prices.