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Consultation of the Financial Stability Board (FSB) on the application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions

Comments of the German Insurance Association

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General comments:

The German Insurance Association appreciates the opportunity to provide feedback on the FSB consultative document "Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions (Resolution of Insurers: Appendix II)". The German insurance industry has a vital interest in resilient financial markets which are adequately regulated to cope with fundamental crisis situations. Accordingly, we basically support the FSB' efforts to strengthen the resistance of systemically relevant financial institutions in order to limit the detrimental effects on the wider economy and prevent a taxpayers' involvement. In particular, we welcome the FSB' awareness that the "Key Attributes of Effective Resolution Regimes for Financial Institutions" published in October 2011 require some significant adaptions to be suitable for insurance undertakings which are deemed to be systemically relevant. Unfortunately, the draft guidance on the implementation of the Key Attributes in relation to resolution regimes for insurers eventually fails to understand the special characteristics of insurance undertakings under recovery and resolution conditions and, therefore, falls short of the objective to provide a tailored and proportionate resolution approach for insurers.

- ***Insurers are very different from banks and other market participants***

The guidance still reveals a considerable misperception of how insurers operate both in going concern and resolution situations. In particular, we do not agree with the assumption that existing tools such as run-off and portfolio transfers may be inadequate to cope with a "sudden deterioration" in the viability of an even larger, complex insurance group. Unlike banks, the unique features of the insurance business model and the way insurance liabilities are funded and claims are settled, prevent insurers from experiencing emergency situations which are critical in terms of time. Investments and reserves are pre-funded by insurance premiums and carefully and effectively calibrated to match the long-term liabilities of insurers. In contrast to the banking-sector, the lack of close business relationships between competing insurance companies excludes the so called "domino effect" in the insurance industry. In addition, the principle of separation of business lines for life and substitutive health insurance leads to the self-sufficiency of these sectors also within insurance groups. As a consequence, crisis situations do not occur "overnight" and do not require abrupt regulatory action to ensure an orderly resolution. Falsely assuming the need for accelerated intervention and applying measures mainly designated for the resolution of systemically relevant banks is likely to cause detrimental effects in insurance, especially in terms of preserving company assets for an appropriate protection of policyholders.

- ***Lack of focus on systemically relevant activities***

We are surprised and seriously concerned that the proposed resolution regime is not limited to those rare cases where systemically relevant activities undertaken by an insurer -regardless whether designated as Global Systemically Important insurer (G-SII) or not- might threaten its viability and the rest of the financial system.

We acknowledge that the identification methodology and the measures on G-SIIs published by the IAIS in July 2013 remain questionable in terms of systemically relevant activities in the insurance sector. Efforts should therefore focus on further specifying this guidance and not on the introduction of new and undefined terms such as "systemically significant" and "critical in failure". Such an ambiguous definition of scope may lead to the conclusion that the resolution requirements are supposed to apply to a broader range of insurance undertakings irrespective of their potential to cause systemic implications.

Overall, the suggested route seems to be highly disproportionate if applied to complex groups where legal entities are not set up according to business lines. Applied vigorously, it could remove any synergy/diversification benefits in a holding structure and impede fungibility of assets. This would be counterintuitive and hardly consistent with the resolution objectives stated by the FSB.

- ***Emphasis on "essential functions" loses track of financial stability considerations***

We are also worried that the FSB requirements on Recovery and Resolution Plans (RRPs) put a strong emphasis on maintaining "essential functions". The proposed catalogue of essential functions should cover, among other things, fundamental aspects such as the provision of services and intra-group transactions including reinsurance and intra-group support which are vital to ensure risk diversification and fungibility of capital resources in a group structure. This extensive interpretation gives reason to believe that the FSB assumes the entire core business as systemically relevant. As a result, insurers could be incentivized to ring-fence traditional business lines in order to maintain the continuation of insurance contracts at any cost and under any circumstances. This is not only a misconception of policyholder protection as a resolution objective. On the contrary, it would even destabilize the group (by damaging diversification of risks and fungibility of assets) rather than contributing to financial stability and the safety of insurance coverage. Other than in banking global activity makes an insurance group safer as it allows group-wide risk diversification.

Moreover, the requirements on RRPs partly suffer from unrealistic expectations. For instance, providing all actuarial assumptions used for calculating insurance liabilities and an independent exit value actuarial valuation of the technical provisions is a undue burden and hardly manageable, especially in large and complex insurance groups.

- ***Legal implications***

Any of the measures proposed for recovery and resolution must (when implemented) comply with generally recognized principles of mandatorily applicable law such as the principle of proportionality and the protection of ownership rights. Some of the proposed measures for restructuring of liabilities and the proposed handling of the pari-passu principle go beyond of what is currently permissible under insurance supervisory law in many jurisdictions (e.g. creation of subclasses of existing policyholders, encroaching on collateralized creditor rights).

Questions raised by the FSB:

Question 22:
Are the general resolution powers specified in KA 3.2, as elaborated in this draft guidance, together with the insurance-specific powers of portfolio transfer and run-off, as specified in KA 3.7, sufficient for the effective resolution of all insurers that might be systemically important or critical in failure, irrespective of size and the kind of insurance activities (traditional and 'non-traditional, non-insurance' (NTNI)) that they carry out? What additional powers (if any) might be required?

The underlying assumption of this question is that the potential systemic relevance of the insurance sector requires regulatory action with regard to the legal frameworks for resolution of insurers. We strongly believe that there is neither a need nor a justification to even consider the implementation of the full range of resolution powers set out in KA 3.2. This regime is clearly motivated by the concern that immediate regulatory intervention is inevitable to avoid contagion effects to other significant market participants. However, in contrast to banks, insurers are not prone to experience sudden cash drains which would impose the need for an accelerated resolution process. The long term nature of insurance liabilities and their extended run-off profiles provide the time necessary for deliberate and balanced action serving the interests of policyholders and financial stability. Adopting a regime that is tailor-made for banks would not take due account these unique characteristics and rather impede the orderly resolution of insurers.

Apart from that, insurance regulators in Germany and Europe already have extensive statutory powers to restructure and wind up insurance companies which are widely consistent with the instruments listed in section 4 of the Insurance Key Attributes. With regard to bail-in, it needs to be recognized that insurers do not rely on this form of recapitalization to a considerable extent. The insurance business model is funded by premiums collected in advance and not exposed to debts and leverage. Therefore, the amount of increased loss absorbency generated by bail-in would be negligible and disproportionate to the interference with creditor's rights.

Question 23:
Should the draft guidance distinguish between traditional insurers and those that carry out NTNI activities? If yes, please explain where such a distinction would be appropriate (for example, in relation to powers, resolution planning and resolvability assessments) and the implications of that distinction.

The guidance should exclusively focus on activities which -according to the definition provided by the FSB itself- cause the risk of disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy. The IAIS has started to offer some guidance in this respect which yet needs to be further specified and elaborated with the industry before new concepts such as "vital economic functions" and "critical types of insurance policies" are being introduced.

Question 24:
Are the additional statutory objectives for the resolution of an insurer (section 1) appropriate? What additional objectives (if any) should be included?

The introduction of new terms like "vital economic functions", "essential and systemically important functions" and "critical types of insurance policies" shifts away the focus from identifying systemically relevant activities to the general viability and maintenance of insurers and policyholder protection in recovery or resolution scenarios. The latter are much broader concepts which might be difficult to reconcile with the mandate of an international body like the FSB specifically entrusted with focusing on risks to the global financial system. As a consequence, the FSB guidance would overlap with existing insolvency regimes at local level which have proven to be adequate for the resolution of insurers. Apart from that, an alignment of existing insolvency regimes with the FSB guidance would raise a number of complex legal issues and constitutional constraints at national level.

While we agree that the protection of policyholders should be a statutory objective of a general resolution framework (and prudential supervision), we do not believe it should be one of the primary objectives of a systemic risk regulation regime (Section 1.1). An international body like the FSB should focus on threats to the global financial system. If understood as an

aim in itself, policyholder protection seems to be a local issue falling out of the global mandate of the FSB.

Moreover, the FSB' guidance shifts - as indicated by the reference to "essential" and "critical" functions - away from systemic considerations to proposals that cover the full spectrum of insurance products, including those derived from traditional business lines. This is not consistent with the overwhelmingly shared conclusion that core insurance business is not prone to systemic risk.

Question 25:
Is the scope of application to insurers appropriately defined (section 2), having regard to the recognition set out in the preamble to the draft guidance that procedures under ordinary insolvency law may be suitable in many insurance failures and resolution tools are likely to be required less frequently for insurers than for other kinds of financial institution (such as banks)?

We believe that both the tools currently available to supervisors and the future framework for the supervision of insurance undertakings - in Europe embodied by the upcoming Solvency II - ensure an orderly recovery and resolution of insurers. These tools take adequate account of the insurance business model, and the prolonged time period in which situations unfold. However, the indifferent scope of application, in particular the extension to insurers which are "critical in failure" seem to contradict this conclusion and is likely to affect insurers which by no means have any systemic impact.

Moreover, with respect to the identification of the relevant resolution authority, a clear distinction needs to be drawn between additional powers to be granted to the insurance regulator acting as administrative insurance supervisory body on one hand and additional instruments that are made available in connection with an insolvency procedure under the control of an insolvency court. The FSB guidance currently lacks this distinction.

Finally, any new resolution instrument must also be closely aligned with new risk-based frameworks such as Solvency II. Anything else would for EU membership countries immediately contradict the new regulation which presumably is to be implemented by January 2015 and applicable from January 2016 onwards. So far neither politicians nor supervisors have been able to explain why Solvency II as a highly sophisticated, risk-

based system should not be sufficient to deal with (potentially) systemic activities.

Question 26:
Does the draft guidance (section 4) adequately address the specific considerations in the application to insurers of the resolution powers set out in KA 3.2? What additional considerations regarding the application of other powers set out in KA 3.2 should be addressed in this guidance?

No. In particular, the criteria for non-viability as a precondition for entry into resolution set out in section 4.1 are vague and lack a thorough consideration of the long-term perspective of insurers. It remains unclear at which stage regulators should assume an „unacceptably low probability" of due and full payments to policyholders. The distinction between viability and non-viability is very important for insurers in crisis situations. As a general rule, there is a full range of recovery options available to regulators which deserve preferential consideration before contemplating resolution procedures. Given the considerable extent of discretion attributed to regulators, there is an immediate concern that regulators are tempted to prematurely step into resolution although there may be reasonable potential for recovery measures in order to maintain the viability of the insurer (we also refer to Q 25 above).

Question 27:
Does the draft guidance deal appropriately with the application of powers to write down and restructure liabilities of insurers (paragraphs 4.4 to 4.6)? What additional considerations regarding the application of 'bail-in' to insurers (if any) should be addressed in the draft guidance?

We basically agree that the restructuring of liabilities (including, as a matter of last resort, also guarantees given to policyholders) should be considered prior to a winding-up of an insurer under stressed conditions. However, given the policyholder and creditor rights affected, regulators need to be sensible to the laws applicable in the corresponding jurisdiction and aware that court approval could be necessary to enforce restructuring measures. With regard to the application of bail-in (of creditors or other policyholders), we reiterate our view that this instrument has little value in insurance. In contrast to banks, insurers do not extensively rely on funding through bonds or other forms of debt financing since they usually have access to a solid funding base generated by insurance premiums.

Question 28:
Is it necessary or desirable for resolution authorities to have the power to temporarily restrict or suspend the exercise of rights by policyholders to withdraw from or change their insurance contracts in order to achieve an effective resolution (paragraph 4.9?

As mentioned in our answer to question 27, the restriction of policyholder rights, of course safeguarded by the consumer protection laws applicable, has to be taken into account if thereby a winding-up could be avoided.

Question 29:
Are there any additional considerations or safeguards that are relevant to the treatment of reinsurers of a failing insurer or reinsurer, in particular to:
(i) the power to transfer reinsurance cover associated with a portfolio transfer (paragraphs 4.7 and 4.8); and
(ii) the power to stay rights of reinsurers to terminate cover (paragraph 4.10)?

The power to "stay any right to no longer reinstate reinsurance cover upon payment of a premium" would require that, as a general rule, reinsurers do have the obligation to reinstate reinsurance against payment of a premium which is, generally speaking, not the case. This would be a massive intervention in a balanced commercial agreement causing an unintended and incalculable impact on the counterparty affected. Thus, the powers set out in section 4.10 should be abandoned.

Question 30:
What additional factors or considerations (if any) are relevant to the resolvability of insurers or insurers that carry out particular kinds of business (section 8)?

As mentioned before, the preconditions for entry into resolution set out in section 4.1 suffer from an inappropriate concept of non-viability of an insurer. The guidance needs to reflect that - due to the long-term perspective of insurance assets and liabilities - maintaining or restoring viability should be the key motive of regulators instead of rushing into early resolution. This should be accompanied by a narrow definition of non-viability emphasizing that resolution should only be considered as a last resort.

Question 31:
What additional matters (if any) should be covered by recovery plans or resolution plans for insurers or insurers that carry out particular kinds of business (section 9)?

Generally speaking care should be taken that overreliance on recovery and resolution plans does not obstruct the regulator's objected view on what it is necessary in the concrete situation Insurers are different from banks. Thus, a simple adaption of bank related concepts and assumptions for insurance is inappropriate und does offer only very limited value for regulators. Content and direction of recovery and resolution plans and measures therefore need to focus on a limited number of realistic and manageable scenarios taking into account insurance specifics.

Question 32:
Are the proposed classes of information that insurers should be capable of producing (section 10) feasible? What additional classes of information (if any) should insurers be capable of producing for the purposes of planning, preparing for or carrying out resolution?

We refer to our answer to question 31. Given the questionable value of recovery and resolution plans for insurers, the burden of providing an excessive amount on information is entirely disproportionate.

Question 33:
Does this draft Annex meet the overall objective of providing sector-specific details for the implementation of the Key Attributes in relation to resolution regimes for insurers? Are there any other issues in relation to the resolution of insurers that it would be helpful for the FSB to clarify in this guidance?

Referring to our general comments and answers stated above, we reiterate our belief that the draft guidance fails to meet the objective to provide a comprehensive sector-specific application of the FSB Key Attributes for insurers. More analysis is strongly needed to properly understand how insurers operate in order to ensure a tailored approach in terms of recovery and resolution. The German insurance industry remains committed to support the FSB to measure this challenge.

Additional remark:

We appreciate that the paper expressively states the continuation of insurance contracts through an insurance guarantee scheme as a very effective solution. From our point of view the member states of the European Union should decide by themselves if they want to use the system of contract-continuation or of financial compensation for the policyholders in default scenarios. To stress the point that these two options are alternative features for a national insurance guarantee scheme and not meant as cumulative requirements, at the end of Sec. 6.1 should be used an "or" instead of an "and" between those two alternatives.

Berlin, 15 th October, 2013