Institute
and Faculty
of Actuaries

Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions

Consultative Document

15 October 2013

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Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

15 October 2013

Dear Sirs,

Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Consultative Document (CD) 'Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions'.

Actuaries undertake important roles within the insurance industry and their expertise is critical to the development and successful implementation of good risk management practices, which reduce the probability of insurers failing. This response has been prepared by the IFoA's Resolution and Recovery Working Party whose members have experience of, and expertise in, the insurance industry; and therefore, this response focuses on Section II Resolution of Insurers.

Good work has been done by actuaries and others, to reduce the risk of insurers failing. The IFoA encourages efforts towards a clear regulatory framework that underpins the activity of supervisors, in regards to the prudential and conduct-related aspects of an effective resolution framework. This draft guidance is a significant step towards providing the clarity that is needed but there remain areas where further refinement is required; to either address areas of residual uncertainty; or to address more effectively the specific issues as they relate to insurance.

The IFoA's general comments are outlined in this letter. The specific points our members raised in response to the questions posed are included in their entirety as Annex A.

<u>Interaction and interface with existing laws, regulations and company structures</u>

There are a number of issues that may hamper the effective implementation of the FSB's objectives concerning the regulatory structures currently in place, namely:

- The IFoA supports the FSB in addressing the potential for conflict between the actions of an insurance regulator (e.g. in respect of bail-in) and "normal" trading company insolvency laws and regulations. It is important for companies to have clarity to develop complete and robust resolution plans. It is also important for the regulators to understand the legal structures of the systemically most important insurance groups as the work proceeds.
- Resolution and continuity is often implemented locally in the insurance sector, as a consequence of it being more common to create subsidiaries rather than branches. The legal

entity focus of the typical insurance group operating model, leads to solo capital and funding considerations.

- Resolution laws generally differ between jurisdictions and can impact an insurance group's recovery and resolution planning. It is important for insurance groups to understand 'local' regulatory powers before 'resolvability' can be properly assessed. Uncertainty can exist for an insurance group regarding cross-border operations. An overriding imperative for the immediate regulatory authority concerned is the unilateral actions that could be taken by local policyholders.
- Many countries have mechanisms to support the continuity of insurance cover, however, in many cases these are not currently aligned with an international framework. Collective policyholder protection funds currently operate on a national basis. However, G-SII / IAIG resolutions are likely to be cross-jurisdictional affairs. These differences could lead to imbalances in how policyholders are impacted by the resolution strategies adopted and inequitable use of the resources available. The IFoA would support greater efforts by the International Association of Insurance Supervisors (IAIS) to converge requirements amongst insurance supervisors to achieve a level of consistency.

Differences across jurisdictions for an integrated approach

At a global level, the measures of insurance company solvency vary, as do the approaches adopted by regulatory regimes to protect policyholders. For instance, across jurisdictions, different views are taken on the level of claim reserves relative to the level of solvency capital. Financial strength cannot be accurately evaluated without taking account of both. The IFoA supports the initiative to establish an international resolution framework spanning jurisdictions, though recognises the disparities that currently exist across jurisdictions and indeed across companies also need to be addressed.

Within the 28 member states of the European Union (EU) a more integrated approach to insolvency structures and requirements could be considered given Solvency II will, from 2016, act as a single prudential framework. The possibility of creating a European-wide framework for compensation schemes for policyholder protection purposes could become part of those considerations. It is also possible that cross-border cooperation and implementation concerning systemic risk analysis could be better facilitated by group supervision effected at the European level. EIOPA may have a role to play in group-wide supervision of the larger European insurance groups, assisted by local regulatory authorities where required. Given the recent announcements regarding plans to enhance the role and coverage of bank supervision via the European Central Bank this could provide a better facilitated European response amongst supervisors, particularly in crisis situations by providing a single reference point for insurance groups and consistency between sectors.

Risks of unintended consequences

The IFoA has identified some instances where giving powers to regulators may, give rise to unintended consequences as they interact with the pressures facing insurers or reinsurers. For example, the additional powers that allow regulators to intervene and direct the actions of reinsurers (who have taken on business from a company that finds itself in resolution) might have the effect of preventing companies from finding the reinsurance they need, at an affordable price, as reinsurers opt not to take on this additional regulatory risk. These points are covered in more detail in answers to question 29 in Annex A.

Policyholder rights and helping them take good decisions

While the objective of achieving continuity of coverage is established for the purpose of reducing the impact of failure, the guidance does not address the issue of whether policyholders need to be advised to avoid them surrendering their policies when that may not be in their long term best interest.

There is also the issue of policyholders withdrawing when it is in their own interests, which can impact the value of the benefits for those who remain. The guidance focuses on powers to mitigate the mass surrender risk, including proposals to restrict the rights of policy holders to surrender their policy. However, the right to surrender (or retire early) is usually a key policy benefit and its withdrawal is likely to considerably heighten policyholders' concerns. Additionally, in several types of contract, continuity of cover will depend on the payment of future premiums. Continuity in the payment of premiums from policyholders will often be outside of the authority's control and cessation could compromise the cover that is available. For short term contracts, which would normally be the case in general insurance, the continuity challenge is to find ways in which policyholders may rapidly obtain cover elsewhere. This is a different challenge to that of the resolution of failed insurers.

Impact of continuing new business

In a resolution scenario, the insurance company, under the control of a resolution authority, may continue to enter into new contracts of insurance and reinsurance. The objectives given in such a case are "maximising value for policyholders" and "providing continuity of insurance coverage". The IFoA sees potential for conflict here, particularly in situations when the origin of the failure stems from the very policies that continue to be issued. The IFoA believes that consideration should be given to changing this objective to conserving value for policyholders.

Ensuring clarity of roles

The IFoA suggests that more needs to be done to make the roles of regulators, protection schemes and company boards/ senior management clear. It may be useful for the FSB to consider giving further details on the roles that should be performed by each party. This could extend to Chief Risk Officers, Risk Function and Actuarial Function.

More detailed comments relating to each question are attached as Annex A. Should you want to discuss any of the points raised in greater detail, please contact Paul Shelley Policy Manager (paul.shelley@actuaries.org.uk, +44791 760 4985) in the first instance.

Yours faithfully

Nick Dexter
Chair Recovery and Resolution Working Party

Annex A

Question 22

The powers are drafted very widely and in theory should be sufficient. The issue in practice will be whether those powers are actually available to regulators. For example, some powers might conflict with primary legislation in individual jurisdictions (e.g. Companies Acts, insolvency legislation), particularly in respect of the priorities of different classes of policy-holder and existing mechanisms for provisions for compensation (e.g. the Financial Services Compensation Scheme (FSCS) in the UK).

Certain insurance specific powers (e.g. portfolio transfer), are also regulated in the EU by primary legislation, this may cause practical difficulties in a resolution situation. A portfolio transfer in the UK would require a court hearing, with the judge taking advice from an independent expert, who is not employed by the company or its sponsoring agencies and other authorities including the regulator. There is a requirement that there is no material detriment to policyholder security or benefits as a result of the judge approving the transfer. The IFoA envisages that in a resolution situation there would be different classes of creditor and can foresee many complex negotiations for the independent expert and judge to sign off on any transfer where the resolution authority has ensured equity with other policyholders/ creditors not involved in that particular portfolio transfer.

Achieving consistency of these powers across different jurisdictions would be welcomed, especially in Europe, which under Solvency II will operate under a single prudential framework. However, significant differences currently exist across different jurisdictions in regards to consumer rights and legal processes in the event of a resolution arrangement.

There are some key governance issues which need to be addressed to enable the regulator to take responsibility and act appropriately:

- There should be a well-articulated and widely understood order of priority in terms of who gets what when an institution fails. For example, with a bank it could be that depositors all get priority, then all unsecured creditors, followed by shareholders. Whereas, for insurers, the hierarchy of priorities is a political decision.
- The regulators would need to recognise that they are unlikely to have all the necessary experience and expertise in house at all times. The IFoA suggests the implementation of a mechanism that enables an advisory group to be convened at short notice. Given the public interest priorities and the need to acknowledge and manage conflicts of interest this requires advanced thinking about the criteria for such a group. With this advance thinking in place, it will be easier for the regulators to have the confidence to act.
- At a company/ group/ entity level, the issues will be in the detail of the inter-group relationships, with the constraints created by the legal structures. These will need to be clearly understood in any resolution planning.

Question 23

The IFoA notes that insurance specific powers may not be adequate for NTNI (non-traditional non-insurance) activities. Portfolio transfers and run-off powers are targeted at traditional insurance portfolios, however, the general powers noted in KA3.2 are wide and generic and the IFoA does not believe that any distinction needs to be made. The IFoA also notes that the risks and issues within some material NTNI activities would be different from those within traditional insurance. The IFoA suggests that for material NTNI activities and any guidance on recovery and resolution planning ensures that specific attention is given to NTNI activities within the planning. In terms of resolvability, it may be appropriate to state that the resolution authority needs to have specific expertise to determine the appropriateness of the actions suggested to resolve NTNI activities. Where applicable,

especially for the non-insurance (NI) activities, there should be consistency with the approach considered for other institutions that conduct similar activities. It is important that the hierarchy of priorities is sufficiently comprehensive and principled and that decisions on how to deploy the assets, and to whose benefit, can be made easily. The IFoA is supportive of efforts to achieve international consistency in regards to this guidance.

The constraints imposed by the legal structures within a group will need to be considered. The IFoA understands that the powers proposed will not extend to overriding the structures of company law. For example, if a subsidiary company is solvent but the parent is not, the IFoA's understanding is that the regulators under these powers could not take value from the beneficiaries of the solvent company to help out those of the insolvent parent. The IFoA would appreciate further clarity from the FSB on this point.

This principle is important if a group engages in NTNI activities. The legal structure of groups in which this is done should be an ongoing concern for all regulators before any problems arise. This is where the importance of group wide supervision and the supervisory college mechanism becomes critical and why international consistency on such measures becomes necessary. The resolution powers and the arrangements to use them may well be more effective if there is a principles-based approach to resolving all groups, irrespective of how they or their business is characterised.

Question 24

The IFoA has not identified any need for further objectives.

As well as an orderly run-off, there is a need to ensure continuity of cover in particular markets. Especially for those classes of insurance where in practice there are a small number of providers. The IFoA considers this objective to be covered in paragraph (i) of the preamble to the 'Key Attributes' document, namely "ensure continuity of systemically important financial services". The FSB may want to consider making this point more explicitly.

Section 1.2 has a wide definition of vital economic function, which in theory could include all insurance activities. The guidance could lay down principles that would determine whether certain insurance activities are of vital economic importance or not.

Question 25

The IFoA believes that the scope is not defined clearly; it does not say who determines whether an insurer is systemically significant or critical. Given that there would be processes to determine G-SII and D-SII, the scope could refer to this process.

Question 26

Standards or indicators of non-viability will inevitably include subjective elements and so it is essential that the supervisory authority can exercise judgement to determine (i) through to (v) of Para 4.1, and that it is explicitly required to do so following a progressive staged process where possible and when appropriate.

The IFoA suspects that in most regimes, including that in the UK, balance-sheet insolvency would commence before the listed risks in i) through to v) in Para 4.1 commence. In the IFoA's view, it will be difficult to define when a company is "balance-sheet insolvent" in practice and invites further examination. It is difficult to know for example, where solvency margins sit in the definition of balance sheet insolvency, and what are "unacceptably low probabilities" relative to solvency margins.

The IFoA believes that the requirement in Para 4.1 (v), that resolution cannot be achieved through ordinary procedures alone, may be complex, controversial and time-consuming to verify in practice, and therefore may set too high a hurdle for entry to the resolution regime.

Non-viability may also arise from serious operational failures, which may occur even if a firm is financially strong. Resolution powers should consider such scenarios and not be confined to purely financial failure.

In Para 4.3, the aim of "conserving value" for policyholders as a whole may be better than "maximising value". For example, how would the resolution authority balance "maximising value for policyholders" and "providing continuity of insurance coverage" if the objectives were in conflict? Also, Para 4.3 iii) could contain guidance on the circumstances in which it might be appropriate for insurers that have fallen into a resolution situation to be free to enter into "new contracts of insurance and reinsurance".

Question 27

Continuity of insurance should include provision for the additional benefits secured by future premiums (i.e. on-going premiums paid after the insolvency) to be protected and to be commensurate with those premiums.

The priority of inwards reinsurance policies relative to direct policies in the ranking of creditors is a key issue for financial stability and for resolution. There appears to be an assumption that inwards reinsurance has a similar priority to direct policies in an insolvency, whereas currently in the EU this is not the case.

Reinsurance may present particular challenges in a resolution situation, and some of these will become clear when "dry run" exercises are carried out by the regulators. Some of these challenges may need to be considered in on-going solvency and prudential reporting. The challenges presented by reinsurance are discussed further under question 29 below.

The IFoA believes that consideration should be given to adding a power to override policy/ contractual structures that are contrived principally to secure priority advantage for the policy over other creditors. In addition, the IFoA notes that the ability to increase the values of insurance contracts after restructuring in relation to the performance of the business would be optional. Despite the voluntary nature of this provision, the IFoA is concerned about the implication that values could be routinely subject to revision based on trading performance and then only in an upwards direction.

Question 28

Surrenders (including early retirements) and policy changes are core components of policy benefits and so they should not be suspended in insolvency or near insolvency. Unless the circumstances are such that practically all policy transactions have to be suspended. In most countries a resolution authority is likely to encounter political and practical difficulties in attempting to force policyholders to continue paying premiums in this context.

Question 29

Reinsurers are a service provider to the failed insurer. The resolution authority may be able to acquire powers under these proposals to override insolvency clauses, requiring all service providers to maintain (and if appropriate renew) their contractual services. However, as reinsurance is frequently international in nature; reinsurers have a need to control their exposure to maintain their own financial strength. If the terms on which they accept risks are capable of being materially changed post underwriting, especially if adversely in stressed situations, this will constrain the basis

on which they are prepared to give cover. Unintended consequences of the regime as it interacts with the commercial pressures of insurers and reinsurers will need careful consideration.

In determining policy and practicality for outwards reinsurance protections (i.e. assets of an insurer), reinsurance arrangements are sometimes set up for very specific purposes. For example, a company may have accepted, through the operation of a legal process (in the UK this would be a Part VII transfer), a particular portfolio of liabilities from another insurer. In that process, the court would have wanted to be satisfied that neither the transferring policyholders nor the pre-existing policyholders were materially adversely affected by the transfer. As part of giving the court that assurance, a reinsurance protection may be put in place that responds only to the losses of, for example, the transferring policyholders, and there may be a stipulation that the benefits of that reinsurance protection go to the transferring policyholders and not the pre-existing policyholders. If the regulators have the power to change who gets the benefit of the reinsurance, they will need to be well aware of the background. It is likely that the same regulators will have had a hand in approving the arrangement at the time of transfer.

In some jurisdictions, underlying insurance claimants may have rights to directly pursue reinsurers in the event that an insurer fails. Resolution powers envisaged in this consultation would presumably negate these rights.

Finally, a number of the reinsurance protections that the reinsurer gives to cedants will have special provisions in place to enhance the security for those cedants. Resolving these may be particularly challenging. There may be letters of credit arrangements with banks, and there may be trust fund arrangements with independent trustees. A number of transactions have in the past been required by regulators to have particular protections in place, without which those transactions would not have proceeded. Those protections have been designed to ensure that even if the reinsurer got into financial difficulties, the credit risk exposure for that transaction would be limited, effectively giving an advantage to that particular cedant in the event of financial difficulty for the reinsurer. Resolution is the very circumstances for which these provisions were designed.

Question 30

The IFoA has provided comments on this question on the basis that it refers to Section 9 of the paper rather than Section 8.
The IFoA considers the additional factors relevant to this section are:

- The fungibility of any surplus assets between jurisdictions in stressed conditions.
- The availability of human resources and particularly key persons. For example, employees may not be employees of the entity that fails, even though they may be permanent staff of the company (for example, staff may be contractually employed by an internal employee services company).
- The Custodians of assets ought to be considered.
- The Requirements for continuity of cover for insured lives.
- Products that participate in profits (i.e. with profits) may need particular consideration due to, for example, schemes of demutualisation, or shareholder/ policyholder gates and how are they treated in resolution.

In relation to the specific areas the resolution strategy should cover that are set out in 9.3:

i. The IFoA believes it will be difficult to assess the likely availability of a transferee or purchaser for any insurance business as it is likely in the extreme stressed conditions being considered that other players in the market are impacted by similar factors. However, if the intention is for the regulator to assess this qualitatively, based on the overall size of the company, or how likely it is that the type of business being considered does or does not contain unusual

features or risk, then this exercise could provide some misguided comfort in assessing the resolution strategy.

ii. The key area that will drive the time taken for companies to evaluate policyholder liabilities would typically be the availability and quality of the data, particularly if outsourcing is involved. Internal and external data will be needed to assess likely future experience so these tie into the quality of management information included in (v).

iii. It is difficult to assess the capacity of a policyholder protection scheme in a future stressed scenario and the extent to which the protection scheme would contribute. As there is a need for the regulator and the protection scheme to decide what the protection scheme's share would be of any payments or capital, in particular, if it is a capital shortfall rather than assets being less than best estimate liabilities. In the IFoA's view the role of a protection scheme would need to be clarified in the resolution of an insurer.

iv. In a solvent run-off it is important to set out who would provide capital resources, on what basis, and how much, as it is likely that in a resolution situation capital requirements will not be met. Meaning the decision on what benefits should be paid to different categories of policyholder whose benefits are due at different times needs to be considered. As well as whether any policyholder benefits may need to be reduced. It will also be necessary to consider the interaction between insurance company legislation and local insolvency laws/ practice in terms of ranking of creditors and when winding-up legislation operates.

v. It is not obvious why the type of policyholder, as opposed to policy or contract is relevant. Clearly, assets and liability data is required but it would also be helpful to have guidance on what granularity is needed. In addition, the benefits due will need to be considered carefully, particularly where a company has some discretion over payments, such as for participating life insurance contracts.

vi. The IFoA notes that it is not necessary for corporate structures and business units to be aligned with legal entities and there will be practical implications in determining if it is possible to break up those structures or business units in the event of a sale.

vii. It will be important that full consideration is given to the interplay of company law and insurance company law with the regulatory regime in each jurisdiction. Particularly as the power of receivers or liquidators may apply and the ability of regulators to override their powers may be constricted.

viii. The IFoA believes it is more appropriate to consider the extent of legal, operational and financial connectivity of the insurance and non-insurance business in a group, rather than looking at how separated "traditional" business is from "non-traditional" and non-insurance business. The allocation of business into these three segments appears to be artificial and could lead companies trying to influence which business goes into which segment, while not addressing the underlying risks.

ix. The IFoA agrees that it is important to consider how continuity of services could be achieved, but it is not apparent why intercompany service agreements themselves would achieve this when companies may be sold or cease to exist.

x. The IFoA believes it is also necessary to consider the actions of third parties prior to a company being in resolution.

In relation to the specific areas the resolution strategy should cover that are set out in 9.4:

i. It is important that there is common understanding of what is classed as a "disruption" and how long would it need to last for it to be classed as material disruption. Also, it is important that "the market" being considered is clear, for instance, is it being defined in reference to the product type.

ii. A policyholder run isn't necessarily as big an issue for the insurance industry as it is for the banking industry due to the structure of the contracts and the reserving requirements for insurance companies. However, it is important to consider the indirect impacts of a run, such as the impact on the company's expense base, which might make the company less viable.

In the short term there could be liquidity issues arising for some types of policies. It is not the clear if (ii) is referring to the macro issue that policyholders terminate policies although it is not in their long term interest.

iii. The IFoA believes it is important for there to be clarity on how adverse the impact needs to be for it to be considered material.

iv. The sale of large blocks of assets could have an impact on financial markets.

Question 31

The IFoA agrees with 10.1 but believes that all insurers should, as a minimum, have a recovery plan to ensure a consistent level of preparedness across the industry. However, such plans should be proportionate to the size, complexity and systemic risk of a particular company.

The IFoA agrees with 10.2, but questions the need to list extensively which items to take into account. The list is not, and cannot be exhaustive, for example, it could also include the legal entity structure and many of the items in sections 10.3 and 10.7.

The IFoA agrees with 10.3. However, an additional matter that needs to be considered is employment contracts that may not be mapped directly to the legal entities within which the functions are performed. For example, the IFoA would like to see clarity over how and what is deemed critical and/or a priority. For point (i), the IFoA requests clarity as to whether this is just for writers of this business or users of these as well.

In 10.7, the list of actions (i) to (viii) looks to be almost in the reverse order of what a board might do in practice. The IFoA suggest starting with changes to new business flow and if that is not sufficient look at reinsurance and investment strategy and then look at raising further capital. Is the order of (i) to (viii) deliberate and should any meaning be taken from it?

The IFoA agrees with 10.8, but suggests that clarity is needed as to the basis of determination of "solvent run-off".

In relation to the specific areas the resolution strategy that are set out in 10.10 should cover:

ii. In the IFoA's view there needs to be clarity on the need to have an independent exit value valuation in all cases and what this implies in practice. Such as does it mean an embedded value calculation, and is it on base or stressed assumptions?

iii. It ought to be made clearer whether this includes information on less liquid assets and how they are valued. The IFoA also notes that the issue here is not about the current value of the asset. It is about the values of assets in a resolution situation when the investment markets may not be as deep or liquid as under normal circumstances.

iv. The IFoA believes greater clarity is needed on what "preparation" means. Is it referring to operational considerations i.e. identifying parts of the portfolio which may be sold more easily?

v. There needs to be further guidance from the UK FSCS for protection schemes over what actions they would take in particular scenarios.

vi. The IFoA assumes this means working through scenarios and planning how it may work but again it will be difficult to be too certain in stressed conditions.

vii. The IFoA would like more clarity on the term "impact on recovery levels". Is this point referring to potential credit risk?

viii. The IFoA notes that for life insurers run off is probably more likely than winding up. Also, the estimated outcome for each class of policyholder would depend on the scenario that leads to resolution and any estimates produced in normal circumstances may not be useful.

ix. It is not clear why practical arrangements only apply to certain types of insurance policies and not all policies.

Question 32

In Paragraph 11.1 it would be helpful to have more guidance on what “timely” means. The IFoA believes that the items in Annex III Section 5 (5.1 to 5.5) are also classes of information that should be required.

Question 33

The IFoA believes that the Annex gives helpful additional information for insurance specific issues and has no further recommendations for further guidance.