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Dear Sirs

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

KPMG welcomes the opportunity to respond to the FSB's consultation on the Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions (Resolution of Insurers: Appendix II). Please note that our response focuses specifically on the insurance sector.

General Comments

We recognise the importance of developing a resolution framework that is appropriate for the insurance sector, not least because such a framework would need the close cooperation and assistance of insurance supervisors and policyholder protection schemes.

There are five specific issues that we believe merit further analysis and discussion before the Key Attributes – and most importantly how the implementation of these attributes can be assessed – are finalised. Indeed, it is not clear to us how an assessment could be undertaken effectively until these points are addressed (to this extent these general comments also address some of the issues raised in the FSB's separate consultation on assessment methodologies).

First, the regulatory and resolution structures currently in place in the insurance sector may hamper the effective implementation of the FSB's objectives. For example, recovery and resolution are often considered locally in the insurance sector given the legal entity focus of insurance groups where subsidiaries rather than branches are created, requiring solo capital and funding. In addition, resolution laws generally differ between jurisdictions and can have a significant impact on an insurance group's recovery and resolution planning. It is important to understand these local considerations and their potential interaction with group-wide approaches before 'resolvability' can be properly assessed. Considerable uncertainty can exist for an insurance group regarding cross-border operations, since unilateral actions could be taken by national authorities in the event of a crisis, especially where the need to protect local policyholders becomes an overriding imperative for the immediate national authority concerned.

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Second, although the FSB has recognised that the "traditional" resolution tools in the insurance sector of run-off and of transfers of business may not be sufficient in all circumstances, there has been very little discussion and analysis of what additional tools might be required and the interaction of these tools with any policyholder protection schemes. Further, it is a likely scenario for a G-SII (or even a D-SII) that a mixture of both recovery and resolution steps may be undertaken in response to a severe stress: it will not necessarily be appropriate to have recovery only or resolution only and the recovery / resolution tools available need to be flexible enough to work effectively together in those circumstances. It is difficult to see how an effective assessment of the Key Attributes could be undertaken until there is greater clarity on this issue.

Third, there has been very little discussion and analysis of the equivalent of "bail-in" in the insurance sector. It is not clear which liabilities might be eligible for the application of some kind of "bail-in" treatment, and how might this be used to ensure that all losses of a failing insurer fall on shareholders and creditors and, if necessary, claims of policyholders (in that order) rather than on taxpayers And it is not clear how this can be achieved in a reasonably predictable manner, so all creditors are aware of how "bail-in" would operate. This also relates to the first point outlined above, since it is not clear how a "single point of entry" bail-in regime could operate for a global insurance group with multiple subsidiaries in different jurisdictions. We expect that liabilities subject to bail-in would be limited to claims, bondholders and unsecured debt providers (whether subordinated or not), rather than other liabilities.

Fourth, from discussions with our clients, there does seem genuine confusion about what is required from an SRMP and the RRP. Many insurance groups consider the resolution plan to be the responsibility of the resolution authorities. However, the expectations outlined for the SRMP in effect require firms to consider actions from a resolution perspective. Such analysis would however pre-empt completion of the RRP. It would be helpful if the SRMP requirements were an output from the RRPs due at the end of 2014. In this regard, and particularly from a European perspective, European supervisors will be waiting for the European Commission's response to your consultation paper. The timing differences between the EC's own response, EIOPA and individual European supervisors may contribute to increased uncertainty and costs for European designated G-SIIs. It would also be expected that other designated firms who may have European operations would be similarly affected. It would be helpful if the FSB were to review the submission timings of the various requirements outlined by the IAIS.

Fifth, there is a risk that the assessment methodology will adopt too much of a "tick-box" approach to whether powers and tools exist in each jurisdiction, rather than assessing whether these powers and tools are used in a reasonably consistent and predictable manner across jurisdictions. To give but one example here, even if all jurisdictions had the power to require firms to change their recovery plans and their legal and operational structures to make recovery and resolution plans more credible, will there be any assessment of whether the relevant national authorities are in practice using this power in a reasonably consistent and predictable manner, even across the small number of G-SIIs?

More generally, we are also of the view that an integrated and effective global approach must have a coordinated and facilitated response from the IAIS. We would support the IAIS strengthening its Insurance Core Principles to include systemic risk issues. We also note that the US has adopted a single resolution mechanism through the Financial Services Oversight Committee and supervisory actions by the Federal Reserve. In a European context, no such pan-European approach has yet been considered. Solvency II will act as a single prudential framework across 28 Member States and, in relation to G-SIIs, we consider it appropriate that consideration also be given to improving coordination between Member States in recovery and resolution scenarios. For example, the creation a European-wide compensation scheme for policyholder protection purposes could greatly assist given any resolution of a large European insurance group would rely heavily on cross-border cooperation and implementation amongst supervisors and policyholder protection schemes. Achieving a consistent approach to systemic risk analysis across Europe could be facilitated by guidelines at the European level. This could provide a better facilitated European response amongst supervisors, particularly during crises, and provide a single reference point for insurance groups and provide consistency of approach and decisions.

In relation to the specific insurance Annex, we provide the following comments:

Question 22

We agree that supervisory authorities and resolution authorities are likely to need new powers in order for regulators to meet the stated resolution objectives as outlined. However, it will be essential to ensure these activities are coordinated across supervisors and resolution authorities, and we are concerned that the IAIS is not yet in a position to facilitate a common set of requirements amongst its members given the short timeframe imposed. This will be particularly important given that it remains unclear how it is envisaged these powers would complement or exceed current legislative requirements in jurisdictions: local insolvency or company law requirements; and existing portfolio transfer arrangements or run-off powers, which are Member State specific and utilise local laws. Such requirements can influence local policyholder compensation scheme requirements, which may already give due regard to the prioritisation of policyholders in the event of an insurer resolution, although we note that eligibility criteria for compensation may not currently match classes of insurance business written (e.g. the concept of retail clients versus non-retail clients). Common principles across jurisdictions concerning the hierarchy of claims needs to be established together with clear guidance as to when an insurer is deemed to be balance-sheet insolvent, to give greater predictability in recovery and resolution planning. This will be particularly important to ensure that actions taken by supervisors and resolution authorities can be implemented fairly in the best interests of all stakeholders, and assist with interaction with receivers or administrators when appointed in such situations.

Consistency across the European Union regarding resolution schemes applied by supervisory and resolution authorities would have significant benefits such as achieving greater coordination, facilitating decision making in the Crisis Management Groups (CMGs), providing G-SIIs with greater certainty of supervisory responses, and allowing these groups greater ability to properly plan and design their resolution strategies for their European operations. Such

efficiencies should lead to significant cost saving measures for insurance G-SIIs, which ultimately would be a positive outcome for European policyholders.

We are concerned that sufficient flexibility in the use of tools is permitted, having regard to the circumstances of each situation for which a tailored and proportionate approach is required. For example, while the nature of insurance business often allows for sufficient time to plan for recovery or orderly resolution, transfers of insurance business may need to be undertaken more quickly than may be prescribed by current regulation (either in EC Directives or in local law). Existing tools may need to be reviewed to ensure that they can be deployed urgently. Insurance is generally considered to have a high degree of substitutability should replacement or new cover be needed, however, it is not always possible to organise in practice: this is critical when policyholders must not have any interruption in cover. In extreme scenarios, replacement cover or transfers of business may need to be achieved within hours or days of the commencement of resolution, rather than weeks or months, so that economic functions and activities can carry on uninterrupted. This means that significant contingency planning steps will need to be undertaken, even to the extent of conditional approval of a transfer.

Question 23

While we appreciate that Non-Traditional, Non-Insurance (NTNI) activities are an important focus for insurance supervisors, establishing guidance which attempts to differentiate between traditional insurance business and NTNI activities is likely to prove unworkable in practice, especially in a crisis. Indeed, there may be firm specific activities which are not classed as NTNI activities, but traditional business, which in themselves could give rise to potential macroeconomic stability issues. Supervisors may want to apply concepts such as RRPs to groups with such activities as part of their risk-based supervisory approach.

Question 24

It is important that there is a high degree of international consistency established in relation to the setting of new statutory objectives. We would expect that the IAIS, as the international standard setter for insurance, would be tasked with outlining such requirements to ensure consistency across its members. The application of such statutory powers will be critical in dealing with a potential G-SII resolution which will require beforehand an optimal consistent set of objectives established for resolution across jurisdictions. This is particularly relevant if CMGs are to be effective in administering any future resolution of a G-SII.

The statutory objectives include a reference to the protection of "functions provided by insurers that may constitute vital economic functions" at section 1.2. Although some examples of such functions have been provided, an assessment of what constitutes a "vital economic function" will need to be made on a case-by-case basis, proportionate to the circumstances of each firm.

Question 25

The scope of application as outlined in 2.1 of the Key Attributes in October 2011 would include those insurers not presently designated a G-SII, but nonetheless deemed domestically systemically significant or critical by their supervisor. They should also therefore be subject to resolution requirements. While the FSB scope is clear in relation to G-SIIs, further clarity from the IAIS regarding the likely application to domestically significant insurers which would fit the definition of a systemically significant or critical firm would be beneficial.

We also do not consider that existing insolvency laws may be wholly appropriate for the reasons we have previously outlined. Ideally, far greater convergence and consistency across jurisdictions is required, particularly where G-SIIs are concerned, since the natural default strategy for many supervisors will be to act in their own national interests in accordance with local insolvency law requirements. This could act as a detriment to other resolution outcomes sought outside the home country. There have been a number of cases where jurisdictions compete for constitutional ownership of primary insolvency proceedings, which delays resolution. Until such time as greater convergence and consistency across jurisdictions is achieved, and to support greater supervisory co-ordination, we expect supervisors to have a full understanding of the nature and operation of existing resolution tools that could be used in the context of G-SIIs and D-SIIs.

Question 26

The guidance on entry into resolution outlined in Section 4 of the Assessment of Key Attributes paper raises particular issues concerning consistency amongst supervisory and resolution authorities, particularly where there does not presently exist a global prudential framework for insurers, nor consistent capital, liquidity, risk or governance requirements other than those set at a very high level in the IAIS Insurance Core Principles. While Solvency II will certainly improve the consistency of the prudential framework in which European insurers will be supervised, the financial crisis amply demonstrated that systemic risk and financial stability issues are not confined by geographical or jurisdictional boundaries. Unlike banking, the insurance industry does not have a globally accepted supervisory framework. The lack of an agreed international supervisory framework to supervise Internationally Active Insurance Groups (IAIGs), let alone assess G-SIIs, remains a potential weak spot in efforts to properly oversee and assess the financial stability and systemic risk issues confronting the global financial services sector.

While we support the IAIS's efforts to develop the ComFrame proposal, it is experiencing tremendous difficulty in seeking agreement among its members regarding the core constituent elements of the proposed framework. FSB intervention may be required in order to make progress on these issues. This is particularly relevant given the need for consistency across jurisdictions with regard to resolution powers. For example, there is no consistency between insurance supervisors regarding the draft guidance listed at 4.1 (i) – (v). In particular, there is no commonality concerning what constitutes 'balance-sheet insolvency'. We believe this is

critical given existing solvency requirements differ significantly between jurisdictions which could unintentionally create distortions in the wider financial services sectors in a crisis.

Similarly, other draft guidance as set out in Section 4 would also not achieve consistency across jurisdictions, such as the guidance contained in section 4.3, and specifically terms such as 'maximising value for policyholders' and 'providing continuity of insurance coverage'. Likewise, at section 4.7 - 4.8 'Portfolio Transfer arrangements', achieving a common supervisory and resolution approach to the application of such resolution mechanisms should be a key requirement of the FSB. Intervention in the creation of such standards may be required.

Question 27

We note that in the EU, inwards reinsurance does not have the same priority considerations in the event of insolvency as direct policies with regards to the ranking of creditors.

In regards to the application of "bail-in" to insurers, there has been very little discussion and analysis of the equivalent of "bail-in" in the insurance sector. For example, it is not yet clear which liabilities might be eligible for the application of some kind of "bail-in" treatment, and how might this be used to ensure that all losses of a failing insurer fall on shareholders and creditors rather than on taxpayers. We are also concerned regarding how this can be achieved in a reasonably predictable manner, so that all creditors are aware of how "bail-in" would operate. This also relates to our other general observation that it is not clear how a "single point of entry" bail-in regime could operate for a global insurance group with multiple subsidiaries in different jurisdictions.

Question 28

If banking resolution authorities have the ability to temporarily restrict or impose certain actions concerning depositor accounts and their access to funds, then it is understandable the draft guidance outlined at section 4.9 proposes a similar tool concerning the exercise of rights by policyholders to withdraw or change their insurance contracts. However, it is unclear what future premium payments would be required to be met by the policyholder for those contracts which require them to continue meeting contractual obligations to pay premiums: such ongoing premiums paid after the commencement of resolution could be afforded a different status or higher priority compared to other claims against the insurance firm, to reflect the additional risks faced by policyholders. Further, many life contracts have substantial surrender penalties which may act to disincentivise policyholders from seeking to withdraw or cancel their contract of insurance, which may act to the benefit of an insurer by not exacerbating its solvency difficulties. In a crisis, any adverse policyholder actions could further contribute to the instability of the financial markets. In addition policyholders may not be acting in their own best long term interests.

Question 29

If the resolution authority will be able to intervene in the ability of policyholders to exercise certain contractual rights, then by extension, the ability by the resolution authority to ensure all contractual services are maintained by relevant stakeholders may be necessary to ensure appropriate resolution responses and to maintain overall stability of the financial services sector.

The power to stay the rights of reinsurers of a failing insurer to terminate coverage for periods relating to, or policies incepting after, the commencement of resolution (set out at section 4.10) may be desirable in certain circumstances, but should be subject to certain safeguards: restricting reinsurers in this way may create financial difficulties for them, for example if claims dramatically escalate in number and value following a resolution event.

Question 30

It appears that this question refers to Section 9 rather than Section 8 of the Annex. We have no further comments.

Question 31

It appears that this question refers to Section 10 rather than Section 9 of the Annex. We consider that any additional matters applicable to recovery plans or resolution plans should be applied proportionately to the circumstances of each firm and its situation.

Question 32

It appears that this question refers to Section 11 rather than Section 10 of the Annex. In relation to run-off as a recovery tool, established good practice for insurance firms in run-off is maintenance of a full list of its policyholders, cedants and reinsurers, and balances due to/from them. This is often referred to as 'principal-to-principal' ledger accounting and may require a conversion of broker accounting systems where financial information is only held at broker level. Having this information enables firms to run-off their business more effectively: it identifies gross/net debtors (i.e. before/after set-off) and gross/net creditors (before/after set-off), especially where IBNR reserves are allocated to policy level. This is important information to support commutations with policyholders and reinsurers, which is commonly used in the closure process.

Question 33

We consider the guidance is comprehensive and we have no further comments.

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