Association of British Insurers

Recovery and resolution planning: making the key attributes requirements operational

The ABI's response to the Financial Stability Board consultation

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The UK Insurance Industry

1. 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, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

2. Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

3. The ABI is the voice of insurance, representing the general insurance, protection, 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.

4. The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.

- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.

- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.

- Promote the benefits of insurance to the government, regulators, policy makers and the public.

Executive Summary

The main purpose of this response is to reiterate as forcefully as we can that the resolution of insurers raises completely different issues from the resolution of banks. Further, a poorly considered extension of banking resolution regimes to insurers compromises regimes for supervision and resolution of insurers that work to ensure orderly failure and would damage the interests of policyholders, insurers - and the economy as a whole. The Key Attributes themselves were clearly written with banking in mind, and do not all read across well to insurance. We therefore urge the FSB to consider carefully, in co-operation with the IAIS and the insurance industry, the differences between insurance and banking before issuing guidance on making the Key Attributes operational in the insurance sector.

Consultation response

Specific resolution powers have been shown to be necessary for G-SIFI banks where the sudden withdrawal of liquidity caused a collapse in confidence that threatened the functioning of the entire global banking system and beyond. 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, the IIF and the IMF. The nature of insurance business and the inverse production cycle means that liquidity does not pose the same risk for insurers as it does for banks and failure of an insurer does not pose the same risks of contagion as the banks. As a result, an insurer will face capital pressures or technical insolvency long before it is illiquid. Insurers hold assets with maturities appropriate to the profile of their expected liabilities.

It is to the benefit of all parties, particularly policyholders, for failing insurers to be run off over a period of time, allowing the actual liabilities to emerge and assets to be managed to that end. Immediate banking-style resolution powers could lead to premature assumption that immediate and definitive action is required. This could result in an assessment of liabilities, and fire sales of assets that undermines fair treatment of all policyholders and fails to achieve optimum value in a distressed situation. Beyond the application of such resolution tools to bank-like activities, it is not clear that additional powers are necessary or even helpful in resolving a distressed insurer.

Banking resolution tools must not therefore be simply assumed to be relevant or beneficial to the insurance sector. We recognise that the IAIS are undertaking work to assess the ‘Key Attributes’ in relation to their relevance to the insurance business model. This work must recognise the robustness of the existing resolution regimes for insurers in providing for orderly failure and that the idiosyncratic nature of insurance liabilities means that the failure of one insurer does not automatically bring into question confidence in other insurers (or indeed, other financial institutions). Where an attribute is not relevant to insurance, or where the underlying objective is better achieved by other means, appropriate adjustments should be made. Furthermore, where existing and proposed insurance-specific national arrangements already achieve the objectives set out by the key attributes, no change should be necessary.

We are concerned by the binary presentation of the Single Point of Entry and Multiple Point of Entry approaches. In practice, a combination of both approaches will be necessary. We expect the FSB to act as a counterweight to the regulatory fragmentation driven by national authorities. The negative externalities to fragmentation can only be seen and combatted at international level.

1 Guidance on Recovery Triggers and Stress Scenarios (Annex 1)

Insurance liabilities are broad, and present a different type of exposure to the credit cycle that dominates banking. As a consequence, insurance stress tests encompass a wider range of scenarios than banking stress tests, and there are a much wider range of events that could trigger the need for recovery planning.

Insurance liabilities are also largely independent of each other. So in a large diversified insurer, difficulties in one line of business may cause management to re-organise that business, which can be done with little impact on other lines of business, limited intervention by the regulator and limited negative impact for policyholders. For example, rising claims rates in the motor insurance business of a non-life insurer need have little impact on that insurer's household insurance business.

The triggers and stress scenarios outlined in the Annex are almost entirely bank-focussed – and many are not relevant to insurance (for example GDP forecasts, LIBOR, per cent renewal of wholesale financing). We also note the inclusion of "run-off" among the potential stress scenarios used by G-SIFIs. We are particularly concerned by the suggestion that it is somehow equivalent to "significant deposit withdrawal". This must not be confused with run off in the insurance context. Run-off is a valuable tool that insurers may use to respond to a stress situation (as well as in other circumstances) it is not in itself a stress scenario. An insurance business may be entered into run-off as a purely strategic decision to withdraw from a particular market or product and protect policyholder interests.

Decision-makers in insurance companies will use a mix of quantitative and qualitative triggers. Because of the diverse nature of insurance liabilities, we question the need for rigid recovery triggers with automatic consequences and escalation procedures. Indeed, it is doubtful whether a standing recovery plan is at all helpful for an insurer, or for its supervisor. Where a jurisdiction already has in place a well-defined ladder of intervention, we question the need for additional measures. In any event, soft triggers would be a more sensible approach to recovery in insurance. For more detailed consideration of these issues, we commend the paper by the CRO Forum *Insurers' Risk Management Systems – Preparing for Recovery.*

In devising guidance for recovery planning, regulators need to take care to avoid blurring the distinction between the role of regulators and of company management. In the recovery phase, the institution in question is still a going concern. It is the responsibility of company management to run the company balancing the interests of its customers, investors and other stakeholders, and excessive intervention by supervisors in recovery risks the regulator assuming a shadow Director role.

2 Guidance on Developing Resolution Strategies and Operational Resolution Plans (Annex 2)

We have considered the relative advantages of the Single Point of Entry (SPE) approach as against the Multiple Point of Entry (MPE) approach, as these issues are highly relevant for insurers as well as for banks. In an ideal world, a single point of entry would be a preferable approach to resolution of multinational groups. However, in view of the differences in national insolvency regimes, and the national responsibilities of authorities involved, we see significant barriers to the application of an SPE approach. There are fundamental reasons why this approach has not in practice been followed in any of the recent failures of financial services institutions. Our concerns are reinforced by the suggested requirements for making a SPE strategy effective. We doubt whether many national regulators can properly meet the suggested requirements for regulators. The requirements on groups impose significant restrictions on the efficient use of capital, and would likely have serious consequences for the availability and cost of insurance cover for consumers.

The MPE approach also has its practical drawbacks. A requirement for legal and financial separation of businesses within the group would lead to further fragmentation of capital, with severe consequences for costs. The consequences are particularly severe for those groups which favour a branch structure. There is already a significant trend, since the financial crisis, for national regulators to insist on capital being held within their jurisdiction. This approach suits national regulators – particularly those in larger and stronger jurisdictions. However, there are important macro-economic externalities, in particular the reduction of insurance cover in smaller jurisdictions. These externalities must be taken into account.

While we agree in principle that barriers to effective resolution should be removed from firms undertaking systemically risky activity, we do not believe that this is best achieved by enforced restructuring to align with one or the other of these binary approaches, which could be extremely damaging to the ability of insurers to enhance their stability through building globally diversified portfolios. In practice, multinational insurers should be resolved by a combination of the SPE and MPE approaches, tailored to the needs of each group, and kept up to date in the COAG. We conclude that the key constraints on the effective resolution of multinational groups are in fact the limitations placed on national regulators. Therefore, the bulk of FSB guidance in this area should be targeted at the behaviour of national authorities.

This conclusion supports our belief that the key lesson of the financial crisis for insurance regulators was the need for improved group supervision. In particular, this should be the main recommendation of any analysis of the failure of AIG. We therefore support the need for authorities involved in resolution 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. We also support in principle the need for firm-specific cross-border co-operation agreements (COAGs).

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.

On some points of detail:

- we note that significant elements of the rationale for the MPE / SPE approaches are based on the application of resolution tools that are inappropriate or irrelevant for insurers, such as bail-in and transfers to bridge entities.

- paragraph 4.4 deals with resolution triggers. As potential investors in banks, we believe that regulatory discretion should be kept to a minimum. The greater the extent of regulatory discretion, the more difficult it is for investors to price bank bond and stock, with adverse consequences for bank funding. Insurers already have little appetite for bail-in bank debt and will assess possible investments in bank stock, in the context of wider investment risk appetites. The greater the regulatory discretion the less likely it is that insurers will be able to match investments in bank stock to their liabilities, and their ability to invest will be correspondingly limited..

- paragraph 4.6 deals with sources of resolution funding. For insurers, the key issue is time. This also affects the valuation requirements in paragraph 4.8. There is no reason to determine these values in a short period for insurers.

- Paragraph 4.12 deals with moratoria on early termination rights. We agree that this may be a helpful power, to prevent the destabilisation of assets. However, the fairness of such a power will also need to be weighed carefully. How will authorities ensure that policyholders properly understand a regulatory over-ride over policy conditions? Would it be clearer to change the underlying policy conditions? The market impact will also need to be considered: for example, powers of this kind may also have the effect of making insurance-based savings less attractive than bank-based or fund-based vehicles. Regulators will need to satisfy themselves that this is proportionate to the risk.

- Communication – covered in paragraph 4.14 - is absolutely key when dealing with insurance failures. The failure of an insurer is most unlikely to have systemic impact. However, it may have a severe impact on individual policyholders, and therefore create political pressure for a sub-optimal early resolution of the issue, with a worse outcome for policyholders.

3 Guidance on Identification of Critical Functions and Critical Shared Services (Annex 3)

The definition of critical functions requires further thought. We urge the FSB to be rigorous in its analysis of “critical functions”, as the risk is that this will be applied unnecessarily to a very wide range of services. Critical functions should be only those functions whose cessation could undermine the financial system as a whole – the definition should not be extended to include functions where cessation could be a temporary inconvenience (even on a national scale), but would not threaten the financial system.

For insurance purposes, the meaning of “sudden failure” requires consideration, as sudden failure is likely to be triggered mainly by regulatory action, for example in the case of non-bank financial institutions, the greatest threat to preservation of “critical functions” may be from unnecessary early resolution. Insurance cover may also be withdrawn because the price of a risk needs to be re-assessed fundamentally, as happened in the aviation market after 9/11. This has nothing to do with resolution; it is a key mechanism for insurers to protect themselves against sudden shifts in the appreciation of risk.

The category of “deposit-takers” is too broad. While insurers may in terms of economic theory be technically deposit takers, their deposit-taking activity is not a critical function, and an insurance failure has never been known to undermine wider confidence in the financial system or to prompt runs on other deposit takers (and certainly has never prompted a bank run). Insurers take on customers’ risks and hold customer deposits in order to meet liabilities as they arise. They therefore act as risk absorbers in the financial system, as opposed to banks who lend out the deposits they receive to risk-takers. Moreover common features of insurance contracts act as a further mitigant to systemic risks, for example restrictions and penalties on early surrender of life policies act as a barrier and a disincentive respectively to mass withdrawal, as well as providing a stabilising effect on the insurer through a reduction of liabilities.