FSB FINANCIAL STABILITY BOARD

Developing Effective Resolution Strategies and Plans for Systemically Important Insurers

Consultative Document

3 November 2015

The Financial Stability Board (FSB) is seeking comments on draft guidance for Developing Effective Resolution Strategies and Plans for Systemically Important Insurers.

The *Key Attributes of Effective Resolution Regimes for Financial Institutions* ("*Key Attributes"*)[1] are an essential component of the FSB's package of policies to reduce the risks of moral hazard and the potential for systemic disruption associated with systemically important financial institutions (SIFIs). The *Key Attributes* call on jurisdictions, among other things, to put in place an on-going recovery and resolution planning process to reduce the potential for failure and promote resolvability. Such a planning process is required for all global systemically important financial institutions (G-SIFIs) and for any other firm assessed by national authorities as potentially having an impact on financial stability in the event of its failure. Global systemically important insurers (G-SIIs)[2] are subject to the set of policy measures, including recovery and resolution planning requirements that were published by the IAIS on 18 July 2013.[3]

In October 2014, the FSB adopted implementation guidance on how provisions of the *Key Attributes,* including resolution powers and the details of recovery and resolution planning, should be interpreted for insurers. That guidance was published in the form of a new Annex to the *Key Attributes.*[4]

This consultative document builds on that guidance. It also incorporates guidance on the identification of critical insurance functions, which was the subject of a separate consultation in 2014.[5] Elements from that consultative document have been included here because of the close connection between critical functions, the institution-specific resolution objectives and the development of resolution strategies.

This draft Guidance that is proposed in this consultative document has been developed by the FSB, in consultation with the IAIS, and is aimed at regulators, supervisors and resolution authorities, and especially those that participate in Crisis Management Groups (CMGs) of G-SIIs. However, it is also likely to be of interest to G-SIIs and other insurers for which recovery and resolution planning is required and feedback from the wider financial community is welcome.

In considering this consultative document, respondents are asked to keep in mind that recovery and resolution planning and assessment processes are iterative in nature and still at a relatively early stage for many insurers. Any guidance may require further refinement and adjustment over time as more experience is gained. The following questions for consultation have been posed against this background.

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1 The *Key Attributes* are published at: http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

2 The list of G-SIIs is published at: http://www.financialstabilityboard.org/wp-content/uploads/r_141106a.pdf

3 http://www.financialstabilityboard.org/wp-content/uploads/pr_130718.pdf

4 See II-Annex 2 for implementation guidance on resolution regimes for insurers.

5 http://www.financialstabilityboard.org/wp-content/uploads/c_141016.pdf

The FSB invites comment on the draft Guidance and the questions set out below by **Monday, 4 January 2016.** Responses should be sent to fsb@bis.org. Responses will be published on the FSB's website unless respondents expressly request otherwise.

Questions for Public Consultation

The FSB invites comments on the draft Guidance and the following specific questions.

1. Do you agree that authorities should identify institution-specific resolution objectives as proposed in Section I.? Are there any considerations relevant to that identification, additional to those discussed in this document, that should be covered in the Guidance?
2. Are the considerations for determining "points of entry into resolution" as discussed in Section I.1 appropriate and relevant for the insurance sector?
3. Do you agree with the considerations in Section II and underlying analysis in Section III for determining a preferred resolution strategy? Are there other relevant factors that should be taken into account?
4. Are the resolution tools that are described in Section II.2 appropriate for use in a resolution of an insurer? Should other tools be considered?
5. Is the proposed framework for developing effective resolution strategies and plans for systemically important insurers flexible enough to take due account of the different types of business undertaken by systemically important insurers?
6. Is the proposed approach for identifying (i) critical functions (Section III.2) and critical shared services (Section III.3) appropriate and relevant for supporting the development of effective resolution strategies and plans for systemically important insurers? If not, what aspects, if any, are missing or need to be changed?
7. Are there arrangements, in addition to those set out in Section IV of the draft Guidance, that may be needed to ensure that a resolution strategy for an insurer can be implemented and that should be covered by this guidance?
8. Are there any other issues in relation to resolution strategies and tools or the resolution of insurers generally that it would be helpful for the FSB to clarify in further guidance?

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Introduction

This Guidance should assist home and host authorities in meeting the recovery and resolution planning requirements under the FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions ('Key Attributes'* or KAs*)*.[6] This Guidance complements *Key Attributes* II-Annex 2 (Resolution of Insurers),[7] I-Annex 3 (Resolvability Assessments), and I-Annex 4 (Essential Elements of Recovery and Resolution Plans).

The *Key Attributes* (KA 11.1) require an ongoing process for recovery and resolution planning covering, at minimum, domestically incorporated firms that could be systemically significant or critical if they fail. The resolution plan is intended to facilitate the effective use of resolution powers with the aim of making the resolution of any firm feasible without severe disruption and without exposing taxpayers to loss. It includes a substantive resolution strategy agreed by top officials (KA 11.6). The resolution strategy should be supported by a more detailed operational resolution plan that sets out the actions necessary to implement the strategy and highlight any "potential barriers to effective resolution and actions to mitigate those barriers" (KA 11.6).

For global systemically important insurers (G-SIIs),[8] the home resolution authority should lead the development of the group resolution plan in coordination with all members of the firm's Crisis Management Group (CMG). The *Key Attributes* (KA 8.1) require home and key host authorities of all G-SIFIs to maintain CMGs with the objective of enhancing preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting the firm.

Resolution strategies and plans for G-SIIs should be underpinned by institution-specific cross-border cooperation agreements (COAGs*)* (KA 9). COAGs should set out the roles and responsibilities of participating authorities and establish processes for coordination and information sharing in developing recovery and resolution plans and carrying out resolvability assessments, and for coordination both in the run up to a possible resolution and in a resolution. They should also "provide an appropriate level of detail with regard to the cross-border implementation of specific resolution measures" (KA 9.1).

The guidance considers the full range of resolution powers and tools provided for in KA 3 and described in the *Key Attributes* II-Annex 2 (Resolution of Insurers), as it assumes that the *Key Attributes* have been implemented.[9] Where jurisdictions have not yet fully implemented the *Key Attributes* for the insurance sector, resolution strategies and plans should be developed on

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6 See the *Key Attributes*, http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

7 *See, in particular,* Sections 8 and 9.

8 In July 2013, the FSB, in consultation with the International Association of Insurance Supervisors (IAIS) and national authorities, identified an initial list of nine global systemically important insurers (G-SIIs) using an assessment methodology developed by the IAIS, and the policy measures that apply to them. The group of G-SIIs is updated annually based on new data and published by the FSB each November. The most recent list was published in November 2014.

9 While important steps have been taken to clarify of the application of the *Key Attributes* to insurers (see, *Key Attributes* II-Annex 2 (Resolution of Insurers)), it should be noted that work in this area is ongoing, and the application of the some features to the *Key Attributes* to insurers may continue to evolve.

the basis of the powers and tools available under the regimes in force, and periodically modified to reflect subsequent developments.

While this guidance focuses primarily on resolution strategies and plans for G-SIIs, many aspects may also be relevant for insurers identified by any national authority as systemically important (if any).[10] Insurance and reinsurance companies, groups and conglomerates within the scope of this guidance are collectively referred to as "insurers".

The guidance covers:

- Objectives of resolution strategies for insurers (Section I);
- Considerations in determining a preferred strategy (Section II);
- The strategic analysis underlying the development of resolution strategies (Section III), including the assessment of the business conducted by the insurer, the identification of critical functions and shared services, cross-border operations, funding and liquidity issues, and coverage by policy holder protection schemes; and
- Issues that should be addressed as authorities develop an operational resolution plan that builds on the resolution strategy, including cross-border cooperation and exit strategies (Section IV).

[10] Refer to discussion of economic importance of insurance functions in Section I and impact on financial stability criticality of an insurer's functions in Section III (2).

I. Objectives of resolution strategies

A resolution strategy should make it feasible to resolve an insurer while protecting vital economic functions, without severe systemic disruption or exposing taxpayers to loss, through mechanisms that make it possible for shareholders and unsecured creditors to absorb losses.[11] *Key Attributes* II-Annex 2 (*Resolution of Insurers*) sets out the specific objective of protecting the insurer's policyholders, beneficiaries and claimants (collectively, 'policyholders').[12]

Authorities should develop resolution strategies with the aim of maintaining financial stability and, to the fullest extent possible, protecting policyholders when an insurer fails.

Additionally, authorities in some jurisdictions may consider it appropriate, for the purposes of developing resolution strategies, to have regard to insurance functions in light of their economic importance, to the extent that it is not already a factor in authorities' financial stability impact analysis. For example, depending on the nature of the activities of the individual insurer, disruption of a particular function or discontinuity of specific types of coverage could have a material impact on the financial system or, more broadly, on the real economy.

In developing a resolution strategy tailored to a firm, authorities should identify institution-specific resolution objectives that relate to the specific activities of the firm. Any resolution strategy chosen by authorities for an insurer should be supported by a more detailed operational resolution plan that sets out the actions necessary to implement the strategy and best achieve any institution-specific objectives. A resolution strategy and plan should serve as a (non-prescriptive) guide to authorities for achieving orderly resolution in the event that recovery measures are not feasible or have proven ineffective. The feasibility and credibility of the strategies and plans should be regularly reviewed within CMGs through technical-level resolvability assessments as required by the *Key Attributes* (KA 10) and as part of the FSB Resolvability Assessment Process (RAP).[13]

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[11] The *Key Attributes* (KA 5.1) specify that resolution powers should be exercised in a way that respects the hierarchy of claims in liquidation, (Annex Section 5.1) but the resolution authorities should also have the flexibility to depart from the general principle of equal (*pari passu*) treatment of creditors of the same class. That flexibility would allow authorities, for example to treat policyholders of different types of policies or policyholders covered by a policyholder protection scheme versus policyholders not covered by such schemes differently in a resolution. That differential treatment may be justified if necessary to maximise the value for creditors (including policyholders) as a whole (subject to the "no creditor worse off" safeguard) or to minimise the potential systemic impact of a firm's failure. Section 5.2 of II-Annex 2 states that there should be no differential treatment of policyholders that hold the same type of product or policies.

[12] Section 1 of KA II-Annex 2 (Objectives) acknowledges that policyholders might not be fully protected under all circumstances, and losses could be absorbed by policyholders to the extent they are not covered by policyholder protection schemes.

[13] The RAP refers to high-level discussions on G-SII resolvability that should be conducted for all G-SIIs by senior policy makers from CMG authorities relying on the technical KA10 resolvability assessments. See Report to the G20 of 12 November 2014 on progress in reform of resolution regimes and resolution planning for global systemically important financial institutions (G-SIFIs).

II. Determination of a preferred strategy

CMG authorities should develop a preferred resolution strategy that is best capable of achieving the institution-specific resolution objectives given the structure and the business model of the insurer, the resolution regimes applicable to the legal entities of the group and the resolution tools available to authorities in all relevant jurisdictions. In cases where the tools specified in the *Key Attributes* have not been fully implemented, authorities should also consider how the preferred strategy may evolve once the full range of resolution tools is available.

The development of a preferred resolution strategy that best achieves the resolution objectives may depend on many factors such as the existing structure and business model, the need for recapitalisation or the degree of internal interconnectedness within the group. Factors that give rise to internal interconnectedness include centralised liquidity; hedging and risk management; cross-default clauses in financial contracts of individual group entities, which may cause intra-group contagion if they enable counterparties to terminate financial contracts on entry into resolution of an individual group entity; internal reinsurance contracts; and other links, such as financial guarantees or other operational interdependencies.

1. Identifying points of entry into resolution

Resolution strategies may involve the application of resolution tools at the holding or parent company level of a group; at the level of a sub-holding; and/or at subsidiary entities. A point of entry is an entity within an insurance group (whether at the top, intermediate or subsidiary level) to which resolution authorities would apply resolution tools under their preferred resolution strategy. The resolution strategy should identify the potential point or points of entry within the group and the specific strategy to be applied at each point of entry.

The choice of points of entry should be guided by the group structure of the firm and the way that its activities are organised within that structure. The following considers two stylised approaches based on entry into resolution at the level of a non-operating holding company and at the level of individual operating entities. Resolution strategies for insurance groups may be based on one of those stylised approaches or combine both, depending on the characteristics of the group.

a. Entry into resolution at a non-operating holding or sub-holding company

Certain types of insurers may be better suited to a resolution strategy that entails entry into resolution at a non-operating holding or sub-holding company (topco) in a manner that maintains the structure of the group and preserves diversification benefits. The topco may be an insurance (or reinsurance) undertaking or a holding company that carries out no financial business other than acting as a holding company.

Group structures that would be more suitable for entry into resolution at the topco typically have the following characteristics:

- fungibility of capital and liquidity between parent and subsidiary entities;
- systematic intra-group support with financial exposure between group entities,

- ability of the holding or sub-holding company to act as a source of strength to its subsidiary entities or provide intra-group reinsurance;
- centralised group funding;
- interdependencies arising from shared services provided by affiliates.

Group structures that meet these conditions typically include groups that pool risks and capital in one place and that distribute centrally held capital through reinsurance contracts.

b. Entry into resolution at the level of individual operating entities

Other types of insurers may be more suited to a resolution strategy that provides for entry into resolution at the level of individual operating entities (opco).

Group structures that may be more suited to a resolution strategy that takes place at the opco level typically have many or all of the following characteristics:

- local subsidiaries managed as stand-alone entities with respect to governance and often with only limited fungibility of capital and liquidity;
- local client basis (driven by local tax regime, pension system, etc.);
- limited amount of intra-group transactions, executed at arm's length;
- intra-group reinsurance that is generally conducted at arm's length and collateralised against default risk;
- intra-group shared services that are generally provided by separate legal entities that are funded by revenues from the services they provide;
- legal and operational separability.

These conditions may be met by subsidiary-based insurance groups (for example, many insurance groups that provide direct life and non-life insurance and similar business models).

The determination of the appropriate point(s) of entry may be affected by the causes of the failure within the group and the particular entities involved in the failure, as discussed below.

Although the determination of the preferred resolution strategy will be based on the structure and business model of the individual firm, it is possible that there will remain obstacles to resolution that are related to the firm's structure or business model. The regular conduct of resolvability assessments should help identify any impediments to resolution that may arise from the legal and operational structure. Authorities may therefore need to require firms to make changes to legal and business structures to address such obstacles and improve their resolvability (KA 10.5).

2. Identifying preferred resolution tools for points of entry

In developing a preferred resolution strategy, authorities should identify possible and preferred resolution tools that could be applied at the points of entry identified in the strategy. Resolution authorities should consider the resolution tools available in light of the institution-

specific resolution objectives and underlying strategic analysis, the types of business carried out by the insurer and the nature of its assets and liabilities.

In identifying possible and specific preferred resolution tools, the resolution authorities should consider whether the resolution objectives can be effectively achieved through more traditional run-off or portfolio transfer procedures. This consideration is particularly relevant where the legal framework provides for both court-led transfer and run-off procedures and administrative resolution powers, including transfer powers, that are exercised by the resolution authority. Relevant factors in determining which procedures or powers are most likely to achieve the resolution objectives may include the timeframe in which the action needs to be taken since administrative powers may facilitate rapid intervention more easily than court-led procedures.

Resolution tools broadly fall into the following general categories, according to their aim:

a. Stabilisation and restructuring tools aimed at achieving continuity of critical business operations and functions

These tools include:

- *A sale or transfer* of the shares in the insurer to a third party or a bridge institution;
- *A sale or transfer* of insurance portfolios or other business of the firm (wholly or in part) to one or more third parties or a bridge institution; or
- *A creditor-financed recapitalisation* of the entity that continues the critical business operations and functions. A creditor-financed recapitalisation may be achieved through bail-in; that is, a restructuring of insurance liabilities or write down of other liabilities and their conversion into equity (or other instruments of ownership) of the firm under resolution, or of any successor in resolution or the parent company within the same jurisdiction. As provided by KA 3.5, this should be done in a manner that respects the creditor hierarchy.

b. Wind down tools aimed at ensuring the orderly run-off of the whole or part of the existing business lines and insurance products

These tools include the following:

- *Run-off on a solvent basis*. A limited degree of recapitalisation may be necessary if the preferred resolution strategy is a solvent run-off. While the insurer needs to be solvent, the required capital levels set by the authorities are likely to be lower than would be necessary for it to write new business.
- *Run-off on an insolvent basis.* A managed run-off of existing claims (without writing new business) could be completed while the entity in resolution is insolvent. Authorities or the courts would need to determine how a potential shortfall is allocated over time and across creditors and policyholders, subject to respect of the creditor hierarchy.
- *Liquidation and winding-up*. A liquidation of assets, and payments to policyholders and other creditors pursuant to the creditor hierarchy. The claims adjudication procedure overseen by the courts may include a process for estimating the value of current and future claims.

c. Stay and suspension powers

Stay and suspension powers may be used to support the use of other resolution tools and to help achieve the resolution objectives, including those related to financial stability and the protection of policyholders. These include powers to impose short stays on early termination or surrender rights and to suspend pay-outs partially or fully for a longer period. A temporary stay on the contractual right to exercise surrender rights or a stay on terminating insurance cover may be used to gain time for the implementation of other resolution tools while preserving value. For example, a stay on 'cashing-out' annuities may support the restructuring of variable annuities and preserve liquidity in the short term. A stay on early termination of derivatives may be necessary where an insurer in resolution holds a large derivatives position.

3. Choice and combination of the preferred resolution tools

Existence of Policyholder Protection Schemes (PPS) - The choice of the preferred tools may also be affected by the existence of PPS or other forms of policyholder protection mechanisms, such as tied assets, that can be used to support the use of resolution tools. For example, they may contribute funds to facilitate a transfer to a bridge insurer or other insurer[14] or a creditor financed recapitalisation. They may also compensate policyholders for their losses in the event of run-off on an insolvent basis or a wind-up and liquidation (see Section III.5).

Different tools may be used at different entry points and in response to different types of failures. For example, a recapitalisation of part of a group (potentially at an intermediate holding company level) may be combined with the use of liquidation, run-off on a solvent or insolvent basis, or sale (for example, of a holding company's interests in operating subsidiaries) for other parts of the group. Tools may also be used in combination in relation to a single legal entity.

III. Strategic analysis underlying the development of the resolution strategy

The resolution strategy needs to be tailored to the specific risks to which each individual insurer may be exposed, the critical functions that it provides and the potential systemic impact of its failure. A range of factors and considerations will have implications for the design of that resolution strategy, examples of which are discussed below. G-SIIs' activities are likely to combine some or most of the business segments considered in subsection 1 below. Where that is the case, the resolution strategy should take account of the interconnections between those different activities and the different timeframes in which intervention may be needed.

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[14] In the case of tied assets, assets backing liabilities may be transferred to another insurer with the insurance contracts to which they are 'tied'.

1. Business segments

a. Life insurance

Since most life insurance products are highly substitutable (i.e. similar coverage can be obtained rapidly from other insurers), there may not be a need for new business to be written by a life insurer in resolution. However, given the long-term nature of most life insurance contracts, the existing life policies should ideally be continued since the policyholder may not easily be able to procure replacement coverage.

In most cases, authorities are likely to consider the feasibility of a solvent run-off, with the possibility that the firm may transfer the existing life insurance portfolios to other solvent insurers.

If the financial position of the insurer is not consistent with a solvent run-off, the strategy may still be to secure continuity of cover and payments for existing life policies. In some jurisdictions this may be achieved by an insolvent run-off within some form of administration, where the administrator will seek to transfer the existing life insurance portfolios to other solvent insurers. In some jurisdictions entry into administration may allow service providers under the terms of service contracts to terminate provision of critical shared services that are necessary to support insurance and other functions. This could potentially result in disruption to continuity of payments to policyholders. It may also trigger contractual rights for derivative counterparties to exercise early termination rights and close out contracts (including cross-default clauses affecting other group companies), which could destroy value and require the insurer to re-hedge its portfolios.

The use of a bridge insurer, as an alternative to administration, could help ensure continuity of cover and payments for existing policyholders and provide time for prospective purchasers to carry out the appropriate due diligence with a view to transferring the insurance business to one or more solvent insurers at a later date. Where contractual rights to terminate services arise on entry into resolution, the risk that providers of critical shared services will exercise such rights may be reduced if those service providers are confident that payment for services to the bridge institution will continue.[15] If entry into resolution or the exercise of resolution powers triggers early termination rights under derivatives and other kinds of financial contract, the resolution authority may exercise its powers to impose a temporary stay in accordance with the terms specified in the *Key Attributes.*[16]

A partial transfer of liabilities, which would involve certain creditors being left behind in the entity that is to be liquidated, could give rise to compensation claims under the "no creditor worse off than in liquidation" (NCWOL) safeguard specified in KA 5.2 if those creditors are worse off than they would have been in the liquidation of the whole firm. If there is a shortfall of assets relative to liabilities that cannot be met by a contribution from a policyholder

[15] Arrangements to support continuity of critical shared services in resolution are discussed further in subsection 3 below on operational continuity.

[16] KA 4 specifies that resolution authorities should have the power to impose a temporary stay on contractual rights to terminate that arise in connection with resolution, and sets out conditions and safeguards associated with such stays.

protection scheme (if available), it may be necessary to restructure policyholder liabilities to enable a transfer.

Ensuring that the entity is sufficiently capitalised to enable a solvent run-off would maintain continuity of cover and payments for existing policyholders. An alternative strategy may therefore be to write-down the unsecured non-insurance liabilities, and if necessary restructure the insurance liabilities, of the life insurer to enable a recapitalisation that is sufficient to run-off the existing business. It may be necessary or desirable to support the implementation of such measures with a restriction or temporary suspension of policyholders' rights to withdraw from their insurance contracts. Where liabilities to policyholders need to be restructured, the policyholder protection scheme (if available) may be able to make a contribution.

b. Property and casualty (P&C)

Where there is sufficient substitutability, which is the case for the majority of P&C insurance products, it may not be necessary for the insurer to continue to write new business. The insurer's authorisation or license could be restricted to exclude writing new contracts and a solvent run-off may be attempted before the use of other resolution tools is contemplated.

Where the financial position of the insurer would not support a solvent run-off, an insolvent run-off or liquidation may be necessary. Liquidation proceedings may be more suitable for a property insurer with insurance liabilities of generally short duration, while an insolvent run-off may be more appropriate for a casualty insurer with insurance liabilities of generally longer duration. Given the short contract duration (normally one year) of many P&C policies and the ease with which policyholders can move to another firm on similar terms (for example, with their no claims bonus), it may be necessary to provide for continuity of cover only for a limited period to enable existing policyholders to find replacement cover in the open market prior to the opening of either type of proceeding. In this scenario, where policyholder protection schemes are available to pay claims and/or return unearned premiums to policyholders, this may affect the determination of the preferred strategy.

Some P&C policies, however, are complex and unique and it might be more difficult to find a substitute product in some jurisdictions. Authorities may consider examining whether there are structural factors that led to a lack of substitutability which may need to be addressed by policy action in other domains (e.g., competition). Where insurers provide insurance functions of particular economic importance that have a lack of substitutability, authorities may consider this factor when developing resolution plans.

c. Reinsurance

The resolution strategy for a reinsurer will need to address how to mitigate the risk that the failure of a reinsurer would give rise to contagion to the extent that it materially weakens other insurers or reinsurers. This might be the case, for example, if the reinsurer defaults on monies owed under contracts of reinsurance or if the business model of the primary insurer fails because it is unable to continue sharing risks. In some cases, the highly specialised nature of the primary business means that very limited reinsurance alternatives are available.

The interconnectedness associated with reinsurance business is in principle contingent in nature: the primary insurer's claim against the reinsurer is contingent on the insured event

happening. However, the existence of reinsurance leads to certain regulatory treatments regarding the primary insurer's capital and reserve requirements, so if the reinsurance cannot be substituted this could lead to the failure of the business model of the primary insurer.

d. Financial market activities and investment products

Insurance groups generally carry on a range of financial market activities in support of their insurance business. Activities that are of a significant size or importance could be a channel for contagion, either within the group or to third parties. Disruption of those activities as a result of the failure of an insurer may have an impact on financial stability that resolution authorities may need to manage through use of resolution tools such as temporary stays to prevent counterparties from terminating financial contracts and transfer tools to preserve derivatives portfolios.

Where the insurer acts as counterparty to derivatives transactions such as interest rate swaps, currency forwards and options, authorities may consider the transfer of derivatives portfolios to a bridge entity or a third party acquirer as part of the resolution strategy, ensuring the transferred insurance contracts remain hedged by those derivatives. To facilitate the transfer, authorities may need the power to impose a temporary stay on early termination rights to enable the transfer and avoid a mass close-out of the derivatives contracts that risks destroying value.

Some insurers may hold types of investments the rapid sale of which in recovery efforts or in an insolvency proceeding could have a wider market impact and lead to financial instability. Similarly, insurers may participate, as either buyers or sellers, in significant investments in money market-type assets that could be affected by the insurer's exit from that market. Resolution authorities may therefore need to take action that avoids 'fire sales' that risk destabilising market prices.

Insurance companies may also engage in securities lending activity and use repo markets, in particular reverse repo, primarily as liquid and secured investments. Given that loaned securities may commonly be returned at short notice, there is liquidity risk in the reinvestment of cash typically received as collateral. Since such cash collateral tends to be reinvested in liquid assets such as reverse repo and other money market instruments, reinvestment constituting liquidity or maturity transformation may be vulnerable to runs.

Other business activities include the writing of annuities and other investment products or policies that comprise either a legal promise or a strong expectation that the policy will produce the kind of return that would be received from long-term investment and a simultaneous short-term liquidity guarantee.[17] A temporary stay on 'cashing-out' annuities may support the restructuring of those annuity products, for example, and preserve liquidity in the short term.

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[17] For example variable annuities, where the policyholder is given the better of the performance of a basket of designated assets or a pre-set promise (monetary amount) that does not depend on the future performance of that basket of assets. A variable annuity tends to invest in risky assets in good times, and exit such assets in bad times. This could produce a pro-cyclical environment, and potentially have a systemic impact.

2. Critical functions and continuity of insurance coverage

An analysis of the criticality of an insurer's functions should help ensure that the resolution strategy and operational plan include appropriate actions that help maintain continuity of those functions or, at a minimum, temporary continuity to facilitate substitutability over time.

a. Definition of critical function

For the purposes of this Guidance, a critical function has both of the following elements:[18]

(i) it is provided by an insurer to third parties not affiliated to the firm; and

(ii) the sudden failure to provide that function would be likely to have a material impact on the financial system and the real economy, give rise to contagion or undermine the general confidence of market participants.

Services that do not have a significant impact on economic and financial stability or that can be substituted with a minimum of time and cost should not be considered critical.

b. Identification of critical functions

The identification of critical functions should in principle entail three steps, which may be carried out in whatever order is most proportionate and efficient. Those steps are:

(i) an analysis of the impact of a sudden discontinuation of the function;

(ii) the evaluation of the substitutability of the function; and

(iii) a firm-specific analysis of the impact of a failure of the continued performance of the function by a specific insurer.

The impact of an insurance failure is likely to differ depending on the conditions in the financial system and the economy at the time of the failure. The identification of a particular function as critical should not generally imply that the function and all related liabilities will be fully protected in a resolution.

In some jurisdictions, authorities may consider it necessary to preserve continuity of functions that are material to the real economy. The prospect of disruption of cover or payments to a significantly large number of policyholders could prompt pressure for government intervention and expose taxpayers to loss. Identification of these kinds of risks, and a decision on whether to intervene, will often involve an element of broader political and economic judgement, and so the issue may need to be approached in conjunction with other public authorities.

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[18] The definition of a critical function is similar to that for G-SIBs and focuses on the effect on financial stability. See: *Guidance on Identification of Critical Functions and Critical Shared Services* July 2013. http://www.financialstabilityboard.org/wp-content/uploads/r_130716a.pdf.

c. Criticality

In assessing the criticality of an insurer's functions and the possible need to ensure the continuity of related insurance cover, authorities should identify which of the following objectives are relevant to the particular function or cover:

(i) the ability to continue to write new business;

(ii) the continuity of existing insurance cover, for example, preventing termination of cover before the term of the insurance policy has expired;

(iii) the continuity of payments falling due under cover written before the commencement of resolution, in particular where those payments are not contingent on an event taking place after commencement of resolution.

The implications for resolution vary between these categories. The ability to write new business may not be relevant where the function is highly substitutable. However, authorities should not exclude the possibility that it may be necessary for a failed insurer to continue to write new business in one or more areas. Where this is the case, it would justify the use of resolution tools to recapitalise the insurer to a sufficient level to enable it to write new business.

In some jurisdictions, authorities may want to preserve continuity of cover for certain types of P&C business to prevent severe disruption to economic activity. In principle, given a reasonable timeframe, the market should in most circumstances be able to substitute the existing cover provided by a failing P&C insurer. An aim of the resolution strategy for a P&C insurer may, therefore, be to provide temporary continuity to facilitate substitutability over time.

Continuity of cover for existing life policies may be needed for the full term of the policy since the policyholder may not easily be able to procure replacement coverage. Likewise, continuity of payments for existing life policies, including annuities, in most cases should be for the full term of the policy. Where continuity of cover or payments for existing life business cannot be achieved by an insolvent run-off within some form of administration, and where this could lead to a disruption of cover or payments to a large number of policyholders, then this could justify the use of other resolution tools.

Some insurers also provide important non-insurance functions to third parties, some of which may be insurance-related, such as claims management, actuarial services, pension fund management, asset management, securities lending or other administrative functions.

The questions in Box 1 should help guide the assessment of criticality and substitutability in resolution.

Box 1: Assessing criticality and substitutability of functions

Assessing the impact of a sudden discontinuation of the function

1. What is the nature and extent of the activity (including reinsurance activity)?
   - Mandatory coverage?
   - Type of products or services provided to policyholders or third parties?
   - Global, regional or national coverage?

- Number of external parties relying on that activity in absolute and relative terms?

2. What is the nature of the counterparties in that activity?

- Corporates: SMEs, large national companies, large multinational companies?
- Financial counterparties?
- Individuals?
- Are any of the above protected under a PPS? If protected; fully or partially?

3. What impact would disruption have on financial or insurance markets and the real economy?

- Direct consequences on financial counterparties or other market participants?
- Possibility of contagion?
- Speed at which the disruption impacts other counterparties?

4. What impact would disruption have on end users (policyholders or otherwise affected third parties)?

- Are end users able to continue their usual activities without this insurance coverage?
- Could some elements of the end users' activity be affected by the failure? Could the end users easily adapt their activity without suffering a negative impact if there is a disruption of the provided function?
- How long are end users able to perform their usual activities without the provision of the function?
- Can temporary cover be provided in administration, possibly using a PPS, to allow time for policyholders to find alternative cover?

Assessing substitutability

5. Are certain functions or products of the failing firm substitutable within a reasonable timeframe? Is there capacity in the industry to replace the amount of protection that the failing insurer provides?

6. Are there other products or markets that provide a function broadly equivalent to the activities of the failing firm? Are the pricing levels, attachment points and terms and conditions provided by the failing firm available?

7. Are other players in the market offering similar products or alternative products?

8. How quickly can end users switch to another firm providing a similar function? Are there any encumbrances (financial, legal, operational, underwriting) to switching from one provider to another?

9. Is the market attractive for potential new providers? Is there evidence that a turnover of providers in the market exists?

10. What are the barriers to entry for new providers? For example:

- Are particular factors (arrangements, infrastructure) necessary to provide this service in the market?
- Are particular skills or expertise necessary to provide the function?
- Are regulatory approvals necessary for providing the function?
- How quickly would a new provider be able to step into the market?

Firm-specific analysis

11. What is the overall market share of the insurer for the specific function and its share in specific market segments (e.g., by counterparty or region)?

13. What is the role of the insurer in the operation of the relevant marketplace (e.g., the provision of expertise,

capital or data, acting as lead insurer, etc.)?

3. Operational continuity (critical shared services)

Operational continuity refers to the means of ensuring continuity of critical shared services that are necessary to maintain the provision or facilitate the orderly wind down of a firm's critical functions in resolution.

a. Identification of critical shared services

Critical shared services are activities performed within the firm or outsourced to third parties where failure would lead to the insurer being unable to continue to perform a critical function. Critical shared services and critical functions are intrinsically linked: without continuity of critical shared services, the continued provision of critical functions in resolution may not be possible. There are two main categories of critical shared services.

(i) **Finance-related shared services**. Finance-related shared services involve the management of financial resources of the insurer related to the operation or provision of critical function(s). This includes, but is not limited to: treasury-related services, trading, asset management, actuarial and risk, including development of underwriting standards and reinsurance risk policies, reporting and monitoring of exposure, actuarial services, assessment of necessary level of claims reserves including market valuations, reinsurance accounting, including accrual, estimation and closing processes, regulatory and management financial reporting, intra-group reinsurance management, policy liability and premium layoff management, reinsurance payable and receivable administration, captive and fronting management, insurance pool oversight.

(ii) **Operational shared services.** Operational shared services provide the necessary infrastructure to enable the financial institution or group to operate or provide critical function(s). This includes, but is not limited to: IT infrastructure and software-related services, human resources support, and transaction processing, payroll processing, intellectual property or data access or ownership; other IT infrastructure, including hardware, servers, telecoms, data centres and related services; real estate management; and legal and compliance. The ability of an insurer (or for the purchaser of that insurer's business) to continue to be able to operate a risk model to calculate regulatory requirements and to manage insurance risks internally may be particularly important.

Given the variety of shared services and the limited time and resources in resolution, it might be helpful to rank the shared services in order of priority. While some shared services have to be continuously provided, there might be others that can be interrupted for a short period without leading to a collapse of the critical function.

The questions set out in Box 2 may help in identifying and prioritising critical shared services for resolution planning purposes.

Box 2: Identifying and prioritising critical shared services

1. Is the function performed by either an internal unit, a separate legal entity within the group or an external provider? Is the separate group entity or external third party service provider established in the home country or a host country?
2. Is the function performed for one or more business units or legal entities of the group?
3. How quickly could the failure of a particular shared service lead to a collapse of one or more critical functions or present a material obstacle to the continuity of such functions?
4. How quickly can the failure of a particular shared service be replaced by an alternative internal source or an external provider?
5. Would a sudden and disorderly failure lead to the collapse of or present a serious impediment to the performance of a critical function provided by the insurer?
6. How severe are the consequences of the failure of a particular service on one or more critical functions?

b. Implications for resolution planning

Critical shared services should be organised or procured in a way that ensures their continued access and availability to all relevant parts of the firm in resolution. Arrangements that could achieve that objective include, but are not limited to: (i) provision of shared services by bankruptcy-remote legal entities; and (ii) advance preparation for substitution by an alternative (external) provider in a crisis. If the service is provided by an external third party provider, arrangements should be put in place in order to ensure uninterrupted access (for example, to data) and continuity of service provision, including to a successor entity to which functions of the firm in resolution have been transferred. Such arrangements need to be enforceable in resolution, including if provided across borders. If cross-border service agreements cannot be enforced in resolution, this may prevent the continuation of the service or access to data.

Special consideration should be given to services that require a highly specific firm-internal knowledge. In this respect, the retention of key personnel in short and medium term is likely to be important for operational reasons.

Given that the vast majority of firms' business processes are likely to depend on information technology (IT) systems, it is important to understand the complexities of dependencies arising from shared IT systems, which may differ from the structure of business processes.

Examples of arrangement that support operational continuity are set out in Box 3.

Box 3: Arrangements to support operational continuity

To achieve the support of operational continuity, the following arrangements could be considered:

- **Contractual provisions**: firms should have clearly and comprehensively documented contractual arrangements and Service Level Agreements (SLAs) for both intra-group and third party critical shared services which, to the greatest extent possible, remain valid and enforceable in resolution provided there

is no default in payment obligations.

- **Management information systems (MIS)**: MIS should allow for timely reporting on the provision or receipt of critical shared services on a legal entity basis and line of business basis, including information about ownership of assets and infrastructure; pricing; contractual rights and agreements; and outsourcing arrangements. Firms' MIS should be able to process and search this information.
- **Financial resources**: intra-group providers of critical shared services should have sufficient financial resources to facilitate operational continuity of critical functions in resolution if necessary or, in the case of third party critical shared services, the service recipient should have sufficient financial resources to ensure that the third party provider continues to be paid. This should take into account the stabilisation and restructuring phases of resolution.
- **Robust pricing structures**: pricing for services should be predictable, transparent and set on an arm's length basis with clear links, where relevant, between the original direct cost of the service and the allocated cost. The cost structure for services should not be directly or indirectly influenced by the financial performance of the service recipient. This is relevant for example for the provision of critical shared services through an intra-group service company (to ensure the service company is financially viable on a standalone basis) or through a regulated entity (to ensure that the documentation could form the basis of an external contract if the regulated entity is restructured in resolution).
- **Operational resilience and resourcing**: critical shared services should be operationally resilient and have sufficient capacity (for example, human resources and expertise) to support the restructuring phase following the failure of a group entity or group entities. In any event, the continued provision of critical shared services should not be unduly affected by the failure or resolution of other group entities.
- **Governance**: critical shared services should have their own governance structure and clearly defined reporting lines. Governance structures should ensure that provision of critical shared services is possible in resolution without relying on senior staff from business lines that may be wound down or that may no longer form part of the same group. The governance arrangements relating to critical shared services should be assessed by the firm's internal audit function.
- **Rights of use and access**: access to operational assets by the critical shared services provider, the serviced entities, business units and authorities should not be disrupted by the failure or resolution of any particular group entity. In some cases, this may require that operational assets essential to the provision of critical shared services are owned or leased by the same legal entity providing these critical shared services (that is, by the regulated entity or by the intra-group service company, depending on the model used). Where this is not the case, contractual provisions to ensure rights of access could be considered. Service recipients should not be restricted from using shared assets directly where appropriate.

4. Cross-border cooperation

Authorities will need to identify the cross-border elements that will affect the implementation of their preferred resolution strategy. Such cross-border dimensions to a resolution may arise, for example, from the provision of services through branches in foreign jurisdictions; the existence of financial contracts governed by foreign law and assets and/or liabilities in, or governed by the law of, a foreign jurisdiction; or service companies located in a foreign jurisdiction.

In the light of those cross-border elements, authorities will need to assess to what extent and in what form the application of the preferred resolution tools requires cooperation from foreign authorities. Forms of cooperation might include, for example:

(i) Recognition by foreign authorities of resolution actions, such as for example transfer of insurance portfolio to a bridge or other insurer, the restructuring of insurance policies held by foreign policy holder, or the bail-in of liabilities held by foreign creditors or governed by foreign law;

(ii) Taking of actions under domestic law to support the application of resolution measures taken by another jurisdiction in relation to domestic operations, assets, rights or liabilities of the firm in resolution);

(iii) Refraining from or staying the initiation of local insolvency proceedings;

(iv) Regulatory approvals, including change of control authorisations.

5. Extent of coverage and role of policyholder protection schemes (PPS)

In jurisdictions where it is available, the PPS (or other mechanism for policyholder protection, such as tied assets) may have an important role in supporting the use of resolution tools by contributing funds. Authorities should assess the availability and scope of cover under PPS and the extent to which PPS can assist in securing continuity of insurance cover and payments, and in particular:

(i) whether the PPS has the legal and financial capability (including the ability to borrow from the public sector) to help fund resolution actions as a means of securing continuity of insurance cover and payments, for example through a transfer of insurance policies or by contributing funds that would otherwise be obtained by a write-down of policyholders' claims; and

(ii) where the PPS is responsible for making payments to policyholders, the extent to which the PPS has the operational and financial capability (including the ability to borrow from the public sector) to make payments under the insurance policy.

6. Nature and location of loss-absorbing capacity in resolution

The nature and location of loss-absorbing capacity can be relevant to resolution strategies. In particular, authorities should assess whether:

(i) adequate loss-absorbing capacity will be available at material legal entities within the insurer to implement their preferred resolution strategy (including whether loss-absorbing capacity is fully fungible and transferable within the group or restricted solely to a specific legal entity);

(ii) the holders of the loss-absorbing capacity can credibly absorb the loss;

(iii) allocation of loss is consistent with the creditor hierarchy and will not give rise to material risk of successful legal challenge or valid compensation claims.

7. Funding and liquidity

A number of sources of funding and liquidity will no longer be available to insurance entities in resolution, including cash from affiliates since intra-group movement of funds is generally stopped and intra-group guarantees may no longer be used. Other sources may shrink. If the insurer is no longer writing new business, the inflow of premiums may be reduced. Derivatives could be closed out and terminated and collateral seized, and it may need to be considered whether and how to replace hedges. It will also be necessary to determine whether to maintain or terminate reinsurance.

To the extent that insurers engage in business activities that might give rise to a need for liquidity, authorities and CMG participants should maintain firm specific plans for providing the liquidity necessary for those functions to the appropriate entities and in the necessary currencies.

In order to do so, authorities should identify which subsidiaries may face a shortage of liquidity and which ones may be providers of liquidity within the group through the existence of external credit lines or liquid assets compared to the duration of liabilities. Authorities should also consider the need to continue the insurer's internal reporting on liquidity risk management to follow liquidity issue and prevent potentially adverse liquidity shortages.

IV. Making the resolution strategy operational

This section sets out aspects that authorities should consider when developing the operational plan for implementing the preferred resolution strategy and arrangements that need to be in place to ensure that the resolution strategy can be feasibly and credibly implemented.

1. Developing operational resolution plans

A preferred strategy for an insurance group should be supported by detailed resolution plans for each point of entry that provide operational detail of how the strategy would be implemented. Such plans might include the following elements, as appropriate to the insurer:

(i) coordination of roles, responsibilities and expectations for different national authorities, communication plans, etc.;

(ii) cross-border aspects of the operational plan and actions (recognition or support) that will be needed by authorities in other jurisdictions to ensure that resolution measures are effective;

(iii) transfer of reinsurance (if any) and impact on cover;

(iv) operational and practical arrangements for ensuring continuity of cover and payment under insurance policies;

(v) treatment of any derivatives portfolio, and possible need to maintain or replace hedges; and

(vi) direct or indirect access to Financial Market Infrastructure (FMI) services.

In resolution planning, authorities should also take into account the time required to implement the resolution options. In particular, in some jurisdictions, the courts may play a

role in the application of certain resolution tools or strategies. Where the measures required to implement the strategy entail judicial intervention, authorities should have regard to any implications for timing that this process may entail. To the extent that any time constraints implied by the resolution strategy and preferred tools are likely to jeopardise the resolution objectives, authorities should consider alternative tools that would not be subject to similar constraints.

2. Failure scenarios

Resolution strategies and plans should be adaptable to different failure scenarios by setting out alternative options that may be used. Accordingly, operational resolution plans should identify and set out how to execute options for actions (including fall back option where preferred options are not available) for a range of severe scenarios, including both idiosyncratic and market wide stress with failure at a parent level and, alternatively, isolated failure of one or several operating entities. Resolution strategies and plans should also distinguish between fast and slow moving scenarios as the adequate responses to these might differ materially.

3. Deciding whether and when to trigger resolution

CMGs should develop a clear understanding of a number of factors relevant for triggering resolution actions, including:

(i) the resolution triggers under relevant national regimes;

(ii) the processes needed to coordinate action in the run-up to a failure; and

(iii) any automatic effects (domestically or in other jurisdictions) of triggering resolution.

4. Cooperation agreements underpinning the resolution strategy and plan

COAGs for G-SIIs need to be firm-specific and support the development and implementation of the resolution strategy and operational plan. They should be agreed by the home and host authorities represented on the CMG and include the elements set out in KA 9 of the *Key Attributes*. In particular they should:

(i) establish the objectives and processes for cooperation through CMGs;

(ii) define the roles and responsibilities of the authorities pre-crisis (that is, in the recovery and resolution planning phases) and during a crisis;

(iii) set out the process for information sharing before and during a crisis, including sharing with any host authorities that are not represented in the CMG;

(iv) set out the processes for coordination in the development of the recovery and resolution plans (RRPs) for the firm, including parent or holding company and significant subsidiaries, branches and affiliates that are within the scope of the agreement, and for engagement with the firm as part of this process;

(v) set out the processes for coordination among home and host authorities in the conduct of resolvability assessments;

(vi) include agreed procedures for the home authority to inform and consult host authorities in a timely manner when there are material adverse developments affecting the firm and before taking any significant action or crisis measures;

(vii) include agreed procedures for the host authority to inform and consult the home authority in a timely manner when there are material adverse developments affecting the firm and before taking any discretionary action or crisis measures;

(viii) provide an appropriate level of detail with regard to the cross-border implementation of specific resolution measures, including with respect to the use of bridge institution and bail-in powers;

(ix) provide for meetings to be held at least annually, involving top officials of the home and relevant host authorities, to review the robustness of the overall resolution strategy for G-SIIs; and

(x) provide for regular (at least annual) reviews by appropriate senior officials of the operational plans implementing the resolution strategies.

5. Information systems and data requirements

Authorities need to ensure that they will be able to obtain the information needed to implement the resolution strategy and plan. As specified by II-Annex 2 to the *Key Attributes,* insurers that are subject to a resolution planning requirement should maintain information systems and controls that can promptly produce, both in business as usual and as the firm approaches resolution, the relevant data and information needed to establish and maintain a resolution strategy and operational resolution plan and to implement resolution measures in a timely manner.

Such information needs may relate to:

- insurance policies, benefits under those policies;
- policyholders covered by the PPS and the amount or proportion of protection provided;
- information needed to facilitate the transfer of insurance obligations to another insurer;
- the reinsurance in place for insurance policies;
- assets backing insurance liabilities (and details of location and custodians, fungibility of surplus assets between jurisdictions, etc.);
- financial products of the insurer that could be prone to 'runs';
- information needed for the valuation of insurance business and for carrying out 'due diligence' by any potential purchaser of all or parts of the insurance business;
- information about arrangements and SLAs with internal and external service providers that support critical shared services.

In the course of developing resolution plans and conducting resolvability assessments authorities should identify and address any impediments to meeting information needs in a manner that is timely and produces up-to-date and reliable information.

6. Exit from the resolution process

Where a resolution strategy provides for the preservation of parts of the business of the failed insurer, for example through recapitalisation through bail-in or the use of a bridge institution, the resolution strategy and plan need to set out clearly how exit from the resolution process will be achieved. This includes setting out measures that need to be taken to underpin the restoration to viability of the operations that emerge from the resolution, for example, transfer of decision making and other governance functions to a new board and management. It also includes the consideration of legal or regulatory requirements that need to be met, including, for example, licensing and regulatory approvals; limits on the duration for bridge entities; restrictions under competition law; governance and requirements under securities laws (such as listing rules); and "fit and proper" tests for new management.