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

Key Messages

1. The FSB's consultation document has identified in resolution a significant issue that merits a public consultation. We agree that insurers should be resolvable. In most cases the conventional tools of run-off and portfolio transfer will be adequate. However, there is enough doubt about whether these tools will be adequate in all cases to justify a detailed examination of the issues.

2. Unfortunately, in considering the application of the Key Attributes in an insurance context, the FSB Secretariat has **failed to take sufficient account of the differences between insurance and banking**. As a result, the proposed objectives of insurance resolution give too much weight to financial stability at the expense of the primary objective of policyholder protection; further thought and guidance for the authorities is needed on the timing of entry into resolution; and the proposed tools are written with a weekend-based bank-style resolution in mind, thus missing the advantages of the longer timescale of resolution in an insurance context. If not corrected, there is a risk that this will produce a resolution regime for insurers that is directed at the wrong issues, and will lead to sub-optimal outcomes for policyholders.

3. We agree that severe economic disruption and exposure of taxpayers to loss should be avoided – with the major caveat that the insurance business model is much less likely to lead to these outcomes than the banking business model. We also agree that the **resolution of insurers requires a wider set of objectives than banking, i**n particular of an objective for the protection of policyholders. However, the objectives need to be re-balanced, with greater weight given to policyholder protection. Further work is also needed on the definition of "vital economic interests; as currently drafted, most of the insurance industry would fall within the scope of "vital economic interests." This may lead to the application of a powerful set of resolution tools in circumstances where they are not needed.

4. Further work is needed on the **conditions for entry into resolution**. As currently drafted, the resolution authority has almost complete discretion. Clearly some element of discretion for the authorities is necessary: we would be opposed to a wholly mechanical set of triggers, which might prove inappropriate in future circumstances. However, there are also risks to complete discretion. Regulators will come under pressure to act too early - with prejudice to the rights of shareholders, and too late – with prejudice to the interests of policyholders. We therefore recommend that the IAIS should be asked to elaborate the principles for the guidance of authorities when considering the point at which a failing insurer should be put into resolution. In particular, this point should not be reached until after all appropriate recovery actions have been tried. We also recommend that legal safeguards should be available in each jurisdiction against poor decisions by the authorities.

5. Similarly, we believe that the **choice of resolution powers** by the resolution authorities needs to be circumscribed. In all but exceptional cases, the existing run-off and portfolio transfer tools will be adequate. However, the consultation document envisages that resolution authorities should have at their disposal a set of far-reaching and invasive tools that could lead to the regulators making decisions with serious impacts on individuals'

retirement income, medical treatment in the event of accidents, or protection against loss. In the UK, outcomes such as these are achievable only through court-sanctioned agreements. If it is the intention that new powers should supersede existing mechanisms, the FSB should clearly indicate why it believes that such a change is necessary. In addition any introduction of new resolution powers should be subject to an appropriate safeguard, in a similar way that sanction by the Courts in the UK currently provides.

6. Some thought has clearly been given to the different purposes, ownership and content, in an insurance context, of **resolvability assessments, and recovery and resolution plans**. We suggest that the arrangements need to be field-tested against a number of failure scenarios, particularly scenarios taking place over a number of years. Further thought is needed on the articulation between recovery and resolution planning, as a consistent approach will need to be taken through going concern and gone concern status. Similar considerations apply to the ownership of the plans, to ensure a coherent approach. Arrangements may need to be made for mediation in the event of disagreement between the different plan owners and stakeholders – particularly for insurance multinationals. The content of these documents is specified at the right level of detail for this guidance, but probably drawn too widely, The risk is that unwieldy plans will be generated that provide little benefit in times of trouble. Any more detailed guidance should be tailored to the circumstance of each insurer, and established between the insurer and its supervisor.

7. Further work is need on the special circumstances surrounding the **resolution of groups**, and particularly multinational groups. This should start with a discussion among insurance regulators about the extent to which they are prepared to co-operate with each other in the event of a failure involving a large insurer. Absent clarification on this point, work by insurers on group resolution and intra-group transactions will have limited value.

8. Finally, the consultation document makes no attempt to balance the **cost of the proposed measures** against the benefits in terms of protection to policyholders or financial stability. This is disappointing, as the G20 has explicitly requested the FSB to consider the impact of its regulatory measures on growth and long-term investment. This omission should be rectified in the next consultation document.

Answers to the FSB questions

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

    With the caveat that there will always be unforeseen circumstances, we agree that the proposed powers cover most eventualities. Indeed, there is a risk that the FSB will produce an over-engineered regime that leads to excessive interference in the activities of healthy insurers. A better approach might be to identify the known and predictable circumstances of insurer failure, and to produce a regime proportionate to those risks.

    The guidance rightly draws attention to the possibility of insurer failure. It fails to point out that insurer failure is rare, and the systemic consequences even less likely, in view of the existing mitigants. We recognise that the FSB has consciously focused on the severity of the consequences of failure, rather than its likelihood. However, the result of this is that the proposed regime is disproportionate to the risks, and may impose unnecessary costs on insurers and policyholders alike.

    In terms of policyholder protection, much can be achieved through communication and consultation with policyholders in the course of a failure. Not all policyholders will be aware of their rights, or of the protection offered by the local policyholder protection schemes. Policyholder detriment can often be caused by ill-advised and precipitate action. The extended timescale of insurance failure allows time for full consultation with policyholders, and the provision of advice on the best course of action to take to replace cover, etc. This is not an additional power for the authorities, but we suggest that this approach may prove more effective in reducing policyholder detriment.

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

    This question is difficult to answer in the absence of an agreed definition of NTNI. However, consensus on this will clearly be difficult to achieve in view of regulators' differing opinions about what is traditional, and what is non-traditional. In the circumstances, we do not see that this can be a helpful distinction in considering a resolution regime. We recommend the creation of a generic insurance resolution regime, and that regulators should decide which tools to use in the light of the business model and circumstances of each failing insurer. As far as non-insurance is concerned, the Key Attributes and the EU's Recovery and Resolution Directive set out a regime for bank resolution, We see no grounds for a special resolution regime for other businesses that an insurer might own.

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

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We also agree that the protection of policyholders should be a statutory objective – indeed we believe that, for insurers, policyholder protection is a more important objective than financial stability. However, the concept needs to be limited. Once an insurer has failed, there is a limit to the extent that resolution powers can protect policyholders from the consequences.

On the other hand, the concept of policyholder protection needs to be extended to include the protection of third parties covered by insurance claims.

The definition of "vital economic functions" needs further consideration in an insurance context. The risk otherwise is that the concept will be interpreted too widely, and that the heavy apparatus of resolution powers might be applied to functions that do not need this level of protection. The non-exhaustive list in paragraph 1.2 of risk transfer, risk pooling and the pooling of savings already covers most insurance activity. Securing continuity of insurance coverage and payments is a laudable objective, but some losses are inevitable once an insurer has failed, and the FSB should clarify what is intended with this objective.

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

We agree that in most cases existing powers will be adequate. The question is: how to ensure that the proposed new powers are only invoked in appropriate circumstances, where the existing powers will not produce a safe and equitable outcome. It is not clear from the consultation whether the FSB intends that new resolution powers should be implemented where there are already existing mechanisms for achieving their aims in an insurance context, should run alongside them, or should be used in special circumstances. If it is the intention that new powers should supersede existing mechanisms, then the FSB should clearly indicate why it believes that such a change is necessary. In addition, any introduction of new resolution powers should be subject to an appropriate safeguard, in a similar way that sanction by the Courts in the UK currently provides. Finally, the authorities may wish to seek the advice of third party skilled persons.

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

Entry into resolution

Entry into resolution rightly involves an element of supervisory judgement. Automatic triggers might leave the authorities unnecessarily hemmed in for the future. However, the current draft leaves complete discretion to the resolution authorities; this will create undesirable uncertainty for insurers' Boards and for investors alike. Clearly entry into resolution needs to take place before an insurer is balance sheet insolvent. However, there are also risks in premature entry into resolution, as this rules out a number of recovery options that might have produced a better outcome for the insurer and its policyholders.

The extended time horizon of insurers also needs to be taken into account: insurers' liabilities can fall due over decades, and this allows considerable time for management action to be taken to restore the situation.

Uncertainty about the timing of entry into resolution will create doubt in the minds of the Board when considering recovery options, and will make insurance companies a less attractive proposition for investors, raising the cost of capital. We recommend that the IAIS produce a more detailed set of principles that would create a clear framework within which supervisors can exercise their judgement that the insurer is no longer viable, that all recovery options have been exhausted, that supervisory powers are no longer adequate, and that resolution is the right option. Authorities may also wish to seek the support of third party skilled persons. We also recommend that legal remedies should be available to policyholders and investors in the event of poor decisions by the authorities. Finally, the authorities should be obliged to produce a public statement why resolution is the best option for policyholders and for financial stability

We have the following comment on the indicators set out in paragraph 4:

- The wording "unacceptably low probability" of payment in full and on time in indicators (i) and (ii) allows the authorities too much discretion. The trigger should be the same as the trigger the regulator would use to close an insurer to new business;

- The judgement in indicators (i) and (ii) should explicitly include the condition that the judgment needs to be made over the full period of the insurer's liabilities

- Indicators (iii) and (iv) should include a judgement that the interests of investors in the company are exhausted

- Indicator (v), involving a judgment that entry into ordinary insolvency, or the application of run-off or portfolio transfer transfer powers would not be adequate to the situation, is an extremely important point, but requires refinement and strengthening to prevent the inappropriate use of powers. Read in connection with indicators (i) and (ii), this indicator suggests that run-off and portfolio transfer are different in nature, and need to be considered separately from the other resolution powers mentioned in the document. We believe that they should be considered together, as tools available to the resolution authorities once an insurer has entered resolution. The first step should be a determination by the authorities that the insurer should be resolved – subject to the considerations set out earlier in this section. The next step should be decisions which resolution tool or tools should be used, including run-off and portfolio transfer; these decisions may take place over a period of time, and may change as external circumstances alter.

Choice of resolution powers

We agree with the document. However, some form of oversight is required to ensure that the resolution authorities have indeed used powers suitable for the event. As ex ante judgements are difficult, and again the authorities may wish to seek the advice of third party skilled persons, some form of ex post assessment may be helpful, for example an examination by the courts whether the actions of the authorities were reasonable in the circumstances.

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

Control, manage and operate the insurer or bridge institution

We agree that these powers are necessary. Further work is needed on the role of a bridge institution in the context of insurance resolution. What will it achieve that could not be achieved through use of the run-off tool? It may be helpful to think through the usual long-drawn out process of insurance failure:

- in the initial recovery phase, where the insurer is still a going concern, we see no reason why action should not be the responsibility of the insurer's Board – subject to the usual discussion with their supervisor;

- if the insurer fails to recover, the logical next step would be run-off. One of the priorities of the authorities should be to search for investors prepared to inject new capital into the business;

- once an insurer is insolvent, the compensation scheme needs to get involved.

Restructuring of liabilities

These are far-reaching powers, which may involve the confiscation of property from individuals. As such, we do not believe that these powers should fall to the regulator alone: they should be subject to the legal safeguards appropriate to each jurisdiction. For example, Schemes of Arrangement are required to be approved by the Courts in the UK. In view of the extended timescales of insurance resolutions, there is time for the approval of the courts to be sought. In view of the impact of some of these decisions, for example reducing annuity rates, we believe that decisions by the authorities would inevitably face legal challenge in any case.

We refer to the Insurance Europe and GFIA comments on the powers proposed in paragraph 4.4, with which we agree.

Resolution authorities should not be obliged to identify all potential creditors (para 4.5 and 4.6), but they should make every effort to do so.

We doubt the need for a specific bail-in power in an insurance context, as we believe that its purpose can be met through existing insurance-based arrangements, for example the existing law surrounding corporate restructuring. The concept of bail-in has been adopted to ensure that banks can be recapitalised quickly by imposing losses on bond holders before the state has to provide financial support. There should be no question of state support for an insurer (the US Government rescued AIG to save its banking counterparties, not to rescue its policyholders). In any case, insurers fund insurance through premiums and investment returns. Bond finance is a useful source of financial flexibility, but represents a much smaller slice of an insurer's balance sheet than the typical bank. Wiping out the bondholders would make a very small contribution to the resolution of an insurer. Given that resolution of an insurer takes place over a long time period, where bailing in bond holders is deemed appropriate there is time for negotiation and court settlement under existing corporate restructuring law. The introduction of a new bail in provision, would therefore seem unnecessary, and it would make it much more expensive for all insurers to issue bonds.

Portfolio transfer

The power to transfer portfolios is agreed in principle – though we question how often this tool will be used in the long timescale of insurance failure.

A power to reduce the value of contracts is another matter, and should be subject to the legal safeguards appropriate to each jurisdiction, along with all other powers that involve the confiscation of property.

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

We agree that this is a useful reserve power in the unlikely event of a "run" on an insurer. Most insurance policies impose penalties for early surrender of policies, and in most cases this has proved effective in preventing a run. The Belgian insurer Ethyas is an exception, which had no such penalties, and was in effect running a bank.

However, at the news of an insurer's failure, it is possible that policyholders will be unaware of their rights, and may act precipitately against their own interests. This proposed power is the least costly and most effective means we have yet seen of mitigating that remote risk. Enhanced communication and consultation of policyholders also has a useful contribution to make.

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

We do not support the power to stay the rights of reinsurers to terminate cover, which may impact adversely on the price and availability of reinsurance. Difficulties may arise in the case of contracts written under the law of an overseas jurisdiction.

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

Resolvability assessments

We agree that regulators should produce resolvability assessments for GSIIs.

The requirements on resolution authorities in paragraph 9.2 need to be modified, or they will produce an outcome that will restrict the activities of insurers in the normal course of business, to an extent that is not justified when balanced against the mitigation of damage in the relatively rare event of an insurer's failure. For example, few resolution strategies can ensure continuity of insurance coverage in all cases. Those that do so would be prohibitively expensive.

We refer to the comments by Insurance Europe and GFIA, with which we agree, on the coverage of the assessment of the feasibility of the resolution strategy in paragraph 9.3, and on the suggested impacts of failure on third parties and financial stability in paragraph 9.4. Inevitably, many of these points will need to be taken into account, but they should provide a framework for consideration rather than a set of requirements that must all be met.

Crisis Management Groups and Co-operation Agreements

There is a real risk of overlap with existing supervisory Colleges and supervisory agreements here.

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

Recovery and resolution planning

The problem is not that additional matters need to be included in recovery and resolution plans, but rather that the articulation between recovery and resolution planning needs further thought, to ensure a consistent approach to policyholders and other stakeholders over time – with consideration given to arrangements for mediation in the event of disagreement between stakeholders.

Particular care is needed with the action taken as a result of these plans. It is through these documents that the resolution regime may reach through to affect the running of a healthy insurer. Measures taken to enable an orderly resolution need to be weighed against the additional cost to the efficient provision of insurance.

The characteristics of insurance allow time for actions to be taken over an extended period to address issues that may arise. Therefore to avoid overlap/confusion between recovery plans and resolution plans, it may be helpful to draw a clear difference between those actions that can be taken while an insurer is a viable concern, and those actions that may need to be taken when an insurer is no longer viable.

Alignment of recovery planning with insurers' ongoing risk management and supervision should limit the circumstances in which resolution becomes necessary. Resolution planning should be focus on circumstances where all practical recovery actions have failed to restore the insurer to a viable position.

Recovery plans

Prescriptive recovery plans covering all the ground suggested could be very extensive, costly to prepare and maintain, and might prove of limited value in the event of difficulty. It is not practical to cover all conceivable scenarios that might lead to losses, but pared down recovery plans have been found useful by insurers' Boards to consider the menu of possible management actions following given levels of stress. It is quite practical to consider a reasonable number of scenarios covering key risks, and consider actions specific to those scenarios. A preferable approach might therefore be for the guidance to recommend the production of plans for dealing with a capital loss of various orders of magnitude.

Resolution strategies and plans

Further thought is needed on the difference between a resolvability assessment and a resolution plan. Different words may be used, but there is a great deal of similarity (estimate of the outcome for each class of policyholder, arrangements for ensuring continuity of coverage and payment) between the suggested content of a resolvability assessment and a resolution plan. Furthermore, some of the proposed requirements for a resolution plan (actuarial assumptions used to calculate liabilities, review of asset quality and concentration) look very similar to the prudential requirements for an ongoing insurance business.

We are concerned about some of the requirements:

- independent exit valuations of policyholders' liabilities would be expensive and of limited use as the values may well not be valid in the real resolution scenario

- estimates of outcome for each class of policyholder upon winding up would again be scenario dependent and any estimates made in normal circumstances may be of limited value in the real resolution scenario

We understand that a recovery plan belongs to the insurer's Board, and that a resolution plan belongs to the authorities. This distinction seems clear, but further thought is needed about how this relationship would develop over the long timescale of a typical insurance failure, and about the involvement of other stakeholders, such as the local supervisors, or the Boards of local subsidiaries. For example, a recovery plan may be owned by the insurer, but any stage on the Solvency II ladder of intervention would require discussion with the supervisor. Supervisors of subsidiaries may have views. Similarly, a resolution plan may belong to the authorities, but an insurer's Board will need to be cognisant of its content. Subsidiary Board members may have views. Further thought is required about the role these documents might usefully play in the long drawn-out circumstances of an insurance failure, and the relations between the parties to the documents.

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

    We see a risk that the data maintenance requirements might be burdensome and costly, and we would certainly not be in favour of producing additional material. The resolution plan should focus on setting out the principles that could be followed for resolution and not focus on becoming repositories of lots of data that could become outdated quickly.

33. *Does this draft Annex meet the overall objective of providing sector-specific details for the implementation of the Key Attributes in relation to resolution regimes for insurers? Are there*

any other issues in relation to the resolution of insurers that it would be helpful for the FSB to clarify in this guidance?

Overall, we believe that the guidance fails to adapt the Key Attributes adequately to the specifics of the insurance business model. The Key Attributes were drawn up with the original banking-based resolution objectives in mind of avoiding severe systemic disruption, exposure of taxpayers to loss, and protection of vital economic functions. These remain legitimate concerns in insurance, but the likelihood of these outcomes is much more remote than in banking. The main reason for the prudential regulation of insurance is policyholder protection. The FSB has rightly recognised this with the introduction of a second objective for the resolution of insurers. The procedure and powers of a resolution regime for insurance also need to reflect the relative importance of these objectives, and this has not yet happened. For example:

- An insurance resolution authority needs to be much closer to the supervision of an insurer than a bank resolution authority
- Further guidance is needed on entry into resolution
- Powers need to recognise the timescale of insurance failure

The guidance rightly draws attention to the possibility of insurer failure, and to the possible systemic consequences. However, it fails to point out that insurer failure is rare, and the systemic consequences even less likely, in view of the existing mitigants. As a result the proposed regime is disproportionate to the risks.

Probably the main difference between insurance and banking that the guidance fails to recognise is the extended timescale of insurance failure. We sense that regulators accept that this is usually the case, but are not convinced that it will be true all of the time, and therefore wish to take powers that may allow a banking-style weekend resolution. We see risks in creating such powers; in the troubled political reaction to the failure of a major insurer, regulators would come under pressure to deliver a quick solution, and to use these powers. It is by no means certain that this would deliver the optimum outcome for policyholders.

Regulators have pointed out that the failure of AIG allowed the regulators no time. This is true, and is because it was a banking failure. Such large exposures based on the credit rating of the AIG parent company should not have been allowed to build up, and the episode represents a serious failure of group supervision – as well as a serious failure of management control.

How to resolve the issue? We suggest that the resolution regime for insurance should not be viewed in isolation, but needs to take into account other measures taken to improve the supervision of insurers since the crisis, When agreed, Comframe will raise significantly the quality of co-operation between supervisors expected in the supervision of groups. Similarly the measures for GSIIs recommend greater use of structural separation to limit contagion within insurance-based groups. We see a limited application for structural separation, which risks creating a string of vulnerable stand-alone businesses. However, we do see a role for structural separation as a tool available to supervisors when a non-insurance subsidiary has grown to such an extent that it begins to over-shadow the insurance businesses in the group.

Finally, the document contains no impact assessment or cost/benefit analysis of the proposed measures. This is a major omission for such far-reaching proposals. Its absence is particularly disappointing when the G20 has explicitly asked the FSB to consider the impact of its proposal on long-term investment. There is a balance to be struck between financial stability and growth, and an attempt should be made to do this in the next consultation.

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