Canadian Life
and Health Insurance
Association Inc.

Association canadienne
des compagnies d'assurances
de personnes inc.

October 15, 2013

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

Submitted via E-mail: fsb@bis.org

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

The Canadian Life and Health Insurance Association (CLHIA) welcomes the opportunity to provide its views to the Financial Stability Board (FSB) on the consultation document entitled *"Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions"*.

Established in 1894, the Canadian Life and Health Insurance Association (CLHIA) is a voluntary trade association that represents the collective interests of its member life and health insurers. Our industry provides a wide range of financial security products such as life insurance, annuities and supplementary health insurance to about 27 million Canadians. Internationally, Canadian life and health insurers have a presence in over 20 jurisdictions around the world and generate over $48 billion or 40% of their total premiums from foreign operations.

1 Queen Street East
Suite 1700
Toronto, Ontario
M5C 2X9

Tel: (416) 777-2221
Fax: (416) 777-1895
www.clhia.ca

1, rue Queen Est
Bureau 1700
Toronto (Ontario)
M5C 2X9

Tél.: (416) 777-2221
Fax: (416) 777-1895
www.accap.ca

Toronto • Montreal • Ottawa

The comments below reflect the views of the Canadian life and health insurance industry on the *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions*. As a member of the Global Federation of Insurance Associations (GFIA), we also endorse the comments put forward in GFIA's submission.

General Comments

The CLHIA is supportive of efforts by international standard setters and regulators to mitigate instances of systemic risk and preserve financial stability. We also accept the rationale for including resolution regimes (RRs) in the FSB's policy measures to be applied to institutions designated as global systemically important (G-SIFIs).

In turning to this consultation document, despite what is suggested in the preamble we find the scope of many Key Attributes (KA) and their application are overly bank-centric and have not been sufficiently tailored to the insurance business and the risks that emanate from an insurance business failure.

The likelihood of a disorderly failure of an insurer is relatively remote in comparison to other financial services sectors such as banking. Due to banks' dependence on short-term funding a bank-style 'run' risks precipitating a disorderly liquidation of assets. Such forced sales entail counterparty risks which can destabilize financial markets. Bank failures can create economic chaos and systemic threats requiring immediate and expensive government intervention.

The wind-down of a traditional insurer, by comparison, has never caused a systemic financial crisis abroad or in Canada. Key third party studies, including the November 2011 IAIS report[1] and the Geneva Association report [2] highlight the evidence and the improbability of go-forward systemic risk transmission from life insurance failures. This is because of the unique insurance business model and insurers' resilient balance sheets:

- Liquidity risks are low as premiums are invested in assets with a view to matching long-term liabilities to policyholders to the extent reasonably possible. Some policyholder contracts extend 40 or even 50 years into the future.
- In most cases early redemption by policyholders is not possible without the occurrence of an uncorrelated event, in others without a sizeable early redemption penalty.
- Where policyholders have access to a cash surrender value, those amounts are a fraction of the face value of the contracts, this together with the inability of the

[1] IAIS. November 15, 2011. "*Insurance and Financial Stability*".
[2] Geneva Association. February 2012. "*Insurance and Resolution in light of the Systemic Risk Debate*."

insurers to replace coverage under same conditions act as a powerful disincentive. Lastly, life insurers' balance sheets provide coverage well in excess of 100% for such potential short term liabilities.

- Liabilities that mature over many years allows for the recovery of market values of supporting assets.
- Further, insurers do not have a propriety trading books like banks.

Moreover, traditional insurance activities have a high degree of substitutability and limited interconnectedness with the rest of the financial system. We therefore submit that the winding-up of an insurer is generally not as time-sensitive as in the case of banking. They also do not need to be pressed into resolution to the extent that banks do. Recovery plans are a much more viable option for a failing insurer than for a bank. Should resolution be necessary, existing solvency laws in many countries including Canada have proven to be adequate in the vast majority of insurance failures.

We question the need for resolution authorities (RAs) with such powers or whether a traditional liquidator subject to a court approved plan would be sufficient to resolve an insurer. Insolvencies in the Canadian life insurance industry involving a traditional liquidator subject to court approval including that of Confederation Life Insurance Co., at the time the fourth largest insurer in the country, served the interests of all stakeholders well. RAs' need for quick powers in the case of banks because of their liquidity issues and systemic importance does not follow through in the case of insurers. An insurance company can have a traditional run-off or wind down without any systemic implications.

We also question the breadth of this guidance. Our key message is that this document should only apply to insurers designated as GSIIs. Our understanding was that the target of the GSII policy measures and the applicable RRs were those global insurers with significant non-traditional non-insurance (NTNI) activities that pose a systemic risk. In our view it is crucial that the language used in this document is consistent throughout and that the parameters in terms of which insurers are captured by this guidance are clear. We find that the guidance falls short in this respect as it introduces new and differing terminology such as "critical insurers", "essential functions" and "at a minimum, all GSIIs", which suggests that the proposed resolution regimes may be applied to a broader group of insurers, which is a direction we do not support and is contrary to the original intent. In instances when new terminology is introduced, they should be defined so there is no confusion that these KAs only and ultimate target are G-SIIs.

We would urge that this guidance document and the application of the KAs to insurers should be in keeping with the FSB's own definition of what constitutes systemic risk, which is defined as "*the risk of disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy.*"

Finally, we believe the reader would benefit from having an established definition of NTNI. In the absence of such a definition, the application of certain KAs lack clarity.

<u>Responses to Consultation Questions:</u>

Please note that our comments to these specific questions should be read in conjunction with the background provided above in the general comments section.

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?*

We believe that the powers provided under this guidance go beyond what the resolution authority will typically require to address a failing insurer. The powers outlined here are more commensurate with the risk of failure in the banking sector than in insurance. As a consequence, a number of KAs carry potentially serious repercussions for policyholders, creditors and reinsurers connected to an insurer in resolution.

As previously stated, in comparison to banking, the likelihood of a failure in the insurance sector is relatively remote. Due to the nature of the insurance business the winding-up of an insurer can occur over an extended period of time using existing tools such as a 'run-off' or 'portfolio transfer'. The powers prescribed here should only be appropriate in the case of insurers designated as GSIIs. Yet the language in this document suggests that the guidance should apply to an even broader group of insurers. We believe that this contradiction should be redressed as the lack of precision may cause authorities in some jurisdictions to inappropriately apply the KAs to insurers which are not GSIIs.

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 assessments) and the implications of that distinction.

For reasons outlined above, this guidance is not appropriate for traditional insurers and should only be applied to those select insurers identified as GSIIs. To this end, it is important that an agreed and clear definition of NTNI is established so that the criterion for what constitutes a GSII versus a traditional insurer is clear and unambiguous.

24. Are the additional statutory objectives for the resolution on an insurer (section 1) appropriate?

While we generally agree with the statutory objectives under section 1, we question the statement under paragraph 1.2 regarding what constitutes “vital economic functions” provided by insurers. While the functions listed are “economically vital” in a general sense it should also be stated that in the majority of insurance markets, the availability and substitutability of these functions is high, their systemic risk relevance is low, the lack of continuity of insurance coverage is transitory and their impact in terms of overall financial stability is limited. As noted earlier the recent research papers released by the Geneva Association and the IAIS generally bear these conclusions out.[3]

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 institutions (such as banks)?

As stated above, the introduction of the term “critical insurer” causes confusion in terms of the breadth of this guidance. What is the distinction between a critical insurer and one that is systemically important? The guidance set out in this document is only appropriate in instances where an insurer’s failure is likely to pose a systemic risk and should therefore not include insurers outside of those identified as GSIIs.

[3] Geneva Association. March 2010. *“Systemic Risk in Insurance: An Analysis of Insurance and Financial Stability”* and
IAIS. November 15, 2011. *“Insurance and Financial Stability”*,

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?

We feel that section 4.1 is not a fair and accurate reflection of how supervisors and resolution authorities should approach a failing insurer. While some guidance here may be the correct approach in a banking context, the long time horizon over which insurers' liabilities fall due provides management time to potentially restore the company to health or to achieve an orderly resolution. The document should explicitly recognize the staging process that most jurisdictions have in place for failing insurers with resolution being the final stage after recovery has failed to work.

We agree that an insurer should enter resolution before it is balance sheet insolvent but there is a fair amount of discretion available to supervisors prior to that point. Establishing "standards" or "indicators" in order to allow for "the timely and early entry into resolution before an insurer is balance-sheet insolvent" restricts that discretion. There is little rationale behind pushing an insurer into resolution prematurely provided it can continue to operate as a going concern and explore recovery options that could provide optimal outcomes for policyholders.

27. Does the draft guidance deal appropriately with the application of powers to write down 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 (section 4.3)

We generally agree with the content in this section. We would like to point out that in most cases existing resolution tools such as a portfolio transfer should prove effective in winding-up a failed insurer thereby eliminating the need for a "bridge institution" for example. This being said, where necessary to preserve value of the insurance company for the benefit of policyholders it may be appropriate for authorities to have the power to take control of domestic holding companies and controlled affiliates.

Restructuring liabilities (section 4.4)

We recognize that certain circumstances may require that the resolution authority have the power to restructure or limit liabilities and allocate losses to creditors and policyholders. This being said, proper oversight (e.g., by the supervisory authority) should be a pre-requisite.

4.4(iii), We consider the proposed resolution power described in this paragraph as being unfeasible in practice. The contractual nature of an annuity will make "reducing or terminating" the guarantees associated with it problematic.

4.4(v), It is unclear what would be gained by converting the annuity into a lump sum payment (presumably with a reduction in the amount payable) to fund a new annuity or for payout. Regardless, the transfer of the contract to a solvent insurer is likely to yield better results for the annuitant.

4.4(vi) In circumstances where an insurer has moved from recovery to resolution stage, for part or whole of the insurers business, having a transferee identified quickly may be desirable to avoid uncertainty. In this context it may be helpful for a resolution authority to have the power to eliminate such contingent liabilities.

Portfolio transfer (section 4.7 – 4.8)

4.7 It is unclear to us what is meant by a "pre-agreed mechanism". This being said, we would like to reiterate that the resolution of a traditional insurer is not time sensitive so there is no urgency attached to the determination of (re)insurance contract values as is suggested in this paragraph.

Safeguards (section 5)

We agree that policyholders should rank above shareholders and unsecured creditors in the hierarchy of claims in the liquidation of an insurer. Priority of secured creditors must be respected, including assets secured under reinsurance security agreements and security agreements for derivatives counterparties.

5.2 We have concerns with allowing resolution authorities to depart from the pari passu principle in the treatment of creditors particularly in the treatment of equal classes of policyholders. While some flexibility may be warranted in determining how to apply the pari passu principle fairly across classes of policyholders, as a general principle the pari passu concept should continue to apply.

5.3 We agree with this section which provides for a "no creditor worse off safeguard." But see our comment above regarding paragraph 5.2.

5.4 The purpose behind this statement is not clear. What is the reason for converting foreign currency claims into the reporting currency? Such exposures would naturally be hedged by holding assets that match the timing and currency of the underlying liability.

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 do not see a problem with providing resolution authorities with the temporary powers outlined here provided they be exercised with court approval. However, we would note that some forms of insurance contracts impose a penalty on the policyholder in the case of early surrender so while it is conceivable that some policyholders may act against their own best interest, the value of having such a tool at the authorities' disposal is relatively small.

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)?***

The integrity of commercial agreements with counterparties (i.e., reinsurers) should not be undermined. Availability of powers to retroactively change contract terms could destabilize ordinary course (going concern) market place business transactions.

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)?

We believe that existing supervisory colleges and cooperation agreements should prove sufficient in dealing with a failing GSII. As such, we are somewhat reticent to accept the idea of also developing Crisis Management Groups (CMGs) and Cooperation Agreements (COAGs) without first having a better understanding of how the two will differ in terms of their functioning. These bodies will likely entail additional resource and administrative costs for insurers, and so wherever possible we hope that layering and overlap can be avoided. We would welcome some additional insight into the rationale behind establishing the proposed CMGs and COAGs.

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 (section 9)?

The guidance under section 9 should only apply to those GSIIs with significant NTNI activities that pose a systemic risk.

<u>Resolvability Assessments (Section 9)</u>

9.3(iv) We believe it would be highly unlikely that a solvent run-off would occur if there were risks that later maturing policyholders would be subordinated to earlier- maturing policyholders. We presume that the insurer would be operating as a going concern and under such circumstances would need to be sufficiently capitalized to meet its obligations to policyholders irrespective of when they fall due.

9.3(vi) We find that this requirement delves too deeply into company affairs and the business decisions that have been made with regard to insurers' corporate structure. It should be sufficient to determine if the structure of a group will allow for resolution in the event of failure.

9.3(viii) At present, there is no agreed upon definition of NTNI to make this particular assessment possible. Plus, the absence of a definition makes an assessment of structural separation entirely subjective. Lastly, its effectiveness in terms of mitigating systemic risks at large insurance groups is unproven.

9.3 (xiii) We would encourage the FSB to provide some further clarification in terms of the definition of "surplus assets".

9.4(i) In only the most exceptional circumstances would the resolution of an insurer have a material adverse impact on economic activity. In most markets substitutability in the case of traditional insurance activities is high. To a large extent, this would nullify the effects of an insurance failure and any resulting disruption in the coverage of "day-to-day economic activities." This is not to say that there would not be a temporary halt in insurance coverage but any lack of continuity is likely to be transitory allowing the individual to be reinsured. Perhaps the biggest risk to economic activity would come from the failure of an insurer with a significant market share.

9.4(ii) The chance of a policyholder 'run' is extremely low due to the fact that most blocks of insurance policies cannot be redeemed early unless a claim is made following an insured event or at substantial penalty. While not widespread, some policyholders can also face penalties for early redemption.

Recovery and resolution planning (Section 10)

Again, we are concerned that this section casts too wide a net; capturing insurers whose failure is not likely to pose a systemic risk, be disorderly or endanger financial stability.

We are generally concerned about the layering of requirements and the resource and administrative costs insurers will need to devote to the recovery and resolution plans and resolvability assessments. We also see some risk of duplication between existing Own Risk and Solvency Assessment (ORSA) requirements and some of the guidance put forward in this document.

10.1 We worry that the frequency with which these recovery and resolution plans will need to be reviewed by GSIIs may be too onerous and will have questionable benefits in terms of reducing systemic risk and protecting policyholders. In our estimation, a key benefit of having management develop these plans in the first place is the insight and understanding they gain about the business and where the risks lie. The statement that "GSIIs should be subject to a requirement for an ongoing process of recovery and resolution planning" is vague in terms of how regularly the plans should be reviewed. We would suggest spacing these reviews out. A requirement to revisit the plans annually could impose significant costs while bestowing little in the way of knowledge on management as the overall direction of the company would not change much year-to-year.

10.3 The lack of definitions supporting the use of the terms "critical" and "essential functions" result in this section being particularly confusing. The reader is led to believe that the breadth of the guidance in this section extends far beyond those insurers designated as a GSII. We are of the view that the application of RRs to insurers beyond those identified as GSIIs is not appropriate.

10.3(i) The guidance in this paragraph should be more specific. Precisely which types of insurance policies are "critical"? It reads as though the majority if not all insurance contracts do in fact fall under this category.

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?

10.10(vi) The focus here should be on an orderly wind-up of the hedges and preserving continuity of the derivatives used for hedging rather than on the wind-up of the derivatives portfolio. Insurers mainly use derivatives for the purpose of hedging the assets or liabilities that sit on its balance sheet. There needs to be an orderly winding up of the insurer’s hedges (i.e., exposures to currencies, equities, interest rates) before there can be a wind-up of the derivatives portfolio. To do otherwise risks exposing the insurer’s assets and liabilities to market risks which could in turn negatively impact policyholders.

10.10(viii) An insurer cannot be expected to comply with this element at the point where it is developing a resolution strategy or plan. It likely could only be ascertained once the insurer has entered into resolution, based on the available assets, their values and market conditions at that time.

33. Does this draft Annex meet the overall objective of providing sector-specific details for implementation of Key Attributes in relation to resolution regimes for insurers? Are there any other issues in relation to the resolution of insurers that would be helpful for the FSB to clarify in this guidance?

No comment.

Thank you for considering the views of the Canadian life and health insurance industry. Please do not hesitate to contact us should you have any questions or require any clarification on this submission.

Sincerely,

N. Simon

Noeline Simon
Vice President, Taxation and Industry Analytics
Canadian Life and Health Insurance Association Inc.