Association of British Insurers' response to:

FSB's Consultative Document: *Recovery and Resolution Planning for Systemically Important Insurers: Guidance on Identification of Critical Functions and Critical Shares Services*

The Association of British Insurers welcomes the opportunity to comment on the FSB's consultative document on the *Guidance on Identification of Critical Functions and Shared Services*.

This letter opens with an overview of our views on the draft guidance, before proceeding to discuss the insurance-specific and practical considerations that should be taken into account. We conclude by answering the FSB's specific questions.

We hope our comments are helpful as the FSB considers this very important subject. The ABI stands ready to provide further input or clarification, and would be happy to address any of the issues raised in our submission in greater detail – please contact Hugh Savill (hugh.savill@abi.org.uk) or Alisa Dolgova (alisa.dolgova@abi.org.uk).

The UK Insurance Industry

The UK insurance industry is the largest in Europe and the third largest in the world. It plays an essential part in the UK's economic strength, managing investments of £1.8 trillion (equivalent to 25% of the UK's total net worth) and paying nearly £12bn in taxes to the Government. It employs around 315,000 individuals, of whom more than a third are employed directly by insurers with the reminder in auxiliary services such as broking.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed.

The Association of British Insurers

The ABI is the voice of the UK insurance industry, representing general insurance, long-term savings and life insurers. Formed in 1985, it today has over 250 members who account for around 90% of UK insurance premiums.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and advocating on behalf of insurers
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation

- Advocate high standards of customer service within the industry and provide useful information to the public about insurance
- Promote the benefits of insurance to government, regulators, policy makers and the public.

General comments/summary

- The paper is a useful start to a debate on critical functions in insurance.
- Given that this guidance relates to policy measures designed to address systemic risk, it is important that the focus of the assessment of critical functions is clearly based on potential ability to materially affect the stability of the financial system and the real economy, and is not blurred through the inclusion of non-systemically risky functions.
- In particular, we welcome the recognition that critical functions vary by firm and jurisdiction and are best approached at jurisdictional level through supervisory judgment in the context of resolution planning. At the same time, a transparent supervisory approach is needed
- We also welcome the acknowledgement that, when applied, the assessment would produce very few critical functions in a particular market. The process for identifying these should therefore be proportionate.
- In particular, the process should not take up too much resource for regulators and companies alike. The proposed analysis is a competition analysis, and this is both time-consuming and resource-intensive.
- So we suggest that a simple filter should be applied by local supervisory authorities based on both market share and substitutability, to allow more targeted and cost-efficient analysis at firm level.

- In terms of the criticality analysis itself, our primary concern is that elements have been imported from banking and, while adjustments have been made, a number of banking concepts continue to be inappropriately applied to an insurance discussion.
- For example, insurers' failure is managed over a long period of time, typically through run-offs, meaning that critical functions do not get suddenly withdrawn on resolution.
- Capacity - and depth of market - for products and services can, however, be affected by strategic commercial decisions. The FSB should therefore ensure that unnecessarily onerous requirements relating to critical functions do not inadvertently disincentivise their provision or make them more expensive for policyholders.

Focus of FSB's consultation

- The paper appears to discuss assessments undertaken by domestic supervisors, and in particular focuses on identifying where an insurer's market dominance in a particular sector domestically may lead to significant negative externalities if suddenly withdrawn.
- The FSB should be mindful that excessive/monopolistic market power has wider implications than the prudential aspects and these types of considerations are already within the domain of competition authorities. In the limited number of cases that a critical function is identified, it is likely that the insurers will wield market power as a result of its high market share. In those circumstances, we suggest that some consideration should be given by local jurisdictions to the structural remedies usual in competition studies. These remedies should

not be undertaken lightly, and this emphasises the need for a limited number of high quality analyses. The risk is that over-emphasis by regulators on ensuring the resilience of insurers providing identified critical functions will entrench their market power by raising barriers to entry.

- In addition, all insurance products are important to those who buy them, and regulators should not substitute their judgement for that of policyholders. It is the role of existing prudential regimes to ensure that there is a suitable level of protection for all policyholders.
- We note that some jurisdictions employ additional tools to limit the impact on policyholders in case of failure, such as policyholder protection schemes, and this should be taken into account.

Insurance-specific considerations

The difference between banking and insurance business must be fully recognised both in terms of how failure looks and its implications:

Nature and causes of failure

- Rather than failing suddenly and requiring a "weekend resolution", insurers' liabilities crystallise gradually over time. This allows for the implementation of a structured wind-down, meaning that existing policyholders are unlikely to be suddenly left without cover, particularly as insurance liabilities are pre-funded through upfront payment of premiums/
- In fact, an unnecessarily early and rushed resolution is the most likely potential cause of a sudden withdrawal of critical functions.
- This can be distinguished from a banking failure scenario, where swift action is key to maintaining market confidence and preventing contagion.

Mechanism for resolution

- Generally, the most effective resolution mechanism is placing the failed insurer, or part therefore, into run-off. This offers policyholders the best outcomes as claims will continue to be met over time as the insurer is wound down.

Capacity and substitutability

- In insurance, portfolio transfers are also common, and capital and expertise – the two key elements in insurance capacity – have in practice proved easy to replace. Again, this enables the continuous provision of services to policyholders. That "a lack of substitutability does not appear to be an issue in the insurance industry" has been confirmed by the International Association of Insurance Supervisors in its *Insurance and Financial Stability* paper.[1] For example, the Bermudan market typically responds with "classes" of insurers after each major event and pay-out to restore capacity.
- There could be exceptional events that may require the price of a risk to be fundamentally re-assessed and insurance cover may be temporarily withdrawn, as was the case in the

[1] IAIS (2011) – Insurance and Financial Stability

aviation market after 9/11. However, this is unrelated to resolution and helps to ensure that insurers do not take on risk they are unable to cover.

Loss of confidence and mass surrenders

- The consultative document suggests that the failure of an insurer can cause disruption to the wider financial system through policyholders' loss of confidence, leading to mass surrenders for all insurers.
- However, the nature of insurance liabilities is very different to banking liabilities. The impact of the failure is also different.
- Unlike banking, insurance liabilities are generally not callable on demand. An insurance liability, i.e., an insurance claim, occurs either at a specified point in time (e.g., retirement) or following a pre-defined, insured event (e.g., a flood, a motor accident).
- Therefore, while the loss of market confidence may be damaging to an insurer, the incidence of insured events will be unaffected. Thus, insurers are not exposed to the equivalent of a "run on banks".
- Also, unlike banks, restrictions and penalties on early surrender of life policies act as a barrier and a disincentive to mass withdrawal. Some insurance liabilities (e.g., annuities) offer no possibility of surrender, while others have market value adjusters which either remove or lower insurers' exposure to surrenders. With some (e.g., unit-linked) policies, the policyholders bear all of the investment risk. These limit the risk of a fire-sale of assets.
- In addition, insurance does not have the same contagion risk as banking, as insurance liabilities are largely independent of each other. For example, rising claim rates in the motor insurance business would have little impact on household insurance business. Diversification is therefore a fundamental element of insurers' risk management.
- A potential risk of mass failure is, however, introduced if insurers follow identical business models, as was the case in the Japanese life insurance market. We would suggest that supervisors should guard against this by encouraging diversity of business models on both sides of the balance sheet. For example, regulation should not have the effect of encouraging "herding".

Fire-sale of assets

- The consultative document also envisages a scenario where an insurer's failure may cause a material impact on the real economy, and the financial system as a whole, through a disposition of large quantities of investment assets quickly at fire-sale prices.
- However, unlike banks, insurers do not typically engage in maturity transformation. Instead, the duration of assets in an insurer's investment portfolio is matched to the timing of its future underlying liabilities. Insurers' stabilising and counter-cyclical role as long-term investors, for example in infrastructure and other long-term assets, was highlighted in a recent Bank of England's discussion paper on procyclicality. [2] This makes the fire sale of assets extremely rare.

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[2] *Procyclicality and structural trends in investment allocation by insurance companies and pension funds*: A Discussion Paper by the Bank of England and the Procyclicality Working Group ; July 2014. http://www.bankofengland.co.uk/publications/Documents/news/2014/dp310714.pdf

- If an insurer fails, forcing a fire-sale of assets or the crystallisation of the assets' current value would be damaging. However, this is not necessary as the underlying liabilities are illiquid and depend on the occurrence of specified events, as outlined above.
- However, recent events (e.g., AIG, Ethias) confirm that this eventuality, though difficult to achieve, can happen. There are obvious preventative lessons to be drawn from each event. In both cases, adequate supervisory oversight, with the establishment of relatively simple limits on risky practices, could have prevented any contagion. Also, since the crisis, the risks associated with an insurance fire sale have been exacerbated by the deterioration of governments' quality of debt, and by banking regulation causing market-makers in the corporate bond markets to run down their inventories. Both these issues require urgent attention, directed at the markets in question, not insurers.

Practical considerations in designing the criticality assessment

We would like to highlight a number of practical considerations in conducting the proposed criticality analysis:

- The criticality assessment outlined in the paper is very elaborate and resource-intensive. This is not proportionate to the few critical functions that are expected to be identified as a result.
- Given the limited capacity for insurers to have functions that are critical, (in that the sudden failure to provide that function would be likely to have a material impact on the financial system and the real economy), the process should not be overly bureaucratic. Therefore a simple filter should be applied based on both market share and substitutability to allow more targeted cost efficient analysis.
- The guidance suggests that local supervisors may be required to consider making a number of challenging judgements, including:
    - how important different types of insurance products are to policyholder. The paper notes that "criticality depends on the importance of the affected activity to the individual".
      However, the fact that an individual has taken out insurance for a particular activity already indicates that it is important to them: all insurance policies are important to those who hold them. This is why prudential regulation aims to ensure that insurers are able to meet the promises they have made to policyholders.
    - which parts of the 'real economy' are essential and need the most protection. This would be a difficult judgement to make and it is not clear insurance regulators are best placed to decide this.
    - the impact of cover withdrawal on policyholders. Parts of the analysis reaches into analysing the financial and liquidity position of policyholders: for example, analysing the resilience of the affected business[3]. Again, this type of analysis would need to draw on areas not typically within prudential regulators' ambit. In any case, aggregate industry data of this nature is unlikely to be available.

[3] "E.g., how long can they survive without producing or trading, given that production and trade is only possible with insurance, whilst continuing to pay staff and suppliers?" (p.11)

- In thinking of how to apply the criticality assessment in their jurisdictions, local supervisory authorities should be mindful of undue interference with the operation of the firms as a going concern. Supervisory intrusion, based on a theoretical possibility of failure, should not lead to sub-optimal or unsound commercial decision-making, or unintended consequences.
- We recommend that there should be more transparency about the non-firm specific stages of the analysis, so that others in the market, and potential market entrants, are aware of the existence of a possible critical function.

Cross-border co-operation

- We welcome the FSB's encouragement of cross-border supervisory co-operation on resolution.
- However, it is unclear how cross-border co-operation at group level reconciles with the domestic focus of the criticality analysis.

<u>Consultation questions:</u>

1. Are the definitions of 'critical functions' and 'critical shared services' appropriate for the insurance sector?

"Critical functions", as presented in the definition section, comprise two elements:

1) Critical functions are provided by an insurer to third parties not affiliated with the firm; and
2) 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.

The circumstances when sudden failure to provide a function may lead to a material impact on third parties are then set out as:

a) if is no mechanism in place to ensure the function's continuity; and
b) the impact falls into one of the listed categories, such as: where the insurance coverage is vital for third parties to carry out economic activity or go about their daily lives; policyholders are dependent on insurance payments being made to them; or where it may cause the insurer to dispose of large quantities of assets.

We are concerned that the list of categories - under b) above – could be read as diverting from the essential element of the definition that there must be a likely material impact on the stability of the financial system and the real economy. Instead, the categories may be taken as inappropriately extending the potential scope of what may be a critical function beyond those activities that may be material to the stability of the financial system into areas covered by normal prudential regulation.

We would suggest that the definition be amended to clarify that these categories must be read within the wider context of a likely material impact on the financial system and the real economy. For example, the sudden failure to provide a critical function may have a material impact on third parties if: 1) there are no continuity plans in place; 2) this insurance coverage is vital for third parties to carry out economic activity; and 3) this is likely to have a material impact on the financial system and the real economy.

We would also like to emphasise our view that it is difficult to envisage how an insurer's failure could significantly impair the financial system and the real economy. In particular, the focus on sudden failure in an insurance context is misplaced, as elaborated in the section on insurance-specific considerations. Examples such as AIG were caused by weaknesses in markets other than insurance. Solutions should be found by improving the regulation of those markets, not tangentially through insurers.

The definition of critical shared services is appropriate for the insurance sector, and we welcome the FSB's approach to this area.

2. **Should critical functions be identified based on whether the disruption of the activity would adversely impact stability of the financial system or the functioning of the real economy, or both?**

We believe that critical functions should be identified both on whether the disruption would adversely and materially impact the stability of the financial system **and** the functioning of the real economy.

This would align with the definition of systemic risk in the FSB/IMF/BIS report to the G-20 on *Guidance to Assess the Systemic Importance of Financial Institutions, Market and Instruments*.[4] The report defines systemic risk is "a risk of disruption to financial services that is (i) caused by an impairment of all or part of the financial system **and** (ii) has the potential to have serious negative consequences for the real economy."

3. **Is the methodology for identifying critical functions laid out in the paper appropriate for the insurance sector? If not what aspects are missing or need to be changed?**

The framework is based on the premise of sudden failure to provide a critical function. Insurers hold assets for their long-term liabilities and sudden failure is therefore unlikely. Assets and capital already exist to meet current and future liabilities. The long-term nature of insurance liabilities means that insurers can be run off over extended periods of time. In addition, the cover available from policyholder protection schemes should be taken into account when considering the potential impact of an insurer's failure.

Given the limited capacity for insurers to have functions that are critical, the assessment process should be proportionate in terms of the time and resource required. We would suggest that, in the first instance, a simple filter should be applied based on both market share and substitutability to allow a more targeted and cost-efficient analysis.

4. **Do the six broad categories of activities outlined below cover all relevant and potentially critical functions? What additional categories should be added?**

[4] http://www.bis.org/publ/othp07.pdf

(i) **Insurance coverage as a precondition for economic activity;**
(ii) **Insurance coverage as a precondition for individuals to go about their daily lives;**
(iii) **Insurance payments that are vital to individuals financial security;**
(iv) **Investments in and lending to the real economy;**
(v) **Acting as a counterparty in derivatives, repo and securities lending markets; and**
(vi) **Pooling of risk, particularly reinsurance, as economic function**

We would like to re-emphasise that these categories of functions need to be considered in the context of the overall critical functions assessment, which is whether the functions' withdrawal is likely to have a material impact on the stability of the financial system and the real economy. We would suggest a proportional approach to reflect that the insurance industry in likely to contain few critical functions.

In addition, in relation to the suggestion that insurers could have non-insurance critical functions such as asset management and pension fund services, we would like to note that these are subject to their own prudential regulation. Treating insurers who provide these services differently from other provides would create an un-level playing field and may have unintended consequences.

We have set out below more detailed comments on the different categories of functions that the FSB considers as potentially critical.

Insurance payments that are vital to individuals' financial security

The impact assessment for "payments that are vital to individuals financial security" (3.3 (c) seems weighted towards the impact to the individual rather than to financial stability and the real economy, within the definition of critical functions.

Consumer protection is a valid focus for regulation, and is addressed through prudential and conduct regimes for insurers. We would suggest that the guidance is clearer on how consumer protection concerns could translate into having a material impact on financial stability and the real economy.

Insurance coverage as a precondition for individuals to go about their daily lives

As in the "individuals' financial security" section, the link between this analysis, and the potential impact on financial stability and the real economy, is not clearly set out. The discussion seems to instead centre on which types of policies are the most important to policyholders, which we believe policyholders themselves are best placed to decide.

We also note that the failure of any institution would, by definition, mean losses of some extent for some people, and the question is of degree and nature. For example, in terms of the impact of failure on individuals, a distinction must be made between an insurer being potentially unable to deliver on an expectation or guarantee for a certain amount at the conclusion of the policy, and being unable to secure equivalent cover at the same cost if a policy is terminated. We note in particular that in cases where failure is the result of the under-pricing of risk, the expectation that policyholders must be able to source alternative cover on similar terms may lead to a repeat of the same problem.

Investments in and lending to the real economy

We consider that "investment in and lending to the real economy" should be removed from the examples of potential critical functions. Insurers' role as investors and lenders to the real economy is small relative to the total activity in this area, and we cannot envisage a scenario where the stability of the financial system could be undermined.

In addition, insurers hold assets to match their underwritten liabilities, as part of asset liability management (ALM). Therefore, treating assets as a separate category instead of an integral part of an insurer's core activity potentially conflicts with other potential critical functions, such as payments that are vital to policyholders which are supported by these assets. For example, would the FSB consider that the potential risk of price volatility from insurers selling assets is more important than policyholders receiving their policy benefits when due, which the assets are held to secure?

While, as discussed above, we do not think "investments in and lending to the real economy" is an appropriate category of insurers' potentially critical functions, we would like to highlight some specific areas of concern with this part of the section, in case it is retained. In particular, the perceived risks set out in this section of the paper seem to be focused around the consequences to asset prices from a fire-sale, and the consequences of an insurer ceasing to provide liquidity in the market through being purchasers of debt.

We would like to highlight that:

- The probability of a fire sale by an insurer is remote (as discussed in this submission's section on the differences between banks and insurers);
- Insurers, as long-term investors, can act counter-cyclicality and be a stabilising influence on the financial system. The Bank of England's Procyclicality Working Group has found that, life insurers in particular, "could therefore play a crucial role in supporting both financial stability and long-term economic growth, which are in turn mutually reinforcing".[5] ;
- In considering whether risks could arise from insurers ceasing to be purchasers of debt, it should be born in mind that insurers purchase debt in order to match their liabilities stemming from their underwritten business. The failure of an insurance company would not reduce the need for insurance within society and the market gap will be filled by other insurers, who would also need to purchase assets to match the liabilities they underwrite.

We would also like to comment on the statement that borrower size generally increases substitutability and decreases criticality (page 17). There may be circumstances where, as identified in the report, smaller insurers have less access to financial markets (both direct and due to the number of intermediaries) or are affected by the fact that less financial information available about them. However, there may be other cases where refinancing is easier due to the smaller size or complexity. On the whole, we do not think it is possible to say that either smaller or larger insurers would be easier to refinance, as this would vary case-by-case.

[5] *Procyclicality and structural trends in investment allocation by insurance companies and pension funds*: A Discussion Paper by the Bank of England and the Procyclicality Working Group ; July 2014. http://www.bankofengland.co.uk/publications/Documents/news/2014/dp310714.pdf

Finally, we would like to highlight that assessments must be tailored to the specific circumstances. For example, the draft suggests that shorter-term lending is more likely to be critical than lending that is longer-term (page 17). However, it also states that sectors which require long-term financing might have a more limited pool of funds providers, therefore increasing the likelihood of criticality (page 16). On balance, it is difficult to generalise whether shorter or longer-term lending/financial is more likely to be critical.

Acting as a counterparty in derivatives, repo and securities lending markets

We note that insurers form a small part of the overall investment market, and play an even smaller role as derivatives counterparties. We hope that this will be reflected through a proportionate response.

Pooling of risk, particularly reinsurance, as an economic function

While the paper states that highly interconnected reinsurance increases criticality, we would like to note that reinsurers' global diversification of risk decreases the overall risk of disruption to the stability of the financial system and the real economy. Market practice generally limits the percentage of business that a reinsurer can write from one insurer, and how much an insurer can cede to one reinsurer. In addition, unlike the inter-bank lending framework, reinsurers have a directly hierarchical relationship with insurers.

5. Is the methodology for identifying critical shared services laid out in the paper appropriate for the insurance sector? If not, what aspects are missing or need to be changed?

The analysis on critical shared services looks useful, and we appreciate the FSB's thoughtful approach to this area.

We agree that the determination of critical shared services should follow the identification of critical functions (if any), and that legal entities providing shared services essential to the provision of the critical functions should be identified. We also agree that it is important to ensure there are appropriate service level agreements in place for the provision of critical shared services provided by other internal or external legal entities to ensure their continuity.

Our main recommendation is that, given the limited capacity for insurers to have functions that are critical, the approach to critical shared services supporting these is proportionate.

6. Is the framework flexible enough to cover different types of business undertaken by G-SIIs? Are the non-prescriptive limits of examples of functions that could be critical helpful?

The framework would be flexible enough if G-SIIs undertake activities that fall within the definition of critical functions.