Response to FSB consultation document: Recovery and Resolution Planning for Systemically Important Insurers: Guidance on identification of critical functions and critical shared services

Introduction

We appreciate the opportunity to comment on this consultative document. The FSB's document "*Key Attributes of Effective Resolution Regimes for Financial Institutions*" makes a number of references to "critical functions" and efforts to arrive at a common understanding of the term are therefore welcome. The key points we would like to make are as follows:

a) **Identifying "critical functions" should be kept separate from assessment of the systemic importance of financial institutions.** The IAIS *Initial Assessment Methodology*[1] for insurance includes a low-weighted category of "substitutability". As, in places, this paper refers to the systemic importance of critical functions, it is possible for the two processes to be conflated and identification of critical functions viewed as part of the process of determining an insurer's systemic importance. For clarity, the Guidance should state that identification of critical functions is not intended to form part of the methodology for designating systemically important insurers. It is part of recovery and resolution planning ("RRP"), intended to follow any such designation.

b) **There should be a single definition of "critical function" applicable to all financial institutions.** The FSB has similar, but not identical, definitions for banks and for insurers. These should be merged into a single definition, which should appear in the FSB "Key attributes" document. All references to the concept of "critical functions" in that document should be aligned with the agreed definition, aiding comprehension. At times other terms are used for what appears to be the same thing.

c) **At the same time, due attention should be paid to differences between banks and insurers.** Although the fundamental concept of "critical function" should be the same, its application in different financial sectors must take account of their differences. The FSB has made efforts to adapt its Guidance on critical functions of banks, published in 2013, to insurers. Nevertheless, we think that further adaptations would be helpful.

d) **The link between global systemic importance and provision of critical functions is more distant in insurance than in banking.** A global systemically important bank usually provides financial services in markets on which firms and individuals are highly dependent. On the other hand, it is quite likely that a global systemically important insurer (G-SII) will not provide functions in any market that are "critical" under the FSB's methodology. Insurance markets are more fragmented than the banking sector and, in the event of an insurer's failure, capacity and substitutability are quickly restored to pre-failure levels. It is sensible for RRP to take account of critical functions, but there is no obvious connection between provision of such functions and G-SII status.

e) **The Guidance should place greater emphasis on proportionality.** It acknowledges that very few services provided by insurers are likely to be critical functions. At the same time it proposes detailed and intensive identification processes for application across the full range of an insurer's operations. This does not look like an effective use of resources. We suggest that insurers should understand the possible impact of a future failure in the markets in which they carry on business and in lines of business where they have large market shares should carry out the more detailed assessments suggested by the Guidance, but that neither insurers nor

[1] IAIS *Global Systemically Important Insurers: Initial Assessment Methodology* 18 July 2013

resolution authorities should be expected to carry out those detailed assessments on an exhaustive basis.

Our responses to the FSB's questions are set out below.

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

It is unnecessary to have insurance-specific definitions of these terms. It will aid clarity and avoid ambiguity if the FSB has single, comprehensive, definitions of "critical functions" and "critical shared services" applicable to all financial institutions, set out in its "*Key Attributes*" document[2]. There are two FSB documents on critical functions and critical shared services:

- This October 2014 paper, relating to systemically important insurers.
- The July 2013 paper on *Guidance on Identification of Critical Functions and Critical Shared Services*", which covers functions and services provided by banks.

Their definitions of "critical shared services" are the same, but of "critical functions" are subtly different. Furthermore, "*Key Attributes*" uses a range of terms, apparently referring to the same thing, i.e.:

Vital economic functions

Systemically important financial services

Critical financial services

Financial and economic functions for which continuity is critical,

Systemically important functions

Functions critical to the economy

Critical financial and economic functions

Systemically critical functions

Essential and systemically important functions

Critical functions

Critical functions and services

Standardisation of reference to this concept as "critical functions" with a clear definition and applicability to all types of financial institution will aid understanding. The fundamental concept of "critical functions" is the same for all financial sectors. Since different sectors offer different products and services, operate differently and have significantly different market features, the outcome of its application will, of course, vary.

[2] *Key Attributes of Effective Resolution Regimes For Financial Institutions*, 15 October 2014

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

   The definition of "critical functions" in 2.1 refers to sudden failure to provide a function having a "*material impact on the financial system* <u>and</u> *the real economy*". The FSB's intentions would be better reflected if it were amended to read "*material impact on* ***the stability of*** *the financial system and the real economy*".

   We think that the definition of critical functions should include references to both financial stability and the functioning of the real economy, since they are closely connected and an impact on one is likely to mean an impact on the other. This aids understanding of the concept of "critical functions", whose cessation is likely to have an immediate disruptive effect on the functioning of the real economy and possibly a more delayed impact on financial stability. Both effects should be consequences of cessation for a function to be critical.

   An important element that the definition should emphasise is scale. In order to be critical, the withdrawal of a function should have a wide-ranging effect. In colloquial terms, its withdrawal should be headline news, as, for example, with the troubles of the UK financial firm *Northern Rock* in 2007. If the immediate cessation of a function provided by a financial firm is unlikely to feature on the front pages of newspapers or in TV bulletins it is probably not critical.

   We therefore question whether the second part of the definition set out in 2.1 is appropriate. This refers to when the "*sudden failure to provide a function may have a material impact on third parties*". However, a material impact on third parties is not the issue here. Insurance is an essential element in modern commercial and personal life and the sudden failure of any insurer, however small, is likely to cause some people inconvenience and financial loss – a "material impact". The essential point about criticality is scale: material impact on financial stability and the real economy, not on unspecified third parties. We therefore suggest that the second part of the definition is removed.

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 methodology laid down in section 2.2 is similar to that in the FSB July 2013 document. It is reasonable to have a similar methodology for different sectors, providing, of course, that the definition of critical functions is the same.

   We agree with the statements that:

   "…it is unlikely that any particular insurer will have a large number of critical functions once all three steps in this methodology are applied."[3]

   And

   "…the number of functions which are finally considered critical should be very small."[4]

   These conclusions confirm the IAIS Report on *Insurance and Financial Stability*[5], which says[6]:

[3] Page 9
[4] Ditto.
[5] *Insurance and Financial Stability*, IAIS, November 2011

"In insurance limited substitutability is unlikely to be systemically relevant in a global context. *In points 38 to 41 it was shown that market concentration rates in insurance are generally small and competition is lively. Consequently, the loss of one carrier is unlikely to cause widespread or systemic issues and problems for policyholders and the real economy. On almost every occasion an insurer has failed in the past, the impact has been local. The resultant gap was covered within a short period, and insurance capacity and substitutability were quickly restored to pre-failure levels."*

A disconnect is apparent between these comments and the deployment of an extensive and complex methodology for identifying critical functions in insurance. The paper notes that *"there is a wide range of functions which could be considered…"*[7], *and* the deployment of personnel "*with in-depth knowledge of the specific circumstances in which a critical function is provided*"[8] by supervisory authorities and insurance undertakings to assess all possible functions for criticality is unlikely to be an efficient use of resources. The more so as an insurance market is a dynamic environment and assessments would have to be repeated at regular intervals.

It is important to take full account of differences between banking and insurance markets. A global systemically important bank will probably have large market shares and provide financial services in national markets on which firms and individuals are highly dependent. A global systemically important insurer is less likely to have large market shares and may not provide functions in any market that are "critical" under the FSB's methodology.

On the other hand, a small, specialist insurer would not be "systemically important", but might well have a significant share of an economically salient niche market. The paper says *"…certain commercial insurance lines require specialised underwriting skills and are dominated by a small number of firms with high market shares."* However, there is no obvious correlation between possessing specialist underwriting skills and meeting the IAIS criteria for being a global systemically important insurer (G-SII). If a G-SII does have a big share of a commercial market requiring specialist underwriting skills, this may be purely fortuitous.

We therefore suggest that neither authorities nor undertakings should be expected to apply the methodology in detail to the full range of an undertaking's operations as part of resolution planning. They should have a high-level understanding of the types of functions provided by an undertaking that could be critical and to focus attention on these. The Guidance should include explicit reference to proportionality: it should be applied with due regard to the nature, scale and complexity of the functions and the risks under consideration.

We agree with the paper's comment that "*it is not necessary to apply the steps in the order as set out in the Guidance*"[9]. There is no point in performing a detailed function-by-function analysis under Step 1, only for 90% of the functions to be ruled out under Steps 2 and 3. Most insurers will find it more constructive to carry out preliminary overall high-level assessments, taking account of factors described under each of the steps, before paying detailed attention to functions identified as possibly critical.

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

---

[6] *Insurance and Financial Stability*, Paragraph 67
[7] *October 2014 Guidance*, page 9
[8] *October 2014 Guidance*, page 5
[9] *October 2014 Guidance*, page 9

We do not think that it is necessary to add any further categories. We query whether it is necessary to have six separate categories of activities, described in detail, for the identification of the small number of insurer functions likely to be designated as "critical".

The key statement on these categories is:

"It is important to note that, to be considered as critical, a function, if disrupted, should adversely affect financial stability and the real economy."[10]

Most insurance policies offered by most insurers will fall under one of the first three categories. Their provision is only a "critical function" if the insurer concerned has a dominating market share. Insurance coverage is not critical on its own, but only in conjunction with an insurer's large market share. Many of the examples given in this paper relate to non-life insurance, even though the IAIS says:

"In general, non-life insurance markets tend to be fragmented and competitive."[11]

The sixth category is "*Pooling of risk, particularly reinsurance, as an economic function.*" Consideration of reinsurance as a critical function should take full account of the IAIS's report *Reinsurance and Financial Stability*[12]. We therefore welcome the FSB paper's acknowledgement that there is no strong evidence that interconnectedness arising from reinsurance business contributes materially to a reinsurer being systemic in distress or failure under normal circumstances and that there is evidence of significant substitutability. However, the paper goes on to say that "*uncertainty exists regarding interconnectedness*". We question whether uncertainty is sufficient for reinsurance to be viewed as intrinsically a critical function. The IAIS concluded that[13]:

"…we find that traditional reinsurance – including the reinsurance of peak risks – is unlikely to contribute, or amplify, systemic risk. While reinsurance establishes inter-sector connectivity, the hierarchical structure of the insurance market dampens the propagation of shocks through the insurance market. Although reinsurers can fail, in the past, primary insurers have typically absorbed the loss of reinsurance recoverables without a significant detrimental financial impact."

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?

We question where, for the insurance sector, the identification of critical shared services fits in the process of developing resolution strategies that minimise systemic disruption. Oversight of critical shared services should be part of the prudential regulation to which all insurers are subject, irrespective of their systemic relevance.

Critical shared services are "*activities performed within the firm or outsourced to third parties where failure would lead to the inability to perform critical functions*"[14]. These services "*provide the internal and essential infrastructure the firm needs to continue operating*"[15]. Consequently, failure of those services will have an immediate impact on the viability of the insurer. The

[10] *October 2014 Guidance*, page 9
[11] *Insurance and Financial Stability*, paragraph 39
[12] *IAIS Reinsurance and Financial Stability*, 19 July 2012.
[13] Reinsurance and Financial Stability, para. 91, page 34
[14] *October 2014 Guidance*, page 24
[15] Ibid

consequences for particular critical functions are part of this wider effect and cannot easily be separated out into a specific workstream.

Most modern insurance regulatory regimes include provisions relating to the functions on which an insurer relies to continue operating. The EU's Solvency II regime, for example, includes requirements on an insurer's system of governance[16], with detailed provisions relating to risk management, internal control, internal audit and the actuarial function. It also contains requirements relating to outsourcing. As the Solvency II Directive's Recital 33 says:

"*The functions included in the system of governance are considered to be key functions and consequently also important and critical functions.*"

If an insurer is subject to intensive supervision of its system of governance in accordance with Solvency II, it is not clear what purpose will be served by carrying out a separate assessment of whether and to what extent particular critical functions are dependent on particular critical shared services. Nor should individual features of an insurer's essential infrastructure be singled out for attention on the grounds that they have special relevance to identified critical functions. An insurer's governance and its operations should be supervised as a single, coherent whole.

An analysis to identify a firm's critical functions should consider how the insurer provides those services. It may be that, in specific cases, there are particular vulnerabilities arising from the way that an insurer operates. However, in most cases, we think that the methodology proposed will not help authorities or insurers to make provision of critical functions more resilient.

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

The framework is similar to that in the FSB's July 2013 Guidance for banks. It is appropriate to have a similar framework for all types of financial firms, due account then being paid to differences between sectors in the application of the framework. We consider that the framework is flexible enough to cover the different types of business undertaken by G-SIIs.

We are not sure that the list of examples of possible critical functions in the annex is particularly helpful. It includes a wide range of different classes of insurance and is qualified by the statement that it is "*neither prescriptive nor exhaustive*". Nearly every insurer worldwide will provide at least one product on the list and most will provide several. So the list does not narrow down analysis to a carefully-defined inventory. Furthermore, it suggests that most forms of insurance are intrinsically "critical", whereas this is only the case if the insurer providing them has a dominating share of the market.

[16] See the *Solvency II Directive, Directive 2009/138/EC*, Articles 41 – 50 and *Draft Delegated Acts*, Articles 258 - 275

7. **Is the framework flexible enough to take account of the external environment in which failure is occurring, for example an idiosyncratic event or a broader situation of more severe distress in the financial system?**

   We consider that it is sufficiently flexible.

8. **Are there any other issues in relation to the identification of critical functions and critical shared services that it would be helpful for the FSB to clarify in further guidance?**

   We do not consider that there are other issues that need clarity.