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FINANCIAL SERVICES

Recovery and Resolution Plans for Insurers

The need for a broader debate

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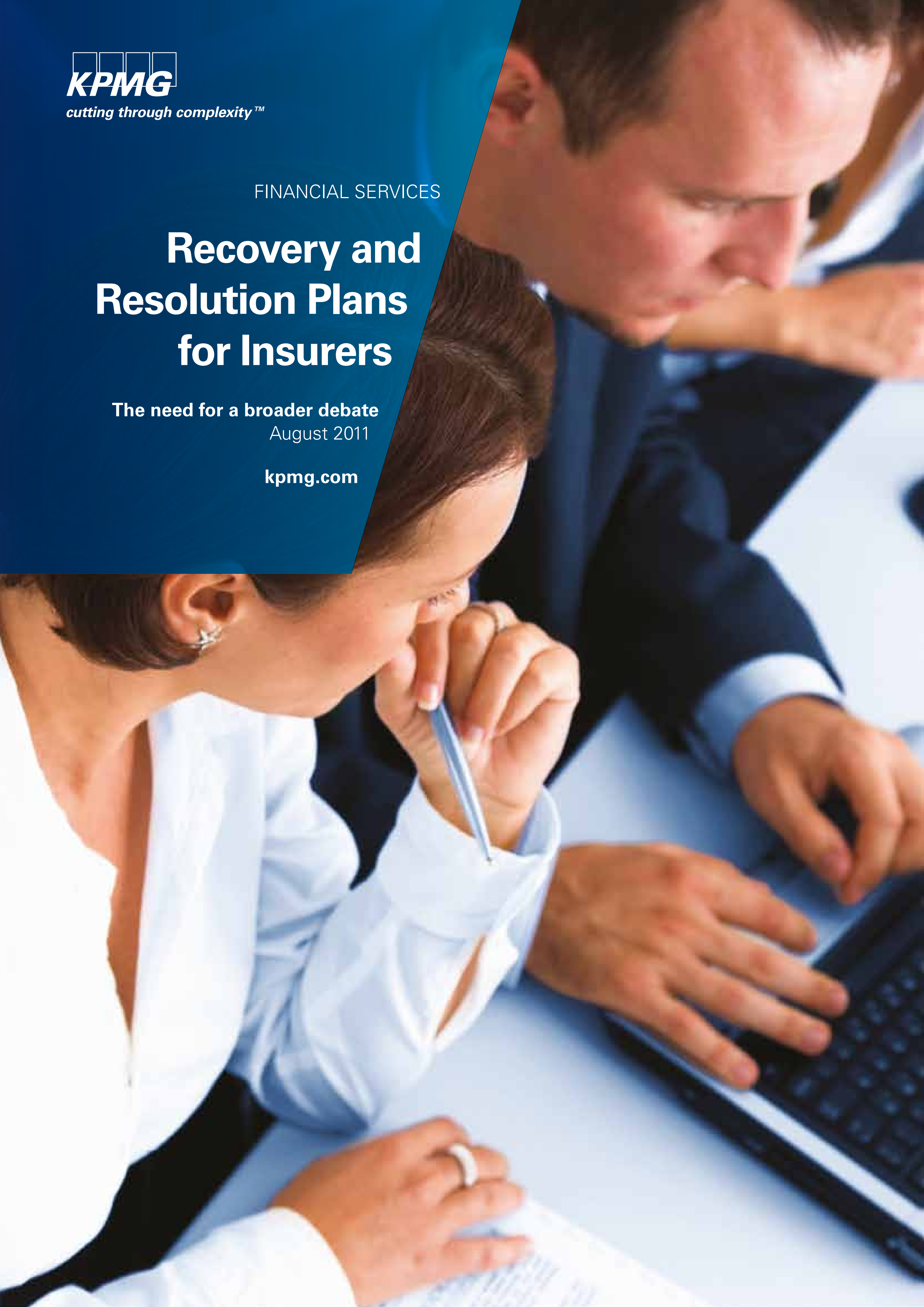

Bringing the issue into focus…

The financial services industry has faced much criticism and fallout from the financial crisis. Recent events serve to highlight the importance of establishing effective provisions so that a future shock does not again destabilize the whole of the financial system and damage the wider economy. While much of the recent attention has focused on banks, insurers are also coming into focus in the systemic risk debate, posing the question: are insurers systemically important? Insurance is certainly not isolated from other sectors, nor immune from risk management shortcomings. The Financial Stability Board (FSB) has made it clear that it expects some insurers to be designated as systemically important financial institutions (SIFIs) and so will be required to prepare resolution plans; much of the detail on resolution planning emerging from the FSB is clearly applicable to insurers.

Many in the sector argue that insurance firms do not pose systemic risk and that there are substantial differences between banking and insurance that should be recognized. To date, debate within the insurance sector has focused largely on the process and timeline for determining whether or not insurers are systemically important. However, this is hindering the advancement of pragmatic policy solutions, particularly concerning recovery and resolution plans (RRPs).

A broader discussion on advancing recovery and resolution planning by insurers to limit the risks arising from the failure of an insurer would help move the debate forward, position the insurance sector to respond positively on the future direction of regulation and represent a natural extension of other insurance regulatory reforms underway. Reducing the probability of a future financial crisis will require innovative solutions that are relevant to the insurance industry.

This paper focuses primarily on the application of resolution planning to the insurance sector. Policymakers need to address the specific features of insurance in order to formulate an appropriate and measured response to the issue of resolvability. Resolution planning could then prove beneficial for the insurance sector since it would complement the enhanced risk, capital management, systems, controls and governance now expected by many supervisors, which is discussed further in *Evolving Insurance Regulation*[1].

Identifying pragmatic policy solutions and ensuring full engagement should create long-term benefits to the insurance industry, regulators and policyholders.

1. *Evolving Insurance Regulation: On the move…*, KPMG International, March 2011.

“Policymakers need to address the specific features of insurance in order to formulate an appropriate and measured response...”

Key issues for firms

- Although there is still considerable debate within the insurance sector around whether certain insurers should be classified as SIFIs, the FSB has made it clear that it expects some insurers to be classified as SIFIs, to be subject to capital surcharges and to be required to prepare credible RRPs.
- The scale of capital surcharges for insurance SIFIs remains to be determined, but recent proposals from banking supervisors for global banks would increase the minimum capital required to be held by a banking SIFI by up to around one third. A lower surcharge might apply to insurance SIFIs since they would be likely to score less heavily on some of the measures of systemic importance than global banks. Even so, the potential impact for the industry and hence on the cost of insurance for policyholders could be substantial.
- Many of the emerging details of what the FSB would expect a resolution plan to address could be directly applicable to insurers, including the need to establish, maintain and ring-fence comprehensive management information systems; reduce complexity in group structures; improve the robustness of service provision for critical economic functions; and undertake intra-group exposures on an arm's-length basis. Major insurers should be developing contingency plans accordingly.
- Reporting requirements for both the new systemic importance indicators and RRPs may also give rise to substantial operational challenges for insurers.
- As a result, insurance SIFIs could face significant cost increases. This could become a limiting factor on growth, require changes in legal and operating structure, and have significant commercial implications, including increasing the cost of insurance for consumers.
- Many insurers are already considering the efficiency of their capital position, group structure and operating models, but major insurers should be starting to add the potential impact of capital surcharges and RRPs to their analysis. Such requirements could have a profound impact on the structure of global insurance markets. Understanding these issues will both benefit the business and place the industry in a stronger position to negotiate proportionate responses and sensible outcomes with policymakers.
- Insurers will also need to deal with the lack of clarity from the authorities on which financial and economic functions should be regarded as being critical; on how the authorities will decide what measures firms should take to change their structure and organisation in advance in order to reduce the cost and complexity of resolution; and on the resolution powers that will be available to the authorities. National authorities may take different approaches within the broad framework outlined by the FSB. Meanwhile, cross-border firms will face differences in national resolution regimes in the absence of effective cross-border resolution measures.
- Insurers will also find it more straightforward to meet requirements for resolution plans if these can be based, as far as possible, on existing and currently proposed regulatory reforms in the insurance sector. Some of these already focus on group and capital structures, including intra-group exposures and external service provision arrangements.
- It is important that policymakers understand and reflect the differences between banks and insurers in formulating regulatory requirements. A bespoke and measured approach by policymakers to address insurance is likely to provide the best outcome for the industry, regulators and policyholders.

The SIFI debate

Following the financial crisis, the G20 set up the Financial Stability Board (FSB) to ensure the financial soundness of systemically important institutions, and to establish a regulatory framework for all systemically important financial institutions (SIFIs), instruments and markets. The FSB has therefore been developing and overseeing regulatory reform initiatives designed to:

- Make SIFIs safer, so they are less likely to fail;
- Introduce resolution mechanisms under which a SIFI could be allowed to fail with minimal disruption to the wider system and economy; and
- Minimize any costs falling on taxpayers when a SIFI is either 'resolved' or allowed to go into liquidation.

The FSB has focused to date primarily on the banking sector, but it has also asked the International Association of Insurance Supervisors (IAIS), which is the global standard setter for insurance supervisors, to provide input into FSB deliberations concerning "the differentiated nature of regulation" and to recommend improvements for the sector.

The insurance industry should therefore take note of the three key components of the FSB's work on SIFIs:

1. Developing a capital surcharge for SIFIs, beginning with global SIFIs and extending this to national SIFIs in due course. The first such proposal has emerged from the Basel Committee on Banking Supervision (BCBS), which has recently consulted[2] on applying capital add-ons to global systemically important banks (G-SIBs), based on how a bank scores against the criteria of global (cross-jurisdictional) reach, size, complexity, interconnectedness, and lack of substitutability.
2. Determining the policy measures that should be available to national authorities to resolve failing SIFIs in a rapid and orderly manner, minimizing wider disruption and any cost to taxpayers, and establishing effective cross-border resolution arrangements.
3. Determining the recovery and resolution plans (RRPs) that SIFIs should have in place to improve their ability to respond to shocks and, if necessary, to enable them to be restructured, wound down or liquidated effectively and efficiently[3]. The FSB has recently published a consultation paper on the RRPs that SIFIs should put in place, and on the resolution powers that should be available to national authorities[4]. In addition, some countries may require all financial institutions in some sectors to put RRPs in place.

This report focuses primarily on the third of these components, and in particular on resolution plans. It is, however, important to note that these components inter-relate and that there is overlap between recovery and resolution issues.

"Policymakers may consider some insurers to be of systemic importance, at least at a national level and in some cases at a global level."

Are any insurance companies systemically important?

The FSB has defined systemic risk 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." Four criteria are used by the FSB to assess systemic risk: size, interconnectedness, complexity and substitutability.

The debate on the systemic importance of insurance companies has typically begun with an analysis of how insurance companies differ from banks. These differences include:

- The insurance model is based on pooling policyholder risks. Policyholder premiums are paid in advance of claims arising. However, insurance companies can still fail, for example because of under-pricing and under-reserving against risks, although such failures tend to be drawn out over a long time and do not usually generate the 'deposit run' problem that a bank might face as soon as problems begin to emerge (although life insurers could face the equivalent of a deposit run if they have sold savings policies that can be surrendered at short notice and without large financial penalties).
- Insurance companies typically match the maturity of their assets and (expected) liabilities. Unexpected claims or a sharp fall in asset values can lead to liquidity issues, but these can generally be met by borrowing against assets, phasing the timing of payments, or limiting payments in the event of early surrender.
- Insurance companies are not direct participants of payment and settlement systems.
- Insurance risks are largely independent of the economic cycle, whereas banking risks are usually characterized by being highly correlated with worsening economic conditions.
- For insurers, size and stability are generally positively correlated, since greater size and scope offer greater opportunity for diversification.
- Insurance groups usually have fewer intra-group exposure than banking groups.
- Insurance companies are usually less interconnected with other financial institutions than banks, even through reinsurance.

Nevertheless, policymakers may consider some insurers to be of systemic importance, at least at a national level and in some cases at a global level.

Systemic risk through the financial sector

First, insurers undertake activities that generate systemic risk through contagion within the financial sector, as was demonstrated during the financial crisis by the large holdings of asset-backed securities by some insurance groups. Problems also arose in the financial guarantee insurance sector as some insurers and financial conglomerates broadened their business models to write credit protection. When borrowers started defaulting, credit rating agencies lowered the ratings of financial guarantee insurers and investors lost confidence that their investments were protected from default by the insurance wrapper.

Contagion could also arise within the financial sector from the failure of an insurer as a result of:

- the failure of a major reinsurer – although research undertaken by the Geneva Association shows that even using conservative modelling, the total loss for the primary insurance industry of an immediate failure of 25 percent of global reinsurance capacity would amount to less than two percent of primary insurers' shareholders' equity;
- some of the activities of insurers as asset managers can create maturity transformation and liquidity risk, for example through:

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2. *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*, Basel Committee on Banking Supervision, Consultative Document, 19 July 2011.
3. *The Implications of Recovery and Resolution Plans… Stressed by the break up?* KPMG International, May 2011.
4. *Effective Resolution of Systemically Important Financial Institutions*, Financial Stability Board, Consultative Document, 19 July 2011.

– buying securitized products and synthetic securitizations as part of a 'search for yield', which exposes insurers to the risk of loss from sharp falls in the value of these assets;

– lending securities, and then accepting asset-backed securities or Collateralized Debt Obligations (CDOs) as collateral rather than cash, which exposes insurers to the risk of holding these assets if a counterparty fails; and

– reinvesting cash collateral arising from securities lending into longer term higher risk securities, which exposes insurers to the risk of loss and to an inability to meet their obligations if the original counterparty unwinds its initial transactions;

- other financial institutions becoming counterparties of insurance companies through derivatives and hedging programs for complex insurance products such as variable annuities; and
- the impact of a severe economic downturn, where insurers may dispose of assets to enhance their solvency, generating a downward spiral of falling asset prices and higher margin calls.

This interconnectedness with other parts of the financial services industry requires greater scrutiny. The IAIS has undertaken a data gathering exercise to assess and understand such interactions and dependencies, and the outcome of such analysis will help inform the response of the IAIS to the FSB on the systemic importance of insurers and the implications for capital surcharges and for RRPs.

"There may be a direct impact from the failure of an insurer on the real economy, if insurers undertake critical economic functions which cannot easily be substituted in the short term through new capacity or new suppliers."

Systemic risk directly to the real economy

Second, there may be a direct impact from the failure of an insurer on the real economy, if insurers undertake critical economic functions which cannot easily be substituted in the short term through new capacity or new suppliers. Reinsurance is typically cited as an example, but it may equally be true of employers' liability insurance, specialist marine and aviation insurance, and the provision of life and health insurance, pensions and motor insurance. As resolution planning by both the authorities and firms has evolved, there has been an increasing focus on the critical economic and financial functions that a firm may provide and on how these functions could best be preserved if a firm failed. For example, although the recent UK FSA proposed rules and guidance on recovery and resolution plans[5] do not apply to insurers, they do include general insurance, reinsurance, underwriting, life insurance, pensions, investments and annuities within a list of economic functions that could be critical to the economy and the financial system. This direct impact may be the trigger that leads some large insurers to be designated as SIFIs; and it may lead some countries to extend the requirement to put RRPs in place beyond SIFIs to some smaller insurers.

One example of the provision of critical economic functions by an insurer was provided by the collapse of HIH (the Australian insurance group) in 2001. HIH was the dominant provider of indemnity coverage for the building industry and some other forms of employers' liability insurance in Australia. Its failure demonstrated the impact that the failure of an insurer focused on a particular market or segment can cause on the local economy. However, the consequences of its collapse were not felt globally.

This potential impact suggests that greater attention should be paid to local concentrations of insurance business and the potential impact of the failure of an insurer on its local economy. Given that some insurers operate as monolines or have a strong home base, it would seem appropriate to consider an approach that defines systemic importance by taking account of the economic dislocation that could arise as a result of the failure of an insurer, such as:

- 'G' SIFI – An insurance group of sufficient global scale and importance that failure could cause considerable economic consequences, both through the financial system and directly on the real economy;
- 'D' SIFI – An insurance group whose failure at the domestic level (such as within one region or country) could pose considerable economic consequences but would be unlikely to cause global disruption, either directly or through contagion effects; and
- 'L' SIFI – An insurer whose failure could cause considerable economic difficulties for a particular locality (such as a state or a city) but not on a national scale.

Greater analysis of the economic impact that the failure of an insurer could cause in a particular market would enable regulators to develop requirements that are proportionate to the potential impact.

Capital surcharges

The IAIS standard on capital adequacy now requires all jurisdictions to set out appropriate target criteria for the calculation of regulatory capital requirements and to set criteria for the assessment of the quality and suitability of capital resources, having regard to an insurer's ability to absorb losses on both a going-concern and wind-up basis. Within the context of group-wide capital adequacy assessment, regulators are expected to establish solvency control levels known broadly as a ladder of regulatory intervention.

The ladder of intervention provides an opportunity for regulators to establish a new control level based on the systemic risk posed by insurers. Such an intervention level could take the form of additional capital and/or risk management requirements and could be based on the supervisory review of the insurer's Own Risk and Solvency Assessment (ORSA).

Recovery plans

The basic proposal for recovery is that a firm should put in place credible and realistic recovery plans to address capital shortfalls and pressures on other resources (such as liquidity) under a range of scenarios including both idiosyncratic and market wide stress; and processes to ensure the timely implementation of recovery options in a range of stressed situations. A recovery plan should go beyond 'business as usual' management actions by providing contingent responses to a range of forward-looking stresses.

One way in which supervisors could require insurance firms to formulate recovery plans would be to incorporate these within firms' ORSA's. The ORSA is a new policy tool being introduced by regulators requiring insurers to undertake an assessment of their own risks, and of the capital required to meet such risks, discussed further in *Evolving Insurance Regulation: On the move...*[6]. In some markets, supervisors are already moving to requiring forward assessments of the financial condition of an insurer under a range of scenarios (see Figure 1).

Stress and scenario analysis of the future financial condition of the insurer/ insurance group forms a key component of these reforms. Before the financial crisis, many firms' stress tests failed to consider adequately the potential magnitude and duration of shocks, risk concentrations and the extent of correlation (and contagion) between different positions, risk types and markets. The challenge for both firms and their supervisors is to set tests that are appropriately severe and broad, while remaining within the bounds of plausibility. Such tests are an essential tool in building a resilient financial sector. Firms should consider modelling further assumptions addressing how exposures may change in light of unexpected shocks and analyze the impact on their business model. The use of reverse stress testing, or test-to-destruction analysis, which identifies scenarios that would cause an insurer to fail, should also form part of a firm's overall risk management analysis and assessment. One benefit of requiring such analysis is that it can provide management, and supervisors, with the necessary information to assess the adequacy of the management actions proposed in order to avoid business failure. Constructing a comprehensive firm-wide view of stress testing is likely to require significant investment in IT infrastructure in order to provide risk information that is sufficiently granular.

5. *CP11/16: Recovery and Resolution Plans*, Financial Services Authority, August, 2011.
6. *Evolving Insurance Regulation: One the move...*, KPMG International, March 2011.

Figure 1

Examples of forward assessments

In the UK, the Individual Capital Adequacy Standards (ICAS) assessment requires extensive stress and scenario testing by an insurer of its capital, insurance, market, credit, liquidity and operational risks, in addition to other relevant risks such as reinsurance risk, strategic risks, and corporate governance risk. Such requirements will be extended in Europe under Solvency II through the ORSA requirements and, for those firms using an internal model, will include the methodology proposed for calculating capital requirements. Similar requirements exist in Australia (Financial Condition Report), Canada (Dynamic Capital Adequacy Testing), Switzerland (Swiss Solvency Test) and Bermuda. The National Association of Insurance Commissioners (NAIC) in the US is consulting with the industry concerning the introduction of an ORSA requirement.

Resolution plans

Under the current FSB proposals SIFIs will be required to put in place resolution plans to ensure that, if necessary, the SIFI could be restructured rapidly and smoothly in ways that (a) preserve critical economic functions; (b) minimize the contagion risk to other financial institutions, and the economy more generally; (c) allow some or all of the SIFI's business to be sold or otherwise transferred in an orderly manner to new owners, with the rest of the business wound down; and (d) enable these three outcomes to be achieved with the lowest possible cost to taxpayers.

Insurance failures are typically resolvable through an orderly run-off, but exceptions to this have occurred and remain plausible, so there is a case for putting in place up-front arrangements to ensure an orderly resolution under various scenarios. Such developments would be a helpful complement to prudential requirements, but should not be seen as a replacement for them, and preventative action should remain integral to prudential regulation.

The FSB published a consultation paper on 26 July 2011 which proposed that SIFIs (whether banks, insurance companies or other non-banks) should prepare robust and credible RRPs, and update these plans on a regular basis. Most of the detailed proposals (see Figure 2) will be relevant to any insurance SIFIs, particularly those relating to information systems and service level agreements, even if the extent of intra-group exposures and the use of financial market infrastructure may be more limited for most insurance SIFIs than they are for bank SIFIs. In particular, insurance SIFIs will need to be able to demonstrate that the critical economic functions they perform are capable of being supported from an infrastructure and operational perspective, as well as from adequate capital.

The FSB proposed that the adequacy of these plans should be reviewed and assessed formally at least annually by the home and relevant host supervisory and resolution authorities; and that the authorities should have, and use when necessary, powers to require SIFIs to address any deficiencies in their plans. The FSB also set out a timetable under which SIFIs should have completed draft recovery plans by the end of 2011 and draft resolution plans by mid-2012, with the authorities completing the first assessments of resolvability by the end of 2012.

The Basel Committee on Banking Supervision (BCBS) published on 6 July a survey of its member countries' progress in implementing resolution regimes. The survey found that only limited progress has been made. Requirements on firms to establish RRPs continue to differ significantly across countries. Even where they have been introduced there remains a lack of clarity on which financial and economic functions should be regarded as being critical, and on how the authorities will decide what measures firms should take to change their structure and organization in advance in order to reduce the cost and complexity of resolution.

The coverage of insurance firms in the survey suggests that they will remain a focus of attention by the authorities in terms of which insurance companies may be of systemic importance; what insurance business should be designated as being critical financial services; the treatment of insurance policyholders in the event of the resolution of an insurance company; and requirements on (some) insurance companies to draw up RRPs.

The US is the only jurisdiction thus far where some insurers will be required to submit resolution plans. The Dodd-Frank Act requires all bank holding companies with total assets of US$50 billion or more, and non-bank financial institutions (including insurance firms) designated by the Financial Stability Oversight Council (FSOC) to be systemically important, to develop resolution plans and to submit these for review by the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC).

The FRB and FDIC consulted in March 2011 on joint rules to establish resolution planning and reporting standards, with the intention of implementing these rules by the end of 2011. These draft rules are broadly consistent with the proposals in the FSB consultation paper. They require SIFIs to submit resolution plans that are sufficient to achieve rapid and orderly resolution and to report quarterly their credit exposures to and from other financial institutions. These resolution plans must include extensive detail on the mapping of business lines to legal entities; corporate structure; critical operations; credit and other exposures;

"The US is the only jurisdiction thus far where some insurers will be required to submit resolution plans."

Figure 2

FSB proposals for resolution plans

The FSB consultation paper published on 26 July provides more detailed material on what SIFIs should include in their resolution plans. These plans should identify:

- financial and economic functions for which continuity is critical;
- suitable resolution options to preserve these functions or wind them down in an orderly manner;
- data requirements on the firm's business operations, structures, and systemically important functions;
- potential barriers to effective resolution and actions to mitigate these; and
- actions to protect insured depositors and insurance policy holders and ensure the rapid return of segregated client assets.

The FSB proposes detailed requirements for resolution planning in four areas where the complexities of SIFIs' operations may pose obstacles to effective resolution, and where SIFIs should therefore consider what information management, legal and structural changes they may need to make in advance in order to improve their 'resolvability' should that become necessary. These areas are:

Information systems – in order to provide comprehensive, pertinent information on a timely basis at both aggregate and legal entity level, SIFIs should:

(i) maintain a detailed inventory of the key management information used in their material legal entities, mapped to their core services and critical functions;

(ii) identify and address legal constraints on the exchange of management information within the SIFI; and

(iii) demonstrate, as part of the recovery and resolution planning process, that they are able to produce the essential information needed to implement such plans within a short period of time (for example, 24 hours).

In effect, this calls for SIFIs to create a comprehensive, regularly updated and ring-fenced management information system, which will be expensive and challenging to deliver.

Service level agreements – SIFIs should enter into service level agreements that are legally enforceable in crises and in resolution, and which include provisions that prevent the termination of these agreements being triggered by recovery or resolution events and that facilitate transferability to a bridge institution or a third party acquirer.

Complexity and intra-group exposures – SIFIs should:

(i) identify and reduce areas in their existing organizational structure, transactions and exposures that generate unnecessary complexity and impede resolution;

(ii) conduct intra-group transactions at arm's-length and adhere to standard practices such as documentation, netting and close-out arrangements, collateralization, and margin maintenance on derivatives trades;

(iii) be able to re-constitute, within a specified time, all separate legs of a transaction booked in separate intra-group entities, and limit imbalances between parent company and legal entities; and

(iv) reduce interconnectedness caused by the terms of financial contracts.

Global payment operations – SIFIs should meet high standards of documentation and record-keeping and undertake contingency planning relating to their continuing access to financial market infrastructures.

In **reviewing and assessing resolution plans**, the FSB proposes that the authorities should focus in particular on, and that SIFIs should therefore be in a position to deliver:

(i) an assessment of the critical financial and economic functions that a SIFI performs – although as in previous papers, the FSB provides no clear statement of what constitutes a critical function;

(ii) how these critical functions map against legal and corporate structures;

(iii) the extent and nature of intra-group exposures;

(iv) the continuity of service level agreements, both internally and with external providers, relevant to the continued operation of key functions, even if a SIFI was placed in resolution;

(v) the adequacy of management information systems to construct a complete and accurate view of a SIFI's aggregate risk profile under rapidly changing conditions;

(vi) the continuity of management information systems in the event of one or more component legal entities entering resolution or insolvency; and

(vii) the ability to provide detailed, accurate and timely information promptly to the home and host authorities.

funding, capital and cash flows; and supporting information systems and other essential services[7].

SIFIs headquartered in the US would be required to provide information on both their domestic and foreign operations, while foreign firms that are designated to be SIFIs in the US would be required to provide information on their US operations and explain how resolution planning for their US operations is integrated into their group-wide interconnections and inter-dependencies.

The initial response of SIFIs in the US has been to focus on capital and liquidity planning, on gathering information on the scope for legal entity rationalization, and on understanding the extent of interconnectivity and intra-group transactions. This information can then be used to determine how easily an institution could be "resolved", for example through running a "mock bankruptcy". The next stage for many financial institutions will be to focus on restructuring and on the sale of peripheral and unprofitable businesses to add to the credibility, and reduce the complexity, of their resolution plans.

Group structure

One key area of concern frequently voiced by regulators in the context of resolution planning is the need for complexities to be ironed out, and for the infrastructure and operational support for critical economic functions to be sufficient to enable the continuity of these functions in the event of the failure of a firm. The expectation that groups will need to structure more simply seems sensible. Indeed, the reality for many large insurance groups is that their group structure reflects a legacy of transactions and out-dated or overly sophisticated tax planning. Key challenges for these groups include:

- multiple cross-ownership structures;
- complex capital and cross-financing structures, terms of financing instruments, and investments by way of complex trusts;
- unconventional reinsurance arrangements, often between group companies; and
- stacked structures, including in some cases double use of capital.

Reviewing group structures as part of the development of a resolution plan will provide insurance groups with an opportunity to take a strategic approach that covers the sometimes conflicting demands of effective access to markets, operational efficiency and efficient use of capital; while also meeting regulatory, fiscal and other operating constraints. Likewise, insurance groups contemplating, or already implementing, new structures

should incorporate RRP considerations when selecting their optimal structure.

Equally, however, in some cases complexity is beneficial to insurance groups and policyholders. For example, cross guarantees are often used to enhance policyholder protection where insurance cover is provided by less well capitalized subsidiaries. Further, there is a risk that the scale and breadth of the risks many successful insurers take on, which benefits policyholders through diversification, may be wrongly confused with complexity.

Simplifying group structures could prove extremely costly for many insurance groups, not least in terms of capital, tax and implementation. A balance will need to be struck between removing unnecessary complexity and recognizing that a degree of complexity may still be compatible with credible and effective RRPs. The time to unwind complex structures will also need to be taken into account, as will the interests of policyholders and the nature and duration of the liabilities, which may require a different approach from that adopted by banks. It remains uncertain how far the authorities will expect SIFIs to go in simplifying their group structures, and the industry has an important contribution to make to this aspect of the debate.

Many groups are already identifying that overly complex group structures are sub-optimal in the long term, and are starting to address these issues over an extended transition period, so as to manage the costs and achieve the right business outcome. Supervisors will need to be mindful of progress towards achieving an optimal group structure when introducing a pragmatic resolution regime. Insurers will need to keep their group structures under review to ensure they remain fit for purpose as corporate strategy and the business environment evolves, just as RRPs will need to be regularly updated.

The insurance industry has expressed concern that the introduction of resolution plans could reinforce moves already being taken by supervisors in some countries to encourage the use of subsidiaries rather than branches, in order to provide greater localization of capital and assets within their market. Such an outcome would cause considerable difficulties for European insurers, particularly in regards to the Solvency II architecture.

For many years now, European insurers have benefitted from the passporting freedoms that allow insurers authorized in one European Union country to operate on a cross-border basis through branches, rather than subsidiaries. Aside from the advantage of a single prudential regulator and a single pot of capital, insurers have benefitted from reduced operating costs and economies of scale, achieved business improvements through better use of data, and been able to take advantage of new market opportunities cost-effectively.

As a result, many European insurers have established pan-European 'supercarriers'. In addition, Solvency II proposals concerning risk-based capital and group supervision have served to drive an increasing number of groups to switch to branch structures, including those for whom legacy structures have previously made this too costly. Part of the reason for this is due to the lack of a group support regime, and hence branching has become an effective way of optimizing capital and achieving diversification benefits.

Other regions such as ASPAC and the Americas operate quite differently and independently country by country, and even state by state. Consequently, as regulators across the regions are contemplating the implementation of risk-based solvency, some insurers are already acknowledging the capital implications of operating their current

7. For more discussion on these proposals, see *Pressure to act now: Implications of US Resolution Plans and Credit Exposure Reporting for foreign-owned financial institutions*, KPMG International, March 2011.

"A balance will need to be struck between removing unnecessary complexity and recognizing that a degree of complexity may still be compatible with credible and effective RRPs."

"An adequate global framework for the application of RRPs to IAIGs would also require agreed frameworks for the operation of supervision and resolution colleges of the relevant authorities..."

group structure. The cost of a sub-optimal group structure is becoming apparent for those planning for group supervision. Additionally, inconsistent standards could entice firms to relocate to avoid complex regulations and higher compliance costs, and arbitrage opportunities are emerging as a result of different regulatory practices and timeframes for implementing the new IAIS standards. This reinforces the need for a global accord for the supervision of internationally active insurance groups.

Resolution powers of the authorities

The FSB consultation paper published on 26 July 2011 set out a wide range of resolution powers that national authorities should put in place for the resolution of any SIFI, including insurance SIFIs:

- establishing a designated resolution authority;
- powers to remove and replace senior management and the board; appoint an administrator; operate and resolve an entity; transfer or sell assets and liabilities; establish a bridge institution; establish an asset management vehicle; effect closure and orderly liquidation; suspend payments; and, as a last resort, take a firm into public ownership;
- specifically for insurance firms, powers to require portfolio transfers, run-off existing insurance business, and hold underlying assets against derivatives;
- providing temporary funding to a firm in resolution, with provision to recover any losses from creditors of the firm or, if necessary, from the financial system more widely;
- establishing a statutory 'bail-in' mechanism (to be applied to existing and new creditors from the point of enactment) to enable the authorities to convert a SIFI's liabilities to unsecured and uninsured creditors into equity at the point that resolution is triggered, thereby ensuring that the costs of resolution are borne by a firm's shareholders and these creditors;
- powers to ensure that SIFIs hold sufficient 'bail-in' debt, over and above capital requirements;
- facilitating cross-border resolution, through empowering and encouraging a cooperative solution with foreign resolution authorities; and
- requiring SIFIs to prepare recovery and resolution plans, to ring-fence activities and operations, and to take action to address any deficiencies.

However, as is evident from the BCBS survey – which included some insurance issues – only limited progress has been made by national authorities in implementing such resolution regimes. Even in the minority of countries that have implemented resolution regimes the details differ across countries, with some of these regimes limited to banks, and not covering insurers and other non-bank financial institutions; and differ in terms of the range and nature of the powers available to the authorities, for example whether they have the power to take control of financial institutions before or upon insolvency, to effect transfers or to implement orderly and rapid liquidation, and to undertake creditor-financed recapitalizations based on the 'bailing-in' of some classes of unsecured creditors.

In most jurisdictions insurers have long been subject to resolution mechanisms that provide for consumer protection, including some combination of insurance guarantee or policyholder protection schemes for some classes of policyholder and schemes of arrangement and portfolio transfers. Such mechanisms assist in the orderly wind-down of an insurer's obligations to policyholders and in preserving the continuity of critical economic functions. There are also techniques to effect new financing and reinsurance structures, for example 'reinsurance to close' within the Lloyd's insurance market. Regulators such as the UK Financial Services Authority have a suite of tools for intervening when insurers face difficulties, and for supervising run off. These include requiring run off plans, claims management strategies, independent evidence for the value of liabilities (including provision for run off

costs), and more frequent reporting, to deal with both recovery and resolution.

The failure of the Reliance Insurance Company in 2001 demonstrated how a regulatory response can avoid any systemic impact. To date, Reliance is the largest property and casualty insurer to have failed. Before its failure, the company was insolvent by US$1.1 billion and owed US$10 billion in claims and was licensed to do business in all 50 US states, Puerto Rico, and the District of Columbia. Despite the size and reach of the company, the regulatory mechanisms in place ensured that its policyholders shared none of the liability for its mismanagement, and the company's failure did not generate an adverse impact on financial markets.

However, insurance resolution regimes differ across countries, and generally do not meet all the 'key attributes' proposed by the FSB. Establishing common standards would assist policymakers to arrive at a consistent set of requirements and increase the likelihood of achieving a harmonized global approach for the protection of policyholders and financial stability.

Cross-border resolution

The failure of a SIFI would also usually require cross-border resolution, but this remains severely constrained by differences in national legislation, limitations on the extent to which national resolution authorities are required or empowered to cooperate with foreign authorities, and limited progress on the establishment of cross-border arrangements for cooperation and information sharing. Making progress on cross-border resolution will be a particular challenge for the insurance industry, which lacks an agreed international supervisory framework for the supervision of internationally active insurance groups (IAIGs). The IAIS is exploring the possibility that a consistent set of requirements could be applied to the supervision of IAIGs, but even in the aftermath of the financial crisis it is proving difficult to reach agreement on the core constituent elements of the proposed common framework (known as ComFrame) for the supervision of these groups.

ComFrame will attempt to achieve a framework that introduces effective group-wide supervision and balances the perspectives of local and group-wide supervisors. The overall aim is to foster global convergence of regulatory and supervisory measures and approaches and to establish a framework for better supervisory cooperation. The ComFrame proposal, released on 1 July 2011, addresses five key areas, including group structure and business – particularly legal, geographical and intra-group issues, including resolution issues.

An adequate global framework for the application of RRPs to IAIGs would also require agreed frameworks for the operation of supervision and resolution colleges of the relevant authorities; a clearer definition of the rights and duties of the different supervisory and resolution authorities; and formal mechanisms to exchange confidential information between supervisors and resolution authorities, and to verify such data. While Memorandum of Understanding (MoU) agreements between supervisors are progressing, these remain largely bespoke and there are practical difficulties to exchanging timely and relevant information. Better co-operation and co-ordination among supervisors using a common platform would facilitate efficient and well-functioning colleges of supervisors.

A clearer understanding is also required of how RRPs should apply to financial conglomerates, where substantial cross-sector and cross-border issues still need to be addressed. Converging requirements across sectors would provide a more consistent set of regulatory approaches to be applied to financial conglomerates in relation to the SIFI debate and RRPs. Following the financial crisis many would argue that it is particularly important for the proposals to apply seamlessly across financial conglomerates.

Moving the debate forward

The insurance sector cannot isolate itself from the policy debates on the regulatory treatment of SIFIs and critical economic functions, including capital surcharges and RRPs. While there are differences between banking and insurance, and the nature of failure is different, events highlighted by the financial crisis reinforce the need for a measured and proportionate response to limit systemic risks. In this regard, insurers are both involved and affected, and should consider now, and engage with regulators on, the practical options which could be implemented.

A fresh perspective is required to analyze the most appropriate and effective response, and ensure there is an effective alignment to other major insurance regulatory reforms already underway. As with the banks, the industry will need to consider how insurers could position themselves to be capable of being resolved without recourse to taxpayer support.

There are a number of ways in which existing initiatives could be developed to include some elements of resolution planning, while recognizing that these might not be sufficient in themselves to meet all of the FSB's current proposals. A number of pragmatic and proportionate policy options exist:

Broadening the classification of SIFIs

From our analysis, there appears to be a strong case for greater firm and supervisory effort to be directed to analyzing those activities undertaken by insurers which could present a potential impact on the broader economy. Using a wider classification of potential systemic importance addressing global, domestic and local importance could enable insurance regulators to focus additional requirements as appropriate.

Establishing a better ladder of intervention

Many national regulators are looking to reform their capital adequacy requirements to take account of the new IAIS standard which becomes effective in October. Analyzing the potential impact of systemic risk by insurers would allow supervisors to widen their intervention approaches and provide a useful input to the management of such risks. The use of better risk management or capital requirements could therefore facilitate proportionate responses by supervisors.

Developing a better framework for group-wide and consolidated supervision

Converging requirements through ComFrame would provide a solid basis for harmonizing requirements across sectors, and would allow a more consistent set of regulatory approaches to be applied to financial conglomerates.

Formalizing a coordinated framework to resolution procedures and establishing common approaches across jurisdictions would be a useful step forward. For insurance, such convergence could be facilitated by the IAIS. A global framework would assist policymakers to arrive at a more consistent set of requirements and increase the likelihood of achieving a more harmonized global approach for the protection of policyholders, which would be welcomed by both insurers and policymakers.

> **"Many national regulators are looking to reform their capital adequacy requirements to take account of the new IAIS standard which becomes effective in October."**

Enhanced ORSA analysis to include resolvability

Supervisors will expect major insurance groups, particularly those in Europe seeking internal model approval, to demonstrate that they have a comprehensive understanding of their business and contractual arrangements, adequacy of reserves, group structure, capital, and intra and extra group relationships. This analysis could be extended to require insurers to have mechanisms in place to resolve the group in an orderly manner in a worst case scenario. The use of reverse stress testing, or test-to-destruction analyses, which identify scenarios that are most likely to cause an insurer to fail, will help to focus on planning for 'resolvability'.

Greater focus on non-core insurance activities and off-balance sheet items

Part of the ORSA could be focused on examining the potential impact that non-core insurance activities and off-balance sheet items may have on an insurer's financial condition. Such an approach should adopt a total balance sheet approach which recognizes the economic impact of the totality of the insurer's material risks. The financial crisis demonstrated that failure to recognize the risks such activities can pose to a group highlights a material weakness in overall risk management capabilities and functions.

The IAIS standard on investments could be extended to provide greater clarity on which of the more complex and less transparent classes of assets may require further regulation, and to provide more consistent requirements relating to investments in instruments such as special purpose vehicles, hedge funds, derivatives, private equity, structured credit products, insurance linked instruments and hybrid instruments that embed derivatives as well as hedging programs. A first step here would be to require firms to undertake specific analysis of such instruments and hedging programs within their ORSA activities, with particular regard to whether these increase systemic risk.

Requiring an analysis of the concentration of business written

To mitigate the impact of the lack of immediate substitutability of some types of insurance cover, supervisors could review insurers' market shares. A market concentration analysis would allow firms to undertake discussions with their supervisors in advance of stress conditions, allowing constructive dialogue regarding a firm's strategic objectives and marketing plans.

Increased use of stress and scenario analyses to improve risk appetite and strategic considerations

To be in a position to effect appropriate safeguards, insurers will need insight into the potential triggers of failure. This is likely to require sophisticated scenario analysis to understand the pressure points and the likely sequence of events in stressed conditions. Some insurance groups are already performing such analysis, though formalizing such arrangements on a consistent basis across jurisdictions is a considerable challenge.

Linking such analysis to the risk appetite of an insurer and how this fits with its strategic direction and related impact on pricing, sufficiency of reserves and capital adequacy would be a further improvement. The financial crisis highlighted that many insurance groups were not fully cognisant of their inherent underlying risks in extreme stress conditions, particularly those risks which may have systemic relevance.

Engaging in the wider debate is essential in moving forward towards pragmatic policy solutions which are appropriate and effective for the insurance industry. As we await the recommendations from the IAIS to the FSB, it is becoming clearer that insurers will be required to implement a version of recovery and resolution plans. While the systemic debate continues, ultimately it is crucial for the global economy to work towards ensuring a stable future to minimize likelihood and impact of a future crisis; insurers form a crucial part of the financial system and are certainly not immune to these challenges.

Contact us

Frank Ellenbürger
Global Head of Insurance
T: +49 89 9282 1867
E: fellenbuerger@kpmg.com

Drew Fellowes
Partner, Head of Insurance UK
KPMG in the UK
T: +44 20 7311 5668
E: drew.fellowes@kpmg.co.uk

Jon Pain
Partner, Financial Services
Regulatory Center of Excellence,
EMA region
KPMG in the UK
T: +44 20 7694 4160
E: jon.pain@kpmg.co.uk

Rob Curtis
Director, Insurance
Financial Services
Regulatory Center of Excellence,
EMA region
KPMG in the UK
T: +44 20 7694 8818
E: rob.curtis@kpmg.co.uk

Clive Briault
Senior Advisor,
Financial Services
Regulatory Center of Excellence
EMA region
T: +44 20 7694 8399
E: clive.briault@kpmg.co.uk

Ferdia Byrne
Partner
KPMG in the UK
T: +44 20 7694 2984
E: ferdia.byrne@kpmg.co.uk

Jane Portas
Director, Insurance
KPMG in the UK
T: +44 20 7311 5437
E: jane.portas@kpmg.co.uk

Jon Greenlee
Managing Director,
Financial Services
Co-Lead Regulatory Center of
Excellence, Americas region
KPMG in the US
T: +1 703 286 8032
E: jdgreenlee@kpmg.com

David Sherwood
US Head of Insurance
Regulatory
Financial Services
Regulatory Center of Excellence,
Americas region
KPMG in the US
T: +1 212 954 5861
E: davidsherwood@kpmg.com

Solomon Abuliak
Manager, Financial Services
KPMG in the US
T: +1 212 954 7709
E: sabuliak@kpmg.com

Simon Topping
Principal, Financial Services
Regulatory Center of Excellence,
ASPAC region
KPMG in China
T: +852 2826 7283
E: simon.topping@kpmg.com

Martin Noble
Senior Manager, Insurance
Financial Services
Regulatory Center of Excellence,
ASPAC region
KPMG in China
T: +852 2685 7817
E: martin.noble@kpmg.com

Mary Trussell
Seconded Partner
KPMG in China
T: +852 2913 2563
E: mary.hm.trussell@kpmg.com

www.kpmg.com/regulatorychallenges

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