IAA Risk Book

Chapter 11—Resolution of Insolvencies

Nick Dexter

1. Executive Summary

This chapter describes the Financial Stability Board (FSB)/International Association of Insurance Supervisors (IAIS) requirements for designated Global Systemically Important Insurers (G-SIIs), and how these have been applied in the United Kingdom. While the general principles hold in most developed economies, details will (of necessity) differ. However, the author believes it provides a good overview of the considerations for the management of an insurance company, and its regulator, in developing recovery and resolution plans.

Since the financial crisis of 2008 there has been an increasing focus on what should happen if a financial services company were to fail, and the implications on systemic risks to increase the likelihood of multiple failures. Whilst the principal focus has been on the banking sector, given the problems at AIG insurance companies have also been under scrutiny. This scrutiny has been on those insurance companies (G-SIIs) adjudged to be globally systemically important. But some regulators worldwide have, to a lesser extent, also been asking whether the detailed stress testing and scenario planning required of G-SIIs, leading to some level of recovery and resolution planning, should also apply to other insurers.

As a consequence, the FSB has issued various requirements for G-SIIs to develop, inter alia, recovery and resolution plans. These requirements are designed to ensure that those insurers that are perceived to pose the greatest systemic risks have plans in place that mitigate those risks and/or remove the barriers to resolution, allowing for timely resolution in times of trouble. A side benefit of this exercise should be to raise the awareness of possible adverse scenarios for firms and hence enable firms to take action to reduce the possibility that those scenarios arise. Supervisors may also wish to assess which firms are systemically important in their domestic market and hence should also have resolution plans.

It should be noted that this is a complex area where supervisors and firms are still in the process of identifying what the key issues are and what steps should be taken to address (or even avoid) adverse events.

Key elements of U.K. recovery and resolution planning include the following:

Recovery

1. “Recovery” is the process by which actions are taken by the management of an insurance company[1] when in a stressed condition to try to prevent failure, by remediation of operational and financial difficulties
2. In recovery mode the insurer is still a going concern and management is able to take actions (hopefully) to remediate the situation.

[1] In some jurisdictions the regulators may be part of this process, and in some instances in control of the process. When the regulators have primary control of the process it is sometimes called “rehabilitation”, although a court order may be required for this to occur.

This paper has been produced and approved by the Insurance Regulation Committee of the IAA on 8 April 2016

3. Typically, as increasingly lower levels of capital are reached (or projected to be reached in the near future), these will be triggers for different types of regulatory and management actions.
4. A "point of non-viability" needs to be clearly set, at which point the recovery plan needs to switch to a resolution plan. This means a transition of the authority and governance of the organization from management to the supervisor.
5. The recovery plan will often cover a range of different actions that could be taken, depending on the circumstances that led the insurer to be in a recovery situation. These actions can be developed so that, if conditions do deteriorate, they make the prospect of recovery more likely and the need for resolution more remote.
6. The various options need to be well-defined with a clear underlying action plan. The plan needs to be sufficiently material and practical to enable the insurer to survive a crisis. Recovery options can be considered to be different from "business as usual" management actions, which are more routine in nature.

Resolution

7. "Resolution" is where recovery is no longer feasible and the principal objective is to mitigate the impact of an actual or prospective failure by ensuring as far as is possible that the company's claims/benefits can continue to be paid.
8. The FSB has published guidance[2] on how the key attributes should be applied for insurers, financial market infrastructures (FMIs), and the protection of client assets in resolution, which applies to all insurers designated as G-SIIs.
9. Many companies will have considered how their business could run-off in certain adverse situations. However, there still can be very short-term issues to consider. In addition, there is value in considering the possibility of more remote adverse situations to be better prepared for such situations if they were to arise (e.g., "black swans").
10. In resolution, control passes to the regulator, or regulators, concerned. If this occurs, it is likely that most of the management team would no longer be in place. The resolution plan is therefore constructed by the regulator(s), and approved by the principal regulators together, based on information provided by the firm.
11. A key component of resolution planning is a strategic analysis that identifies the firm's essential and systemically important (or "critical") functions that are linked to how its aggregate business model creates value and the risks associated with its value creation process.[3]
12. The contents of a typical resolution plan include, inter alia, details of the company's structure, products, systems, and operations (in particular, details of its

[2] www.fsb.org/wp-content/uploads/r_141015.pdf

[3] This is a critical element that will be expanded on in the chapters on capital and stress testing as it will identify the road map(s) that need to be followed for the wisest integration of capital and stress testing requirements for the sustainability of the firm and its critical functions in the marketplace.

interconnectedness, both with any other group companies and other service providers).

Recovery and resolution planning is an important focus for insurers and regulators alike. Therefore, this paper will cover:

- What is resolution planning? What are the key concepts and requirements as considered by the FSB and the IAIS, and how does resolution of banks differ from that of insurers?
- What is the value of resolution planning for insurers and the role of the actuary in that process?
- What are the outstanding philosophical, political, and practical implementation issues?
- Lastly, there is a series of appendices to document the application of resolution/recovery requirements in several countries with an emphasis on the United Kingdom.

2. Background

The financial crisis of 2008–2009 highlighted that risks are not necessarily contained within a single company, sector, or even a single country. We live in a global economy that has become ever more interconnected—this means that the potential for widespread systemic risk is greater than ever.

The initial drive to consider systemic risk has been focused on the banking sector. Clearly the preference would be that financial institutions have an effective risk management framework in place to avoid stresses in the first instance. However, it is recognized that steps taken to strengthen financial institutions cannot guarantee that they will never fail; to attempt to achieve this level of security is likely to be counterproductive. A key focus is therefore planning for the possibility of severe stress and seeking the ability to resolve such stress situations in an orderly manner without taxpayer exposure to loss, while maintaining continuity of the failed financial firms' vital economic functions.

The FSB's July 2011 consultation paper "Effective Resolution of Systemically Important Financial Institutions (SIFIs)"[4] stated: "Many countries entered this crisis without a proper resolution regime, and no country had a regime that could cope with failing SIFIs. Where effective resolution tools existed, these did not address the cross-border dimension or obstacles arising from within firms themselves. This meant that proper market discipline was not in place in the years preceding the crisis and made the handling of the crisis more difficult." The G20 called upon the FSB to address these challenges.

In November 2011 (and updated in October 2014), the FSB paper "Key Attributes of Effective Resolution Regimes for Financial Institutions"[5] was endorsed by the G20 leaders as the international standard for resolution regimes. It was recognized that these key attributes

[4] www.financialstabilityboard.org/2011/07/r_110719/

[5] www.financialstabilityboard.org/2011/11/r_111104cc/

were an "umbrella" standard for resolution regimes for all types of financial institutions that are potentially systemically significant or critical in failure and that further guidance was required on how these should be implemented, taking into account sector-specific considerations, including the issues specific to insurers.

In October 2014, the FSB published specific guidance on how the Key Attributes[6] should be applied for insurers, financial market infrastructure firms (FMIs), and the protection of client assets in resolution. The updated Key Attributes apply to "any insurer that could be systemically significant or critical if it fails". In particular, all insurers designated as G-SIIs will fall under the scope of the Key Attributes. The FSB issued a further consultation paper on 3 November 2015 [7] on "Developing Effective Resolution Strategies and Plans for Systemically Important Insurers"; whilst this is aimed at supervisors of G-SIIs, it includes useful guidance for anyone involved in developing a resolution plan.

In addition to the Key Attributes, the Solvency II Directive also covers requirements for recovery planning and other areas that are relevant to resolution planning[8]. In particular, firms are required to produce a recovery plan in the event they fail to cover their solvency capital requirement (SCR) and/or minimum capital requirement (MCR) and are required to carry out "reverse stress tests" that consider scenarios that would cause the business to fail and the potential consequences of those scenarios. Solvency II also sets out responsibilities on the local regulator to take all measures necessary to protect policyholders.

3. What Is Resolution Planning?

I. Resolution Planning vs. Recovery

As the capital position of an insurer deteriorates, the ability of management to take actions to remediate the situation effectively diminishes and the intrusiveness and powers of regulators becomes ever greater. Initially the situation often starts out as "recovery", although it may ultimately result in a company entering "resolution":

1. Recovery actions try to prevent failure, by the actions taken by a firm to remediate operational and financial capability to meet regulatory requirements, to continue providing insurance current and future coverage, and to pay policyholder benefits in full without financial assistance from any industry compensation scheme or guarantee fund arrangement.
2. Resolution planning seeks to mitigate the impact of an actual or prospective failure by ensuring as far as is possible that claims are paid. It should secure continuity of insurance cover (possibly at reduced levels, subject to policyholder protection minima) for the remaining period of the policy, or in some cases the insurer may be wound up and compensation paid. Financial and/or operational assistance from an industry or governmental compensation scheme may be required. Whilst the

[6] www.financialstabilityboard.org/2014/10/r_141015/

[7] www.fsb.org/2015/11/consultative-document-on-developing-effective-resolution-strategies-and-plans-for-systemically-important-insurers/

[8] Solvency II Directive Article 142.

recovery plan is the responsibility of the firm, the resolution plan is owned by the regulator.

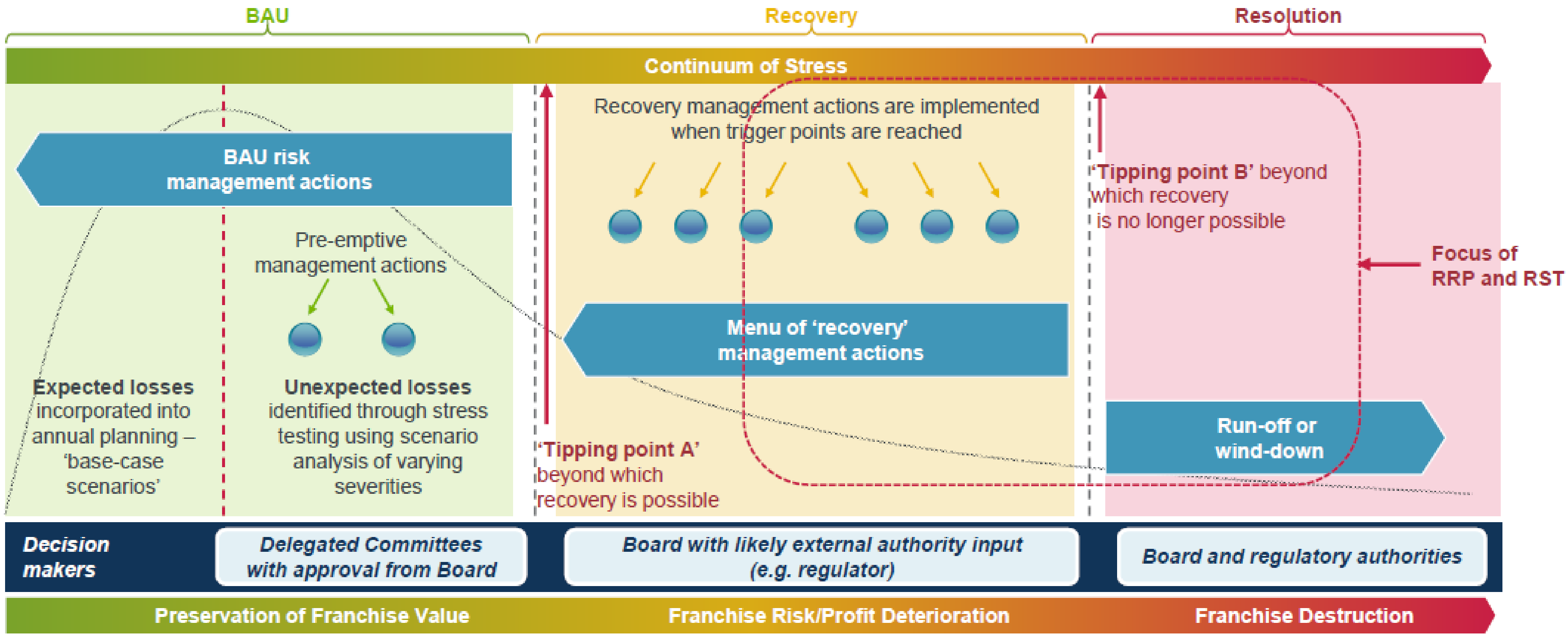
This leads to the concept of a continuum of actions (ladder of regulatory intervention) as insolvency (and the accompanying bankruptcy framework) in the traditional business sense is unlikely to be the trigger for recovery and resolution actions.

Regulators often have a "proactive intervention framework"—in the United Kingdom the prudential regulator, the "PRA", sets out five levels of "crisis" where different recovery options are considered with differing sets of regulatory tools and authorities being used depending on the stage of "crisis":

1. Low risk to viability of insurer: The insurer will be required to plan for stressed conditions, to identify appropriate recovery actions and/or exit strategies with resubmission every two years thereafter.
2. Moderate risk to viability of insurer: The insurer will be required to reassess recovery actions and exit strategies. The PRA may set additional reporting requirements and require realignment of capital and/or restrict activities.
3. Risk to viability of insurer, absent any action by the insurer: The insurer will be required to submit a recovery plan in a timely manner and initiate recovery actions that may include capital raising, asset disposal, sale/transfer of insurance business, confirmation of the adequacy of property and casualty (P&C) loss reserves, and changes to management. The PRA may restrict new business.
4. Imminent risk to viability of insurer: PRA will most likely remove all capability to write new business. The insurer will be required to accelerate and complete all recovery actions.
5. Insurer in resolution or being actively wound up: No recovery action applicable. Management of the insurer is likely to have passed to the regulator or a court-appointed individual.

The PRA's approach is designed to be proportionate to the size and complexity of the firm.

Because there is a continuum of actions from recovery through to resolution the chart below is used to illustrate this continuum.



To submit comments about this paper or to report any problems with the website, please send an email directly to riskbookcomments@actuaries.org.

It is also helpful to think of this continuum in light of the material included in Chapter 12 (Capital—A Regulatory and Management Tool).

The above chart illustrates that interventions occur to ensure as far as possible the timely and orderly transition of authority from company management to supervisors as franchise value approaches zero (or needs to be supplemented by any industry compensation schemes and/or guarantee funds). Typically, as the level of capital reduces (or it is projected to reduce in the near future), different regulatory and management actions will be triggered (including restructuring or risk reduction exercises). However, the processes used to manage risk are what ensure that capital or access to capital allow the organization to sustain its promises and existence.

Many regulators, as a preliminary starting point, ask the insurers they supervise to establish an internal minimum capital level. They may challenge an insurer on this if they feel the insurer has misstated its risk exposure and ability to withstand shocks. The regulator would then increase its regulatory activity as an insurer begins to fall further behind its minimum capital level. If the insurer continues to experience stressed conditions, at some point its capital level may fall sufficiently to threaten to breach the regulator's well-defined minimum capital requirement. At this point viability comes into question and the regulator would likely enforce more stringent action as outlined above. Ultimately, in many jurisdictions, the authority to oversee the resolution process will be transferred to a resolution authority distinct from the supervisory authority. This resolution authority can have three distinct aspects—conservation, rehabilitation, and liquidation.

II. Overview of Key FSB/IAIS Proposals

The financial crisis in 2008–2009 highlighted the complexity and interconnectedness of banks and the potential systemic impact of a failure. Consequently, in November 2011, the IAIS published its "Insurance and Financial Stability" report.[9] This stated that insurers carrying out traditional insurance activities "were largely not a concern from a systemic risk perspective" in the financial crisis of 2008–2009. In particular, key reasons why the business model of insurers typically differs from banks are:

- Insurers have wider, more diversified risks (and underwriting risks tend not to be correlated with market risks).
- Insurers tend to have long-term illiquid liabilities, so are not susceptible to "runs" in the same way as banks.
- Insurers are less interconnected than banks with the broader economic cycle and with each other.
- Within the insurance sector competition and hence substitutability is often high, and so it is likely that business can be transferred away from insurers in trouble , or run-off with the existing assets of the insurer.

[9] http://iaisweb.org/index.cfm?event=getPage&nodeId=25255

But there continue to be some potential areas of concern for regulators:

1. Are there activities for which insurers are more vulnerable and "more likely to amplify, or contribute to, systemic risk"? These have been generically labelled Non-Traditional or Non-Insurance (NTNI) activities, but the term needs more clarification. For example, the failure of AIG during the financial crisis was widely thought to be a result of its NTNI activities, which meant it was highly interconnected with other (non-insurance) financial institutions. Note that some feel that products with banking activity elements or that have complex guarantees, like some variable annuity products, should also be labelled as NTNI.
2. Could the failure of a dominant insurer in certain market niches be systemic?
3. Should one try to prevent price volatility in the wake of large natural catastrophes?
4. What are the important connections with the financial markets—e.g., through guarantees that are sold to financial institutions, through the investments an insurer makes, or through capital raising or debt issuance?

Part of the challenge in addressing these concerns is that they reflect different kinds of systemic "catastrophes" that may differ from the catastrophe experience of the liquidity and credit crisis of 2008–2009.[10] The above concerns could add price volatility and lack of access to insurance as another systemic catastrophe, along with the uncertainty caused by large changes in balance sheet values that may or may not be reflective of the underlying liquidity needs of the firm due to the time horizon (sometimes referred to as procyclical measures). Just as preparation for resolution as a result of various natural catastrophes requires different emergency preparedness, so will the preparation for resolution as a result of various systemic breakdowns, and this will require specific adaptations of regulatory policy and management action plans.

In November 2011, the FSB paper "Key Attributes of Effective Resolution Regimes for Financial Institutions"[11] was endorsed by the G20 leaders as the international standard for resolution regimes. The Key Attributes were updated in October 2014 to include an annex on the resolution of insurers.

It is intended that the Key Attributes should apply to "any insurer that could be systemically significant or critical if it fails". In particular, all insurers designated as G-SIIs will fall under the scope of the Key Attributes. Typically the regulator will have two primary objectives for insurers—to promote safety and soundness of the insurer, and policyholder protection. To meet these objectives, it is important that insurers can regain capital stability and maintain needed liquidity. Alternatively, insurers need to be able to exit the market in an orderly manner, preserving their critical economic functions and minimizing adverse effects on

[10] For example, a December 2015 paper by the European Systemic Risk Board (ESRB) has identified possible areas of systemic contagion for European insurers where they may engage in herd-like behaviours that contribute to financial instability (https://www.esrb.europa.eu/pub/pdf/other/2015-12-16-esrb_report_systemic_risks_EU_insurance_sector.en.pdf).

[11] www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

financial stability and the wider economy. These actions should be taken without exposing taxpayers to loss.

The FSB issued a further consultation paper on 3 November 2015[12] on "Developing Effective Resolution Strategies and Plans for Systemically Important Insurers". Whilst this is aimed at supervisors of G-SIIs, it includes useful guidance for anyone involved in developing a resolution plan.

The options for resolving an insurer as identified in the August 2015 paper on "Principles of Funding for an Insurance Guarantee Scheme" from the International Forum of Insurance Guarantee Schemes[13] include:

1. A transfer of the policies by transferring the whole business to a third party through the sale of the shares of the company or through the sale of the assets and liabilities.
2. The transfer of single lines of the business such as wealth management, automobile insurance, individual life, group life, retirement products, or other specialist portfolios to a third party. Transfers can be effected by assumption reinsurance or by the provision of substitute policies.
3. Providing guarantees such as on asset or liability values or providing stop loss reinsurance on certain blocks of problematic business. This can facilitate the transfer of the whole business or individual portfolios by lowering the risk to the acquiring third party.
4. A transfer of the whole or individual portfolios to a company related to the insurance guarantee scheme (IGS). This might be a "bridge institution" or a "work out" corporation.
5. The run-off of the business by paying the claims or benefits as they come due and collecting premiums until the renewal date.
6. A refund of premium on some policies, in particular non-life policies.
7. The termination of policies and payout of assessed policy values.

The appendices include some examples of country-specific resolution frameworks, with some practical experience in recovery and resolution planning from the United Kingdom.

III. Why Resolution of Insurers Is Different to That of Banks (This reflects material found in "Why Insurers Differ from Banks" by Insurance Europe,[14] October 2014.)

The unique characteristics of the insurance business model (long time horizon, illiquidity, and contingency of liabilities) stand in clear contrast to those of banks. Many insurance practitioners believe that resolution regimes should reflect these differences. For banks, the value of their liabilities (deposits) is easily quantified but highly liquid. Developing values of

[12] www.fsb.org/2015/11/consultative-document-on-developing-effective-resolution-strategies-and-plans-for-systemically-important-insurers/

[13] www.ifigs.org/wp-content/uploads/Funding-an-IGS.pdf

[14] www.insuranceeurope.eu/sites/default/files/attachments/Why insurers differ from banks.pdf

their assets (loans) involves a much more difficult estimation process and is in stark contrast to the liquidity right held by the depositor. For insurers, the asset values are almost always readily available and, typically, have a high degree of liquidity. In contrast, the liabilities (with some exceptions) tend to be illiquid with more uncertainty surrounding the estimates of their value (obligations).

Thus, a key difference between a bank's resolution and an insurer's resolution is that the latter can occur over an extended period of time. Given that insurers cannot generally be subject to a "run" as banks can be, there is no need to rush into resolution, particularly because this could generate avoidable losses for policyholders. When devising resolution rules or guidelines for insurers the focus should therefore not be on speed, as this could in fact be detrimental to policyholders/claimants, but instead on protecting policyholders/claimants from the adverse effects of the resolution. Hence the toolkit made available to resolution authorities should be tailored to the specificities of insurance.

A. Bank Resolution

There are various ways in which banks' finances can be adversely impacted:

1. Maturity transformation. Banks act as intermediaries between savers who deposit money into generally liquid accounts and borrowers in need of loans with typically long maturities. This maturity transformation is an important aspect of the role of banks in the economy, as it frees up funds for investment projects with a long-term horizon, while still offering liquidity to depositors. A bank's business model relies on a key assumption: All depositors will not be asking for their money back at the same time, since depositors' needs for cash are unlikely to occur at the same time. In other words, even though in principle most depositors enjoy a right of instant withdrawal, only a fraction of them will act upon this right.
2. Run on the bank. If confidence in a bank's ability to repay its obligations is lost, there is a chance that most or all of its depositors will suddenly and simultaneously attempt to withdraw their funds, giving rise to a "bank run". The bank will be able to repay the first depositors who request it, but given its inability to realize its illiquid assets in a short period of time, it will run out of money long before all its liabilities toward all its creditors are repaid.
3. In principle, nothing fundamental needs to go wrong within the bank for a bank run to occur. The underlying health of a bank is irrelevant if all depositors believe that the other depositors will withdraw funds. A liquidity problem can in theory occur even in the absence of an underlying solvency issue.
4. Interconnectedness. Another feature of banking is that the lack of confidence in one bank can be transmitted to others, given the high level of interconnectedness within that sector. This so-called "contagion" threatens the whole financial system.
5. Rapid resolution. When a bank run is triggered, normal insolvency procedures are not fast enough to preserve financial stability. Therefore, rapid resolution is needed to protect critical stakeholders and payment systems and to ensure the continuing stability of the entire financial system.

Speed is therefore critical in the resolution of a bank in order to limit to the extent possible the damage to the institution itself, while also avoiding the contagion phenomenon described above. As a consequence, resolutions (especially those of large banks) typically happen over a weekend (from the closing of financial markets Friday evening to their re-opening on Monday morning). This is the so-called "weekend of resolution". Precisely for this reason, the EU opted to include in the new Bank Recovery and Resolution Directive rules that would allow for resolution to occur over the weekend. It should be noted that in reality resolution is a much longer process—in the U.K. framework, for example, over the resolution weekend there would be an issuance of certificates to creditors who are potentially in the scope of the bail-in (whereby debt is converted to equity), bonds would be blocked from trading, and shares suspended. It usually takes at least three months to finalise the terms of the bail-in.

B. Insurance Resolution

The essential role of insurers is to provide policyholders[15] protection from risk. In exchange for premiums, insurers promise to compensate policyholders should certain events occur. They achieve this by pooling and transforming different types of risk. Insurers need to retain sufficient funds to allow them to pay claims and benefits on existing policies as they fall due, as well as to cover their operating and capital costs.

1. Illiquidity. There are two key characteristics of the insurance business model that need to be taken into consideration when devising insurance resolution regimes:

   a. For long-duration insurance contracts (and short-duration contracts with a long payment tail), there is an extended period of time between when an insurer receives premiums and when it is asked to pay a related claim (e.g., life insurance, especially pension products). This extended time horizon means that insurers' liabilities for these types of contracts are typically paid over a period of decades.

   b. Insurance liabilities are generally illiquid. For example, paying an annuity entails predictable, long-term payments to policyholders; or for non-life, claims arise on the occurrence of a specified event, and generally are only paid after a sufficient investigation, and potentially contentious, negotiation process. Unlike banks', insurance liabilities are therefore a contingent rather than an unconditional claim. In most cases, the policyholder/claimant may only demand payment if the insured event has occurred, and even then only after an appropriate investigation (and for some claims) negotiation process.

   Therefore, if an insurer fails, these characteristics can allow for resolution to take place over a long period of time. Arguably a "run" or a liquidity crunch is unlikely to occur in insurance, since many policyholders cannot simply withdraw their money from the insurance policy on demand (at least without significant penalties). However, with a trend to lower early surrender penalties, and intermediaries advising blocks of policyholders, it may be expected that a spike in

[15] And their third-party claimants in the case of liability insurance. In the rest of this chapter, the term "policyholders" will be used to represent both the policyholders and these third-party claimants or other similarly situated beneficiaries.

surrenders/lapses would occur but the extent of the spike will vary from company to company, and by type of product.

2. Contagion. For the same reason, there is typically a much lower risk of contagion than is true for banks in trouble. For those lines of insurance that can expose them to less predictable and potential sudden large claims (e.g., catastrophe insurance[16]), insurers almost always rely on reinsurance to transfer some of the risk. In addition, certain types of insurance have an inherent loss absorbency capacity in the form of beneficiary participation to gains and losses (e.g., participating life insurance contracts).

3. Easier orderly resolution. Consequently, there is less need for a "weekend of resolution" if a traditional insurer fails. In the case of AIG, resolution needed to occur over the weekend, but this was in effect not the resolution of an insurer, but the resolution of non-insurance entities and the parent holding company, triggered by activities that could be classified as NTNI and that were undertaken on a large scale without proper risk management. For insurers, a court-led insolvency process retains the risk that legal challenges lead to disruption to the continuity of payments made to policyholders; for insurers with a million-plus annuitants any disruption to payments is likely to be politically unacceptable. Another rationale for the resolution authority to use stabilization tools on a G-SII is that entry into a court-led administration procedure may trigger contractual rights for counterparties to exercise early termination rights and close out contracts, which is problematic for insurers with large derivative and securities lending programs.

   The FSB's Key Attributes state that a temporary stay on termination rights should be strictly limited in time (for example, for a period not exceeding two business days). This means that stabilization tools need to be exercised over a resolution weekend. This does not mean that the valuation has to happen over a resolution weekend. For banks, it would take approximately three months to undertake a valuation between the resolution weekend and the bail-in terms being announced. It would be reasonable to expect that the resolution of an insurer would be carried out over a similar timeline. If a transfer were envisaged, a bridge insurer could provide time for due diligence to be carried out before the liabilities are subsequently transferred to another insurer, or failing that any industry compensation scheme or guarantee fund.

   Because there should be no sense of emergency, resolution authorities and insurers can take the necessary time needed to come up with the resolution process that ensures the best outcome for all parties involved. For instance, the decision of entry into resolution is made after an assessment of when the insurer's liabilities

[16] Even catastrophes do not generate the immediate cash liquidity calls similar to banks. In general, the larger the natural catastrophe the slower the payout, with the largest events taking years to pay out. This is due to the severe disruption of infrastructure and overwhelming of local rebuilding resources that occur during such an event. For the largest events, it may take weeks before the claim adjusters are even allowed to inspect the insured's damaged property. Even the smallest catastrophes can take many months to pay out.

exceed its assets or are likely to exceed its assets in the near future; this requires significant judgment on the part of the resolution authority simply because both asset values and liabilities fluctuate and liabilities are merely best estimates of expected claims/benefits rather than certain amounts. So a correct assessment of the situation takes time (even for some of the shorter-tailed general insurance classes), given that the judgment should take full account of the time available before liabilities have to be met. Making ample use of the time available for insurer resolution should help avoid suboptimal results such as unnecessary losses being imposed on policyholders.

4. Exceptions. However, there are quite a few types of insurance business for which clear protocols must be in place quite quickly (perhaps within days of an insurer resolution). Clients of any insurance product with short-term/quick-pay claims (e.g., group health benefits, certain general insurance personal lines products) will seek quick assurance that their coverage remains in effect. Liquidators would seek to avoid such a situation. Further, any policyholders with payment streams underway will require quick reassurance of their continuity (e.g., annuity payments, long-term disability payments).

IV. The Requirements for G-SIIs

In 2011, the FSB published an international standard for resolution—Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes), which were updated in October 2014.[17] It is intended that Key Attributes should apply to "any insurer that could be systemically significant or critical if it fails". In particular, all insurers designated as G-SIIs will fall under the scope of the Key Attributes.

The supervisors of G-SIIs, and G-SIIs themselves, are expected to comply with the Key Attributes. This standard sets out a range of specific requirements that should apply to any financial institution that could be systemically significant or critical if it were to fail. The requirements that apply to G-SIIs include the:

1. Establishment of Crisis Management Groups (CMGs), which will include the supervisors of the principal entities in the Group—see section V below;
2. Elaboration of recovery and resolution plans (RRPs), including supporting documents such as the liquidity plan;
3. Carrying out of resolvability assessments; and
4. Adoption of institution-specific, cross-border cooperation agreements between supervisors.

The desired outcomes of effective resolution as outlined by the FSB are to:

- Ensure the resolution of G-SIIs can take place without severe systemic disruption and without increasing taxpayers' exposure to loss;

[17] www.financialstabilityboard.org/2014/10/r_141015

- Protect vital economic functions through mechanisms that make it possible for shareholders and unsecured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation;
- Ensure that policyholder protection arrangements remain as effective as possible;
- Avoid unnecessary destruction of value and ensure that non-viable G-SIIs can exit the market in an orderly way; and
- Identify and remove impediments to smooth resolution.

According to this FSB standard on resolutions, G-SII measures on enhanced supervision (including the development of a systemic risk management plan, the "SRMP") and effective resolution should begin to be implemented immediately after designation. RRPs should be developed and agreed by CMGs (by the end of 2015 for the initially designated group of G-SIIs). The SRMP should include the following elements:

1. A reference to its liquidity management planning (e.g., as documented in a liquidity management plan) in order to explain how the G-SII intends to manage potential higher liquidity risks;
2. A reference to its recovery plan and how that plan would mitigate the systemic risks in a potential recovery situation;
3. An outline of its intra-group financial transactions, including especially guarantees as well as reinsurance/retrocession granted within a group, with respect to its effects on the overall risk and risk distribution;
4. A description of linkages to other measures that are related to the plans to manage, mitigate, or reduce its systemic risk;
5. A brief explanation of the recovery triggers that require a reassessment of recovery plans (see the FSB's Guidance on Recovery Triggers and Stress Scenarios—16 July 2013[18]); and
6. A statement that G-SII's board of directors, supervisory board (if relevant), and their relevant subcommittees have approved the plan.

In addition, the following elements should be addressed in the SRMP, depending on the G-SII's decisions:

- If the G-SII decides to continue or grow any or all of the systemically risky activities, then it will provide an explanation of how these activities, and the amount of those activities, are adequately managed or mitigated, so as to address their potential for resulting in a systemic impact on the financial system or the overall economy.
- If the G-SII decides to reduce or discontinue any or all of the systemically risky activities, an outline of the planned timeline for that is needed.

[18] www.financialstabilityboard.org/2013/07/cos_130716b/

- If the G-SII's strategy is to raise additional capital, then it should provide a plan for how and when it will accomplish this objective.
- If the G-SII's strategy involves the effective separation of its nontraditional, non-insurance activities, then it should provide details about the envisaged timeline and the measures to be taken in order to achieve the separation. In particular, the relevant IAIS criteria on effective separation should be addressed, including how the G-SII will treat the systemic activities in the new separated entity.

V. Resolution Planning—Some Key Concepts

There are some key concepts that need to be considered in resolution planning:

A. Crisis Management Group, "CMG"

The FSB requires home and key host supervisors of all G-SIIs to maintain CMGs,[19] with the objective of enhancing preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting the firm. CMGs should include the supervisory authorities, central banks, resolution authorities, finance ministries, and the public authorities responsible for guarantee schemes of jurisdictions that are home or host to entities of the group that are material to its resolution, and should cooperate closely with authorities in other jurisdictions where firms have a systemic presence.

B. MPE vs. SPE

There are two general regulatory options for resolution intervention:

- Single point of entry ("SPE" or top-down): This is resolution of the group at the level of its ultimate parent, rather than the operating company in difficulty (bearing in mind that the operating company in question may be located in a different country to the ultimate parent company). This enables continuity of service on the part of the insurer, avoids disrupting the insurer's balance sheet, and keeps the group together (this is generally the preferred approach for banks but has capital implications as it means that the group is saying it will stand behind all group member companies in stressed scenarios). SPE is difficult to achieve in the current state of cross-border cooperation and often national priorities of supervisors. Also absent SPE there can be a number of sub-SPEs addressing parts of a group on national/regional or product groupings.
- Multiple point of entry ("MPE" or bottom-up): This refers to resolution of the group at the level of the entity or entities in difficulty, possibly involving multiple resolution authorities (this approach is possibly more appropriate for some large firms where the parent company can insulate the rest of the group if one entity is in difficulty and can be "let go").

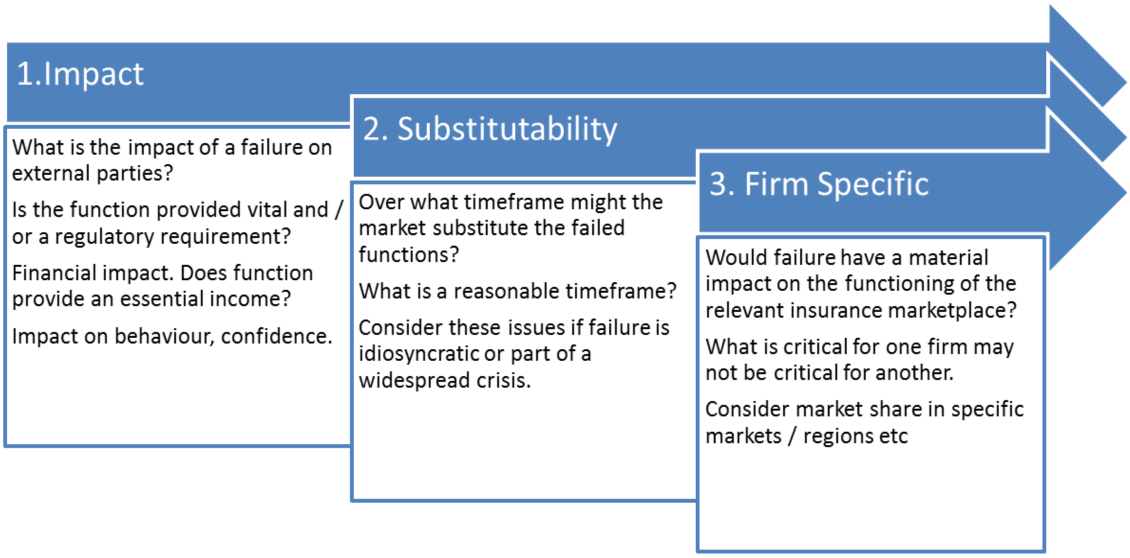
[19] FSB Key Attributes of Effective Resolution Regimes for Financial Institutions Ch 8.

C. Critical Economic Functions and Critical Shared Services

The FSB Consultation Paper[20] on "Identification of Critical Functions and Critical Shared Services" outlines two concepts that are relevant to resolution planning, critical economic functions, and critical shared services:

Critical Economic Functions

Critical economic functions are activities performed for third parties where failure would lead to the disruption of services that are vital for financial stability and the real economy due to the insurer's size or market share, external and internal interconnectedness, complexity, or cross-border activities. Examples might include insurance cover that is mandated by statute, or insurance cover that participants require in order to provide essential services or to undertake activities that underlie the functioning of the real economy. Fulfilling disability or annuity claim payments to policyholders or related beneficiaries/claimants may also be a critical function if those payments are necessary for the policyholder to meet day-to-day living expenses, although the systemic implications of a reduction in payments versus no access to payments will be an important consideration here.



The identification of a function as critical is meant to assist authorities in developing resolution strategies that minimize systemic disruption and preserve value. The identification of a particular function as critical does not generally imply that the function and all related liabilities will be protected in a resolution and should not lead market participants of that function to rely more than before on the assumption that the function will be maintained under all circumstances and that they will be immune from losses if the firm providing the function fails.

A resolution strategy should take into account the materiality and the potential impact that the failure to provide a certain function could have on the financial system and the functioning of the real economy—a firm may provide certain economic functions that are so elemental that they will need to be preserved in all circumstances. Resolution strategies therefore need to

[20] www.financialstabilityboard.org/2014/10/c_141016/

include essential options that identify those most elemental functions and the conditions that need to be in place to ensure continuity of those functions in all resolution scenarios.

Authorities need to undertake their own assessment for each firm that takes into account aspects of the market and the firm, the characteristics of a jurisdiction's financial system, the economic and competitive landscape, and the range of functions provided by other firms. As a result, the functions and services may be, but are not necessarily, critical for different firms in different markets. The firm- or jurisdiction-specific lists of critical functions will be one important input into the resolution planning process and the resolvability assessments.

Criticality is considered in the context of a firm's threat to financial stability. For insurers, this includes an assessment of the potential impact on policyholders.

Key considerations for an assessment of criticality are:

1. The size, interconnectedness, complexity, and business type.
2. The nature of business carried out by the firm, in particular details of any NTNI activities.
3. Substitutability of products. Would it be difficult for policyholders to protect themselves through alternative means? This should include a consideration of the extent to which substitutes would be available during stressed circumstances and the impact if the firm were to exit the market of certain products.
4. How easily can business be transferred to another insurer?
5. What is the impact on policyholders in terms of severity and consequences of a lack of cover?
6. Does the firm have a concentration of policyholders by market or geography?
7. What are the key risks to the firm and how interconnected is it with other insurers and financial institutions?
8. What is the corporate structure and how fungible is capital? Can capital be transferred to areas of need? How critical are the most susceptible areas?
9. Have potential failure scenarios been considered in detail and, if so, are those potential failure scenarios recoverable?
10. What is the current capital strength of the firm and what is its ability to raise more, including in times of stress? How material and credible are the identified recovery actions?

Firms may have a different view of what they consider to be critical and may undertake different methods for determining criticality. For example, a firm may prioritize its franchise value or profitable business lines. While such considerations can play a role in recovery and may be relevant in terms of internal business planning and long-term restructuring, they are not expected to be the main focus of resolution planning which must target promoting financial stability and reducing adverse impacts on external parties including policyholders.

A critical function has the following two elements:

- It is provided by an insurer to third parties not affiliated to the firm; and

- 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.

In an insurance context, the sudden failure to provide a particular function may have a material impact on third parties if:

- No mechanisms that ensure the continuity of certain functions are in place;
- The insurance coverage is vital for third parties to carry out economic activity or to go about their daily lives;
- Policyholders are dependent on insurance payments being made to them;
- The failure of an insurer may cause it to dispose of large quantities of investment assets quickly at fire-sale prices, or cause liquidity or funding strains on borrowers before they can find alternative sources of credit; and
- The insurer plays a critical role as a counterparty in the derivatives, repo, or securities lending markets such that its sudden failure would impact the normal functioning of the markets or cause significant disruption or contagion.
- This failure may also have a material impact through the pooling of risk. The pooling of risk, particularly reinsurance, is a sufficiently important economic function in its own right such that there could be an effect on the economy if the activity was no longer performed.

Critical Shared Services

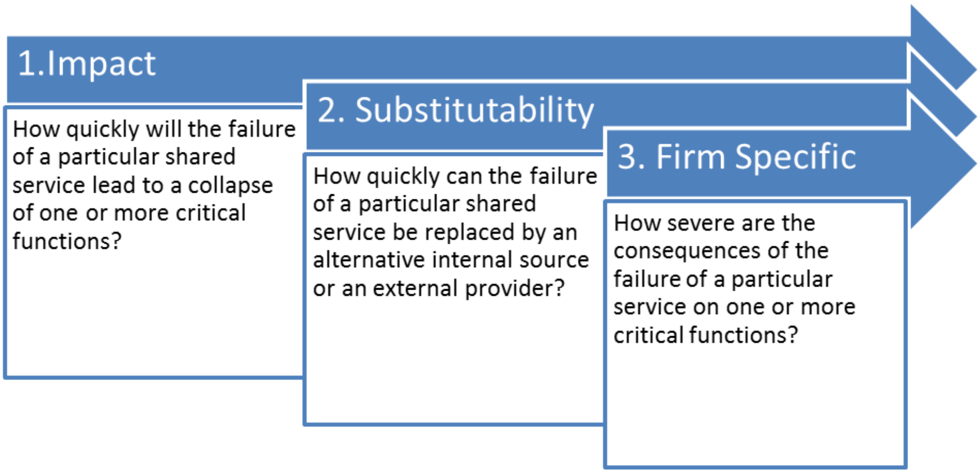
Critical shared services are activities performed within the firm or outsourced to third parties where failure would lead to the inability to perform critical functions and, therefore, to the disruption of functions vital for financial stability and the real economy. Examples may include the provision of information technology and other services such as facility management and administrative services.

A critical shared service has the following elements:

- An activity, function, or service is performed by either an internal unit, a separate legal entity within the group, or an external provider;
- That activity, function, or service is performed for one or more business units or legal entities of the group; and
- The sudden and disorderly failure or malfunction would lead to the collapse of or present a serious impediment to the performance of critical functions.

If one of the above elements is absent, this suggests that the shared service is not critical. For example, if an internal activity, function, or service, such as facilities management, can easily be substituted from other external sources, then that shared service is not critical, even if it is necessary for maintaining the critical functions of the company.

Again, a three-part assessment can be used as summarised below:



4. Why Should Insurers Undertake Resolution Planning?

I. There Are Several Reasons Insurers Should Undertake Resolution Planning Before It Might Be Needed

Continuity of insurance cover for policyholders is important for certain types of insurance:

1. For life insurers, rearranging coverage of long-term commitments is difficult and expensive—securing long-term continuity of coverage is subject to a range of potential obstacles. Retirement pension or annuity income is also critical for the welfare of the population, and is a politically sensitive matter.
2. For P&C insurance, short-term continuity of cover is normally sufficient given the competitive market for renewals, but the payment of outstanding claims and maintenance of payments under long tail claims (such as Periodical Payment Orders (PPOs) in the United Kingdom) is also important, as these payments are designed to cover the needs of—often vulnerable—individuals.
3. Ensuring that substitute cover is available for statutory covers (for example, in the United Kingdom, employers' liability and third party motor) is also important. The example of HIH in Australia shows the potential disruption caused where an insurer has a substantial market share of a statutory cover and other market players are unable to provide sufficient capacity over the short term.
4. There may well be additional complexities for subsidiaries, or branches of foreign insurers. If continuity cannot be secured (more likely if the failed insurer is based outside the country), then what compensation is due may become an issue.
5. Valuing any lost cover is non-trivial for certain long-duration liabilities and certain guaranteed-renewable contracts (e.g., it should reflect individual policyholder circumstances, including health and any tax impact).
6. Policyholder protection needs to be readily achievable in practice; otherwise this will exacerbate a failure as well as hitting confidence and bringing the insurance industry into disrepute.

7. Tax issues and occupational pension regulations can complicate matters when dealing with stressed circumstances because of the uncertainties surrounding the particular situation, so it helps to have considered these issues in advance.

A clearly defined trigger for what constitutes a need to invoke the recovery plan in each country will enable firms to prepare better and respond. A "point of non-viability" needs to be clearly set, at which point the recovery plan needs to switch to a resolution plan and the authority and tools to manage the organization switch from control by management to control by the supervisor. However, whilst the certainty of triggers can be helpful in the planning process, in practice there does need to be some flexibility as circumstances can vary greatly. Recovery can take a number of forms. For example, it could be that recovery is possible at a group level but certain subsidiaries may require solvent or insolvent closure, possibly requiring a restructuring of liabilities and financial support from any policyholder protection scheme. However, resolution is likely to involve restructuring liabilities as well as financial support from any policyholder protection scheme—this may include the sale of parts of the business to other parties or run-off.

For international groups, with an international liquidation, the differences between jurisdictions typically lead to very different views on the urgency to act and the types of intervention and resolution actions that should be undertaken (as well as the ability of pre-existing frameworks to handle the resolution). It is almost a certainty that one jurisdiction will have a different view than another over the quantum of assets it needs to protect policyholders (i.e., assets being "trapped" in some cases and therefore unavailable to other jurisdictions). In the worst case, the respective jurisdictions dig in for a costly litigious battle. However, in many cases, the various parties can make accommodations so that the global resolution can proceed. This is why it is important for the group's supervisors (or CMG for G-SIIs) to work together on developing and agreeing on the resolution plan.

II. Resolution Is a Relevant Concept to Address an Extreme Combination of Events (or Gross Mismanagement)

For most firms the current insurance company capital regime means that it would take an event that may be considered to be very extreme to burn through the existing capital resources and get a company into a resolution situation. Hence this may seem to be an unnecessary piece of work. However, that is not necessarily the case:

1. There is value in considering more remote situations to be more prepared for (e.g., "black swans"). A number of insurance companies have gotten into problems despite their apparent capital resources because their models were inadequately calibrated or they did not take account of certain risks. Hence it cannot always be assumed that insolvency-triggering events are as far in the tail as may be assumed.
2. A "tool box" of mitigating actions can be developed so that if conditions deteriorate, actions can be taken that make the prospect of recovery more likely and the need for resolution more remote. This would include more than just devising the actions—it may not only include detailed planning but may, for example, entail contingency planning with third parties and the implementation of actions now in order to enhance the "resolvability" of the firm.

3. Given the uncertainty over the occurrence or impact of certain events, companies can be better prepared to react should they occur, and trigger points and management information can be developed to forewarn management and initiate escalation.

Insurers should be mindful of political imperatives. Insurance companies are part of the wider financial sector and it should be recognized that the taxpayer has limited/no appetite for future bailouts of financial firms.

III. Access to Actuarial Services

There are a lot of tasks that are already undertaken by actuarial (and other) insurance functions that can be developed to cover key parts of the resolution planning process. Actuaries are well-placed to lead on the development of these tasks and coordinate the production of the RRP. These tasks include:

1. Stress and scenario testing;
2. Reverse stress testing;
3. Emerging risk assessment;
4. Economic capital assessments;
5. Detailed liquidity plans;
6. Development of management actions; and
7. Overarching Own Risk and Solvency Assessment (ORSA) process.

Whilst there are many aspects of recovery and resolution planning that are not directly actuarial in nature, particularly much of the operational aspects, the core actuarial processes and analysis, along with the intrinsic understanding of the business that the actuaries have, make the actuarial team well-positioned to be involved in coordinating this work—in practice, the operational elements of resolution are very heavy and require a well-coordinated effort by many functions across an organization.

During intervention the actuaries are typically involved both with the insurer and the regulator. As the situation worsens toward resolution, the field of participants (and hence employers of actuaries) expands and may include the professional firm retained as liquidator (if required), resolution authority (if not the regulator), the policyholder protection fund, various consultancies retained to assist any of the preceding parties, etc. At this latter stage actuaries are needed to:

1. Advise on favourable terms for any buyers of the liquidated business;
2. Advise the liquidator on possible values for blocks of business; and
3. Advise the liquidator and the policyholder protection fund on assets needed to support any business that may be retained in run-off mode, etc.

IV. Uncertainties Associated with Resolution Planning

Resolution planning for insurers remains a developing concept. Consequently, there are inevitably some uncertainties attached to the concept and how it will apply in practice, including:

- Understanding of what are necessary, desirable, or achievable outcomes from resolution planning continues to evolve in all stakeholder groups.
- Recovery and resolution will always need periodic reassessment in the context of the evolving economic and societal environments in which financial institutions operate.
- Most countries already have laws that apply to all insurance company insolvencies that may override some of the FSB's recommendations.
- There may be gaps and or overlaps in a country's application of bankruptcy laws and insurer resolution requirements.
- There may already exist resolution authorities and policyholder protection funds and their powers may also not be in accordance with the FSB's recommendations or be well-coordinated with the powers of the supervisory authorities.
- It is likely that some or all of the existing resolution powers may be untested in practice so there may well be uncertainty of how they will actually apply.
- There often isn't a precise point at which a company would move from recovery into resolution, and how the resolution authority would work with the local policyholder protection fund and/or any insolvency practitioner.
- For larger insurers the policyholder protection fund may be exhausted by the insolvency and there will be uncertainty over the extent that benefits have to be reduced or there is government intervention. Different considerations may apply if the circumstances of the resolution impact are systemic and impact a number of insurers.
- For internationally active groups, there may be uncertainty over whether some subsidiaries would be allowed to fail to enable the recovery or orderly resolution of other entities (as often resolution will be on an MPE basis). Even for G-SIIs the operation of the CMG will have been planned but depending on the circumstances of the resolution may require plans to be amended.

As with all forward-planning exercises based on tail scenarios, inevitably resolution plans will need to be reviewed on a regular basis by the regulator(s)/CMG in conjunction with the insurer as circumstances change and as regulation/practice develops.

———

Nick Dexter, FIA, FSA, is a senior advisor at the Prudential Regulation Authority and is based in London, United Kingdom. His principal areas of expertise include life insurance and enterprise risk management. He can be reached at *Nick.Dexter@bankofengland.co.uk*.

Appendices—Examples of Country-Specific Resolution Proposals

Appendix I: United Kingdom

In the United Kingdom, from 2014, the high-level requirements for firms relating to recovery and resolution are set out in Fundamental Rule 8 (FR8) in the Prudential Regulation Authority (PRA) Rulebook, which requires all U.K. insurers to have a recovery plan (although this is not being enforced currently but is seen as best practice).[21] Thus Recovery and Resolution Planning applies to all PRA-regulated insurance firms in meeting the fundamental rules set out by the PRA; however, it should be noted that there are differing degrees of detail required by a firm dependent upon its potential impact on financial stability and on policyholders in the event of failure.

There is a requirement for a proportionate approach under FR8—"the manner in which a firm is expected to show compliance with FR8 will be determined by the type of business it carries on". The PRA have said that what constitutes a "critical service" for resolution purposes will be determined by reference to the PRA's general objective and, for insurers, its insurance objective. The amount of information a firm is required to provide under FR8 will therefore vary depending on an assessment of that firm's criticality.

It should be noted, as described above, that the crucial difference between recovery and resolution in the United Kingdom is that in recovery mode the insurer is still a going concern and management is able to take actions (hopefully) to remediate the situation. However, in resolution, control passes to the regulator, or regulators, concerned and it is likely that most of the management team is no longer in place. The resolution plan is therefore constructed by the regulator(s), and approved by the CMG, based on information provided by the firm.

A. <u>Key Elements of a U.K. Recovery Plan</u>

The key elements that would typically be expected to be covered in a recovery plan are:

1. The identification of two to four principal scenarios, including idiosyncratic and sector-wide or market-wide stress situations that create significant capital or liquidity shortfalls;
2. Detailed quantitative and qualitative description of the scenarios;
3. A description of the principal recovery options that are likely to have a material impact on the firm in at least one of the scenarios considered, including an assessment of each option in detail;
4. Valuation and impact analysis (capital, liquidity, franchise);
5. Speed and timing of actions;
6. Suitability and feasibility in each recovery scenario;
7. Operational aspects and responsibilities, including dependencies on outside suppliers;
8. Impediments and constraints;

[21] www.bankofengland.co.uk/pra/Documents/publications/ps/2014/ps514.pdf

9. Internal and external risks and issues;
10. Credibility and necessary preparations; and
11. Maintenance of the recovery plan, including the process by which the recovery plan is refreshed and aligned to the changing shape of the business.

Recovery options need to be well-defined with a clear underlying action plan. They also need to be sufficiently material and practical to enable the insurer to survive a crisis. Recovery options can be considered to be different from "business as usual" management actions, which are more routine in nature.

The recovery plan will often cover a range of different actions that could be taken, depending on the circumstances that have led the insurer to be in a recovery situation. Examples of the recovery options that might be employed by insurers are:

1. Capital raising (equity and/or debt);
2. De-risking the investment portfolio;
3. Enhanced use of reinsurance;
4. Reduce the volume of new business written/transition into run-off;
5. Proactive run-off by actively commuting policies;
6. Disposal of subsidiaries or blocks of business; and
7. Scheme of arrangement—use the U.K. Companies Act or similar to agree on a compromise that binds all parties.

Note that a number of the above actions may also be taken as part of a resolution plan. These options are not mutually exclusive, and an insurer suffering from an extreme stress will often undertake multiple actions.

The effectiveness of the identified recovery options considered can be reviewed using a number of different lenses:

- Reputation: What impact will the proposed action have on the reputation of the insurer in connection with its various stakeholders (e.g., policyholders, regulators, and media)?
- Value: What value can be realized (vs. current value) and what difference does this make in dealing with specific issues?
- Speed: How quickly can the recovery option be implemented?
- Execution risk: How risky is the proposed option and how vulnerable is it to outside parties (e.g., lack of buyers) even with substantial price cuts?

B. Key Elements of a U.K. Resolution Plan

Many companies will have considered how the firm would run-off in certain adverse situations. Indeed it may be part of setting capital requirements that the costs of running-off the portfolio should be allowed for in calculating technical provisions. However, even if the firm does have sufficient capital resources so that, ultimately, all policyholders (and other creditors) are likely to be paid in full except in very extreme circumstances, there still can be very short-term issues to consider.

In the first few days following a ”black swan” event, there can be critical actions that need to be taken and these need to be considered and mitigated where possible. Broadly these fall into three categories:

- Financial: There may be some immediate actions that may be taken to mitigate the change in financial position, e.g., realigning the company’s investment mix.
- Liquidity: There may be liquidity concerns if the deterioration in the company’s financial position triggers covenants, or large numbers of policyholders (or other creditors) require payment.
- Other operational considerations: Depending on the circumstance of the event there may be operational issues that need to be addressed, e.g., if there is a cyber-attack, failure of a third-party supplier, etc. (see some practical comments on operational issues in the following section).

Typically, the regulator will have two primary objectives for insurers—to promote safety and soundness of the insurer, and policyholder protection. To meet these objectives, it is important that insurers can recover capital and liquidity stability, or exit the market in an orderly manner, preserving their critical economic functions and minimizing adverse effects on financial stability and the wider economy. This should be done without exposing taxpayers to loss.

In assessing an insurer’s resolvability, the regulator will take into account many factors, including:

- The structure of the group to which a firm belongs;
- The various ways in which value is being generated (or lost) through the various business models being used by the company;[22]
- The critical economic functions carried out; and
- The robustness and feasibility of the recovery options identified.

The regulator will expect insurers to have:

- Completed and signed off a robust recovery plan—within this plan, to have agreed on a potential point (or points) of non-viability and identified scenarios that get the insurer close to that point;
- Identified a number of recovery/resolution options, and assessed the benefit and feasibility of each option;
- Provided clarity on the constraints and dependencies that may limit any freedom of action;

[22] For example, beyond the traditional pooling of risk, one could be “loaning” out one’s balance sheet for rents as was done by AIG. Or, one could be providing business continuation coverage functions or other administrative services.

- Analyzed the critical economic functions provided by the insurer and the potential consequences if these were disrupted;
- Identified the business models being used to generate value and the risks associated with those models;
- Collected information on any shared services that are necessary to maintain those critical economic functions;
- Collated information on any non-traditional insurance activities undertaken by the firm that could lead to contagion elsewhere in the financial system; and
- Set up credible steps to maintain or restore their business to a stable and sustainable condition in the event of stress.

The more serious the impact is, the greater the degree of supervisory focus that will be applied as set out in the regulator's intervention framework.

To expand on the typical resolution plan contents this would probably include:

1. Company/Group Background and Structure: It is expected that this section would normally include:
    a. General overview and history of the company;
    b. Company structure, subsidiaries (home country and overseas) and activities within the subsidiaries;
    c. Corporate overview, legal entities, and structure;
    d. Information on interconnectedness and reparability of entities, from a financial, legal, and operational perspective;
    e. Extent of major reinsurance arrangements, counterparty risks, intra-group loans, guarantees, etc., split between direct and inwards reinsurance policyholders and assets backing policyholders;
    f. Level of new business;
    g. Main methods of distribution, including key advisors;
    h. Operational matters (including joint ventures, etc.); and
    i. Major financial and operational risks and uncertainties.
2. Product Types and Volumes, including:
    a. Undertakings given to policyholders e.g., in the United Kingdom, the Principles and Practices of Financial Management (PPFM);
    b. Types of products in force and volumes; and
    c. Premium and claims payments profile by product.
3. Principal systems and processes, including:
    a. IT systems, processes, and controls;
    b. Investment management arrangements;

c. Outsourcing arrangements;

d. Internal and external audit recommendations;

e. Recovery governance;

f. Triggers, thresholds, impacts;

g. Early warning indicators/triggers; and

h. Triggers for escalation, triggering formal adoption of recovery plan and options.

4. Operational considerations:

   a. Internal financial/structural/operational dependencies;

   b. Reliance on third-party service providers, independent or within Group;

   c. Availability and cooperation of management and key staff;

5. Business model considerations:

   a. Bancassurers, potentially bringing together multiple (bank and insurer) resolution plans; and

   b. Life, P&C, and composite insurers have specific business model considerations.

The plan would also likely consider

1. Potential contagion stemming from reinsurance

   Direct policyholders rank above inwards reinsurance within a firm in an insolvency (due to EU Directive). Therefore, the more inwards reinsurance an insurer has, the better its direct policyholders are protected. However, there is a risk of contagion to the reinsurers' clients, and policyholder protection schemes may not protect reinsurance buyers.

2. Priorities

   Depending on local legislation, some large policyholders such as pensions trustees may have agreements with the insurer that effectively give them priority if the insurer fails, thus leveraging the risk for other policyholders. Thus the solvency position "in default" and the impact on individual policies will need to be determined at an early stage. Intra-group loans and warranties may pose complex issues in default.

3. Responsibilities in default

   Cross-border transfers of portfolios raise questions as to where protection responsibility lies if the receiving insurer subsequently fails. There may be a need to make final settlement of claims below 100 percent if necessary in a continuity situation, because the solvency level will fluctuate over time.

   There is a need to clarify the roles and responsibilities of any insolvency practitioner, any policyholder protection scheme, management, regulator, etc. so that resolution can be managed in practice, as in a resolution situation control of the firm will have passed from the board and management to another party. The need to maintain confidence and avoid panic after a failure means that devices such as suspending surrender rights are to be avoided if possible.

4. Other practical aspects

   There have been numerous insurance companies that have had "near-death" experience and some practical lessons can be learnt from these case studies about other elements that should be covered by the plan.

C. Policyholders' Interests—Short-Term Plans vs. Long-Term Run-off

Given liquidity constraints and the uncertain financial position of the company in a resolution situation, it may not be possible to continue to pay claims as they fall due. There may need to be a balance between maintaining urgent payments where policyholders are dependent on claims being paid (e.g., to finance house repairs or dependence on pension payments) versus damaging the interest of other policyholders in the longer term. In these situations there is often short-term uncertainty relating to any potential shortfalls (e.g., due to uncertainty in data, asset values, or extent of liabilities) even though ultimately the policyholder protection funds will mitigate this.

D. Public Relations

With any form of crisis there is bound to be interaction with the press. The senior management team may not be used to the intense publicity and may need media training

Media may well also approach staff and so it is helpful to have plans to prepare/warn them. It was not appreciated for some cases in the past that media would infiltrate staff briefings.

E. Operational Aspects

Often, with the benefit of hindsight, overall planning is found to be inadequate and not pessimistic enough. Some contingency planning may be in place but specific (framework) agreements need to be put in place with third-party firms to supply staff or services in the event of a crisis. For example, IT and phone systems need to be able to cope with the demand/changes required—if manual processes have to be introduced they can exacerbate the situation. In one actual case the increased levels of policyholder communications took four to five years to sort out.

Disgruntled policyholders can prove to be an issue—in the past media/policyholders have managed to get into buildings/meetings, and the physical security of staff in such situations can be an issue.

F. Personnel Aspects

It can be a challenge to know how much to tell staff (in hindsight, management was in denial that the problems were as bad as they were). There can be a lack of appreciation of how the culture may need to change in order to cope with new (resolution) environment. Short-term staff performance levels may drop due to the shock of change and demotivated staff, so training would be required to prepare staff for dealing with an abnormal situation. Consequently, management needs to be aware of the time that may need to be devoted to being supportive of staff. In addition, management may need to be alert to the increased possibility of fraud. Finally, consideration needs to be given to the skills that may be needed in the transition to new business models and structure.

G. Approaches to Resolution Planning that U.K. Companies Have Used in Practice

Whilst the resolution plan is owned by the regulator, clearly the bulk of the development work is inevitably undertaken by the companies themselves. Resolution planning can be a major project but the work involved can be reduced by carefully planning and focusing the work—note the key steps that may arise in a resolution situation:

1. Barriers to resolution will need to be addressed;
2. Deterioration of company profitability, solvency or liquidity (which may vary by line of business);
3. Recovery and resolution plan refreshed to reflect the current (adverse) position;
4. Supervisory monitoring by regulator;
5. Relevant recovery action invoked, if appropriate;
6. Recovery action failed, if appropriate;
7. Threshold point for trigger of resolution actions breached, regulator informed;
8. Appropriate resolution response identified from resolution plan;
9. Relevant resolution action invoked, solvency position assessed; and
10. Policyholder Protection Scheme cooperation initiated, if required.

The U.K. G-SIIs (and other major U.K. insurers) have spent a lot of time developing their approaches and there are some key lessons that can be learned from their work to date.

1. Form a small, senior central team with access to the very top of the institution.
2. Determine the balance of home and host regulatory focus, and seek to agree this with the key regulators/CMG.
3. Allow for effective recovery without significant assistance from the authorities.
4. Ensure that it is possible to reconcile the business easily to legal entities and economic functions.
5. Get clarity over interdependencies throughout the global firm.
6. Identify the potential point(s) of non-viability and scale of recovery required.
7. Build on existing stress testing experience, but focus on macro-level scenarios and impacts—avoid detailed economic analysis if possible (existing stress testing may be less extreme, so existing management actions may not be material enough to recover from the "near death" crisis approaching the "point of non-viability").
8. Know when to declare a "crisis" and have documented individual responsibilities, including company directors.
9. Focus recovery on a relatively short menu of truly material, practical actions.
10. Agree what will not be volunteered as a potential action.

11. Overcome internal and external confidentiality concerns.
12. Establish strong governance and crisis management structure within the Plan and within defined parameters.

The governance for the position where the Resolution Plan is formally invoked will look very similar to the version noted in the Recovery Plan. The main difference will be the level of attention/ownership by the regulator. In formal resolution, the Resolution Plan is owned by the regulator, but in a formal invocation of the Recovery Plan, the directors remain in charge but with significantly greater attention from the regulator.

Potential conflicts should be noted, particularly when action is taking place that impacts a subsidiary, and directors of that subsidiary need to consider the position for that subsidiary and not necessarily the wider group.

Note that "recovery" may well be to a different business model; it is less likely that the pre-crisis status quo can be returned to. A key element in recovery and resolution planning is to have carefully examined the communication strategy. There are many stakeholders to address and mis-communication can be viral and lethal. Stakeholders can include: employees, advisors, service providers, policyholders, non-executives, creditors, reinsurers, agents/distributors, media, social media comment, shareholders, bond holders, and capital markets.

Appendix II: United States[23]

In the United States there are "hazardous financial condition" laws that allow a regulator to take over an insurer that is operating in a hazardous manner. This can include taking over and shutting down a company with positive net assets, but that is at risk for insolvency due to a single event such as a future hurricane or windstorm.

As stated previously, three distinct forms—conservation, rehabilitation, and liquidation—can be distinguished in the receivership proceedings. Most states have enacted statutes that govern the conservation, rehabilitation, and liquidation of insurance companies and are patterned after three model acts (the Uniform Insurers Liquidation Act, the Insurers Rehabilitation and Liquidation Model Act, and the Insurer Receivership Model Act) that have been adopted by the National Association of Insurance Commissioners (NAIC).

Conservation allows the receiver a period of time in which to analyze the company and its financial condition and determine whether the policyholders and creditors will be best served by liquidation, rehabilitation, or returning the company to private management.

If rehabilitation is warranted, state regulators must allege and prove a specific statutory ground in order to proceed. In rehabilitation, a plan is devised to correct the difficulties that led to the insurer being placed in receivership and return it to the marketplace.

The regulator must determine whether a rehabilitation of the company is likely to be successful, or if its problems are so severe that they would significantly increase the risk of loss to policyholders. If the latter is true, the appropriate course of action is to liquidate the insurer. Courts have held the order of liquidation effectively cancels outstanding policies and fixes the date for ascertaining debts and claims against the insolvent insurer. However, the insolvency of a life insurer presents a unique situation. The NAIC Model Acts provide for the continuation of life, health, and annuity policies.

[23] www.naic.org/cipr_topics/topic_troubled_companies_and_receivership.htm

Appendix III: Japan

In Japan there are two ways insurers can enter resolution, and the focus of the resolution is on ensuring the continuity of existing insurance contracts and restructuring of insurance liabilities.[24] The Financial Services Agency (FSA) monitors sufficiency of reserves and solvency margin ratio of insurers. The FSA has a "ladder of intervention" depending on but not limited to the levels of solvency margin ratio. Each of the two Policyholders Protection Corporations (regarding life and non-life, collectively "PPC") play an important role in resolution.

One route for resolution is through the Insurance Business Act. Insurers are required to report to the FSA when continuing their insurance business is difficult in light of the state of their business or property. FSA will order the insurer to suspend all or part of its business and the insurer will be put under the control of Insurance Administrators. The PPC will make financial aid to find a successor institution. The PPC, through establishment of its subsidiary company, will be allowed to be a bridge insurer when no successor institution can be found.

The second way is a court-led process by the Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions. Not only an insurer but also the FSA can file a petition for the rehabilitation of the insurer when there is a risk of bankruptcy caused by excessive debts or insolvency. Application of reorganization proceedings is allowed for both mutual and stock insurers. A reduction in reserves is allowed basically to 90 percent, with the help of funding from the PPC. Reorganization plan may include differentiation of terms and conditions between policyholders (e.g. reduction in guaranteed interest rates), introduction of early surrender charges, and conversion from a mutual company to a stock company.

All insurers except for reinsurers need to be a member of the PPC. All life insurance and most lines of non-life insurance (such as automobile insurance, retail fire insurance, earthquake insurance, etc.) are covered by compensation upon insurer failure. Basically 90 percent of the policy reserve will be compensated. One hundred percent of the claim for non-life insurance will be compensated for accidents within three months after the insurer failure. To cover the cost of the future failure member insurers of the PPC need to contribute to the fund in advance up to a certain amount. If the cost of financial aid exceeds the accumulated amount, a guarantee by government for borrowing or government subsidies can be applied.

Reflecting the global trend, a framework for an orderly resolution regime of financial institutions (including insurers) was established in 2013 in order to address risks that may spread across financial markets.[25]

---

[24] Shinya Kobayashi, How Should Resolution Regimes for Insurers Be Established? Experiences in Japan and Implications for Global Standard Setting, Regulation and Supervision Newsletter SC5 October 2014, The Geneva Association.: https://www.genevaassociation.org/media/905874/ga2014-progres_sc5.pdf

[25] www.fsa.go.jp/en/refer/legislation/20130416/02.pdf